THE BANKING REFORM ACT OF 1971

HEARINGS

BEFORE THE

COMMITTEE ON BANKING AND CURRENCY
HOUSE OF REPRESENTATIVES

NINETY-SECOND CONGRESS

FIRST SESSION

ON

H.R. 5700

A BILL TO PROHIBIT CERTAIN CONFLICTS OF INTEREST AND ENCOURAGE COMPETITION IN THE BANKING INDUSTRY AND RELATED FIELDS TO PROVIDE FOR RESTRICTIONS AND DISCLOSURES WITH RESPECT TO CERTAIN LOANS, TO PROHIBIT BROKERED DEPOSITS IN BANKS AND OTHER FINANCIAL INSTITUTIONS, TO PROHIBIT THE USE OF GIVEAWAYS IN THE SOLICITATION OF DEPOSITS, TO PERMIT FULL DEPOSIT INSURANCE FOR GOVERNMENT DEPOSITORS, AND FOR OTHER PURPOSES

H.R. 3287

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H.R. 7440

A BILL TO CLARIFY THE AUTHORITY OF THE FEDERAL HOME LOAN BANK BOARD TO REGULATE CONFLICTS OF INTEREST IN THE OPERATION OF INSURED SAVINGS AND LOAN ASSOCIATIONS, AND FOR OTHER PURPOSES

PART 2

APRIL 28, 29, 30; MAY 3 AND 4, 1971, AND APPENDIX

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CONTENTS

(The same table of contents appears in parts 1 and 2)

	Page
Hearings held on—	
April 20, 1971	1
April 21, 1971	113
April 22, 1971	173
April 23, 1971	227
April 26, 1971	267
April 27, 1971	387
April 28, 1971	453
April 29, 1971	569
April 30, 1971	657
May 3, 1971	741
May 4, 1971	837
Text of—	
H.R. 5700	1
H.R. 3287	9
H.R. 7440	14

STATEMENTS

Bryan, John William, Granite State Bank, and the Bank of Arlington, Granite Falls, Wash. 675

Burns, Hon. Arthur F., Chairman, Board of Governors, Federal Reserve System 276

Camp, Hon. William B., Comptroller of the Currency 129

Carlson, Donald M., president, Independent Bankers Association of America; accompanied by Rod L. Parsch, chairman, Federal Legislative Committee 592

Darnell, Prof. Jerome C., associate professor of business administration, University of Colorado 396

Dooley, Prof. Peter C., University of Saskatchewan 417

Farrar, Prof. Donald E., senior fellow, University of Pennsylvania Law School, Center for the Study of Financial Institutions 388

Fey, John T., president, National Life Insurance Co., Montpelier, Vt., on behalf of the American Life Convention and the Life Insurance Association of America; accompanied by Bruce P. Hayden, vice president, Connecticut General Life Insurance Co., Hartford, Conn.; and Thomas F. Murray, senior vice president and chief investment officer, The Equitable Life Assurance Society of the United States 474

Green, Sampson, chairman, Activists, Inc.; accompanied by Father John Martinez, cochairman, housing committee, Activists, Inc., Baltimore, Md. 321

Groos, Ernest, Jr., president, Groos National Bank, San Antonio, Tex. 821

Hamilton, John S., Jr., vice president and general counsel, American Mutual Insurance Alliance; accompanied by James P. Allen, Jr., vice president, Liberty Mutual Insurance Co. 490

Herbert, Edward, senior vice president, First National Bank, Montgomery, Ala., on behalf of Robert Morris Associates, National Association of Bank Loan and Credit Officers 624

Herman, Prof. Edward S., Wharton School of Finance, University of Pennsylvania 227

Hinrichs, Dr. Harley H., The Saver Incentives Premium Industry Committee; accompanied by John F. Daly, International Silver Co.; William M. Dalton, W. M. Dalton & Associates; Larry O. Edwards, Lincoln Rochester Trust Co.; and Neil Kanney, Grace China Co. 677

Hovde, Donald I., Madison, Wis., chairman, Realtor's Washington Committee, National Association of Real Estate Boards 464

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Federal Reserve Bank of St. Louis

Jackson, Philip C., vice president, Mortgage Bankers Association of America; accompanied by Walter F. Terry III, vice president, James W. Rouse & Co., Columbia, Md. Page 468
Levine, Milton E., chairman of the board, Meyers Pollock Robbins, Inc., New York, N.Y. 347
McDonald, Angus, consultant to the Mid-West Electric Consumers Association 236
McLaren, Hon. Richard W., Assistant Attorney General for Antitrust, Department of Justice; accompanied by Donald I. Baker, chief, Office of Policy Planning 838
Martin, Hon. Preston, Chairman, Federal Home Loan Bank Board; accompanied by Arthur W. Leibold, Jr., General Counsel 37
Meyer, John M., Jr., chairman of the board, Morgan Guaranty Trust Co. of New York 796
Oberg, Dr. Harold S., vice president, Arthur Lipper Corp., New York, N.Y. 676
Renchard, William S., president, The New York Clearing House Association, and chairman of the board, Chemical Bank, New York, N.Y.; accompanied by Richard S. Simmons, counsel 605
Rockefeller, David, chairman of the board, Chase Manhattan Bank; accompanied by Herbert T. Patterson, president, Chase Manhattan; and Ray C. Haberkern, counsel 746
Scott, Tom B., Jr., chairman, Legislative Committee, United States Savings and Loan League; accompanied by Stephen Slipher, legislative director; and Arthur Edgeworth, Washington counsel 179
Smith, Richard B., Commissioner, Securities and Exchange Commission; accompanied by Prof. Donald E. Farrar, University of Pennsylvania; and Philip A. Loomis, General Counsel, SEC 114
Sommer, Clifford C., president, American Bankers Association; accompanied by Richard P. Brown, president, ABA Trust Division; and B. Finley Vinson, chairman, ABA Federal Legislative Committee 575
Stastny, John A., president, National Association of Home Builders; accompanied by George C. Martin, vice president and treasurer, Louisville, Ky. 453
Swift, Harlan J., past president, National Association of Mutual Savings Banks, and chairman of the NAMSB Committee on Relations With Federal Supervisory Authorities; accompanied by Edward P. Clark, past president of NAMSB; and P. James Riordan, general counsel 657
Vance, Prof. Stanley C., H. T. Miner professor of business administration, Graduate School of Management and Business, University of Oregon, Eugene, Oreg. 173
Ward, Alan S., Director, Bureau of Competition, Federal Trade Commission 136
Wille, Hon. Frank, Chairman, Federal Deposit Insurance Corporation 25

ADDITIONAL INFORMATION SUBMITTED FOR THE RECORD

Annunzio, Hon. Frank, submission of letter and statement of Donald M. Graham, chairman of the board of directors, Continental Illinois National Bank and Trust Co., Chicago, Ill., relating to H.R. 5700 and the committee staff report on sales of Penn Central stock (part V) 861
Axelrod, Irving M., Big Bonus Stamp Co., Houston, Tex., letter dated April 21, 1971 737
Battle, William C., president, Premium Advertising Association of America, Inc., New York, N.Y., letter dated April 29, 1971 733
Begich, Hon. Nick, a Representative in Congress from the State of Alaska: Letters to Hon. Wright Patman:
April 9, 1971 110
April 5, 1971, with attached letter from Eric E. Wohlforth, commissioner, Department of Revenue, State of Alaska, dated March 30, 1971 109
Berle, Rudolph, P., Berle & Berle, New York, N.Y., letter dated April 22, 1971, re H.R. 5700 with attachment on proposed amendment No. 5 prepared by the National Association of Mutual Savings Banks 673
Bodine, William H., president, Savings Association League of New York State, Scarsdale, N.Y., letter dated April 13, 1971 739
Bright, Edgar, Jr., Standard Mortgage Corp., New Orleans, La., letter dated May 6, 1971 552

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Building Industry Association of California, Los Angeles, Calif., resolution adopted March 30, 1971, supporting H.R. 18676 introduced in the 91st Congress ..... Page 566
Burns, Hon. Arthur F.:
Response to questions of:
Chairman Patman 286, 314, 316
Hon. Parren J. Mitchell 304
Hon. Henry S. Reuss 293
Hon. William B. Widnall 964
Hon. Lawrence G. Williams 301
Camp, Hon. William B.:
Prepared statement 130
Response to questions of Chairman Patman 169
Carlson, Donald M., prepared statement on H.R. 5700 597
Caton, Richard B., vice president and manager, loan administration, Stockton, Whatley, Davin & Co., Jacksonville, Fla., letter dated April 30, 1971 559
Cederberg, Hon. Elford A., a Representative in Congress from the State of Michigan:
Statement on H.R. 3242 and H.R. 5700 363
Attached articles to statement:
"Small Banks Go Under, and Authorities Assail Role of Money Brokers," from the Wall Street Journal 364
"Times Reporters Unearth the Story Behind the Story," with accompanying article, "Shadow Syndicate Seen Lurking in Background of Bank Failures," from the Bay City Times, June 28, 1970 368
Chase, Goodwin, president, Pacific National Bank of Washington, Tacoma, Wash., letter dated April 5, 1971 570
Clark, Edward P., president, Arlington Five Cents Savings Bank, Arlington, Mass., letter to Hon. Leonor K. Sullivan, dated May 5, 1971 699
Cooper, W. M., letter date May 5, 1971 552
Crow, Trammell, Dallas, Tex., letter dated April 20, 1971 563
Dalton, William M., president, W. M. Dalton & Associates, Inc., statement 724
Daly, John F., International Silver Co., statement 723
Darnell, Prof. Jerome C.:
Prepared statement 400
Response to questions of Hon. Stewart B. McKinney 450
Deane, Disque D., New York, N.Y., letter dated May 4, 1971 556
Dooley, Prof. Peter C.:
Prepared statement with an attached study entitled, "The Interlocking Directorate" 421
Response to questions of:
Hon. William A. Barrett 447
Hon. Stewart B. McKinney 449
Dwyer, William J., Jr., Mount Kisco, N.Y., letter dated May 3, 1971 563
Edwards, Larry O., vice president in charge of marketing, Lincoln Rochester Trust Co., Rochester, N.Y., statement 726
Fey, John T.:
Prepared statement 480
Response to questions of:
Hon. Margart M. Heckler 528
Hon. William B. Widnall 509
Gilliland, John A., first vice president, Stockton, Whatley, Davin & Co., Jacksonville, Fla., letter dated May 5, 1971 551
Graham, Donald M., chairman of the board of directors, Continental Illinois National Bank & Trust Co., Chicago, Ill.:
Letter to Hon. Frank Annunzio, dated May 4, 1971 861
Statement relating to H.R. 5700 and the committee staff report on sales of Penn Central stock (part V) 862
Green, Sampon:
Letter from Hon. Preston Martin, Chairman, Federal Home Loan Bank Board, dated February 18, 1971 380
Submission of studies prepared by Activist, Inc., Baltimore, Md.:
"A Conspiracy to Defraud and Exploit Homebuyers: The Story of Jefferson Federal Savings and Loan" 325
"Communities Under Siege" 334
"Two Blocks on Mount Holly Street" 323
Greene, Raleigh, chairman, Committee on Legislation, National League of Insured Savings Associations, statement 187

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Griebel, Richard H., president, Lehigh Valley Industries, Inc., New York, N.Y., letter dated May 5, 1971, with excerpts from statements of Hon. William B. Camp, Comptroller of the Currency; Hon. Preston Martin, Chairman, Federal Home Loan Bank Board; and Hon. Frank Wille, Chairman, Federal Deposit Insurance Corporation ..... Page 734
Gross, Jenard M., chairman of the Legislative Committee, National Apartment Association, statement 502
Hallowell, Burton C., Tufts University, Medford, Mass., letter dated April 26, 1971 561
Hamel, John F., New York, N.Y., letter dated April 28, 1971, with attached commentary of sections 20 and 21 of H.R. 5700 354
Hamilton, John S., Jr.:
Prepared statement 492
Response to questions of Hon. Margaret M. Heckler 527
Hayden, Bruce P., vice president, Connecticut General Life Insurance Co., response to question of Hon. Thomas L. Ashley 515
Henderson, S. T., executive vice president, Home Realty and Management Co., Charlotte, N.C., letter dated May 12, 1971 555
Henri, Joseph R., Commissioner, Department of Administration, State of Alaska, letter dated April 13, 1971 110
Herbert, Edward, prepared statement 625
Herman, Prof. Edward S.:
Prepared statement 231
Summary of conflict of interest study on savings and loan associations entitled, "Conflict of Interest Reform" 254
Hinrichs, Dr. Harley H., prepared statement with attached partial list of firms in the premium industry 681
Hovde, Donald I.:
Prepared statement 467
"The Future Largest Landlords in America," article from Fortune Magazine, July 1970 536
Hume, Kenneth C., president, Alaska State Bank, Anchorage, Alaska, letter dated May 11, 1971 110
Jackson, Philip C., letter with attachment to Hon. Thomas L. Ashley, dated April 30, 1971 544
Kaiser, Edgar F., chairman of the board, Kaiser Industries Corp., Oakland, Calif., statement 741
Kanney, Neil, president, Grace China Co., South Hackensack, N.J., statement 729
Kenney, Thomas J., Baltimore, Md., letter with attachments to Hon. Wright Patman, dated April 27, 1971, replying to certain aspects of study submitted by Activists, Inc., of Baltimore, Md 342
Klein, Michael J., vice president, J. P. Cabot, Inc., New York, N.Y., statement 373
Kling, Herbert R., director, Central National Bank, Canajoharie, Fultonville, N.Y., letters dated:
January 25, 1971 572
February 8, 1971 573
Levine, Milton E., prepared statement 352
Lipper, Arthur, III, president, Arthur Lipper Corp., letters dated May 17, 1971, to:
Hon. Henry S. Reuss 704
Hon. John H. Rousselot 710
McDonald, Angus:
Letter to Chairman Wright Patman, dated April 28, 1971 ..... 266d
List of power company executives who may have conflicts of interest in their financial corporate directorships 244
Prepared statement 239
McLaren, Hon. Richard W., response to questions of Hon. William A. Barrett 847
Manges, Clinton, stockholder, Groos National Bank, San Antonio, Tex. with attachments:
Statement on H.R. 5700 823
Letter from Lloyd M. Bentsen to Hon. Wm. B. Camp, Comptroller of the Currency, dated March 24, 1971 827
Letter from Tim Timmins, Dallas, Tex., dated January 21, 1971 827

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Martin, Hon. Preston:
Letter to Speaker Carl Albert dated April 17, 1971, with attached draft and section-by-section analysis of proposed bill: Housing Institutions Modernization Act of 1971 ..... Page 84
Prepared statements:
Discussion of Housing Institutions Modernization Act of 1971 78
H.R. 5700 and H.R. 3287 40
Response to questions of:
Chairman Wright Patman 51
Hon. Leonor K. Sullivan 62, 63, 64, 66
Martin, George C., additional statement submitted in response to questions of Hon. Margaret M. Heckler 526
Mayo, Robert P., president, Federal Reserve Bank of Chicago, letter dated April 12, 1971, expressing views on H.R. 5700 274
Melody, Lawrence J., vice president, Northland Mortgage Co., Minneapolis, Minn., letter dated May 11, 1971, with attached copy of letter to Hon. Bill Frenzel commenting on section 14 of H.R. 5700 553
Meyer, John M., Jr.:
Appendix to statement: response to committee report, "The Penn Central Failure and the Role of Financial Institutions," Part V 802
Response to questions of:
Chairman Wright Patman 805, 817
Hon. Stewart B. McKinney 814
Hon. William B. Widnall 807, 808
Miller, Stanley L., Port Chester, N.Y., letter dated April 23, 1971, with attached analysis and commentary of sections 19 and 21(a) of H.R. 5700 358
Moody, Dan M., Jr., Houston, Tex., letter dated May 14, 1971 567
Myrick, Richard S., The Myrick Co., realtors, letter dated April 30, 1971 562
National Association of Home Builders, response to questions of Hon. Frank Annunzio 548
National Association of Small Business Investment Companies letter from Charles M. Noone, general counsel, dated May 3, 1971 557
New York Clearing House Association, memorandum of comments on H.R. 5700 609
Oberg, Dr. Harold S., response to questions of Hon. William B. Widnall 695, 697
Patman, Hon. Wright:
Exchange of correspondence with Hon. Arthur F. Burns, Chairman, Federal Reserve Board 268–273
"Interlocking Directorships Between 10 Largest Life Insurance Companies and Competing Financial Institutions—1971" (table) 285
"Interlocks Among 10 Largest Commercial Banks and 10 Largest Life Insurance Companies—as of December 31, 1969" (table) 284
Letter from Robert P. Mayo, president, Federal Reserve Bank of Chicago, dated April 12, 1971 274
Letters received from various small town banks concerning H.R. 5700:
Chase, Goodwin, president, Pacific National Bank of Washington, Tacoma, Wash., dated April 5, 1971 570
Kling, Herbert A., director, Central National Bank, Fultonsville, N.Y., dated:
January 25, 1971 572
February 8, 1971 573
Shapiro, Ernest M., Lewiston, Maine, dated March 18, 1971 573
Watson, William R., Peoria, Ill., dated April 17, 1971 574
"Mutual Savings Bank Investment Authority in Commercial Bank Stock" (table) 692
Response to statement submitted by Donald M., Graham, chairman, Continental Illinois National Bank and Trust Co., Chicago, Ill 869
Survey of Interest Rate Calculations carried out by Federal Reserve Board at request of Chairman Patman, along with covering letter from Hon. J. L. Robertson, Vice Chairman, Board of Governors, Federal Reserve System, dated April 30, 1971 940
"Ten Largest Life Insurance Companies and 10 Largest Commercial Banks in United States—1970" (table) 283
Parsch, Rod L., chairman, Federal Legislative Committee, Independent Bankers Association of America, submission of statement on H.R. 3287 600
Phalle, John de Saint, vice president, Paine, Webber, Jackson & Curtis, Inc., New York, N.Y., letter dated May 3, 1971 563

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Pittman, Steuart L., counsel for Committee of Foreign-Owned Banks, Washington, D.C., letter dated May 5, 1971, with attached enclosures consisting of (A) suggested amendment to section 14 of H.R. 5700 and (B) list of members ..... Page 564
Proctor, Edward A., Jr., president, Proctor Homer Warren, Inc., Detroit, Mich., letter dated May 17, 1971 566
Renchard, William S., attachment to statement entitled, "Memorandum of Comments of the New York Clearing House Association on H.R. 5700" 609
Rockefeller, David:
Appendix to statement entitled, "Information Concerning Sales of Penn Central Stock by the Chase Manhattan Bank During May and June of 1970" 752
Response to questions of:
Chairman Wright Patman 759, 786, 787
Hon. Bill Chappell, Jr 775
Hon. James M. Hanley 775
Hon. Edward I. Koch 784
Hon. Robert G. Stephens, Jr 767
Hon. Leonor K. Sullivan 764
Hon. William B. Widnall 762
Rollings, R. C., president, Specialty Advertising Association International, Chicago, Ill., letter dated April 28, 1971 732
Ruby, Howard F., general partner, R & B Development Co., Los Angeles, Calif., letter dated April 30, 1971 558
Ruffin, Peter B., Galbreath-Ruffin Corp., New York, N.Y., letter dated April 27, 1971 561
Schnitzer, Kenneth, chairman of the board, Greenway Plaza—Century Development Corp., letter dated May 13, 1971 566
Scott, Tom B., Jr.:
Response to questions of:
Hon. Henry B. Gonzalez 205
Hon. Leonor K. Sullivan 201
Supplemental statement with attached document entitled, "Officer's Questionnaire" 182
Shapiro, Ernest M., Lewiston, Maine, letter dated March 18, 1971 573
Smith, James B., mortgage vice president, Equitable of Iowa, Des Moines, Iowa, letter dated April 28, 1971 566
Smith, Melville H., president, D F S, Inc., Chadds Ford, Pa., letter dated May 6, 1971 733
Smith, Richard B., prepared statement 118
Sommer, Clifford C.:
Prepared statement 582
Response to questions of:
Hon. Frank Annunzio 650
Hon. Henry B. Gonzalez 646
Hon. John H. Rousselot 644
Stallard, Carton S., chairman of the board, Jersey Mortgage Co., Elizabeth, N.J. letter dated May 17, 1971 567
Stastny, John A.:
"A Special Report—Equity Participation," report on survey conducted by NAHB in June 1969 523
Correspondence between Federal Home Loan Bank Board and William F. McKenna, general counsel, National League of Insured Savings Association regarding Board's position on S. & L. loans which include "equity participation" 462
Extract from NAHB Statement of Policy for 1971, adopted at annual convention, January 20, 1971, Houston, Tex 462
Prepared statement 457
Resolutions on "equity participation" adopted at NAHB board of directors meetings, 1969–70 461
Response to questions of:
Hon. Frank Annunzio 548
Hon. Margaret M. Heckler 523
Stern, Edgar B., Jr., president, Royal Street Corp., New Orleans, La., letter dated May 3, 1971 551

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Federal Reserve Bank of St. Louis

Page

Sullivan, Hon. Leonor K.:
Excerpt from House Conference Report 91–1781 23
Excerpts from the Congressional Record on H.R. 7440:
April 7, 1971 15
December 2, 1970 18
Relevant excerpts of letter received from the Federal Home Loan Bank, dated December 11, 1970 21
Submission of table, "Baltimore—29 Savings and Loan Associations and Their Interlocks" 382
Swalling, A. C., president, Matanuska Valley Bank, Anchorage, Alaska, letter dated May 10, 1971 110
Swift, Harlan, J.:
Prepared statement 663
Response to request of Hon. John H. Rousselot 711
Submission of table, "Savings Bank Activity in Premium Campaigns in 1970" 715
Terry, Walter F., III:
Letter to Chairman Wright Patman, dated May 5, 1971 548
Prepared statement 472
Response to questions of Hon. William B. Widnall 508
Tweedy, Harold L., president, First Federal Savings & Loan Association of Pittsburgh, letter to Hon. Thomas S. Gettys, dated April 30, 1971 560
Vance, Prof. Stanley C.:
Prepared statement 174
Response to questions of Hon. Parren J. Mitchell 220
Viertel, Joseph, Presidential Realty Corp., White Plains, N.Y., letter dated May 6, 1971 552
Venzke, E. W., Hennepin Federal Savings and Loan Association, Minneapolis, Minn., letter dated April 6, 1971 738
Ward, Alan S., prepared statement 138
Watson, William R., Peoria, Ill., letter dated April 17, 1971 574
Whatley, Brown L., chairman of the board, Stockton, Whatley, Davin & Co., Jacksonville, Fla., letter dated May 12, 1971 555
Wille, Hon. Frank:
Letter to Chairman Patman dated April 12, 1971, expressing views on H.R. 3287 36
Prepared statement 27
Response to questions of:
Chairman Patman 48
Hon. Fernand J. St Germain 102
Williams, Hon. Lawrence G., submission of financial advertisement by Pennzoil United, Inc 154
Wohlforth, Eric E., Commissioner, Department of Revenue, State of Alaska, Juneau, letter dated March 30, 1971 109

Appendix

Adams, Gene D., president, The First National Bank, Seymour, Tex., letter to Hon. Graham Purcell, dated April 15, 1971 933
Allen, R. S., president, Shoshone First National Bank, Cody, Wyo., letter to Hon. Teno Roncalio, dated April 1, 1971 875
Allen, Richard, president, Clear Lake Savings Association, Houston, Tex., letter dated May 6, 1971 913
Arthur, John M., Duquesne Light Co., Pittsburgh, Pa., letter dated April 15, 1971 917
Association of American Railroads, submission of statement 881
Bennett, Hon. Charles E., a Representative in Congress from the State of Florida, submission of statement with attached copy of H.R. 583 871
Berle, Rudolf, P., Berle & Berle, New York, N.Y., letter with proposed amendments, dated April 26, 1971 926
Binsfeld, Joseph J., senior vice president, attorney at law, Milwaukee Federal Savings & Loan Association, Milwaukee, Wis., letter dated April 19, 1971 911
Bisselle, Morgan F., secretary-general counsel, Utica Mutual Insurance Co., Utica, N.Y., letter to Hon. Alexander Pirnie, dated April 29, 1971 915
Brereton, Harmar, vice president and general counsel, Eastman Kodak Co., Rochester, N.Y., letter dated May 19, 1971 960
Burns, Franklin L., president, the D. C. Burns Realty & Trust Co., Denver, Colo., letter dated May 20, 1971 963

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Federal Reserve Bank of St. Louis

California Savings and Loan League, Pasadena, Calif., Franklin Hardinge, Jr., executive vice president, submission of statement ..... Page 883
Carlander, John, chairman of the board, the State Bank of Faribault, Faribault, Minn., letter to Hon. Albert H. Quie, dated May 12, 1971 954
Chapman, Alger B., Jr., president, Shearson, Hammill & Co., Inc. and Robert M. Gardiner, managing partner, Reynolds & Co. on behalf of the Legislative Council of Association of Stock Exchange Firms, New York, N.Y., and Investment Bankers Association of America, Washington, D.C., letter dated May 21, 1971 962
Chisholm, John D., president, Olmsted County Bank & Trust Co., Rochester, Minn., statement 887
Coffey, J. A., president, the First National Bank of Sanger, Sanger, Tex., letter to Hon. Graham Purcell, dated April 15, 1971 934
Conference of State Bank Supervisors, submission of statement 876
"Corporate Directors Under Fire," article by Ephraim P. Smith, Ph. D., University of Rhode Island and Louis R. Desfosses, Ph. D., University of Rhode Island, submitted by Hon. Fernand J. St Germain 890
Credit Union National Association, Inc., Washington, D.C., letter from Evert S. Thomas, Jr., acting managing director, dated May 6, 1971 909
Crow, Trammell, Dallas, Tex., letter to Hon. Graham Purcell, dated April 14, 1971 938
Davis, Charles Lee, president, Texarkana Federal Savings & Loan Association, Texarkana, Ark., letter dated April 21, 1971 911
Davis, Hilton, general manager, legislative action, Chamber of Commerce of the United States, Washington, D.C., letter dated May 5, 1971 918
Dixon, George H., president, First National Bank of Minneapolis, Minneapolis, Minn., letter to Hon. Bill Frenzel, dated April 27, 1971 901
Ellis, James H., Ellis, Holyoke & Co., Lincoln, Nebr., letter dated April 27, 1971 931
Elson, Gerald W., the Gerry Elson Agency, Inc., Brookfield, Mo., letter dated April 23, 1971 916
Faust, Joseph, president, First National Bank of New Braunfels, New Braunfels, Tex., letter dated April 22, 1971 901
Feagin, David A., president, The First State Bank, Colmesneil, Tex., letter dated April 16, 1971 906
Floreen, David A., Atlantic Mutual Insurance Co. and Centennial Insurance Co., New York, N.Y., letter dated May 14, 1971 916
Getz, Bert A., Scottsdale, Ariz., letter dated April 6, 1971 931
Gilchrist, Charles W., Lee, Toomey & Kent, Washington, D.C., letter dated May 4, 1971 929
Glaze, Robert E., of Trammell Crow, Dallas, Tex., letter to Hon. Graham Purcell, dated April 15, 1971 938
Graham, Donald M., Continental Illinois National Bank & Trust Co., Chicago, Ill., letter dated March 30, 1971 899
Gullander, W. P., president, National Association of Manufacturers, New York, N.Y., letter dated May 7, 1971 918
Hagan, Hon. G. Elliott, a Representative in Congress from the State of Georgia, letter dated April 22, 1971, with attached letter from John B. Spiney, president, First Federal Savings & Loan Association of Swainsboro, Swainsboro, Ga 898
Hall, W. G., Citizens State Bank, Dickinson, Tex., letter dated April 5, 1971, with attached list of Texas bank failures and schedules of the dollar losses 903
Hodges, Joe H., president, Abilene National Bank, Abilene, Tex., letter to Hon. Graham Purcell, dated April 15, 1971 937
Holman, Bill, president, the First National Bank of Henrietta, Henrietta, Tex., letter to Hon. Graham Purcell, dated April 15, 1971 932
Horton, Charles C., chairman, legislative committee, Rhode Island League of Savings and Loan Associations, Providence, R.I., letter dated May 10, 1971 910
Jones, L. D., Jr., Seymour, Tex., letter to Hon. Graham Purcell, dated April 20, 1971 933
Josch, Martin, Jr., vice president, the Huntington State Bank, Huntington, Tex., letter to Hon. Graham Purcell, dated April 22, 1971 935
Kimberlin, Sam O., Jr., executive vice president, Texas Banking Association, Austin, Tex., letter to Hon. Graham Purcell, dated April 13, 1971 934
Lee, John F., executive vice president, New York Clearing House, New York, N.Y., letter dated May 24, 1971, with proposed amendment to section 19 of title 15 of the Banking Reform Act of 1971 959

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Page

Leighton, Howard H., president, National Association of Insurance Agents, Inc., Washington, D.C., letter dated May 14, 1971 914
Levine, Milton E., chairman of the board, Meyers Pollock Robbins, Inc., New York, N.Y., letter dated March 15, 1971 925
Lewis, A. J., chairman of the board, Jefferson State Bank, San Antonio, Tex., letter to Hon. Henry B. Gonzalez, dated April 26, 1971 906
Lumsden, Arthur J., president, Greater Hartford Chamber of Commerce, Hartford, Conn., letter dated May 19, 1971, with policy statement re Banking Reform Act of 1971 961
McAuliffe, William J., Jr., American Land Title Association, Washington, D.C., letter dated May 3, 1971 923
Miracle, R. W., president, the Wyoming National Bank, Casper, Wyo., letter to Hon. Teno Roncalio, dated April 6, 1971 874
Nathan, Robert R., Robert R. Nathan Associates, Inc., Washington, D.C., letter dated March 29, 1971 899
National Association of Insurance Agents, Inc., Washington, D.C., letter from Howard H. Leighton, president, dated May 14, 1971 914
Needham, Oran F., chairman and chief executive officer, the Millers Mutual Fire Insurance Co. of Texas, Fort Worth, Tex., letter to Hon. Graham Purcell, dated April 16, 1971 937
Orth, Frederick J., Unigard Insurance Group, Seattle, Wash., letter dated April 22, 1971 917
Pittman, John H., president and cochairman, Commonwealth National Bank, Dallas, Tex., letter to Hon. Graham Purcell, dated April 20, 1971 934
Price, Hon. Robert D., a Representative in Congress from the State of Texas, submission of statement 872
Purcell, Hon. Graham, a Representative in Congress from the State of Texas, letter dated April 27, 1971, with attached letters 932
Quie, Hon. Albert H., a Representative in Congress from the State of Minnesota, letter dated May 18, 1971 954
Ray, W. Wilson, president, First National Bank, Bridgeport, Tex., letter to Hon. Graham Purcell, dated April 16, 1971 932
Rhode Island League of Savings and Loan Associations, letter dated May 10, 1971, from Charles C. Horton, chairman, legislative committee 910
Robertson, Hon. J. L., Vice Chairman, Board of Governors, Federal Reserve System, letter dated April 30, 1971, with attached final tabulations of responses to committee's survey of interest calculations banks use on loans 940
Roncalio, Hon. Teno, a Representative in Congress from the State of Wyoming, statement 874
Attached letters to statement:
Allen, R. S., president, Shoshone First National Bank, Cody, Wyo., dated April 1, 1971 875
Miracle, R. W., president, the Wyoming National Bank, Casper, Wyo., dated April 6, 1971 874
Steadman, Oliver W., Steadman & Steadman, Cody, Wyo., dated March 31, 1971 876
Rushlow, B. C., chairman of the board, the National Bank of Northern New York, Watertown, N.Y., letter dated March 25, 1971 900
St Germain, Hon. Fernand J., letter dated May 11, 1971, with attached paper entitled, "Corporate Directors Under Fire" 890
Sawyer, William P., president, Massachusetts Federal Savings Council, Inc., statement re H.R. 5700 882
Shands, Ned, Jr., Peavy & Shands, Lufkin, Tex., letter to Members of Congress from the State of Texas, dated April 19, 1971 939
Shuman, Charles B., Sullivan, Ill., letter dated March 26, 1971 900
Spivey, John B., president, First Federal Savings & Loan Association of Swainsboro, Swainsboro, Ga., letter dated April 14, 1971 898
Stathis, Gus, Gus Stathis Construction Co., Inc., Oak Lawn, Ill., letter dated May 13, 1971 924
Steadman, Oliver W., Steadman & Steadman, Cody, Wyo., letter to Hon. Teno Roncalio, dated March 31, 1971 876
Stewart, Maco, Stewart Information Services Corp., Princeton, N.J., letter dated April 30, 1971 922
Still, Willard J., president, Southwest National Bank, Wichita Falls, Tex., letter to Hon. Graham Purcell, dated April 26, 1971 939
Talley, Jerry L., president, Grayson County State Bank, Sherman, Tex., letter to Hon. Graham Purcell, dated April 20, 1971 936
The First National Bank of Atlanta, submission of comments on H.R. 5700 955

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Page

Thomas, Evert S., Jr., acting managing director, Credit Union National Association, Inc., Washington, D.C., letter dated May 6, 1971 909
Tippett, Robert A., Tippett Land & Mortgage Co., Kennewick, Wash., letter dated April 29, 1971 924
Vander Zee, Harlan D., president, Hereford State Bank, Hereford, Tex., letter to Hon. Graham Purcell, dated April 23, 1971 936
Waggoner, Dick, City National Bank, Wichita Falls, Tex., letter to Hon. Graham Purcell, dated April 19, 1971 933
Walden, Roland W., Midway National Bank of Grand Prairie, Grand Prairie, Tex., letter to Hon. Graham Purcell, dated April 16, 1971 937
Wetzel, Carroll, Dechert Price & Rhoads, Philadelphia, Pa., letter dated March 31, 1971 899
Wimmer, Ed, vice president, public relations director, National Federation of Independent Business, Covington, Ky., letter dated April 16, 1971 920

TABLES

Baltimore—29 Savings and Loan Associations and Their Interlocks 382
Interlocking Directorships Between 10 Largest Life Insurance Companies and Competing Financial Institutions—1971 285
Interlocks Among 10 Largest Commercial Banks and 10 Largest Life Insurance Companies—as of December 31, 1969 284
Mutual Savings Bank Investment Authority in Commercial Bank Stock 692
Savings Bank Activity in Premium Campaigns in 1970 715
Ten Largest Life Insurance Companies and 10 Largest Commercial Banks in United States—1970 283

CHART

Daily Sales of Penn Central Common Stock by Three Banking Institutions During Period May 15, 1970 to June 19, 1970 (fold-in) ..... facing page 804

ORGANIZATIONS REPRESENTED AT HEARINGS

Government:
Comptroller of the Currency, U.S. Treasury 129
Department of Justice 838
Federal Deposit Insurance Corporation 25
Federal Home Loan Bank Board 37
Federal Reserve Board 276
Federal Trade Commission 136
Securities and Exchange Commission 114
Private:
Activists, Inc 321
American Bankers Association 575
American Life Convention 474
American Mutual Insurance Alliance 490
Arthur Lipper Corp 676
Chase Manhattan Bank 746
Independent Bankers Association of America 592
James W. Rouse Co 468
Life Insurance Association of America 474
Morgan Guaranty Trust Co 796
Mortgage Bankers Association of America 468
Myers Pollock Robbins, Inc 347
National Association of Home Builders 453
National Association of Mutual Savings Banks 657
National Association of Real Estate Boards 464
New York Clearing House Association 605
Robert Morris Associates 624
Saver Incentives Premium Industry Committee 677
United States Savings and Loan League 179

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Federal Reserve Bank of St. Louis

THE BANKING REFORM ACT OF 1971

WEDNESDAY, APRIL 28, 1971

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND CURRENCY,
Washington, D.C.

The committee met, pursuant to recess, at 10:05 a.m. in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman, Barrett, Sullivan, Ashley, St Germain, Gonzalez, Gettys, Annunzio, Griffin, Koch, Cotter, Widnall, Johnson, Blackburn, Brown, Williams, Heckler, Lent, and Archer.

The CHAIRMAN. The committee will come to order.

This morning the committee will take testimony from representatives from five trade associations, two representing businesses involved in construction and real estate, and three representing the insurance industry.

The witnesses are John A. Stastny of the National Association of Home Builders; Donald I. Hovde, chairman, Realtors' Washington Committee, National Association of Real Estate Boards; Philip C. Jackson, vice president, Mortgage Bankers Association of America; John T. Fey, American Life Convention and Life Insurance Association of America; and John S. Hamilton, Jr., of the American Mutual Insurance Alliance.

These witnesses were primarily scheduled at one time because of their particular interest in the issue of equity kickers or equity participation. In this way the committee is provided with an opportunity to hear all sides of the argument on this issue at the same time.

We will hear from these gentlemen in the order I listed them. Please try to summarize your statements in 10 minutes so we will have time to ask questions of the witnesses. And usually most of the things in your statement are brought out anyway. But if the things you want brought out are not brought out, you have permission to extend your remarks when you look over your transcript to bring out any points that you want to in your own interest.

The first witness is Mr. Stastny of the National Association of Home Builders.

STATEMENT OF JOHN A. STASTNY, PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS; ACCOMPANIED BY GEORGE C. MARTIN, VICE PRESIDENT AND TREASURER, LOUISVILLE, KY.

Mr. STASTNY. My name is John Stastny. I am a homebuilder from Chicago. And I am here in my capacity as president of the National Association of Home Builders of the United States.

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I have asked Mr. George Martin of Louisville, Ky., to accompany me. Mr. Martin is a vice president of our association, and has had a great deal of personal experience with lenders in this business of equity kickers and equity participation.

The CHAIRMAN. We are glad to have him.

Mr. STASTNY. We appreciate the opportunity to be before you and testify and we support the section of H.R. 5700 which we will address ourselves to.

The bill is a broad and comprehensive effort to regulate certain activities of financial institutions and certain relationships which their officers, directors, and employees have with other financial institutions, business, and customers of the institutions.

We feel, though, that our competence and our personal experience make us most useful to this committee and to the Congress in the specific area that we will address ourselves to, and we will leave to others, who are more knowledgeable in the business, the task of dealing with other issues in the bill.

The one section of H.R. 5700 with which we do have a great deal of familiarity and which we feel competent to testify on is section 14. And we feel that because of many actions taken by our board of directors—we have gone on record on four different occasions with resolutions which we have attached to the prepared statement we have submitted—we feel that, in line with the many expressions we have made publicly and incorporated in our policy statements which have also been submitted to you, we must come in and support vigorously the provisions of section 14 of H.R. 5700.

We first became concerned with equity participation in 1969. Our first resolution was adopted at our board meeting in October 1969 in San Diego, and then subsequently in the next several meetings. It was during the spring and summer of 1969, as money got tighter and tighter, that many lenders found the possibility, and exercised it, of squeezing that extra last drop of blood through equity participation from the people who were borrowing the money. The practice was growing rapidly, and our board felt that there was a serious necessity to register its feelings.

Now, in the statement of policy which we adopted at our convention in Houston in January 1970 we again called on the Congress to investigate what we then called a rapacious practice. With your permission, sir, I would like to read one paragraph from that policy statement, because I think it describes our feeling, and I think it is constructive:

> We call on the Congress to investigate the rapacious practice—now standard in insurance company lending and spreading to other institutions (including pension funds)—of demanding a share of property income in addition to astronomical interest and fees. Whether or not it is a device to protect lenders against long-term inflation, the practice is thoroughly and intrinsically unsound. Unless checked, it will lead to widespread foreclosures at the first substantial economic downturn—with serious adverse consequences to developers, to lending institutions and those entrusting their savings to them, and, most important, to the general public.

Now, our members are very concerned. And you might question why. There are many, many reasons. We feel that it is a disturbance to the historic and basic relationship between borrower and lender. The lender who is also a borrower in a transaction of this kind might

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simply not tend to be as rigorous as he otherwise would be in assuring that the risks of a particular loan are reasonable. In too many cases we have seen a desire on the part of the lender to lend money on an unsound deal where he can get a piece of the action, as opposed to a solid transaction where no equity participation is obtainable. This can only result in ultimate serious trouble for such lenders.

Where the lender, in addition to the normal payment of principal and interest, takes a substantial portion of the earnings of the project, the incentives to the project owner to maintain the project and to be concerned about its long-term stability and feasibility are severely lessened. In fact, we did a study a couple of years ago that showed that the developers building under equity participation simply had no intention of keeping their projects for as long a period as they would had there been no equity participation.

Many lenders are thus liable to find themselves 5 to 10 years after making such a loan the owners of apartment projects which have had to be abandoned because the economic feasibility had been beaten out of them.

One of the frequent arguments made by those favoring equity participation is that it permits the borrower to obtain a more favorable interest rate, and that this is especially important in times of tight money. We have not seen it work that way, sir. Our experience has been to the contrary. Interest rates charged in connection with mortgage loans in which there has been equity participation have usually been at the same levels as those charged without equity participation. And the only more favorable aspects of the financing have been somewhat longer terms, and in some cases occasionally higher loan to value ratios.

A very serious side effect of equity participation in apartment financing is that the builder-owner of the project, in order to realize a return commensurate with that earned by investors in real estate projects without equity participation, has to set rents higher than those charged in competitive projects. These rents are frequently difficult to obtain, unless there is a severe shortage of rental apartments available. The net result can be an increase in housing cost to all of the people in a given community because of this kind of effect, because if he is able to raise those rents, the other guys are going to follow along with him.

Perhaps one of the most serious indirect effects is this unwarranted increase in the cost of housing, an increase which in many cases drives people out of the market who in the past have been able to afford modest-priced housing without subsidy.

Now, a potential real problem is the future of a project which carries a mortgage of 9 to 10 percent because it was initiated at the height of the money crunch and which carries the additional burden of an indirect charge being paid in the form of an equity kicker which is locked in for perhaps 10 or 15 years. The rents that will have to be charged if such a project were to stay financially alive generally have to be higher, certainly higher than the project which is put in today at 7½ percent, with no equity participation driving up the cost.

Now, there are many, many approaches—and I am sure you are aware of all of them—to equity participation. We enumerate them in the testimony we submitted for the record. Some of them are more

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complicated than others. Some of the simpler methods, and therefore the more common methods, have been described in the July 1970 issue of Fortune magazine. (See page 536.) And that issue of the magazine—I recommend it to you, sir—also details some very esoteric approaches developed by some of the Nation's largest insurance companies.

The article also points out why equity participation became such a factor in the multifamily mortgage market during 1969 and 1970. The lender had the upper hand because of the shortage of money, and they were not satisfied with the interest rates at the highest level in a hundred years, and they endeavored to grab as much as they could during the process.

The CHAIRMAN. Would you pick out some of the examples in the Fortune magazine article and insert them in connection with your remarks so that it will be a part of the record?

Mr. STASTNY. We shall, sir, if we are permitted to submit them in writing at a later time.

The result of what is pointed out in this article is that the projects were not being built during a time of housing shortage because of the resistance by borrowers to giving lenders a piece of the project. Now, if a deal cannot work you cannot build it. And this certainly did contribute to the downtrend in housing production during a time of severe housing shortage. A review of housing starts figures during that period will show that apartment starts were down considerably more than single family starts.

Now, this committee should be aware of another proposal which we find shocking, with reference to equity participation. And that is that lenders should be allowed to develop methods of participating in the equity which is created for and by homeowners in single-family housing.

We object strongly to his idea, and we oppose it greatly. One of the strongest incentives for the purchase of a home for most families is the opportunity that it provides to develop equity and thus a family estate. We see no reason why lenders should be given any opportunity to curtail the operation of the American system under which families since the beginning of our history have had an opportunity to become property owners. We hope the committee will agree with us.

The most avid practititoners of equity have been the insurance companies. The banks and savings and loan associations have not been as active in this field as yet.

We are heartened by the recognition of the FDIC that it might well be advisable to ban the practice of equity participation. Mr. Frank Wille, who is Chairman of the Federal Deposit Insurance Corporation in his statement to this committee on April 20, pointed out the problem, and his recommendations, and tied it to action which was taken by the Congress on one-bank holding companies.

We are concerned, though, by the position taken by Dr. Preston Martin, Chairman of the Federal Home Loan Bank Board. I refer you to his statement to this committee on April 20. He suggested that prohibition of this practice might be undesirable. That is quite disturbing. We do not agree with him.

We make reference in our testimony to letters that have been

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written by the general counsel of the Federal Home Loan Bank Board and others with whom they have corresponded. I would like to point out that, in the April 25 letter to which we refer from Mr. Wilfand, stating that receiving a percentage of gross rents of a project did not constitute a form of equity participation, but that receiving a percentage of net rents would, we find it terribly disturbing to see that the Home Loan Bank Board is apparently endorsing what is probably the unsafest of the equity participation approaches. Where a percentage of gross rents must be paid regardless of whether enough rents are collected to meet debt service requirements, and operating costs, a project might well be forced into foreclosure as a result.

On the other hand, where a percentage of net rents is paid, the extra pay out only occurs after all of the project obligations have first been met.

I would like to touch briefly on the details of section 14 of H.R. 5700. A similar prohibition contained in H.R. 18676 of the 91st Congress was endorsed by our board of directors. However, that endorsement was conditioned on the prohibition being applied only to loans involving real property. It was the feeling of many of our directors that they were not qualified to pass upon the appropriateness of equity participation in other types of situations. So they limited their endorsement to that area with which they were most familiar.

The prohibition in H.R. 5700 would be limited to insured banks and savings institutions, bank and savings and loan holding companies, as defined in Federal legislation, and their subsidiaries, and insured mutual savings banks and insurance companies. This would seem to exempt from the prohibition non-insured banks and savings and loans as well as mortgage bankers and other lenders in the business of making loans. These would have been covered by chapter 4 of H.R. 18676.

We urge this committee to expand the prohibition in section 14 of H.R. 5700 to include all lenders.

Some question arose in our board deliberations as to whether the prohibition contained in the bill barring a lender from accepting any equity participation in consideration of making any loan would bar a true joint venture, which might be initiated at the behest of a builder, and not imposed by a lender as a condition of the making of a loan.

It was our feeling that such would not be prohibited. But we urge the committee to make the point clear either with statutory language or with adequate legislative history.

In closing, I want to say how much I appreciate the opportunity to be here, and the fact that the committee is giving serious consideration to the provisions that we have mentioned.

(Mr. Stastny's prepared statement with attachments follows:)

PREPARED STATEMENT OF JOHN A. STASTNY, PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. CHAIRMAN: My name is John A. Stastny. I am a home builder from Chicago, Illinois and I appear before you today in my capacity as President of the National Association of Home Builders. With me today is Mr. George C. Martin who serves as NAHB's Vice President and Treasurer. Our members build about two-thirds of the homes and apartments constructed annually by professional builders. About two-thirds of those who build apartments do so with the intention of retaining ownership.

I appreciate this opportunity to appear before you and present the views of the home building industry on H.R. 5700, the Banking Reform Act of 1971. This bill

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is a broad and comprehensive effort to regulate certain activities of financial institutions and certain relationships that their officers, directors or employees have with other financial institutions, businesses and customers of the institutions. These proposals are complex, many are of a technical nature, and they deal with areas upon which we do not really consider ourselves qualified to comment. We will, therefore, leave to others, more knowledgeable with the workings of the various financial institutions, the making of detailed comments on these provisions.

There is, however, one section of H.R. 5700 with which we do have great familiarity and on which we do feel ourselves fully competent to testify. That is Section 14 which would prohibit certain lenders from accepting "any equity participation in consideration of the making of any loan." A similar provision contained in H.R. 18676 of the 91st Congress was endorsed by our 800–member Board of Directors at its meeting in Boston on September 21, 1970.

That resolution was the fourth resolution in a row adopted by our Board of Directors in opposition to the practice of lenders making equity participation a condition for the granting of a loan on an apartment project. These resolutions were adopted at our Board of Directors' meetings in October 1969, January 1970, and May 1970, as well as the September 1970 meeting. The practice was also condemned in the Statements of Policy adopted at our Annual Conventions in Houston in January 1970 and 1971. Copies of these resolutions and the pertinent extracts from our Statements of Policy are attached.

The first resolution, adopted as our Board meeting in San Diego in October 1969, reflected the fact that this insidious practice had just begun to be a significant factor in the financing of apartments. It was during the spring and summer of 1969, as money got tighter and tighter, that many lenders found it possible to squeeze out the extra drop of blood that equity participation often represents.

This practice had grown so rapidly that, by the time of our Board of Directors meeting in San Diego during the second week of October, there was great alarm among those who build multifamily dwellings. As stated in that resolution this practice "often encourage(s) unsound loans with high loan-to-value ratios . . . (and) . . . the economic feasibility of many apartment complexes is jeopardized by such practices." In that resolution we urged the Congress and Federal and state regulatory agencies to investigate and curb these practices.

In the Statement of Policy adopted at our Convention in Houston in January 1970, we again called on the Congress to investigate this "rapacious practice." I believe that the paragraph of that Statement of Policy dealing with equity participation states as well as practically anything else the problems inherent in it. I would, therefore, like to read you that entire paragraph.

We call on the Congress to investigate the rapacious practice—now standard in insurance company lending and spreading to other institutions (including pension funds)—of demanding a share of property income in addition to astronomical interest and fees. Whether or not it is a device to protect lenders against long-term inflation, the practice is thoroughly and intrinsically unsound. Unless checked, it will lead to widespread foreclosures at the first substantial economic downturn—with serious adverse consequences to developers, to lending institutions and those entrusting their savings to them, and, most important, to the general public.

Why is it that our members are so concerned about any widespread incidence of equity participation: There are many reasons. A prime reason is that it disturbs the historical relationship between lender and borrower. It is not the disturbance itself which is of such concern but the potential results from this disturbance. The lender who is also a borrower in the same transaction may tend to not be as rigorous as he would otherwise be in assuring that the risks of a particular loan are reasonable. In too many cases have we seen a desire on the part of a lender to lend money on an unsound deal where he can get a piece of the action, as opposed to a solid transaction where no equity participation is obtainable. This can only result in ultimate serious trouble for such lenders.

Where the lender, in addition to normal payments of principal and interest, takes a substantial portion of the earnings of a project, the incentives to the project owner to maintain the project and to be concerned about its long term stability and welfare are severely lessened. In fact, a study conducted by us two years ago indicated that those developers building under an equity participation scheme were intending to hold the project for a much shorter period of time than those not giving any equity participation to the lender. Many lenders are thus liable to find themselves five to ten years later, the owners of apartment projects which have been abandoned by their owners, because they do not make economic sense any longer, and which are in need of repairs and past due maintenance attention.

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One of the frequent arguments made by those favoring equity participation is that it permits the borrower to obtain a more favorable interest rate and that this is especially important in times of tight money when interest rates are otherwise very high. Our experience has been to the contrary. Interest rates charged in connection with mortgage loans in which there was an equity participation involved have usually been the same as those charged without equity participation. The only more favorable aspects of the financing have been somewhat longer terms in some cases and occasionally higher loan-to-value ratios.

A very serious side effect of equity participation in apartment financing is that the builder or other owner of the project, in order to realize a return commensurate with that earned by investors in real estate projects without equity participation, must set rents which are higher than those charged in competitive projects. These rents are frequently difficult to obtain unless there is an extremely tight vacancy situation in the community. Then they have the unsatisfactory side effect of tending to draw up rents in other projects, thereby increasing the cost of housing to all. Perhaps one of the most serious indirect effects is this unwarranted increase in the cost of housing, an increase which in many cases drives people out of the market who in the past have been able to afford modest, unsubsidized rental housing.

A potential real problem is the future of a project carrying a mortgage at 9% to 10% because it was initiated at the height of the money crunch and carrying the additional burden of an indirect interest charge being paid in the form of an equity participation locked in, as is common, for perhaps 10 to 15 years. The rents that will have to be charged in such a project for it to stay financially alive generally will be considerably higher than those needed in a project started today with 7 to 7½% mortgage money and no equity participation to drive up the carrying cost of the project. As the vacancy situation hopefully becomes better, we may see many of the projects financed with equity participation going under.

You may be asking exactly what do we mean by equity participation. We mean many separate things, since there are almost as many schemes as there are lenders. However, there are about five basic approaches which I will briefly describe. Perhaps the most common is a flat percentage of the project's gross income. This is uncomplicated and thereby does not involve the lender in any management considerations. The percentage commonly varies from 1% to 3%.

A variation on this approach is a participation in all gross income after a certain break-even point. This approach at least leaves enough money in the project to pay some of the basic expenses, a deficiency of the first approach. A third approach is to take a percentage of the net income of the project. This approach does not jeopardize the financial stability of the project to the same extent as the first two.

A more complicated approach, which has several variations, is for the lender to buy all or part of a project, such as the land, for example, and lease it back to the developer. The lender then may become the ultimate owner of the project upon termination of the lease or the developer may have an option to buy back the property upon full payment of the mortgage. This scheme is also frequently combined with some percentage of gross or net receipts.

A fifth means is for the lender to insist upon a substantial portion of any increase in rents over those calculated at the time the project is put together, regardless of whether increased operating costs necessitate such increased rents. The lender's objective is to get at the increased values stemming from inflation.

These are the simpler methods and therefore the more common. An article in the July 1970 Fortune details some very esoteric approaches developed by some of the nation's largest insurance companies. This article also points out why equity participation became such a potent factor in the multifamily mortgage market during 1969 and 1970. The lenders had the upper hand because of the shortage of money. They weren't satisfied with interest rates at the highest levels in 100 years and endeavored to grab as much more as they could.

One result of this greed pointed out in this article is that projects were not being built because of the resistance by borrowers to giving lenders a piece of the project. The deal just won't work, and for the builder the project becomes an impossibility. This certainly contributed to the downturn in housing production during 1969 and 1970. A review of housing starts figures over the last two years indicates that apartment starts declined considerably more, proportionately, than did single family starts.

The Committee should be aware of another proposal which we find shocking

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with reference to equity participation, which is that lenders should be allowed to develop methods of participating in the equity which is created for and by home owners in single family housing. We object strongly to this idea, we oppose it completely. One of the strongest incentives to the purchase of a home, for most families, is the opportunity it provides to develop equity and thus a family estate. We see no reason why lenders should be given any opportunity to curtail the operation of the American system under which families since the beginning of our history have had an opportunity to become property owners. We hope this Committee agrees.

The most avid practitioners of equity participation have been the insurance companies. Many, in fact, will only lend money on that basis. The pension funds have increasingly required it. Less active in this area have been the banks and the savings and loans.

We were heartened by the recognition of the Federal Deposit Insurance Corporation that it may well be advisable to ban the practice of equity participation. In fact, Frank Wille, Chairman of the FDIC, in his statement to this Committee on April 20 points out one further problem with this practice—that the acceptance of equity participations by banks runs counter to the philosophy, underlying the determination of the Congress last year in its actions on bank holding companies, that banking and commerce should be separate.

Of concern to us however was the position taken by Preston Martin, Chairman of the Home Loan Bank Board, in his statement to this Committee also on April 20. His statement that any prohibition of this practice would be undesirable is quite disturbing. This statement, taken in conjunction with a decision by the Board's General Counsel's office in April 1969 and the recent announcement by the Federal Home Loan Mortgage Corporation that it is willing to purchase participations in loans which included an equity participation, seems to indicate a feeling on the part of the Home Loan Bank Board that this practice is desirable.

The decision by the Board's General Counsel's office is set out in a letter dated April 25, 1969 from Max Wilfand, Acting General Counsel of the Board, to Mr. William F. McKenna, General Counsel of the National League of Insured Savings Associations. That letter distinguished a position taken by a previous General Counsel of the Board in a letter of January 15, 1969, to Mr. McKenna. In the January 15 letter, Mr. Alan Jay Moskov stated there was no authorization for a Federal savings and loan association to invest in the equity of a real estate project. The particular approach proposed was that, in addition to its earning interest on the loan, the association would receive a specified percentage or share of the income derived from the operation of the project.

The April 25 letter from Mr. Wilfand stated that receiving a percentage of the gross rents of a project did not constitute a form of equity participation, but that receiving a percentage of the net rents would. It is disturbing to see the Home Loan Bank Board endorsing what is probably the unsafest of the equity participation approaches. Where a percentage of the gross rents must be paid regardless of whether enough rents are collected to meet debt service requirements and operating costs, a project may well be forced into foreclosure as a result. On the other hand, where a percentage of net rents is paid, the extra payout only occurs after all the project's obligations have first been met. A copy of this correspondence is attached.

I would like now to touch briefly upon the details of Section 14 of H.R. 5700. As I stated before, a similar prohibition contained in H.R. 18676 of the 91st Congress was endorsed by our Board of Directors. However, that endorsement was conditioned upon the prohibition being applied only to loans securing real property. It was the feeling of many of the members of the Board of Directors that they were not qualified to pass upon the appropriateness of equity participation in other types of situations and, therefore, they limited their endorsement to that area with which they were most familiar.

The prohibition in H.R. 5700 would be limited to insured banks and savings institutions, bank and savings and loan holding companies, as defined in Federal legislation, and their subsidiaries, uninsured mutual savings banks, and insurance companies. This would seem to exempt from the prohibition noninsured commercial banks and savings and loans, as well as mortgage bankers and other lenders in the business of making loans. These would have been covered by chapter 4 of H.R. 18676 and we urge the Committee to expand the prohibition in Section 14 of H.R. 5700 to include all lenders.

Some question arose in our Board of Directors' deliberations as to whether the prohibition contained in the bill barring a lender from accepting "any equity

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participation in consideration of the making of any loan" would bar true joint ventures initiated at the behest of a builder and not imposed by a lender as a condition to the making of a loan. It was our feeling that such would not be prohibited, but we urge the Committee to make the point clear, either with statutory language or with adequate legislative history.

In closing, let me say that we are very pleased that this Committee is seriously considering this legislation on equity participation. It has been one of the most serious problems confronting our industry in its efforts to provide needed apartments over the past two years of tight money. We urge the Committee to approve Section 14 of H.R. 5700.

Thank you.

NAHB Resolutions

Mortgage Finance Committee,
Apartment Construction & Management Committee,
San Diego, Calif., October 13, 1969.

EQUITY PARTICIPATIONS

Whereas the practice of requiring an equity participation, as a condition for extending long term permanent financing, has grown to the exclusion of fixed yield mortgages, and

Whereas such participations often encourage unsound loans with high loan-to-value ratios, and

Whereas the economic feasibility of many apartment complexes is jeopardized by such practices: Now, therefore, be it

Resolved, That we once again condemn these practices in the strongest terms possible and that we urge the Congress and Federal and State regulatory agencies to investigate and curb such practices and that NAHB examine and develop as a priority a program aimed at curbing the abuses inherent in these practices; and be it further

Resolved, That there be presented to this Board, at its next meeting, proposals which are aimed at this objective.

Mortgage Finance Committee,
Houston, Tex., January 19, 1970.

Be it resolved that legislation be sought to bar lender participation, in any form other than interest, in the proceeds of a project securing a loan made by a lender who operates across State lines or who pays less than a fully effective Federal income tax rate.

Mortgage Finance Committee,
Washington, D.C., May 25, 1970.

Whereas, current NAHB policy is that legislation be sought to bar lender participation, in any form other than interest, in the proceeds of a project securing a loan made by a lender who operates across state lines or who pays less than a fully effective Federal income tax rate,

Now, therefore, be it resolved, that a fiduciary be precluded from using a majority interest in, or a wholly owned subsidiary, as a vehicle to circumvent the objective of this policy.

National Legislative Committee,
Boston, Mass., September 21, 1970.

PROHIBITION OF EQUITY PARTICIPATION

Whereas, NAHB has consistently expressed its opposition to the practice of mortgage lenders requiring, in addition to interest and fees, a share of the equity or comparable participation in the proceeds of a project in return for making a mortgage loan, and

Whereas, Chairman Wright Patman (D-Texas) of the House Banking and Currency Committee in July introduced the Safe Banking Act of 1970 (H.R. 18676) which under Chapter 4 would subject to civil and criminal penalty any lender requiring equity participation in consideration of making any loan,

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Now, therefore, be it resolved, that with respect to the financing of projects NAHB express to the Congress its complete support for the provisions of Chapter 4 of H.R. 18676 providing that, "No lender may accept any equity participation in consideration of the making of any loan.", providing that such restrictions are applied to loans securing real property only.

EXTRACT FROM THE NATIONAL ASSOCIATION OF HOME BUILDERS' STATEMENT OF POLICY FOR 1971

APPROVED BY NAHB BOARD OF DIRECTORS, JANUARY 20, 1971, HOUSTON, TEX.

The need for thorough investigation of residential lending is emphasized by: (*a*) almost complete abandonment of this area of activity by large segments of the private mortgage market; and (*b*) the rapacious practice—now standard in insurance company lending and rapidly spreading—of demanding compulsory equity participation (in addition to an insupportably high-cost first lien). This forfeiture by those entrusted with huge pools of the people's savings raises a real and unwelcome threat that the secondary markets provided by the Federal National Mortgage Association and by the Federal Home Loan Bank Board may, of necessity, develop into a huge mortgage company rather than a last resource.

FEDERAL HOME LOAN BANK BOARD,
Washington, D.C., July 8, 1970.

Mr. NORMAN J. FARQUHAR,
Director, Mortgage Finance Department, National Association of Home Builders, National Housing Center, Washington, D.C.

DEAR MR. FARQUHAR: This is in reply to your letter of June 25, 1970, regarding our opinion of April 25, 1969 concerning the practice of Federal savings and loan associations receiving a percentage of the rent in addition to interest on a loan.

That opinion still represents our thinking on this matter, and a copy of it is enclosed for your information.

You will note that we have no legal objection to this practice provided that the association does not obtain an equity interest in the project.

Sincerely yours,

ARTHUR W. LEIBOLD, Jr.,
General Counsel.

FEDERAL HOME LOAN BANK BOARD,
April 25, 1969

Mr. WILLIAM F. MCKENNA,
General Counsel, National League of Insured Savings Associations, Washington, D.C.

DEAR MR. MCKENNA: This is in reply to your letter of April 8, 1969, inquiring as to whether a Federal savings and loan association may legally make a loan on a multifamily housing project under the terms of which the association would receive a percentage of the rent in addition to the stated rate of interest.

In our previous letter to you dated January 15, 1969 we indicated that a Federal savings and loan association was not authorized to invest in an equity interest in a real estate project, either in the form of stock ownership or a percentage of the rent. You now ask whether our position would be different if the association received, in addition to the stated rate of interest, a percentage of the gross rent rather than a percentage of the net rent. The argument is made that such arrangement does not place the lender in the position of an equity holder in the project because his right to receive a share of the gross income removes him from the risks carried by an equity owner.

We agree that there is no prohibition in the Federal Regulations against an association receiving a percentage of the rent in addition to the interest as long as the association does not acquire an equity in the project. We would also agree, in general, that the right to receive a percentage of the gross rent in a project probably would not constitute an equity interest. It should also be noted that a transaction involving a percentage of rent may be subject to state usury laws.

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I know you realize that we cannot render any definitive ruling in the foregoing connection, in the absence of the facts in a particular case.

Sincerely yours,

(Signed) Max Wilfand
MAX WILFAND,
Acting General Counsel.

FEDERAL HOME LOAN BANK BOARD,
Washington, D.C., January 15, 1969.

Mr. WILLIAM F. MCKENNA,
General Counsel, National League of Insured Savings Associations, Washington, D.C.

DEAR BILL: This is in reply to your letter of January 9, 1969, in which you request my opinion as to whether a Federal savings and loan association may engage in a transaction which you describe as follows:

> A loan would be made by a Federal association to a contractor for construction of an apartment house. The loan would carry the market rate of interest and would be repayable according to a schedule of periodic payments of principal and interest calculated to repay the loan completely by the maturity date. No disproportionately uneven (or balloon) payment of principal would be included in the repayment schedule.
>
> The portion of the investment arrangement that would distinguish it from the normal apartment house loan would be a provision that in addition to repayment of principal and of interest at a stated rate in the mortgage note, the association would also be entitled to receive a specified percentage or share of income derived from operation of the apartment project. To this, extent, the Federal association would be acquiring an equity interest in the project. The equity interest might be evidenced by ownership of stock in a corporation that owns the apartment project, or it might be evidenced by a provision in the mortgage documents entitling the lender to receive a share of the income from the project.

The transaction under consideration involves, in addition to a real estate loan, an investment by a Federal association in an equity interest in the project. As you know, the authority of Federal associations to make loans and investments is contained in § 5(c) of the Home Owners' Loan Act of 1933, as amended, and in Part 545 of the Rules and Regulations for the Federal Savings and Loan System. While a Federal association is certainly authorized to make loans secured by a first lien upon real estate, there is no authorization for it to invest in the equity of a real estate project.

Of course, it may be argued that the Federal association would not be investing in the equity of a real estate project but only in the loan, with the equity being an additional benefit. This argument, however, ignores the fact that the equity aspect is part of the inducement for the association to enter into the transaction, and, therefore, the association would, in fact, be investing in both the loan and the equity features of the transaction.

It may also be argued that the only concern of the statutory and regulatory provisions on loans and investments is to assure the safety of loans and investments, and that the loan feature of the proposed transaction, by itself, provides such assurance. In view of the fact, however, that the association would probably not make the loan without the added inducement of the equity interest, some doubt is cast on the safety of the loan. This is because an association might be willing to make a high risk loan if the profit potential were high enough. By the same token, the borrower would probably not be compelled to offer an equity interest in addition to the market rate of interest if the risk were not high.

For the foregoing reasons, therefore, it is my opinion that a Federal association is not authorized to engage in the type of transaction you have described.

Sincerely yours,

ALAN JAY MOSCOV,
General Counsel.

The CHAIRMAN. Thank you very much. Your statement is very interesting. And it includes the points, of course, that we are hearing testimony on, right now. And we appreciate your testimony.

Mr. Hovde, chairman of the Realtors' Washington Committee of the National Association of Real Estate Boards is our next witness.

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STATEMENT OF DONALD I. HOVDE, MADISON, WIS., CHAIRMAN, REALTORS' WASHINGTON COMMITTEE, NATIONAL ASSOCIATION OF REAL ESTATE BOARDS

Mr. HOVDE. Mr. Chairman, I am Donald Hovde, a realtor in Madison, Wis., and president of Hovde Realty. I am appearing here today as chairman of the Realtors' Washington Committee of the National Association of Real Estate Boards.

I have a prepared statement to read, and the balance of it is to be incorporated in the record. And after I read this prepared text I wish to make a summary of my remarks.

The CHAIRMAN. Each of the witnesses may insert whatever he desires if it is pertinent to this inquiry.

Mr. HOVDE. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, I appreciate this opportunity to testify on behalf of the National Association of Real Estate Boards, in regard to certain aspects of H.R. 5700 which directly affects the real estate industry.

EQUITY PARTICIPATION

We will first address ourselves to section 14 of H.R. 5700 which would prohibit equity participation, as a condition for making a loan, by insured and regulated financial institutions in addition to insurance companies.

We support the enactment of this provision. Our national convention in November 1970 and by the way also November of 1969—adopted a policy statement on this issue as follows:

> We deplore the trend whereby mortgage lenders are demanding equity positions as a condition to making mortgage loans. We feel this policy jeopardizes historically sound lending practices.

Equity participations, or equity kickers as they are known in the trade, represent a fairly recent innovation in real estate financing. New managerial concepts inspired by an unfortunate reconciliation or surrender to increasing inflation and consequent erosion in mortgage portfolio values, have generated the equity kicker as a compensating factor. While the logic behind this innovation may appear persuasive, the consequences in terms of lender morality and risk, coupled with entrepreneurial discouraging in real estate development, pose serious problems to which the Congress must appropriately address itself.

The 91st Congress in its deliberations on bank holding companies sought to draw a line between the lenders of money and the users of money. We believe that it is vital to our financial institutions to insist that this line not be blurred by permitting these institutions to be influenced in their lending decisions by the degree of the equity kicker which they exact from the developer seeking financing for a housing or commercial project. Not only is there the danger of unsound lending practices, influenced by a sizable kicker from a marginal project, but the temptation of preferential treatment for the developer, acceding to the kicker, injects an element of trade restraint which discourages entrepreneurial activity in the real estate business.

The introduction of the equity participation as a condition for making a mortgage loan introduces a new factor which puts an undue

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strain on the fiduciary responsibility of financial institutions. They should not be permitted to dilute the criteria applicable to their investments because of the kicker surrendered by a developer who might otherwise not qualify for financing under sound lending practices. Financial institutions should not be permitted to forsake normal business risks for those of a more speculative nature because of the equity kicker.

We recommend that the definition of institutions covered by the ban against equity participations be extended to cover all financial institutions, including pension funds, mortgage bankers, real estate mortgage investment trusts, and other financial institutions engaged in the business of making or placing mortgage loans.

We strongly recommend approval of section 14 of H.R. 5700.

Those comments with respect to interlocking relationships have been submitted and are on record. And rather than read them I would rather take this time allotted to me to speak some more on the equity participations.

In 1965 we saw the insurance companies—and I speak of the insurance companies because in the equity participation or kickers we have found that it has been these institutions that have perhaps practiced this or required it far more, in larger dollars and degrees than the other two, and also the banks, in fact those other two type institutions have not really gotten into it in any magnitude whatsoever. In early 1966 the insurance companies decided for some reason to get out of single family home loans primarily, which they have been doing for many, many years. And it was in the spring of 1966 that we in the housing industry of single family homes first saw evidence of tight money.

This can be attributed perhaps to many factors. However, when you take one of the large suppliers of funds out of the market, one of the three large suppliers, the S. & L.'s the commercial banks and the insurance companies, and take the insurance companies who charged their mortgage portfolios from single family residences into multi-family and commercial loans, we experienced in our industry the first evidence of tight money. Then after they got into the multi-family and commercial loans in a much bigger way, it then became a practice for what we are talking about here today, the equity participation.

They saw a way through this route, they said to increase their yield, to help offset inflation, and to get a better run on their mortgage portfolios.

However, as a result of this several things have taken place. You have through Congress and through the various States established certain laws for the protection of the public interest. One of them was State usury laws. The equity participation, Mr. Chairman, I submit to you has made a mockery out of State usury laws, because they can establish an interest rate that would comply with a State usury law and through equity participations totally circumvent that. And we have found that this has made a mockery of State usury laws.

You have established a limit on loan ratios; namely, 75 in most cases. Nevertheless we see through equity participations that concept goes out the window. Ninety to one hundred percent loans are made in order to get a piece of the action by the lender.

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While the insurance companies went for the equity participation because of higher yield to offset inflation, I submit to you gentlemen and ladies that it in itself was highly inflationary, for through the equity participations rents had to be raised and projected at much higher levels than normally would be the situation.

It is rather ironic that the very thing that caused or created the higher interest rates came back to plague many insurance companies, and therefore policyholders. Policyholders, recognizing the exceedingly high interest rates, would go back and borrow on the face value of their loans to the point that the policy loan or loans to policyholders became of such a magnitude that it caused deep concern to the insurance companies. And had rates not gone to the exceedingly high rate that they did, it is questionable whether this outflow of policy loans would have in fact taken place.

I submit to you that the single family home mortgage loan has now, because of this practice, become such a low point on the totem pole that they no longer are attractive to insurance companies. We fear that if this practice is to continue by other financial institutions, the single family home loan because it has a fixed interest rate and may not be attractive comparatively speaking, is going to be the real sufferer in this entire practice.

We have found that standard loans, normally 75-percent loans, may not even be accepted.

And I submit to you also the article appearing in Fortune magazine of July 1970 (see p. 536). I will quote from that:

> One company was so devoted to the idea of acquiring equity that if the developer came forward with his own equity money and said, lend me 75 percent of the value of the building, I can put up the rest, the insurance company would reject it. So in fact would many other companies. In the fifties scrupulous lenders worried that developers had too little of their own equity in the project. Today the developers are not allowed to put any in.

We regard the equity participation as a highly speculative position for these lenders to be in. They are dealing primarily with the marginal developer who has little to lose.

The normal economic criteria of credit analysis and appraisal analysis we have seen minimized and diminshed in relationship to profit items by the lender seeking the equity kicker, and the long-term investor, the developer that has the capital, cannot get the normal type of loan that has been historic in the past.

I salute you, Mr. Chairman, for the introduction of this bill, particularly section 14. We have in our industry for these past 3½ years or 3 years wondered how such a practice could continue at such a magnitude, and with somany biases, and obvious economic unsoundness. We have wondered that it could continue as long as it has.

I appreciate this opportunity to appear before you today and salute you for what takes great courage, to introduce this type of prohibition, because of the magnitude and the concentration of wealth that exists for those companies that are practicing this very unsound mortgage lending.

Thank you.

(The prepared statement of Mr. Hovde follows:)

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PREPARED STATEMENT OF DONALD I. HOVDE, MADISON, WIS., CHAIRMAN REALTORS' WASHINGTON COMMITTEE, NATIONAL ASSOCIATION OF REAL ESTATE BOARDS

Mr. Chairman and members of the Committee, I appreciate this opportunity to testify on behalf of the National Association of Real Estate Boards, in regard to certain aspects of H.R. 5700 which directly affects the real estate industry.

EQUITY PARTICIPATIONS

We will first address ourselves to section 14 of H.R. 5700 which would prohibit equity participation, as a condition for making a loan, by insured and regulated financial institutions in addition to insurance companies.

We support the enactment of this provision. Our national convention in November, 1970, adopted a policy statement on this issue as follows:

> We deplore the trend whereby mortgage lenders are demanding equity positions as a condition to making mortgage loans. We feel this policy jeopardizes historically sound lending practices.

Substantial use of equity participations, or equity kickers as they are known in the trade, represent a fairly recent innovation in real estate financing. New managerial concepts inspired by an unfortunate reconciliation or surrender to increasing inflation and consequent erosion in mortgage portfolio values, have generated the equity kicker as a compensating factor. While the logic behind this innovation may appear persuasive, the consequences in terms of lender morality and risk, coupled with entrepreneurial discouragement in real estate development, pose serious problems to which the Congress must appropriately address itself.

The 91st Congress in its deliberations on bank holding companies sought to draw a line between the lenders of money and the users of money. We believe that it is vital to our financial institutions to insist that this line not be blurred by permitting these institutions to be influenced in their lending decisions by the degree of the equity kicker which they exact from the developer seeking financing for a housing or commercial project. Not only is there the danger of unsound lending practices, influenced by a sizeable kicker from a marginal project, but the temptation of preferential treatment for the developer, acceding to the kicker, injects an element of trade restraint which discourages entrepreneurial activity in the real estate business.

The introduction of the equity participation as a condition for making a mortgage loan introduces a new factor which puts an undue strain on the fiduciary responsibility of financial institutions. They should not be permitted to dilute the criteria applicable to their investments because of the kicker surrendered by a developer who might otherwise not qualify for financing under sound lending practices. Financial institutions should not be permitted to forsake normal business risks for those of a more speculative nature because of the equity kicker.

We recommend that the definition of institutions covered by the ban against equity participations be extended to cover all financial institutions, including pension funds, mortgage bankers, real estate mortgage investment trusts, and other financial institutions engaged in the business of making or placing mortgage loans.

We strongly recommend approval of section 14 of H.R. 5700.

INTERLOCKING RELATIONSHIPS

We will now address ourselves to prohibitions against directors, officers, or employees of insured institutions who are appraisers or who directly or indirectly control a company "which provides services in connection with the closing of real estate transactions." The latter quotation is so broad that we must assume that it includes real estate brokers and counselors who in the regular course of their business provide services in connection with the closing of real estate transactions.

The bill is so sweeping in its prohibition that an appraiser could not serve on the board of directors of a savings and loan association or an insured bank in Washington, D.C., even if he did no appraising for such institution, if his son were a broker or an appraiser in California.

We seriously doubt that the drafters of the bill intended such a sweeping and grossly unreasonable prohibition, yet that would be the result of the bill as we conclude from the meaning of the language employed.

We now shift to another prohibition in the bill which presents a more debatable issue.

The bill would prohibit a director, trustee, officer or employee of an insured institution from, at the same time, occupying a comparable position in an appraisal company or a company providing services in connection with the closing

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of real estate transactions if the institution has a "substantial and continual business relationship with such company."

In everyday language this means that an appraiser or broker could not be a director, officer, etc., of a savings and loan association or a bank if he at the same time did business with the institution.

While we conceded that such a relationship could give rise to a conflict in interest situation, we believe that the regulatory agencies have ample authority to require disclosure of such relationship and to prevent any abuse which might arise.

The broad prohibition contemplated by the bill would deny to savings and loan associations the expertise which appraisers and brokers could bring to bear on the problems facing these institutions in investment decisions. The Federal Home Loan Bank Board, for example, requires annual disclosure of any business relationship between an association and any officer, director, or employee, and also any commission, fee, or other benefit. Other regulatory agencies should have comparable disclosure requirements, and, if necessary, their cease-and-desist and removal power should be extended, as the Chairman of the Federal Deposit Insurance Company recommended on April 20, to this Committee.

We recommend, therefore the deletion of these prohibitions as they apply to appraisers and brokers serving as directors of financial institutions covered by the bill.

I want to emphasize that in making this recommendation we sincerely believe that appropriate regulatory measures by the agencies concerned would minimize the chances of abuses such as those found by the Ad Hoc Subcommittee on Home Financing Practices and Procedures in the District of Columbia.

The CHAIRMAN. Thank you very much, sir.

Now, Philip C. Jackson.

You have a prepared statement. You may proceed in your own way, sir.

STATEMENT OF PHILIP C. JACKSON, VICE PRESIDENT, MORTGAGE BANKERS ASSOCIATION OF AMERICA; ACCOMPANIED BY WALTER F. TERRY III, VICE PRESIDENT, JAMES W. ROUSE & CO., COLUMBIA, MD.

Mr. JACKSON. Because our statement is relatively brief, I believe I can present it in short order.

Mr. Chairman, my name is Philip C. Jackson. I am vice president of the Jackson Co., a mortgage banking firm in Birmingham, Ala., and vice president of the Mortgage Bankers Association of America. With me this morning is Mr. Walter F. Terry III, vice president of James W. Rouse & Co. in Columbia, Md., with whom I would like to share a portion of my time.

It is our belief that Mr. Terry and his company have a unique position as both borrowers and lenders from which they can enlighten the committee.

The CHAIRMAN. You may share part of your time with him.

Mr. JACKSON. Thank you, sir.

We appreciate this opportunity to appear before your committee to express our views on H.R. 5700, the "Banking Reform Act of 1971." To understand our interest in this legislation, it might be well for me to explain whom our association represents and what our members do.

The Mortgage Bankers Association of America (MBA), now in its 57th year, consists of more than 2,000 members, the largest proportion of which are mortgage banking companies that engage directly in the origination, financing, selling, and servicing of real estate mortgage loans for such institutional investors as life insurance companies,

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commercial banks, mutual savings banks, savings and loan associations, fire and casualty insurance companies, investment funds, and pension funds.

Our interest in H.R. 5700 is directed principally to those sections of the legislation which deal with the restrictions it would place on interlocking directorates and the prohibition on the use of equity participation financing. Because the greater portion of my remarks will be addressed to section 14 which deals with equity participations, I shall direct my initial comments to that matter.

The mortgage banker's involvement in the use of equity participations stems from the fact that he usually stands between the developer and the investor and manages the details of financing the project which the developer seeks to build and the investor wishes to finance. In this capacity, the mortgage banker has a responsibility to both parties to the transaction and it is therefore, to his advantage to see that the interests of both parties are protected. For this reason, the mortgage banker finds it of great importance that the developer as well as the investor find this arrangement to be mutually beneficial.

The equity participation is a creature of inflation and also of situations where the lender's return may be long deferred. In times of inflation those who require large sources of capital are deterred not only by the strong competition for available financing, which is reflected in the form of high interest rates which they have to pay, but also by the desire of individuals, fiduciaries and other investors to place funds where they can obtain an inflation hedge.

It is mainly during such periods that other means than a mortgage loan must be found by which money can be made available to those who wish to build large projects such as office buildings, apartment complexes, hotels, motels, shopping centers, and even whole cities.

There is no typical equity participation arrangment since the form taken is tailored to the particular project and developer in question. Mr. Stastny, I believe, outlined several different potential arrangements.

Some of the various approaches are:

1. A means by which the cash flow is shared and the lender receives a specified share of the project income after payment of expenses and amortization;
2. An arrangement under which the lender purchases the land, leases it back for a fixed rent plus some percentage of gross income, and then also makes a first leasehold mortgage to the developer;
3. A stipulation giving the lender a percentage of all rent increases over the first year's projected rent.

The equity participation form benefits both the lender and the developer. It provides the investor with a hedge against inflation and gives the borrower added advantages of:

1. Borrowing at a lower fixed-interest rate than would otherwise be the case, thus reducing the required interest expense of a project and thereby making it feasible in a highly competitive market;
2. Paying little or nothing beyond the limited fixed charges if the property yields no profit; and
3. Expanding the scope of his activity since his limited equity funds are supplemented by the equity contributions of the lender.

Section 14(b) of H.R. 5700 prescribes that "No lender may accept any equity participation in consideration of the making of any loan."

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What would be the effect of this prohibition?

1. The interest cost of financing apartments and commercial properties, the monthly carrying costs, and therefore the rents required for constructing these buildings will increase substantially.

When confronted with substantial and continuing prospects that the funds loaned will be repaid in cheaper dollars. lenders will seek investments where this risk can be offset. Inflation is the culprit, while the equity participation and high interest rates are the whipping boys. In a continuing inflationary economy, long-term fixed-rate securities become relatively unattractive to savers or lenders. Their only choice is to seek hedges against inflation—hedges that make savings worthwhile, i.e., (*a*) an interest rate that provides for a competitive real rate of return after allowing for inflation or, (*b*) a means for participating in the inflating value of the asset created.

2. Indications are that lenders probably would continue to make mortgage loans to finance construction of apartments and other commercial properties, but only in greatly reduced volume.

As late as the spring of 1970, a survey conducted by the McElvain-Reynolds Co., an active mortgage banker located in Chicago, revealed that two-thirds of the Nation's largest life insurance companies were willing to make large mortgage commitments on income properties at a simple interest rate—if the developer had substantial cash equity.

3. The volume of lending and construction of apartments and commercial properties would decline substantially.

If the institutional investor is restricted to a creditor position, he must be assured that the borrower has an equity position sufficient to secure the loan and to protect the savers he represents.

Developers of apartment buildings, office buildings and shopping centers are typically short on available capital funds and unable on their own account to supply large amounts of equity investment. That is why they have actively sought and preferred to borrow as much of the property's appraised value as the lender is willing to supply and to trade a larger percentage of financing in return for a participation by the lender in the equity.

The point is that developers of commercial properties do not have, or do not care to employ, the equity capital necessary to develop large apartment and commercial properties on the scale they have in recent years without this type of assistance. A reasonable analogy, created and approved by the Congress, is the Small Business Investment Corporations which extend credit and at the same time invest in the common stock of their borrowers. This is substantially the same type of equity participation which this legislation would prohibit.

4. Dollars of credit driven from financing of apartment and commercial properties by the prohibition against equity participations will not be transferred into the home mortgage market.

For reasons already cited, many lenders, particularly those who were willing and able to make equity participation loans, shifted away from the home mortgage market in the early sixties, well in advance of the expanded use of equity participation. They made the move originally because other lenders were flooding the stagnant home mortgage market with ample funds whereas the growing apartment and commercial markets were short of funds.

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After mid-decade, the shift continued because fixed interest rates on single-family home mortgages did not protect investors from inflation, especially when they were called on to provide loans as high as 97 percent of value, and because more attractive investment opportunities, which would better protect their savers' funds, were available elsewhere. Under these circumstances, it would be wishful thinking to expect the prohibition of equity participations to result in a larger flow of credit into home mortgages.

If inflation subsides, the use of participations will subside. Nevertheless, they will not disappear altogether since many developers will still want to trade a share in an ownership position in order to obtain the higher leverage and larger financing they cannot command with the limited capital they are able or willing to invest.

The prohibition of equity participations by lenders can do nothing except reduce the volume of needed construction. It can promise no offsetting increase in the flow of funds into the home mortgage market. In summation, we urge that Congress not enact this prohibition against equity participations since its effect will, in our view, be counterproductive. In the final analysis, it would place the borrower in potentially a less advantageous position.

INTERLOCKING DIRECTORATES

The sections of the "Banking Reform Act of 1971" that deal with interlocking directorates are not of direct concern to the Mortgage Bankers Association of America. Some officers of our member firms undoubtedly serve as directors of financial institutions and title companies. In many cases, they participated in the formation of these institutions and without their assistance their communities would not now be served by the bank, savings and loan association, or title company they helped form.

In all cases, they bring to the directorships a knowledge of local real estate conditions and national credit conditions that is of value to the institution's management.

Our concern about this legislation is more broadly based. Never before have the financial institutions of this Nation been in greater need of expert and experienced directors on their boards. As the economy becomes complicated by advanced technology and by governmental intervention, wise and experienced leadership is necessary to their survival. At the same time, the age group of our population that represents experience and technical know-how is in short supply and declining. Legislation that reduces the use of this pool of experienced men to a one-for-one relationship would use these men inefficiently and force many institutions to accept the cost of relying on less experienced directors.

Financial institutions located in small towns and communities, where experienced men are most scarce, will be most affected by this legislation. If there is a management scarcity in this country today, this legislation will undoubtedly magnify that scarcity many times. In many of the Nation's smaller communities an independent banking facility would not be economically feasible without this use of talent on a part-time basis. Our fear is that this legislation could well create a situation wherein only large branching institutions will be able to survive this prohibition.

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Surely a less repressive way can be devised to avoid conflicts of interest. Furthermore, legislation will not change the moral fiber of any individual. The appropriate solution to this problem is to enforce present laws by vigorously seeking out and prosecuting those who violate their fiduciary responsibilities as members of boards of directors. The remedy would seem to be to vest adequate authority in the Federal supervisory agencies that currently regulate the industries affected by this legislation and to provide adequate funds to investigate and enforce the present law.

Thank you for providing us the opportunity to express our views on this measure.

I would like to surrender the rest of my time to Mr. Terry, Mr. Chairman.

Mr. TERRY. Walter Terry with the James Rouse Co. I have submitted a prepared statement.

The CHAIRMAN. It will be included in the record, sir.

Go ahead and give us your comments.

Mr. TERRY. I will try to quickly summarize our concern as a real estate developer.

We are continually frustrated by the inability of the real estate industry in general to attract sufficient capital to carry out the various tasks of the industry.

We as a developer, for example, in Columbia simply could not have carried on what we have carried on in Columbia if we did not have the right to give to a lender the participation that would enable us to do things sometimes with higher, but I think prudent risks.

We are a large real estate developer, but a very small company. And to do things at the pace we do them we need every right to give a lender an equity participation. We have not found any lenders to be lowering their investment standards. We are receiving, I feel, legitimate 75 percent financing on our projects. Financing beyond that point is through an equity participation. And for that equity participation a lender, I think, is very well deserving of an extra item of interest.

We have not had to slowdown in the last few years because of tight money. The reason we have not is because we have been able to give lenders a participation. We are still a very profitable real estate developer. We simply as a company could not live with short-term financing. And I think lenders are motivated by inflation. If they are motivated by inflation, I think the natural result of section 14 would be life insurance companies and banks seeking shorter term investments, requiring us to refinance periodically. That could break us. We are a very small company, with very large real estate debt.

Thank you, Mr. Chairman.

(The prepared statement of Mr. Terry follows:)

PREPARED STATEMENT OF WALTER F. TERRY III, VICE PRESIDENT, THE ROUSE CO., COLUMBIA, MD.

I appreciate the opportunity to express my views to the Committee concerning H.R. 5700. My remarks are limited to Section 14 of the Bill, since that is the only area on which we feel competent to comment. We are opposed to Section 14.

It is probably worth a moment to explain the make-up of The Rouse Company so you might better appreciate our reasons for opposing Section 14. The Rouse Company is a real estate developer and mortgage banker. The company pioneered

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the concept of enclosed, air-conditioned, heated mall shopping centers; and is today one of the largest developers of shopping centers in the country. Columbia, a new town between Baltimore and Washington, is a major project of the company. The company is currently developing apartments, office buildings, motor inns, and shopping centers. Through its wholly-owned subsidiary, James W. Rouse & Company, Incorporated, the company is the tenth largest mortgage banking firm in the country, servicing over $900 million in mortgage loans for 70 institutional investors. Because of the developer/mortgage banker make-up of the company, we feel we are in a unique position to clearly see both sides of the issue. My personal responsibility within the mortgage company is that of negotiating financing for The Rouse Company.

During the past two years, the company has borrowed over $100 million in long-term financing for its various projects. The last two years have certainly represented the tightest money market we have ever seen as a company. Virtually all of the $100 million carried some form of equity participation.

There are many legal restrictions that affect the lending of money secured by real estate. One of these restrictions is that most first-mortgage lenders are prevented from making a loan in excess of 75% of the value of the property. Because of ever-increasing building costs and higher capitalization rates applied to income streams, the resulting equity requirement needed above a 75% loan is today more than most developers can stand. Financing above 75% of value can be obtained through second-mortgage financing or equity financing. Both methods are more expensive than a typical 75% first-mortgage loan; however, the greater risk justifies the greater reward. If equity financing methods had not been available to us in the last two years, many of our projects would not have gotten off the ground because of our capital limitations, large as they are compared to most developers. We don't represent to you that we are happy to pay the higher cost of equity participation or higher interest rates; however, we do suggest that it is a very necessary option we must keep open to ourselves. If project financing in total does not permit us to achieve a satisfactory economic result, we simply would not move forward. Therefore, we do not feel we need to be protected by Section 14.

If Section 14 is included in H.R. 5700, it appears to me that the result would be disastrous to real estate financing. The reasons:

1. If participation is not available to lenders, an immediate increase in the fixed interest rate would occur. This fact greatly increases the difficulty in carrying a project in the early stages. Participation in future income permits a lender to accept a somewhat lower-than-market return in fixed interest rate. This fact allows a developer to keep rents on apartments, stores, or offices at a competitive rate. Participations are usually on an "if, as, and when earned" basis. Clearly, this is to the developers' advantage.

2. Since most long-term lenders are greatly motivated by inflation, the inability to receive a participation would greatly reduce the amount of money available for long-term real estate debt, forcing short-term financing. Short-term debt to finance real estate development is totally unacceptable since periodic refinancing could bankrupt a developer. If a developer accepts a five-year loan on a property, he runs the unsatisfactory risk of refinancing when economic or real estate conditions may well be to his disadvantage.

3. Real estate development involves many high risks. A developer may not want to take those risks by himself and hence seeks a financing partner, as we did in Columbia. We feel it is absolutely necessary in the conduct of our business to be able to share high-risk situations with a financial partner.

Real estate development has always had difficulty in attracting capital because of its non-liquid character. As we look ahead at real estate challenges and opportunities in the years to come we are very excited. Responding to those challenges and opportunities would be frustrating for us as a company and as an industry if we are unable to attract capital in enormous amounts. To attract capital we must have the right to join forces with financial institutions in the most economic and creative ways possible, including equity participations.

The CHAIRMAN. Thank you, sir. If you desire to extend your remarks and bring in any additional points you may do so.

Mr. John T. Fey, president of the National Life Insurance Co., on behalf of the American Life Convention and the Life Insurance Association of America.

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STATEMENT OF JOHN T. FEY, PRESIDENT, NATIONAL LIFE INSURANCE CO., MONTPELIER, VT., ON BEHALF OF THE AMERICAN LIFE CONVENTION AND THE LIFE INSURANCE ASSOCIATION OF AMERICA; ACCOMPANIED BY BRUCE P. HAYDEN, VICE PRESIDENT, CONNECTICUT GENERAL LIFE INSURANCE CO., HARTFORD, CONN.; AND THOMAS F. MURRAY, SENIOR VICE PRESIDENT AND CHIEF INVESTMENT OFFICER, THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES

Mr. FEY. Mr. Chairman and members of the committee, I am John T. Fey, president of the National Life Insurance Co., Montpelier, Vt.

With me this morning are Mr. Bruce P. Hayden, the vice president in charge of mortgages and real estate at the Connecticut General Life Insurance Co. of Hartford, Conn., and Mr. Thomas F. Murray, senior vice president of the Equitable Assurance Society of the United States, of New York City. Mr. Murray is the chief investment officer of that institution.

Together we represent the American Life Convention and the Life Insurance Association of America, two associations with a membership of 360 companies and representing approximately 91 percent of all of the life insurance in force.

As the other speakers, we have submitted our written statements. I would like to briefly summarize some of the major points which we consider to be of importance in considering the memorandum.

First of all, the opposition which we are presenting this morning includes not only section 14, the equity participation, but also the sections dealing with the interlocking directorates. Since the other speakers have addressed themselves to the equity participation this morning, I shall take that section first.

So far we have heard a great deal about the so-called equity participation, which may be a misnomer, because often it does not represent an equity position in the usual sense. It is actually an income participation based upon gross incomes expected to be realized or projected in the future. When we refer to this we would prefer to refer to that type of credit transaction as an income participation.

Our concern extends beyond this to other types of equity participations or credit transactions that could be covered by the broad and sweeping language of section 14, which says that no lender may accept an equity participation as a condition to making loans. In the broad sense this could include convertible bonds, particularly those convertible bonds which are private placements. It could cover bonds, notes, and debentures with warrants. It could cover a sale and leaseback transaction. It could cover a joint venture in real estate. And of course as we have heard this morning, it does cover the so-called income participation.

I would like to make three observations on these types of credit transactions. First of all, in the case of the income participation, this is not an extra which has been given. There is a reduction in interest in consideration of the additional income participation.

Second, I think it should be emphasized that all of these credit transactions, with the exception of the income participation, are of longstanding usage in the business community. They have been tested during the last century.

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And finally, I should like to emphasize the fact that all of these are used in commercial transactions; none of them has been applied to the case of a private single dwelling home.

Now, I would like to cover some of these various types of transactions.

Convertible bonds are a very important part of the financial operation of the American economy. A large number of convertible bonds are privately placed in order to save the expense of a public issue, and many of the private placements are with pension funds, insurance companies, and other trust funds.

In the period from 1967 to 1969, over $12 billion in financing of of corporations was raised by the use of convertible bonds, about 20 percent of the total capital raised on bonds during that period.

The second area, bonds or notes or debentures with warrants, again does not present any opportunity for control, because, like convertible bonds, initially they are a debt position. While convertible bonds provide for a subsequent transfer to an equity position, the bonds, notes or debentures with warrants attached also provide for a second infusion of capital into the business enterprise at the time that the warrant is exercised. So not only is the borrower receiving the benefit of the initial loan, but also the corporation is receiving the benefit of an additional capital contribution in the form of an equity position at a later date if the leader chooses to exercise his warrants.

Now, those types of transactions are used largely by the smaller and the medium sized business enterprise, although not restricted to them entirely. As many of the members of this committee may recall, American Telephone and Telegraph during the past year issued debentures to the extent of $1.6 billion with warrants attached. These credit transactions are indeed an important part of our financial world.

The sale and leaseback likewise is a recognized and well-established method of financing of long standing.

The advantage of the sale and leaseback to the landowner is that it gives him the maximum capital in the initial stages of his enterprise. In the sale and leaseback a loan is generally made for the construction of the building. The land is conveyed to the lender in consideration of the payment of a sum of money. So in addition to the financing of the construction, there also is the purchase of the land which adds to the capital stability of the borrower.

In this case similarly there is no control by the borrower. The lease is a straight leaseback for a period of years, depending upon the business factors that are within the consideration of the borrower. The borrower is in complete control of his property.

The fourth type of transaction which would be outlawed by the broad sweeping language of section 14 would include joint ventures. The Columbia project which has been mentioned this morning, and which one of our witnesses, Mr. Hayden, has been very instrumental in organizing, represents a joint venture in the true sense today. A joint venture is nothing more than a partnership to provide for putting together a real estate operation.

In the typical case a developer comes to a lender with an option on land, with a plan, and without the capital necessary to develop the property. They decide on the basis of commercial negotiation to establish a partnership, and to build an enterprise that will provide

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either housing, shopping center facilities, or office facilities—in the case of Columbia, a city by 1980 of over 100,000. We all know that we could well use several hundred new cities of this type in our country today.

Finally, I wish to discuss the income participation which we have heard mentioned here this morning. There are many forms it can take, but typically it takes the form of a lower rate of interest at the going-in period, with a provision for sharing in the gross or net rentals in the event that they exceed the projections. This, of course, is designed to offset the impact of inflation.

Now, the percentage that is provided for generally runs anywhere from 2 to 20 percent, depending on whether the base is gross or net revenue. When this is worked out it really, over the lifetime of the loan, amounts to an additional one-half to 1 percent return on the investment. So the actual gross amount that is provided is a very deceptive factor. What it really does amount to is a reduction in the present rate of interest collected, and an increase in the later rate of interest, if inflation results in increasing the gross income of the project.

It does not require that this income participation be added to the rents. It does not require that the developer or the owner or the manager of the operation increase rents. It merely provides that if the rents are increased, then the lender shares in the windfall that the developer has received in borrowing money at a lower interest rate than would probably be the result in a different type of market without this vehicle.

I emphasize the fact that all of these except the income participation have for many years been all important to the operation of our financial system in the United States. In terms of the businesses involved, all businesses need both equity and debt capital. And one of the characteristics of the real estate industry is that it is grossly undercapitalized.

The fact is that through these credit transactions we can provide the needed credit at the lowest possible interest rate. They are used in a competitive situation. They are used with business and commercial borrowers. And they all represent an arm's length transaction between these parties.

The comment has been made that we went out of the housing market the individual housing market because of the ability to get income participations. The fact is that most of our companies began to move out of the individual housing market in the 1950's. This was partly a function of changing levels of interest. And it was also partly a recognition of the fact that the servicing function of thousands of individual housing mortgages was very difficult for a company that was remotely situated. In our own company we had over 68,000 mortgages that averaged $11,000 apiece. We had 144 mortgage managers throughout the United States that serviced these mortgage loans. The servicing costs were very high. We felt that as a matter of real service to the borrower it was a much healthier situation for the individual to borrow from his local lending institution, the savings and loan or the banking institution where he had a total credit relationship and where they had their local appraisal and where they could look out for the interests of the individuals. We felt that we could produce the most significant contribution to the needs of our country through

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providing multiple housing units and through providing commercial money for the development of our economy. And so many of our companies as a matter of practice have already gone out of the individual housing market.

I mentioned that the Life Insurance Industry began to move out of the single-family home finance field in the early 1950's which, of course, was long before equity participations became a matter of common practice. A number of our companies have reported that their move out of this field was only semi-voluntary. As one institution put it, "We didn't withdraw from the field of single-family home financing—we were chased out. Beginning in 1953, we found instance after instance around the country wherein local financial institutions competing with us for residential mortgages could beat us six ways: local institutions were allowed by law to make a larger loan, for a longer term; they would make it at a lower rate of interest and grant the borrower considerably faster service and the cost to the borrower of getting the loan was materially less than we had to charge. We came to the conclusion that in anything like a normal market, the out of town life insurance company was at a marked disadvantage in competing for this single-family loan business—in fact, we couldn't compete. As a result, we abandoned to the local financing institutions, a field in which they could serve the public better than we could, in order to concentrate on the larger commercial loan field where, in most instances, we could serve better than they could."

We also found in 1966, with the rapid rise in inflation, and the rapid rise in interest rates, that our liquidity needs were much greater than we had anticipated, largely because policyholders were borrowing on their policies at a 5 percent rate. This resulted in a very heavy cash flow out of our companies.

We found that we needed a new degree of liquidity. We also found that we were being buffeted a bit by inflation, because the effect of inflation has been to raise the level of interest rates. The fixed income mortgages and bonds which we had bought that were providing for an interest rate of two and a half to three and a half percent could only be sold at a loss. We could not liquidate our bonds, and we could not sell our mortgages. In order to provide this liquidity it was necessary to look to other investment vehicles.

We did find that we could sell our common stock at a gain. And this was one of the factors that directed our own company into looking at equity positions and providing for some method of protecting our policyholders against the excessive impact of inflation.

The CHAIRMAN. Mr. Fey, so that we can get through in a reasonable time and allow the members an opportunity to interrogate you gentlemen, I suggest that you shorten your statement. We will have one other witness, Mr. Hamilton for about 10 minutes. But if there is anything lacking in your testimony, we want you to put it in, because we want you to present your case from your viewpoint the very best way possible.

Mr. FEY. May I complete this part of the equity participation, and later cover the interlocking directorate. I would like to say just a few words about that.

The CHAIRMAN. Go right ahead, sir.

Mr. FEY. I think of most importance is the fact that the effect of

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eliminating the right to use these types of credit transactions would be, No. 1, that it would disrupt the flow of capital into housing and shopping centers and offices, and it would be contrary to the best interest as expressed by Congress in the Housing Act of 1968 and the Housing and Urban Redevelopment Act of 1970.

Second, it will divert many of these borrowers to the real estate investment syndicates. It will operate to the disadvantage primarily of the small investor.

Third, it will have an adverse impact on our security markets.

And fourth, it will result in a higher interest rate on our fixed income investmeuts.

And now, if I may, I would just like to say a few words about the interlocking directorates, because this is a very important factor to our industry. It is really like a second subject. It has not been covered here this morning, and I would like to have an opportunity to cover it if I may, Mr. Chairman.

The CHAIRMAN. You may do so, of course you are taking the time away from someone else. But go ahead.

Mr. FEY. If I could just have about 5 minutes I think I could cover it.

The CHAIRMAN. Is there objection?

The Chair hears none. You may proceed for 5 minutes.

Mr. FEY. There has been reference to the fact that income participation will result in taking a greater risk than normal, that perhaps we are taking steps that are not in the interest of the security of our portfolios.

I would like to say here and now that the life insurance industry is one of the most heavily regulated industries in the United States. If you do business in several States, the life insurance companies investment program is subject to the examination of each one of those States. We are periodically examined by the insurance examiners from all of the States in this country, or by their representatives. They do look at each one of our investments in terms of the type of security which we have received in return for the investment.

Also—and this gets to the point of the interlocking directorates—the financial practices and policies of our companies are reviewed by our directors. One of the most important functions of a director of a life insurance company is to safeguard the interest of the policyholders and to review the financial operation of our investment departments, and to formulate a policy that will provide security, and a reasonable rate of return to the investor, and also the desired or necessary liquidity to carry out the interest or the payments that are being made under the life insurance contracts and the annuity contracts.

There are six sections under the interlocking directorates provisions of H.R. 5700 which are of concern to the life insurance business. I will skip over the ones that deal with the blanket prohibition. All I can say about them is that they would destroy and upset the total operation of our boards of directors. All of our boards of directors depend upon the wide counsel and views of individuals with a financial background and, thus, who may happen to be directors on a bank board. In our own company, out of eight directors who are members of bank boards—there are 14 directors in total—there is only one who is a bank officer. He is an officer of a savings bank.

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This independent overview and backup is very important. We depend upon the competency of our management. But we also depend upon the safeguarding of our decisions and the overview of our fiduciary relationship that is exercised by these outside directors.

We oppose section 7, which prohibits an interlock where a financial institution manages a pension plan or a welfare fund.

We have had some difficulty in finding the reasoning for this, because in the vast majority of our cases pension funds and profitsharing plans are pooled in our reserves or in our separate accounts. And in order for there to be any collusion or management in favor of the second company it would be necessary to have these accounts segregated, in fact they are not segregated.

But even aside from that, if there are some abuses, there certainly is no need for this flat prohibition to have interlocking directors. We have State examiners who examine these transactions each time that they examine the company. And certainly we have the Federal fiduciary standards approach. I understand H.R. 1269, the Dent bill, is now before the Committee on Education and Labor. If the committee should desire to review the fiduciary standards in this respect, this would certainly seem to be a more direct approach to handling a few abuses that may appear in this area. But certainly in the case of a life insurance company there is little or no opportunity for abuse, because of all of the other safeguards that are provided in the case of the management of the pension funds.

In the case of 5-percent ownership of a corporation, interlocks are also prohibited under section 8 of the bill.

I would like to suggest to the committee a very important point. This provision would rule out our legitimate subsidiaries. Many of our life insurance companies have subsidiary and holding companies under State laws just as the banks have holding company situations under the act of 1956. And so I ask at least the same exemption as the bill grants to banks for their holding companies.

But quite aside from that, there certainly can be no control danger because, number one, in most of our States there is a limit on the percentage of our assets that may be invested in any one company other than a subsidiary. In our own case in Vermont and in New York, which we comply with, it is 1 percent of out total assets. We may not under those same laws hold more than 5 percent of the outstanding stock of any company. So we already have the necessary safeguards as far as the States are concerned.

Finally, with respect to the prohibitions where a continuing financial relationship exists as provided in section 9, we feel that this would be very unfair in the case of lines of credit. A line of credit is a very standard transaction, it is usually based on the prime rate. Insurance companies, incidentally, are not normally borrowers. They borrow occasionally on a line of credit to smooth out their cash flow. The fact is that a line of credit is subject to continuing scrutiny. There is very little likelihood of one single director being able to influence this in the first place, but in the second place, it certainly is subject to objective review as to whether it is fair or not. So at the very least we ask that this be stricken out.

And finally, since many of us are broker-dealers dealing in variable annuities, which is part of our pension trust business, we would say

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that any reference to broker-dealer, or any reference to services performed in appraising or closing a loan, should not result in the insurance companies being included in this prohibition on interlocking directors.

I know I have talked too long, Mr. Chairman. But I do appreciate your courtesy.

The CHAIRMAN. Thank you very much.

(The prepared statement of Mr. Fey follows:)

PREPARED STATEMENT OF JOHN T. FEY, PRESIDENT, NATIONAL LIFE INSURANCE CO., ON BEHALF OF THE AMERICAN LIFE CONVENTION AND THE LIFE INSURANCE ASSOCIATION OF AMERICA

Mr. Chairman, my name is John T. Fey, and I am President of the National Life Insurance Company, located in Montpelier, Vermont. I am accompanied by Bruce P. Hayden, Vice President of the Connecticut General Life Insurance Company, located in Hartford, Connecticut, and Thomas F. Murray, Senior Vice President and Chief Investment Office of the Equitable Life Assurance Society of the United States, located in New York. We are appearing on behalf of the American Life Convention and the Life Insurance Association of America. These two associations have an aggregate membership of 360 United States and Canadian companies, accounting for about 91 percent of the total life insurance in force in the United States.

We appreciate this opportunity to comment on H,R. 5700. My statement will be directed to two aspects of this bill which would have a serious adverse impact on life insurance companies: (1) those provisions relating to prohibited directors, and (2) the provision prohibiting equity participations in connection with loans.

PROVISIONS RELATING TO PROHIBITED DIRECTORS

H.R. 5700 contains a variety of provisions imposing restrictions on the composition of an insurance company's board of directors and on the ability of a director, officer or employee of an insurance company to serve on the board of directors of other corporations. These provisions, if enacted, would require wide-sweeping changes in boards of directors—to the detriment of the insurance companies and their policyholders—through a series of broad prohibitions which in our opinion go far beyond any demonstrable need.

I would now like to address myself to specific provisions of H.R. 5700.

1. *General prohibition againet interlocking directors among financial institutions (sections 2, 3, and 4 of the bill)*.—These provisions would flatly prohibit any individual who is a director, trustee, officer or employee of a commercial bank, a mutual savings bank or a savings and loan association from serving on the board of directors of any other financial institution—which is defined for this purpose to include insurance companies. This prohibition would apply not only where the individual involved is an officer or employee of the bank or sayings and loan association, but also where he is engaged in some completely unrelated field and merely serves on the board of directors of the bank. Enactment of these provisions would have serious and unreasonable implications for the life insurance business.

Since one of the most important functions of a life insurance company is the investment of the funds underlying its commitments to policyholders, it is essential that the company and its policyholders have, through its board of directors, the counsel and judgment of men of broad experience in the field of business and finance. Moreover, in order to obtain this board experience and overview, it is necessary for a company to reach beyond its own management in selecting its directors.

The question then is simply one of where an insurance company can find individuals outside of its own employees with the prerequisite financial and business background. A logical—if not the most logical—source is persons with a broad banking background. They understand the meaning of maintenance of reserves and liquidity. They have experience with the problems of financial standing, credit worthiness, and credit risks in lending activities. They have knowledge of real estate values. They are accustomed to assuming and exercising fiduciary responsibilities in accordance with the same high standards of probity and integrity that are called for in reaching overall policy decisions concerning the investment of reserve funds in behalf of millions of life insurance policyholders.

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The Chairman of the Federal Reserve Board, Dr. Arthur Burns, has clearly spelled out the advantages individuals with banking experience bring to a board of directors. In his letter to Chairman Patman, dated December 16, 1970, he recognized that interlocking relationships may in some instances impair competition between firms in the same line of business. However, he concluded that such relationships should be prohibited only where there is a real risk of abuse and that a case had not been made for flatly prohibiting interlocks between banks and nondepository institutions. In this regard, he stated:

> On the other hand, economic benefits flow from a high standard of performance by corporate boards of directors. This entails a free interchange of advice, ideas, and experiences among directors of varied backgrounds. Bankers often often have experience and expertise that qualify them to render valuable service in this role. Interlocking directorates, in other words, are not inherently wrong. They may be good for the corporations involved and the public they serve. The problem is to define those situations where the risk of abuse outweighs the expectation of benefit.

Thus, we believe that the skills, experience, and knowledge of individuals with banking experience are necessary to complement the skills of other directors—common examples of which include university presidents, businessmen, economists, and lawyers—so as to produce a well-rounded board of directors who are able to offer the insurance company and its policyholders the breadth and depth of leadership which are required for the successful operation of the company. It is believed that the inclusion of such individuals on an insurance company's board of directors could in particular instances result in undesirable practices, the proper solution is not to enact sweeping legislation outlawing the use of bankers in general, but rather, as Dr. Burns indicates, to define the particular situations where there is a real risk of abuse and deal with them on that basis.

This, however, is not the approach taken by H.R. 5700. Instead, this bill would flatly prohibit an individual who is a director, trustee, officer or employee of a bank from serving on the board of directors of any instance company. The prohibition would apply without any necessity for the showing of wrongdoing and, for that matter, without regard even to any potential for wrongdoing. This would be truly a novel and undesirable step. We know of no existing antitrust law which so broadly proscribes a relationship between corporations or individuals.

Actually, in the usual situation covered by the bill, there is not even a potential for abuse since the mere fact that an individual is one of a number of directors—typically, a rather large number—of an insurance company will by no means give him control over the actions of that company. Without this control, he cannot effect any of the anticompetitive arrangements or agreements at which the bill is apparently aimed.

As already indicated, the breadth of the prohibition is unlimited. It would, for example, prohibit outstanding industrialists, educators, or others of prominence from serving on an insurance company's board of directors merely because they also happen to have been selected as a director by a bank. Moreover, the prohibition would apply where the bank and insurance company are clearly not even serving the same geographical area, as, for example, where an insurance company located on the Eastern seaboard has a director who is also a director of a bank located on the West Coast. These examples clearly illustrate the arbitrary nature of the proposed prohibition.

In conclusion, we strongly believe that the present ability of life insurance companies to draw on the financial expertise of men familiar with the banking business through having such men on their boards of directors is of substantial value to the companies, their shareholders, and their policyholders. This widely accepted business practice should not be proscribed unless abuse can be proven and existing remedies are demonstrably inadequate. Neither condition has been met. Moreover, we believe that the same principles should apply with respect to interrelationships between insurance companies and savings and loan associations and mutual savings banks. Thus, we strongly urge that H.R. 5700 be amended by deleting the words "any insurance company" now found in sections 2, 3 and 4.

2. *Prohibition against interlocking directors where financial institution "manages" a pension of welfare plan for the other corporation (section 7 of the bill).*—This provision would prohibit an individual who is a director, trustee, officer or employee of a financial institution (defined to include an insurance company) from serving on the board of directors of any corporation for which such institution "manages" an employee welfare or pension benefit plan.

It is not clear from the bill or background statements what is meant by the

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term "manages". However, it appears that the prohibition is directed at the possibility that, through an interlocking relationship, the corporate employer and the financial institution may use the funds in the welfare or pension plan for the benefit of the corporation rather than invest them for the benefit of the employee beneficiaries. For this possibility even to exist, it is necessary that the funds for the particular plan be kept segregated. This, of course, is not the case with the usual type of insured plan where the funds are commingled with other assets of the insurance company so that no particular asset can be traced to any specific plan. Thus, at a minimum, section 7 should be amended to make clear that it does not prohibit an interlocking relationship between an insurance company and another corporation merely because the second corporation has a welfare or pension benefit plan which is wholly or partly funded through insurance contracts under which the premiums are commingled and invested along with other assets of the insurance company.

However, we would not stop at this point but further urge that the prohibition be completely deleted as it relates to insurance companies. As is the case with the other provisions of H.R. 5700 relating to interlocks, section 7 would flatly prohibit interlocking relationships which otherwise may serve a valid business purpose solely because it is thought that they could in particular instances lead to possible wrongdoing. In fact, even this possibility is extremely remote in the case of insurance companies because of the strict fiduciary standards to which they are held by the state authorities.

If any action is considered necessary in this area, it should be along the lines of imposing federal fiduciary standards where appropriate as would be done under legislation which is presently before the House Committee on Education and Labor. Under his approach, specific practices can be prohibited and effective remedies can be made available when abuses actually occur. This is clearly a more effective and equitable way to approach the problem than is the sweeping and tangential approach taken in section 7 of H.R. 5700.

3. *Prohibition against interlocking directors where there is more than 5 percent stock ownership (section 8 of the bill).*—Under this provision, a director, trustee, officer or employee of a financial institution (defined to include an insurance company) would be prohibited from serving as an officer or director of any other corporation which the financial institution owns, and has power to vote, more than 5 percent of the stock.

As currently drafted, this provision would not apply to prohibit interlocking relationships between companies within a bank or savings and loan holding company group. We assume that the Committee would be willing to provide a similar exemption for insurance holding company groups or insurance companies and their subsidiaries, which are permitted and regulated by state law. We would be happy to submit language to accomplish this purpose.

However, turning to the prohibition as a whole, we have extreme difficulty in understanding the basic purpose of the provision especially in view of the existing laws in this area. Apparently there is some feeling that an insurance company can gain control of another corporation through a combination of stock ownership and an interlocking director relationship where such control would not occur if only one or the other existed. Additionally, one must also assume that this control—if, indeed, it exists—is inherently bad.

We believe the basic premise is wrong. As I have already indicated, the fact that a corporation has one of its directors or even an officer or employee on the board of directors of another corporation certainly does not automatically give it control over the other corporation. The interlocking director will be only one of a number of directors—frequently a large number. In this capacity, he certainly cannot direct the affairs of the other corporation. In fact, under the apparent theory of the bill, each of 5 or 10, or even as many as 19, different companies, each in an entirely unrelated line of business, could be assumed to have control of a single corporation. Such an assumption is clearly illogical.

The premise underlying H.R. 5700 is also inconsistent with the pattern of state regulation of life insurance companies. One of the prime responsibilities of state regulation is to insure that insurance companies invest their funds in a manner which will provide maximum safety and return for their policyholders and not for some other purpose such as gaining control over a wide variety of businesses. To enforce this standard, the states provide two types of limitations: first, most of the states restrict the percentage of an insurance company's assets which may be invested in any one corporation, and, second, many of the states restrict the percentage of any one corporation's stock which may be owned by an insurance

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company. These limitations do not vary depending on the presence of an interlocking director situation. The states have had a long and successful history of regulation in the insurance company area and the fact that they do not consider an interlocking director relationship to be of importance in applying their investment standards would seem particularly significant.

It is true that there are cases where an insurance company may wish to acquire control of another corporation either as a subsidiary or as a part of a holding company system. In these situations, there is comprehensive state regulation designed to protect the interests of policyholders and to assure that all transactions between the insurance company and its subsidiaries are fair and reasonable.

In summary, it seems clear, as a practical matter, that the basic premise of section 8 is wrong to the degree that it assumes that the addition of an interlocking director relationship to a stock interest will automatically give a company control over the other corporation. Even if there are isolated cases where such control might evolve, the prohibition of section 8 would extend far beyond them. It would strike down all situations in order to reach the rare case. This is not sound legislative policy.

It appears that another purported abuse at which the prohibition in section 8 is aimed is the possibility that the interlocking director will take advantage of his position to obtain insider information which will then be used by his company in making its investment decisions relating to the stock it holds in the other corporation.

The federal securities laws provide clear and adequate remedies in the case of a director who misuses his position in this manner. There are three general antifraud provisions operative in this area—section 17(a) of the Securities Act of 1933, Rule 10b–5 promulgated under section 10(b) of the Securities Exchange Act of 1934, and section 15(c)(1) of the Exchange Act—which provide the basis for administrative, civil or criminal action against directors who take advantage of inside information for their own benefit or for the benefit of their companies.[1]

4. *Prohibition against interlocking directors where continuing financial relationship exists (section 9).*—Under this provision, a corporation would be prohibited from including on its board of directors an individual who is a director, trustee, officer or employee of a commercial bank, a mutual savings bank, or a savings and loan association if such corporation has a "substantial and continuing relationship" with that bank or savings and loan association with respect to the making of "loans, discounts, or extensions of credit".

While insurance companies do not generally borrow money—but, in fact, are in the business of lending money—there are situations where an insurance company finds it necessary to utilize a line of credit with a bank in order to even out its cash flow. These lines of credit arrangements generally permit the insurance company to borrow up to a specified amount at any time with the interest rate geared to the prime rate prevailing at the time a particular loan is made. The loan is generally paid off in a matter of weeks or months—six months is the longest period we know of in the case of insurance companies.

It would appear that the literal language of section 9 of H.R. 5700 might encompass an insurance company which has such a line of credit. As is the case with the general prohibition of interlocking directors between banks and insurance companies contained in earlier sections of the bill, we believe this prohibition is unwarranted and would unduly restrict insurance companies in obtaining qualified directors from the financial community. I have, in a preceding section of my statement, outlined the reasons why it is highly desirable that an insurance company have available to it the financial advice of indiviudals with a banking background.

Apparently, the sponsors of H.R. 5700 feel that an interlocking relationship with a bank might lead to conflicts of interest and a lack of arm's length dealing with respect to the business relationships between the bank and the insurance company. We do not believe that any such potential exists in reality, especially in the context of the typical line of credit arrangements between banks and insurance companies. First, such a line of credit is a standard transaction with comparatively little that could be manipulated, even if there were a disposition to do so. The interest rate generally fluctuates in relation to the prime rate, the terms of the loans are short, and the details of the arrangement are standard. Moreover, even

[1] These provisions are discussed extensively by Professor Louis Loss in his book on *Securities Regulation* (see, in particular, second edition [and supplement], Vol. 3, Chapter 9).

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if there were a potential for abuse, the mere fact that an officer or director of one of the corporations is on the board of directors of the other will not provide an opportunity for that individual to effect the abuse. As I have already indicated, such an individual will be only one of a large number of directors with the result that he will by no means have control over the actions of the corporation.

For these reasons, we strongly urge that section 9 of H.R. 5700 be amended to delete insurance companies from its prohibitions or, at a minimum, to make clear that a line of credit is not the type of relationship which will trigger these prohibitions.

5. *Insurance companies registered as broker-dealers.*—Most of the provisions on interlocking directors which I have discussed (sections 2, 3, 4, 7 and 8) apply separately to "any broker or dealer registered under the Securities Exchanges Act of 1934".

There are situations where a life insurance company, although it is engaged only in the insurance business, is required to register as a broker-dealer and, thus, would technically be classified both as an insurance company and as a broker-dealer under the existing language of H.R. 5700. This will occur when the company sells variable annuity contracts which are, in essence, contracts providing for payments which will vary to reflect the investment results of assets held in a separate account. These contracts have been held by the Securities and Exchange Commission to constitute securities with the result that the company is required to register as a broker-dealer in order to sell them.

Nevertheless, these variable annuity contracts represent a natural extension of the business of life insurance companies. They are, for purposes of state law, insurance contracts and are regulated as such. Thus, the fact that the insurance company is required to register as a broker-dealer in order to sell them should not affect the treatment such company is afforded under H.R. 5700. In other words, if, as we have urged, life insurance companies are excluded from the prohibitions of H.R. 5700, it should be made clear that the exclusion applies even though the company is registered as a broker-dealer. Also, of course, the exclusion should apply in the same manner to a subsidiary engaged solely in the distribution of the insurance company's variable contracts. More specifically, if any references to broker-dealers are retained in the bill, the descriptive language should be amended to read: "any broker or dealer (other than an insurance company, or a subsidiary thereof engaged solely in the distribution of variable contracts issued by the parent company) registered under the Securities Exchange Act of 1934".

Along similar lines, any exclusions provided for insurance companies should not be nullified merely because a company participates in the closing of real estate loans made by it or by a real estate investment trust established by it. Unless amended, this might be the result under sections 2, 3, and 4 of the bill which prohibit interlocking relationships between a bank or savings and loan association and a company which provides service in connection with the closing of real estate transactions. Clearly the fact that an insurance company participates in the closing of its own loans (or loans made by its real estate investment trust) should have no bearing on whether it may have an interlocking relationship with a bank. Thus, these provisions of sections 2, 3, and 4 should be amended to exclude insurance companies.

This completes my comments on the provisions of H.R. 5700 relating to interlocking relationships. In short, these sweeping prohibitions would cause a wholesale disruption of the boards of directors of a large number of life insurance companies. And this would be done not on the basis of proof that the individual directors have done anything wrong or are likely to do something wrong, but solely on the basis of conjecture that they might do something wrong. In our opinion, this is an unsound approach.

PROVISION PROHIBITING EQUITY PARTICIPATIONS

Section 14 of the bill would prohibit commercial banks, savings banks, savings and loan associations or insurance companies from accepting "any equity participation in consideration of the making of any loan". Equity participation is defined in the bill as an ownership interest in any property or enterprise, or a right to payment which is proportionate to or contingent upon net or gross income from any property or enterprise, including a share in the earnings of the borrower, or warrants to purchase the stock of the borrower, or shadow warrants based on changes in the market price of the borrower's stock.

These broad prohibitions would rule out a wide range of established techniques

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for raising capital in the corporate bond market and in the mortgage market for apartment houses, shopping centers, office buildings, and other commercial structures. We are opposed to this legislation on the grounds that it would (1) seriously disrupt essential flows of private capital in traditional and desirable channels; (2) hamper business financing, especially for new ventures and expanding firms; and (3) adversely affect the development of real estate projects, including multifamily housing, by constricting the availability of funds.

Motivations toward equity markets

There are many reasons why the investing public has been attracted to equity markets over the past 20 years. It has been widely recognized that the increase of population, the rise in productivity, and the expansion of the gross national product is accompanied by similar growth over the long term in the dollar earnings of business enterprise. In a dynamic economy, investors quite naturally seek to share in that growth through the direct purchase of common stock.

An added stimulus toward equities has come from prolonged high rates of inflation, particularly over the past three or four years. In an inflationary environment, investors are impelled toward those outlets with a prospective growth in dollar return, such as common stock, convertible bonds, or real estate. Conversely, investments with a fixed-interest return and repayable in fixed-dollar amounts, such as non-convertible bonds and straight mortgage loans, tend to lose much of their attraction. At a 5 percent annual inflation rate, price levels would more than double in 15 years; the real value of a fixed-dollar bond or mortgage loan would be cut in half over that period. In contrast, equity investments hold out the potential of keeping pace with general price trends as business earnings and land values rise in dollar terms along with the economy

One response to the inflation factor has been a sharp rise in interest rates on borrowed money. Borrowers are willing to pay the higher rates to beat tomorrow's higher prices, while investors require higher rates to offset the loss of real value from inflation. Another response has been to shift increasingly toward various forms of equity with a dollar growth potential, including common stock, convertible bonds, bonds with warrants, real estate, and mortgage loans with variable income provisions beyond the traditional fixed interest rate.

These responses reflect far more than the portfolio practices of institutional investors; they originate in a shift in financial preferences by the public at large. For example, we in the life insurance business have responded to changing public preferences over the past several years with the development and marketing of variable annuities and mutual funds that provide a return based largely on the performance of equity investments. We are now in the process of developing variable life insurance which will also enable beneficiaries to share in the growth of investment dollars through insurance coverage that can rise above a fixed-dollar minimum.

As a result of the greater emphasis on equities, both in our insurance products and our investment portfolios, the net purchases of common stock by life insurance companies have risen substantially during the past decade. In the years 1968–70, for example, net purchases of common stock by life companies averaged $1.7 billion per year, compared with about $200 million per year during the period 1961–63. In addition, many of the corporate bond holdings of life insurance companies are convertible into common stock or carry warrants to purchase stock, reflecting more active purchase of such bonds in the past few years. We believe this is a sound financial practice in the best interests of our policyholders and stockholders, responsive not only to the effects of inflation on operating expenses in our companies but also to the desire to share in the long-term growth and expansion of our economy.

Funds invested by life insurance companies primarily represent the accumulated savings of millions of small policyholders and annuitants. It is our responsibility, in the interests of these families, to invest these savings at the most attractive return available, consistent with safety of the invested funds. Investment return is a key factor in the net cost of life insurance for these families. Inflation poses a threat to the financial position of our policyholders and our search for inflation hedges in investment operations is to their benefit.

Investment earnings also have a direct impact on pension plans which we administer for millions of business employees. One rule of thumb is that a ¼ percentage point increase in investment return will produce a 5 to 6 percent increase in benefits or reduction in pension costs. It should be clear that the long-term return on investments is of great concern to all types of investing institutions

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EFFECTS OF H.R. 5700 ON THE SECURITIES MARKETS

In the corporate bond market, the purchase of convertible bonds would appear to be ruled out by section 14 of the proposed legislation. For a business corporation, the sale of common stock and the issuance of bonds are two major forms of raising needed long-term capital. Convertible bonds represent a hybrid security combining elements of both debt and equity financing in a single instrument. The typical procedure is to issue long-term bonds with a provision for conversion of a prescribed number of bonds into a specified number of common shares of the borrowing corporation after a certain date, perhaps 3 or 5 years later. Because of the conversion feature, the coupon rate or interest cost on the bond issue is usually substantially below the rate for a straight bond issue, thus reducing the debt service charges to the borrowing corporation. The attraction for the lender lies in the potential of sharing in the earnings growth of the corporation at some later date, after the borrowed funds have generated additional earnings which lift the price of the common stock to higher levels. The use of convertible bonds is particularly helpful to a business which is expanding rapidly but lacks an adequate earnings record to support the current sale of common stock at economical prices. This technique also provides a method for the borrower to increase his equity capital base when later conversion takes place, thereby maintaining a balance between debt and equity in his financial structure.

Convertible bonds have been a standard technique in bond market financing throughout the twentieth century. In the 1967–69 period, almost $12 billion of convertible bonds were sold, representing about 20 percent of all corporate bond offerings during those three years. To prohibit this form of financing would limit the ability of business corporations to borrow at lower interest costs and to provide for the orderly enlargement of their equity capital base as their business expands over future years.

The use of stock purchase warrants attached to bonds is generally similar to convertible bonds and also dates back more than fifty years. However, the arrangement takes a somewhat different form. A warrant represents the right to purchase for cash at some future date a certain number of common shares of the borrowing corporation. When warrants are attached to bonds, the investor does not turn in his bonds but instead can exercise the right to acquire common stock at a price fixed in advance, assuming that the appreciation in market price makes this attractive. From the investor's point of view, the debt capital he has provided makes possible a new venture or expanded operations which will generate higher earnings and hopefully a rising stock market price some years hence.

From the borrower's standpoint, the sale of bonds with warrants provides long term debt capital which is much less expensive to him than financing a new venture through the immediate sale of common stock to the investing public. As his business grows and earnings rise, the exercise of warrants brings a new infusion of cash through the issuance of stock which enlarges his equity base and also his further capacity to borrow. This technique is especially useful to a small- or medium-sized business firm which may be in a poor position to raise equity capital but can plan to sell common stock to the warrant holders after the original infusion of debt capital has enlarged its operations and its earnings base. Stock purchase warrants have also been used by larger corporations, as in the case of AT&T when it sold $1.6 billion of 8¾ percent debentures to the investing public one year ago, with warrants to purchase AT&T stock at $52 per share.

For a business corporation, both debt and equity financing are necessary to a balanced financial structure. From the standpoint of investors such as life insurance companies, purchase of both corporate stock and corporate bonds has long been accepted as a legal and judicious form of investment. Thus, it is difficult to understand why a stone wall should be built between debt and equity financing and thus impair the ability of expanding business firms to obtain new capital in a time-tested fashion.

EQUITY PARTICIPATIONS IN REAL ESTATE AND MORTGAGE LENDING

A fairly recent development in mortgage and real estate financing has been the emergence of financial arrangements which provide additional income to the investor, either by participation in real estate project revenues or by capital appreciation from direct equity positions acquired by the investor. Such techniques have been utilized in the financing of income-producing properties such as office buildings, apartment houses, shopping centers, hotels, and commercial developments. The desire to hedge against inflation, through investments which

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can yield a growing dollar return, has been a primary incentive in the development of financial techniques often referred to as "equity participations." Because of the complexities of the real estate market, and the wide variety of income properties being developed, there have been a great many variations in the techniques used to provide additional income or potential capital gains for investors engaged in real estate financing. However, the following are the major forms that would seem to be affected by section 14 of the proposed legislation:

1. Mortgage loans which provide that the lender may receive "contingent interest" in addition to the fixed interest rate, depending on the revenues generated by the project being financed.
2. Land purchase and leaseback by an investor who also provides a mortgage loan against the security of the building.
3. Joint ventures between developer-borrowers and mortgage lenders who provide substantial equity capital in a real estate project in addition to long-term mortgage financing.

Within each of these categories, there has been much diversity of details in the agreements between borrowers and lenders, depending on the requirements of each party and the characteristics of particular projects. Each of these broad approaches will be described in turn, emphasizing the positions of borrowers and lenders in the transaction.

1. CONTINGENT INTEREST ON MORTGAGE LOANS

In a contingent interest arrangement, the lender looks to a return on his investment in two distinct forms: (1) a fixed interest rate on the amount borrowed and (2) additional or contingent income based on the earnings performance of the project being financed. As set forth in the loan agreement, contingent interest may be calculated as a percentage of gross rental income from the project, or a percentage (usually smaller) of net income after expenses and taxes. In some instances, the borrower is not required to pay contingent interest until revenues from the property rise above a predetermined dollar base related to the projected rate of occupancy and the expected scale of rent payments. Moreover, the contingent interest payment is not the entire amount above the agreed base, but only a predetermined percentage of any overage, usually 10 or 15 percent.

As an example, take the case of a $1 million loan to finance a proposed three-story office building in a newly developed area. The developer, working out his plans with the lender, might project his gross rents, at $5.75 a square foot, to $285,000 a year. The loan agreement might provide that 15 percent of any rents collected over this $285,000 base would be paid to the lender each year as contingent interest, beyond the fixed interest rate on the mortgage, but in no event to exceed maximum legal limits. If the office building enjoys unusual success, or if inflation raises the whole rental structure to produce higher gross income, the lender receives a 15 percent share of that overage as added compensation for the fact that his funds made the project possible.

It is important to recognize that in such a case contingent interest does not place a burden on the property or the developer until such time as justified by the higher revenues from the project. From the borrower's standpoint, contingent interest is more desirable than a higher fixed interest rate. When interest rates on bonds and mortgages moved sharply upward in 1968, 1969, and early 1970, many planned real estate projects became infeasible at the going market rates because of heavier debt service resulting from higher fixed rates. In this situation, many lenders and developers turned to contingent interest arrangements in which the fixed rate was held to a level that would allow the borrower's debt service costs to be covered by projected revenues. For their part, lenders could receive a competitive rate of return from the combination of a fixed rate of interest plus contingent interest payments tied to the growth of project revenues. Thus, both the developer and the lender could overcome inflationary pressures and financial stringency in an economically productive endeavor.

The widening use of contingent interest features on mortgage loans has been closely associated with continued inflation and the rise in market interest rates during the 1968–70 period. With investible funds in short supply, lenders have given preference to those projects offering the most favorable terms and the highest long-term yield consistent with adequate safety of the principal invested. Contingent interest has become one of the many terms of negotiation in long-term financing, along with such items as loan maturity, loan-value ratio, repayment provisions, and contract interest rates. In the main, the developments being

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financed are of substantial size, ranging upward from one million to several millions of dollars, and often involving major business corporations or large development firms. Borrowers and lenders in these negotiations are sophisticated professionals who are acquainted with money market matters and financial contracts, with access to a wide number of lenders. Contingent interest techniques have been applied to income-producing business properties but not, of course, to single-family mortgages for individual homeowners.

Over the years, inflationary forces appear likely to bring rising rental scales on business and apartment properties, in addition to the pressures from a growing population and expanding business. The project owners are in a position to obtain an inflation hedge from tenants, through tax and expense escalation clauses, or renegotiation of short-term leases. It would be inequitable to deny an inflation hedge to the lender while permitting the owner-borrower to pass inflated costs on to his tenants and still repay the lender with depreciated dollars.

It is important to recognize that contingent interest features on income-property mortgages do not involve ownership or control by the lending institution, since it has no voice in the management of the property, nor does it receive common stock or voting rights in the development corporation. Thus, it is inaccurate to describe this arrangement as an "equity" participation, since the lender does not obtain an equity position in the property, either during or after the life of the loan. In fact, the lender's claim to income participation comes to an end whenever the loan is paid off. The lender merely has a contingent right to additional income beyond the fixed interest rate, which may improve the overall return by perhaps ½ percent or 1 percent above the contract rate over the 10- to 15-year life of the loan, if the project achieves a success beyond normal expectations.

It is interesting to consider what would have happened in the real estate field if the provisions of section 14 had been in effect during the past three years. Within a life insurance company, the mortgage loan department must compete against the bond department and the common stock department in the allocation of available investment funds, depending on the relative attraction of the expected rate of return. If real estate financing had been confined to straight mortgage loans without contingent interest or variable income features, investment funds would have flowed into other outlets which can offer an inflation hedge. More funds would have been channeled toward common stock or direct ownership of real estate, to the detriment of developers seeking funds for construction of apartment dwellings, shopping centers, and other commercial properties. In actual practice, the emergence of participation features which retain the competitive edge of mortgage loans against other investment has helped to sustain the flow of credit available to real estate developers. More housing has been built and more commercial facilities provided during these tight-credit years than would have been possible under traditional financing techniques.

2. LAND PURCHASE AND LEASEBACK

A second type of financing that would appear to be ruled out by section 14 is the making of a mortgage loan on an income-producing building with the simultaneous purchase of the underlying land. In this transaction, the borrower receives mortgage financing for perhaps 75 percent of the value of the building and also obtains cash from the sale of the land to the lender. The borrower is thus able to recapture nearly all of his out-of-pocket costs and minimize the amount of his own capital tied up in the property. Although the investor is the nominal owner of the underlying land, he leases it to the developer on a long-term basis and has no control over the management of the building.

The purchase-leaseback financing technique has been a long-established practice in the financing of real property. Recent modifications in purchase-leaseback arrangements have permitted the investor to obtain a variable income hedge against inflation in a number of ways, based on his ownership of the land. For example, periodic adjustment or renegotiation of the ground lease allows the investor to increase his income as property values rise over the years. Or an escalation clause in the ground lease can be tied to the gross or net rentals from the building, to provide a rising income as dollar rentals advance over time. Also, when the mortgage loan is paid off, the land can be resold to the borrower or a third party at its higher current value, thereby producing a capital gain for the investor. These recent innovations have meant that the investor may obtain variable income and possible capital gains on his equity position, rather than limiting his investment return to a fixed interest rate and an inflexible ground lease over a 20 to 30 year period of financing.

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The advantages of purchase-leaseback financing for the developer-borrower are many. In addition to conserving his limited capital, the borrower retains control and management of the property whether it is used for rental space or occupied by the borrower's own company. Prohibition of these arrangements by section 14 would be clearly detrimental to the interests of developers and borrowers who obtain many financial advantages from this method of financing.

3. JOINT VENTURES IN REAL ESTATE

Under a joint venture arrangement between a developer-builder and an institutional investor, the latter provides an equal or substantial share of the equity capital needed for a new real estate venture, in addition to providing mortgage financing. An outstanding example of this kind of arrangement is found in the case of Columbia, Maryland, in which a joint venture was formed between the Rouse Company of Baltimore and the Connecticut General Life Insurance Company to develop a new town with a planned population of 100,000 by the year 1980. Subsequently, the Chase Manhattan Bank and Teachers Insurance and Annuity Association became part of the financial structure. Other instances of joint ventures have involved large land tracts or industrial park complexes or housing-shopping-commercial developments in various parts of the country.

Because of the many years of development that are required, and the millions of dollars of capital expended before any return can be expected, the joint venture participation with an institutional lender is frequently an essential ingredient in large-scale real estate development. Projects such as Columbia, Maryland, started more than six years ago, could never have been contemplated on the basis of equity capital from a single development corporation. Moreover, no responsible lender could have undertaken the risks involved on a flat-rate mortgage basis. Even in smaller ventures, outside equity capital is sought by developers to supplement their own limited funds or to permit a greater number of projects. Experienced mortgage lenders are obvious and natural partners in such enterprises because of their acquaintance with development techniques, the technical assistance they can provide, and the ability to supply "seed money" without rewards for several years.

National policy has been directed toward the construction of new towns, the redevelopment of urban areas, and the expansion of community facilities through recent legislation that often was initiated by the House Banking and Currency Committee. Establishment of national housing goals by the Congress in the Housing Act of 1968 has highlighted the need for 26 million new housing units within a decade. Operation Breakthrough represents an effort to mobilize the skills of private industry to produce mass housing with lower cost construction techniques. All of this new housing will also require an accompanying development of shopping facilities, industrial parks, and commercial structures that are necessary to an expanding population.

Title VII of the Housing and Urban Development Act of 1970 specifically describes one of the purposes of the new communities provision as "encouraging the orderly development of well-planned, diversified, and economically sound new communities, including major additions to existing communities, and to do so in a manner which will rely to the maximum extent on private enterprise . . . ." We believe that the joint-venture real estate activities of life insurance companies and other investors are aimed toward identical goals and, indeed, are crucial to their accomplishment. If section 14 were to rule out joint ventures where equity capital and loan capital are combined, it is difficult to visualize how the enormous need for real estate development can be met over the next 10 to 20 years, unless both seed money and long-term capital are provided directly from government funds. If lending institutions are prevented from providing equity capital to supplement the resources of real estate developers, these developers will be forced to think small, plan small, and build small. In the light of the nation's housing and real estate needs, such prohibition would clearly work against the national interest.

CONCENTRATION OF ECONOMIC POWER

Concern has been expressed in some circles that the recent trend toward so-called "equity participations" in real estate financing could lead to a situation in which real estate throughout the United States would be dominated or controlled by life insurance companies and other institutional lenders. For example, an article in the July 1970 issue of *Fortune* was entitled "The Future Largest Land-

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lords in America" and pointed with alarm at the growing involvement of lenders in real estate activities.

We do not believe that there is a sound basis for these fears. As pointed out above, many forms of so-called "equity participation" do not actually involve ownership or control by the lender. Moreover, the state investment laws which govern the operations of life insurance companies would obviate any future trend toward domination of real estate markets or ownership and control of business enterprise. These laws typically fix upper limits on the percentages of total assets which may be held in various investment forms. Further, most state laws limit the percent of an insurer's assets which may be invested in the stock of any one corporation and many states also restrict the percentage of outstanding common stock of any one corporation that may be held. As one illustration, New York State imposes a one percent limit on the first basis and a five percent limit on the second. Special provisions are often made, of course, for the holdings of stock of a subsidiary or of other insurers and a variety of rules are applied to the formation or operation of holding companies which involve insurance companies. In addition, there frequently are limits on the percent of a life insurance company's total assets which may be held in the form of common stock.

State investment laws also limit the percent of an insurer's assets that may be held in investment real estate. These percentage ceilings range from 5 percent in some states to 10 percent in many others and were imposed in the interest of a diversification of assets. In actual practice, present real estate holdings account for 3 percent of total assets of U.S. life insurance companies, of which about one-quarter is used for company accupancy and the remainder was purchased for investment or acquired through foreclosure.

Nevertheless, it is worth considering what the outer limits might be for life insurance assets in real estate markets. In 1968, according to a recent study by the National Bureau of Economic Research undertaken for the SEC Institutional Investor Study, the total value of private non-farm land was $419 billion and the value of private buildings (residential and non-residential) was $1,040 billion. (These figures do not distinguish between rental properties and owner-occupied homes or buildings.) Against this total of $1,459 billion, actual real estate holdings of life insurance companies were $5.6 billion, or less than ½ of one percent of total real estate value. Even if life company holdings rose to the 10 percent limit permitted by some states, only 1.3 percent of total real estate would ke owned or controlled by life insurance companies.

It should be further recognized that life insurance lenders have not demonstrated a widespread interest in owning, managing, and controlling rental properties as a primary form of investment. Such operations would require different skills than are present in most companies. Diversification of investments, together with the continuing attraction of other market outlets, are important factors which militate against any supposition that life company domination of real estate markets could be a future possibility.

We are grateful to the Committee for this opportunity to present our views in opposition to a proposal which could have serious adverse consequences upon the flows of private capital being used to finance the expansion of growing business firms and the greatly needed development of real estate over the decade ahead.

The CHAIRMAN. We will hear from Mr. Hamilton.

Mr. Hamilton, if you will take about 10 minutes we will have more time to ask questions. We tried to divide it up evenly, but this last gentleman had more than 10 minutes by unanimous consent.

STATEMENT OF JOHN S. HAMILTON, JR., VICE PRESIDENT AND GENERAL COUNSEL, AMERICAN MUTUAL INSURANCE ALLIANCE; ACCOMPANIED BY JAMES P. ALLEN, JR., VICE PRESIDENT, LIBERTY MUTUAL LIFE INSURANCE CO.

Mr. HAMILTON. I am John S. Hamilton, Jr., vice president and general counsel of the American Mutual Insurance Alliance of Chicago. I am accompanied by James P. Allen, Jr., who is vice president and general counsel of Liberty Mutual Insurance Co. Mr. Allen is from Boston.

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We appreciate very much the opportunity to present the views of our 101 mutual property and casualty companies on H.R. 5700.

We submit our statement and ask that the full statement be placed in the record, please.

The CHAIRMAN. Yes, it will be inserted in the record, Mr. Hamilton.

Mr. HAMILTON. By no means do all the provisions of this bill affect our member companies. As I will indicate in just a moment, we have no position on section 14 with respect to equity participation. And I think I can explain the reason.

Those which do affect our companies would have an extremely adverse effect on the ability of these companies to survive and to grow, and on their ability to serve their policyholders.

As a basis for this I would like to take a moment to distinguish between mutual and stock insurance companies, and between life insurors and property/casualty insurance companies.

A mutual insurance company has no stock and no stockholders. It is owned by its policyholders, each of whom has an indivisible ownership. There is no way to transfer that ownership. The directors of the company must be policyholders or representatives of corporate policyholders, they have an interest in the company as to its insurance service. Mutuals like many other corporations, have had difficulty in attracting the more competent directors because of the problems that certain directors have run into in recent years.

Mutual companies, our member companies, need directors that are competent and experienced in the financial field. They cannot offer these persons a chance to buy into the company and make a profit out of the investment that they will help guide and direct. You cannot buy into a mutual company. You can only buy insurance from it.

Now, as to the difference between mutual property casualty companies and other insurors, we do not consider that our companies have any competitive aspect with banks or other banking institutions, or even the life insurance companies in the areas primarily under consideration here.

We have made a survey of our member companies and their ratios of mortgage and collateral loan investment. In 1969 it was three-tenths of 1 percent of their total assets. This has been going down over the last 20 years. It never was very large. The ratio of real estate to total assets was 2.3 percent in 1969. This has been going down. In addition, the real estate is used primarily in the insurance companies' insurance business.

Part of the reason for this, perhaps the major reason, is that a property and casualty insurance company, like a life insuror, needs stability and income in its investments, but it has a much greater need for liquidity of investments because of the more unpredictable fluctuations of losses.

I will pass over the prohibitions of section 7 with respect to employee welfare and benefit plans. Our statement covers this. I believe that our friends in the life insurance business cover it, and Dr. Fey has referred to it.

I would like to come to the serious handicap that would be presented to our member companies by the prohibition of section 8 against having a director who is connected with the mutual insurance company on the board of any corporation of which the mutual company owns

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more than 5 percent of the stock. This would be a severe handicap on growth and on the maximum use of assets of our member companies. The trend in insurance in the past few years has been toward diversification through the use of holding companies and direct subsidiaries. The New York Insurance Department appointed a blue ribbon committee, including a prominent CPA, lawyers, regulators, and law educators, which in 1968 recommended the removal of certain restraints on investment, and the creation of new forms of regulation.

Shortly thereafter the National Association of Insurance Commissioners developed a model holding company act which has been adopted by a great many States. It regulates the acquisitions, intercompany transactions, requires registration and reporting, and provides for other regulation, and provides for examination. All of this is in addition to existing State regulation with respect to conflict of interest situations and restraints on competition.

As I have indicated, a mutual company has no stock. It cannot become a part of a holding company by being bought by a holding company. The only way our members can participate is by owning a holding company, organizing a holding company, or buying a direct subsidiary themselves. If the subsidiary is organized or acquired by the mutual for this purpose—that is, to provide greater total financial services to its policy holders—obviously a majority of the stock, quite frequently all of it, is owned by the parent mutual insurance company. In such a situation it seems to us totally unfair to prohibit designation of personnel from the parent mutual from serving on the board of directors or as officers of the subsidiary. It is unfair to the personnel in limiting their opportunities to gain business experience and business knowledge, it is unfair to the mutual in its competition with other insurors for growth and service, and it is unfair to the subsidiary which is trying to compete as best it can with other entities in its field of operations.

We have tried to make a survey of the situation in which our member companies are today, and we have found no situation in which an officer, director or employee of one of our members is on the board of or an officer of another company where the 5 percent stock ownership exists, except in the case where the other company is a subsidiary of the mutual.

I will come to a conclusion quickly. I will point out that all of the investments in business operations by insurance companies are subject to strict regulation by State insurance departments under the principles that were established most recently in the McCarran-Ferguson Act, Public Law 15.

There is in this bill in a number of places an exemption of bank holding companies and savings and loan holding companies. We urge that you give favorable consideration to including in the bill an exemption of mutual property and casualty insurance companies and their subsidiaries along the lines of the bank holding company exemption.

Thank you, sir.

(The prepared statement of Mr. Hamilton follows:)

PREPARED STATEMENT OF JOHN S. HAMILTON, JR., VICE PRESIDENT AND GENERAL COUNSEL, AMERICAN MUTUAL INSURANCE ALLIANCE

My name is John S. Hamilton, Jr., vice president and general counsel of the American Mutual Insurance Alliance, Chicago, Illinois. The American Mutual

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Insurance Alliance is a voluntary association of 110 mutual property and casualty insurance companies which write a substantial portion of all fire and casualty insurance written by mutual insurance companies in the United States, and whose total annual premium volume for all lines of insurance is approximately 3.3 billion dollars. I am here today to comment upon the effect that certain provisions of H.R. 5700 would have upon the operations of mutual property and casualty insurance companies, generally, and also upon the operations of our member companies, specifically.

In order to understand the drastic and unique effect that certain provisions of H.R. 5700 would have upon the operation of mutual property and casualty insurance companies, it is necessary to point out the differences between the corporate structure of a mutual property and casualty insurance company and that of a stock property and casualty insurance company. It is also necessary to distinguish between life and property/casualty insurance companies, both as to the type of risk covered and the general investment policy followed by such companies, and also to distinguish between property and casualty insurance companies' investment policies and those of other financial institutions such as banks.

MUTUAL INSURER HAS NO STOCKHOLDERS

A mutual insurer is defined as an insurance corporation without capital stock, owned by its policyholders collectively, who have the right to vote in the election of its directors. The ownership of a mutual insurance company, residing as it does with its policy holder members, cannot be exchanged in the open market place. A stock insurance company, on the other hand, has capital stock which is owned by its stockholders, who may or may not be policyholders of the company. The stock of a stock insurance company may be freely purchased or sold in the market place, and ownership may reside in a group of persons which to a large extent are different from that group which comprises its policyholders. In contrast, the mutual policyholder's interest as an owner is not transferable, and cannot be liquidated except upon dissolution of the company.

The directors of a mutual insurance company must be policyholder members of that company, or must be officers or representatives of such a policyholder member. The directors of a stock insurance company need not necessarily be policyholders of the company.

INVESTMENT POLICIES

Property and casualty insurers also must be distinguished from life insurers, both as to the type of risk covered and as to the type of investment policies engaged in by each.

A property and casualty insurer provides insurance against certain catastrophic events which may or may not occur during the life of the policy. While it is possible over a period of years to predict with reasonable accuracy the volume of such catastrophic events which will occur, it is extremely difficult to predict what that volume will be in any given year. Unlike the property and casualty insurer, the life insurer provides insurance for an event which is certain to occur, the death of the policyholder. However, the life insurer, through the use of mortality tables, is able to predict with startling accuracy the number of deaths among its policyholders and thus the approximate volume of payments which it will make during any given year. Unlike the property and casualty insurer whose volume of losses for catastrophic events may fluctuate widely, the life insurer is reasonably certain that its payments will be made on a more or less stable basis from year to year.

This difference in the experience of property and casualty companies as opposed to life insurers with respect to volume of losses in any given year points out a basic reason for the difference in investment policies of the two types of insurers.

The property and casualty insurer has a need for liquidity in its investment program. Property and casualty insurance rates are regulated by state insurance departments and such companies have a special need for maximizing income derived from the investment program, in order to provide for a growing insurance market on a stable basis.

The life insurer with its more stable volume of annual payments does not need such liquidity in its investment program and is attracted to longer term, less liquid, investments.

This difference is pointed out in the publication "Non-Bank Financial Insti-

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tutions" published by the Federal Reserve Bank of Richmond, June 1965, on page 11, in which it is stated as follows:

> There are important distinctions, however, arising from the basic differences between the two types of companies. For example, life insurance companies must pay most policies in full since all policyholders eventually die, whereas only a fraction of fire and casualty policies ever results in losses. Consequently, life companies accumulate relatively larger asset holdings in relation to the volume of their business, since the average policyholder must pay in enough premiums, together with the income the company earns on these funds, to pay, eventually, the proceeds of the policy. In addition, the pattern of deaths among policyholders is much more predictable than the volume of fire and casualty losses. The net result is that life companies can appropriately invest in longer term, less liquid, investment than can fire and casualty companies.

Even among property and casualty insurance companies, there are some differences in the nature of their investment policies due to the type of insurance written by the company and to some extent their corporate structure.

The publication of the Federal Reserve Bank of Richmond, cited above, succinctly points this out as follows:

> There are many differences among fire and casualty companies, however, Those that do primarily a casualty business typically invest in somewhat more liquid securities than fire companies since the extent of casualty losses cannot be predicted as precisely as the volume of property losses. Mutuals also usually hold more liquid investments than stock companies since they ordinarily have less policyholder surplus in relation to assets than to the stock companies.

Thus, it can be seen that mutual property and casualty insurance companies have unique requirements as respects their investment programs, as opposed to those of life insurance companies and even those of stock property and casualty insurance companies

Clearly then, if the investment needs of a mutual property and casualty insurance company are different from other types of companies within the insurance industry, they are vastly different from the other types of financial institutions which would be subject to the requirements of H.R. 5700.

For example, mutual property and casualty insurance companies cannot be thought of in any manner as being in competition with banking institutions insofar as their investment programs are concerned,

One of the primary functions of the investment program of most banking institutions is the making of mortgage and collateral loans and investments in real estate. However, these types of loans represent an extremely small percentage of investment programs of mutual property and casualty insurance companies.

This point is clearly illustrated by the figures taken from the summary of classified assets of member companies of the American Mutual Insurance Alliance for the year 1969 and the trend over the past 20 years. In 1969, the percentage of total assets of such companies represented by mortgage and collateral loans was 0.3%, down from 0.4% in 1959 and 0.7% in 1949. In 1969 the percentage of total assets represented by real estate investments of our member companies was 2.3%, whereas in 1959 it was 3.1% and in 1949 it was 2.4%. A very large part of the real estate investment is in the office buildings occupied by the insurers in carrying on their business. In contrast to this was the percentage of total assests of member companies represented by investments in all types of bonds and in stocks. In 1969 this was 86.2%, up from 84.9 % in 1959 and 82.5% in 1949 %.

These figures clearly show that the type of investments which will fit the needs and requirements of mutual property and casualty insurance companies are totally different from those which comprise the bulk of investments of other financial institutions which would be subject to the requirements of H.R. 5700.

The difference between property and casualty insurance companies, whose investment goals are liquidity and income as well as stability, and other types of financial institutions such as those specified in H.R. 5700, which are primarily lending institutions, was recognized in a report of the Subcommittee on Domestic Finance of the Committee on Banking and Currency entitled "Comparative Regulations of Financial Institutions" issued on November 22, 1963.

In the introduction to chapter 6, entitled Property and Casualty Insurance Companies, the following statements are made:

> Property and casualty insurance companies are financial intermediaries that obtain the bulk of their funds from businesses and households; they

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invest their funds mainly in the bonds and stocks of governments and corporations. The flow of funds into these intermediaries arises from the specialized service that they offer—providing monetary protection against losses arising from fire, other accidents and misfortunes, and legal liability associated with injury to persons.

From the policyholders' point of view, the service rendered cannot be thought of as including a liquid or even near liquid asset. Consequently, the influence of fire and casualty companies in money and capital markets is mainly to be found in the amounts of funds obtained and the investment policies pursued. Property and casualty companies command only a moderate amount of funds. They consequently represent a relatively limited influence.

Property and casualty companies are principally investment institutions in contrast to lending institutions. The flow of funds out of property and casualty companies is regulated by state law. The purposes of regulations are, presumably, the achievement of a high degree of liquidity and the maintenance of solvency. However, within existing limits, the investment policies of stock companies and of mutual companies as well, are in all probability motivated by the desire for income and growth.

State insurance supervisory authorities exercise close supervision over investment policies of property/casualty companies (as well as life insurers). Statutes, regulations and procedures cover types of investments, liquidity, diversification and valuation of invested assets.

The foregoing explanation of the type of business engaged in by property and casualty insurance companies, and particularly mutual property and casualty insurance companies, and their investment needs and requirements, is made to demonstrate the many important differences between such companies and the financial institutions which are to be subject to the requirements of H.R. 5700. We express no views as to the desirability or need for the requirements of H.R. 5700 with respect to those other financial institutions. This is for the Congress to determine. However, we do wish to point out that property and casualty insurance companies, and particularly mutual property and causalty insurance companies, are not the type of business institutions which should be considered in connection with the category of financial institutions which H.R. 5700 intends to regulate. The nature of the property and casualty insurance business and the investment requirements to engage in this business make it imperative that it not be swept under the provisions of legislation establishing requirements for an entirely different type of business institution.

Furthermore, the requirements of H.R. 5700, if applied to property and casualty insurance companies, and in particular if applied to mutual property and casualty insurance companies, would seriously restrict the fulfillment of their business requirements, and in the long run operate to the detriment of the insurance-buying public.

NEED FOR COMPETENT DIRECTORS

Several provisions of H.R. 5700 would establish some far reaching restrictions on the relationships between banks, savings and loan institutions, mutual savings banks and other "financial institutions," among which is included "any insurance company."

Section 2 of the bill would prohibit any person who is a director, trustee, officer or employee of a bank insured under the Federal Deposit Insurance Act from being at the same time a director, trustee, officer, or employee of certain specified "financial institutions," among which is "any insurance company."

Section 3 of the bill would add a similar prohibition with respect to any director, trustee, officer or employee of a savings and loan institution from acting in a similar capacity in certain specified "financial institutions" including "any insurance company."

Again, in section 4 a similar prohibition is contained with respect to a director, trustee, officer or employee of a mutual savings bank from acting in the capacity of a director, trustee, officer or employee of other "financial institutions" including "any insurance company."

The effect of these provisions, insofar as mutual property/casualty insurance companies are concerned is to prohibit a director, trustee, officer or employee of any of the listed banking institutions from serving in the capacity of a director of any of our member companies. In addition, a similar prohibition would be exercised with respect to a director, officer or employee of an insurance company serving on the board of any one of the specified financial institutions.

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We feel that this prohibition, at least insofar as mutual property and casualty insurance companies are concerned, is an unreasonable restriction upon their right to seek out the most competent and experienced individuals available in the various areas of the business community encompassed by an insurance company's operations.

Under today's conditions, it is difficult at best for any corporation to secure the kind of competent experience among its directors that is necessary for a successful business operation. Recent court decisions have made it abundantly clear that directors and officers of corporations will be held strictly accountable for their actions undertaken in that capacity. This is true not only if the activities of the directors or officers were the result of intentional wrongdoing, but also if they were the result of an uninformed or a negligently formed decision.

Consequently, individuals who have the necessary business knowledge to be of assistance in guiding the operations of a corporation have become extremely reluctant to serve as directors of these corporations in view of the potential liability which might be placed upon them as a result of their activities as a member of the board of directors of a particular corporation.

This difficulty in securing competent individuals to serve as directors is being experienced by all corporations at the present time. However, it is especially true with respect to mutual property and casualty insurance companies.

Corporations which have stock which is bought and sold in the market place have some incentive to offer to individuals to encourage them to participate as a member of the company's board of directors. The individual may purchase shares of stock of the corporation and earn a financial reward through the increase in value of that stock as the result of the successful operation of the company.

No such incentive is available to the directors of mutual property and casualty insurance companies. As indicated above, the corporate structure of a mutual property and casualty insurance company is such that it offers no opportunity for its directors to participate in the ownership of the company other than ownership rights inherent in his position as a policyholder of the company. The opportunity to earn a major financial reward for his endeavors is not available to the director of a mutual property and casualty insurance company as a compensatory factor for his efforts as a director and for assuming the risk of potential liability for the consequences of his service as a director.

Thus, the prohibition contained in sections 2, 3 and 4 of H.R. 5700 would drastically curtail an already restricted pool of competent manpower from which a mutual property and casualty insurance company can hope to attract its directors. Furthermore, it would curtail manpower in an area of judgment which is sorely needed by mutual property and casualty insurance companies, that is, those individuals who have special competency, knowledge and acquaintance with developments in the financial area.

As pointed out above, a mutual property and casualty insurance company is an investing institution rather than a lending institution and because of the great fluctuation in fire and casualty losses, it is a necessity that such a company maintain liquidity in its investments. Furthermore, because of this fluctuation, it is vital to the successful operation of a mutual property and casualty insurance company that its investment portfolio is managed so as to maximize income for any given year. Thus, it is absolutely essential for a mutual property and casualty insurance company to have the competence available at its board level to establish the policies which will insure the maximum success of its investment program.

It is true that larger mutual property and casualty insurance companies have investment departments which are charged with the day-to-day administration of the investment portfolio of the company. It is also true that there are a large number of smaller mutual property and casualty insurance companies which do not have available to them the extensive facilities of a large scale investment department.

However, even in the case of the larger companies which do have investment departments, they are primarily concerned with the day-to-day administration of the investment portfolio based on the policy and direction formulated at the board level. It is essential to them that they have available to them at the board level individuals with the necessary skill and competency in the financial community to establish the guidelines under which they operate. For smaller mutual companies without an extensive investment department, the availability of proficiency at the board level is vital to their continued successful business operation.

Furthermore, the prohibitions contained in these sections of H.R. 5700 not only

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would deprive the mutual property and casualty insurance company of the talent which is essential to its continued successful operation, but it would do so without any resulting public benefit since a decline in the success of the company's operations could only operate to the detriment of its policyholders and to the insurance-buying public in general.

STATE REGULATION

Finally, the restrictions that would be imposed by H.R. 5700 insofar as mutual property and casualty companies are concerned would operate to place additional burdens upon companies which are already regulated by perhaps the most comprehensive set of regulations to which any part of the business community is presently subjected.

Insurance companies are subject to the insurance laws and to regulation by the insurance department of each of the fifty states. Companies are regulated not only in the state in which they are domiciled, but also in each of the states in which they do business. Many state insurance codes have specific provisions within the insurance code dealing specifically with conflict of interest situations among directors of an insurance company. In other states, such provisions are contained in the general business corporation provisions to which insurance companies are also subjected.

In addition, the broad regulatory authority conferred upon the insurance commissioners in the various states is more than sufficient to authorize appropriate action to remedy conflict of interest situations with respect to insurance company directors.

The National Association of Insurance Commissioners has also seen the need for close regulation by the states of possible conflict of interest situations among directors of insurance companies. The uniform Annual Statement Blank (Fire and Casualty) promulgated by the NAIC contains in the General Interrogatories section, question 12b which includes a series of questions designed to elicit information which would indicate whether a conflict of interest situation exists among the members of the board of directors of the particular company, and whether the company has established procedures for disclosure of conflicts and their control.

Furthermore, the NAIC has promulgated its model Insurance Holding Company Act which contains strict disclosure provisions relative to possible conflicts of interest among insurance company directors and directors of insurance holding companies.

Finally, the courts of the several states have been especially alert to the possibility of conflict of interest situations arising among directors of corporations and holding companies, and particularly insurance companies. Transactions between corporations having directors or officers in common have been subjected to close judicial scrutiny to determine the absence or presence of fraud or unfairness.

Thus, the prohibitions contained in H.R. 5700 which would preclude property and casualty insurance companies from having individuals serve upon their boards of directors who have the necessary financial mastery vital to the successful operation of their business is not only unreasonable, but it is unnecessary due to the close scrutiny to which the operations of insurance companies are subjected by the insurance departments and courts in the several states.

MANAGING EMPLOYEE BENEFITS

Section 7 of H.R. 5700 would prohibit a person who is a director, trustee, officer or employee of a financial institution, the definition of which includes any insurance company, from at the same time serving on the board of directors of any corporation with respect to which the financial institution manages an employee welfare or pension benefit plan.

It has become increasingly more common over the past several years for a property and casualty insurance company, including mutual property and casualty insurance companies, to have subsidiary life insurance companies in order to provide their policyholders with a broad range of insurance services. Usually the life insurer subsidiary is wholly or majority owned by the parent mutual, and usually this life subsidiary is a stock company. This trend toward providing policyholders with a broad range of financial and insurance services will be discussed in greater detail in the comments with reference to section 8 of H.R. 5700.

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In a typical situation in which a mutual property and casualty insurance company organizes a subsidiary life insurance company, a number of the members of the board of the parent property and casualty insurance company may also serve as members of the board of the subsidiary life insurance company. Since the life insurance company's services were designed to be integrated with the services offered by the parent property and casualty insurance company so as to present a broad range of insurance services to the insurance-buying public, it is not unreasonable that the boards of the two companies should have common directors.

In a number of the cases in which a subsidiary life insurance company exists, it manages on behalf of the parent property and casualty company the employee welfare or benefit pension plans of that parent company. The prohibition contained in section 7 of H.R. 5700 would preclude the subsidiary life insurance company from managing the employee welfare or pension benefit plan of its parent property and casualty insurance company or would necessitate a board of directors of the subsidiary life insurnace company which is totally different from the board of directors of the parent property and casualty company.

It would seem that either result would be unreasonbale in the situation outlined. Certainly it is reasonable to give a parent property and casualty insurance company the opportunity of placing the management of its employee welfare plans or pension benefit plans in a subsidiary life insurance company if it chooses to do so. However, this section would require that placement and management of such welfare or pension plans be in an entirely different company, or that the companies forego having common directors. Either situation would operate to hinder the integration of the insurance services provided by the two companies.

We feel that this provision should be modified so as to permit the management of employee welfare or pension benefit plans by a life insurance subsidiary of a property and casualty insurance company even though the boards of directors may have some members in common.

DIRECTORS OF SUBSIDIARIES

Section 8 of H.R. 5700 would create far reaching prohibitions applicable in some respects to all corporations, but would place severe limitations upon the growth potential of mutual property and casualty insurance companies in particular.

This section would prohibit a director, trustee, officer or employee of a "financial institution" from serving as a director or officer of any other corporation with respect to which the financial institution holds the power to vote, more than 5% of any class of stock. The definition of financial institution in this section also includes "any insurance company."

This provision would place severe obstacles in the path of any mutual property and casualty insurance company that wished, through growth and diversification, to supply its policyholders with a total package of insurance and ancillary services through the establishment of subsidiary companies, although stock property and casualty insurance companies would be able to bypass the restrictive effects of this section through the utilization of the holding company procedure as will be pointed out later. However, this section would stifle, in the case of a mutual property and casualty insurance company, any possibility of providing a broader range of service to its policyholders through diversification.

The need for diversification within the insurance industry, and particularly within the property and casualty insurance industry, was recognized several years ago by industry and regulatory officials alike.

INSURANCE HOLDING COMPANIES

In 1967, the New York Insurance Department, concerned over a trend among non-insurance holding companies to acquire insurance company subsidiaries, established a Special Committee on Insurance Holding Companies to evaluate the reasons for this trend and to determine the best way of reconciling the public interest, the protection of policyholders and the reasonable expectations of company management in the holding company field.

The New York Special Committee in its report in February 1968, concluded that there is a definite public need for a broad range of insurance and related services and that the growth of the industry, which would enable it to provide these broad services, was being stifled by unduly restrictive investment laws. The utilization of a non-insurance holding company device was considered a method

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whereby the unreasonable restrictions of state insurance investment laws could be avoided. The Committee recognized that some of the restraints incorporated into insurance practice and insurance law were no longer essential and added unnecessarily to pressures to organize non-insurance holding companies. The Committee recommended that such investment restraints be relaxed to enable insurance enterprises directly and affirmatively to deal with the economic realities that they faced. It further recommended that life and property/casualty insurance companies be given greater latitude in the formation and acquisition of subsidiaries, both as to insurance subsidiaries and to non-insurance subsidiaries which are ancillary to the insurance enterprise. This liberalization permitting more diverse insurance company activity would, of course, be, at all times, subject to the scrutiny and appropriate regulation of the state department of insurance.

In 1969, the National Association of Insurance Commissioners took formal cognizance of the need for insurance companies to diversify by adopting the NAIC Model Holding Company bill.

The NAIC, in adopting this model bill, recognized that, as a minimum, insurance companies should be allowed to organize or acquire one or more subsidiaries engaged in businesses ancillary to the insurance enterprise.

Among the ancillary activities specifically authorized for insurance company subsidiaries in this model bill are the following:

Acting as an insurance broker or as an insurance agent,

Management of an investment company,

Rendering investment advice to governments, government agencies, corporations, or other organizations or groups,

Rendering services related to the operation of an insurance company including actuarial, loss prevention, safety engineering, data processing, accounting, claims, appraisal and collection services.

Ownership or management of any assets which the insurer itself could own or manage,

Financing of insurance premiums, agents and other forms of consumer financing, and finally,

Any other business or activity determined by the insurance commissioner to be reasonably ancillary to an insurance business.

The NAIC, in its Model Holding Company Act, further recognized that while the organization or acquisition of subsidiaries whose business function is ancillary to that of the insurance operation was the minimum that was necessary, some states might wish to permit insurance enterprises even broader authority to own and operate subsidiaries. Therefore, they included as an alternate provision in the model holding company act authorization for an insurer to organize or acquire one or more subsidiaries which would be permitted to engage in any type of business activity.

A pertinent summary of the reasons that the NAIC felt that insurance company diversification was desirable is found in the Appendix to the NAIC Model Holding Company Act which is set forth as follows:

> (1) *Findings* (*a*) It is hereby found and declared that it may not be inconsistent with the public interest and the interest of policyholders and shareholders to permit insurers to: (1) engage in activities which would enable them to make better use of management skills and facilities; (2) diversify into new lines of business through acquisition or organization of subsidiaries; (3) have free access to capital markets which could provide funds for insurers to use in diversification programs; (4) implement sound tax planning conclusions, and (5) serve the changing needs of the public and adapt to changing conditions of the social, economic and political environment, so that insurers are able to compete effectively and to meet the growing public demand for institutions capable of providing a comprehensive range of financial services.

The prohibitions imposed by section 8 of H.R. 5700 would operate *contra* to this recognized need for the ability of property and casualty insurance companies to diversify.

The provisions of this section offer a property and casualty insurance company two choices, neither of which is reasonable or desirable. The company could either totally abandon any diversification program to provide broader insurance and financial services, or it could embark upon a program of acquiring or organizing subsidiaries with the knowledge that once having obtained an interest in the subsidiary it would be unable to direct the business activities of that subsidiary because it would be precluded from having any of its officers or directors serving on the board of that subsidiary.

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In effect, the second alternative would be asking the insurance company to provide the capital for a subsidiary operation, and then walk away from that operation without any control over how the capital which it provided is being utilized by that subsidiary. Therefore, the practical effect of the provisions of section 8 would be to eliminate the ability of property and casualty insurance companies to diversify through the mechanism of a holding company or owned or controlled subsidiary companies.

As pointed out previously, a stock property and casualty insurance company could avoid the prohibitory effect of section 8 by the organization of what is termed a "upstream" holding company. In this situation, a holding company could be formed which would purchase the stock of the insurance company. The holding company could then proceed to organize or acquire subsidiary companies engaged in any number of business activities. Since the insurance company would own no stock of the holding company, but would, in fact, be owned by it, and since the insurance company might own no stock in the subsidiaries, the prohibitions contained in section 8 would not be applicable, and the officers and directors of the insurance company would be entirely free to serve as directors or officers of the holding company or any of its subsidiaries.

This alternative is not open to a mutual property/casualty insurance company. By the very nature of its corporate structure, a mutual property/casualty insurance company cannot be owned by anyone but its policyholder members. It cannot form an "upstream" holding company since it has no stock to sell to such a holding company. The only way in which a mutual property/casualty insurance company can employ the holding company mechanism is to form what is known as a "downstream" holding company. In this situation, the mutual property/casualty insurance company would supply the capital to form a holding company and would either wholly own, or own a controlling interest in the stock of that holding company. The holding company would then proceed to organize or acquire subsidiary companies in various fields of business activity.

However, in this situation, the prohibitions contained in section 8 of H.R. 5700 would be applicable. Since the mutual property/casualty insurance company would own something in excess of 5% of the stock of the holding company, it would be precluded from having its directors or officers serve on the board or as officers of the holding company or any of its subsidiaries. Thus, a mutual property/casualty insurance company would be precluded from any form of diversification either through direct ownership of subsidiaries, or through the holding company mechanism.

The prohibitions contained in section 8 of H.R. 5700 would operate in diametric opposition to the need recognized by both industry and regulatory officials for property and casualty insurance companies to diversify. When a property and casualty insurance company diversifies, it not only improves its own competitive position by being able to offer a broader range of services to the public in general, but it also would tend strongly to improve the competitive position of its subsidiaries in their particular fields.

The provisions of section 8 would operate to destroy the competitive position of mutual property and casualty insurance companies, since they would be unable either through direct ownership of subsidiaries, or through the holding company mechanism, to diversify to provide the broad range of insurance and related services that their competitors would be able to supply. To this end, the provisions of section 8 are unjustly discriminatory in their effect on the operations of mutual property and casualty insurance companies, their policyholders and the public in general.

HOLDING COMPANY EXEMPTION

Section 8(b) contains an exception to the prohibitions contained in subsection (a) of that section. It provides that an individual may hold any number of positions as director, trustee, officer, or employee of any number of companies within any given group of companies if one of the companies is either a bank holding company or a savings and loan holding company, and all the rest of the companies in the group are subsidiaries of that holding company.

We feel that there are equally compelling reasons for excepting property and casualty insurance companies from the prohibitions of section 8. These reasons are particularly compelling in the case of mutual property and casualty insurance companies. To fail to except such companies from the prohibitions of this section would be unjust and discriminatory and operate to the detriment of their policyholders and the insurance-buying public at large.

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We strongly urge the committee to adopt such an exception to the provisions of section 8 of H.R. 5700.

STATE REGULATION OF INSURANCE

In the overall consideration of the provisions of H.R. 5700 on which we have commented, we suggest that due consideration should be given to the decision made by Congress in 1945 that the "continued *regulation* and taxation by the several States of the business of insurance is in the public interest." The provisions of the McCarran-Ferguson Act (Public Law 15, 79th Congress, 15 US Code, Sections 1011 to 1015) specifically state that the business of insurance and every person engaged in it shall be subject to the laws of the several States which relate to regulation or taxation of such business.

The insurance business is believed to be more comprehensively regulated than any other type of business enterprise, although under a system of state rather than federal regulation. As has been pointed out, state regulation covers matters relating to interlocking directorates and ownership of holding companies or subsidiaries by an insurer. It does not appear that there has been any compilation or production of evidence of abuses or improper activities in the areas affected by the sections of H.R. 5700 which we have discussed.

It is suggested that this Committee should not recommend the inclusion of mutual property and casualty insurance companies with respect to the matters discussed in this statement. The result would be a system of partial federal regulation, overlapping unnecessarily, and possibly conflicting with state regulation, in the absence of a full study and consideration of the total area of insurance regulation.

CONCLUSION

It is the position of the American Mutual Insurance Alliance and its member mutual property and casualty insurance companies that:

1. Inclusion of these mutual insurers within the prohibitions of sections 2, 3, and 4 would seriously handicap these companies in the appointment of knowledgeable directors, by still further reducing the pool of suitable persons available, a group which is already too small in many areas.

2. The provisions of section 7 by flatly prohibiting the use of the mutual insurer's subsidiary life company for the management of employee welfare or pension benefit plans would unreasonably limit the business purposes of the mutual in creating or acquiring the life insurer and would unfairly burden both the parent mutual and the subsidiary life insurer in their ability to contribute to the markets for insurance and their ability to serve all of their policyholders.

3. The provisions of section 8 would irreparably damage the ability of mutual property/casualty insurance companies to diversify their investments, make maximum use of their capital funds, and provide the increasingly necessary broad range of insurance and ancillary services by the use of subsidiary holding companies or direct subsidiaries.

Mutual property and casualty insurance companies need to have available the widest possible number of persons in business and financial community to serve as their directors, each of whom must be himself a policyholder of the mutual or a representative of a policyholder. Mutual companies cannot seek the advantages of diversification of investments and services through being acquired by an "upstream" holding company which holds the insurer and other business enterprises. Because of the corporate structure and the legal fact that mutuals are owned by their policyholders, the mutual cannot be acquired by such a holding company. Mutuals can obtain such diversification only through "downstream" holding companies or direct subsidiaries. Although various provisions of the bill make exceptions for bank holding companies and savings and loan holding companies, there is no exception for insurance holding companies, the only diversification means available for a mutual property/casualty insurance company.

The American Mutual Insurance Alliance respectfully urges this Committee that if any such legislation is to be recommended, there be incorporated in it an exception for mutual property and casualty insurance companies and their subsidiaries, with respect to the prohibitions of sections 2, 3, 4, 7, and 8.

The CHAIRMAN. A statement from Mr. Jenard M. Gross, chairman of the legislative committee, National Apartment Association has been received by the committee. The statement will be placed in the record at this point.

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(The statement referred to of Mr. Jenard M. Gross follows:)

STATEMENT OF JENARD M. GROSS, CHAIRMAN OF THE LEGISLATIVE COMMITTEE, NATIONAL APARTMENT ASSOCIATION

Mr. Chairman and Members of the Committeee, I appreciate this opportunity to present this testimony on behalf of the National Apartment Association, a trade association consisting of approximately 16,000 apartment owners, developers, and managers.

Our Association endorses in principle the Administration's bill, S. 3639, which would revise and recodify as well as simplify the very complex statutes on housing programs which appear to have proliferated with increasing complexity during the thirty-six years that have elapsed since the FHA was created by the National Housing Act.

However, we would like to express one word of caution at what appears to be substantive rather than procedural changes in the bill's approach to assisting lower income families to obtain decent adequate shelter. Our Association has endorsed the Section 236 and the rent supplement programs which provide effective mechanisms to assist lower income families to obtain adequate rental housing. However, we detect in the bill, as explained by HUD Secretary George Romney in his July 13, 1970, testimony before the Subcommittee, an attempt, through higher income limits and higher mortgage limits, to extend the benefits of these programs to higher income families. We strongly oppose the extension of these rental assistance programs to families whose incomes are 80% of the median in the area and we are more emphatic in our opposition to the use of 20% of the contract authority for families whose incomes are up to the median income in the area. Such income limits presuppose that this nation can afford to house with subsidies half of the families of the nation. When there are fourteen million American families earning less than $6000.00 per year, it is difficult to comprehend how we can provide subsidies for families earning up to $10,000.00 per year. Up to now, we have barely made a dent in assisting families that are truly in the "poor category"; how can we afford to divert our energies to families in income groups that are being housed adequately without subsidy?

Our nation's housing goals will be accomplished not by expanding the rolls of subsidized tenants to embrace the great middle class, but by pursuing sound fiscal and monetary policies which strengthen the economy through a more stable price level thereby attracting more savings into thrift institutions. It is true that housing has borne a disproportionate burden of the monetary policies made necessary by an unfortunate inflationary psychology which appears to have the country in its merciless grasp. However, the answer does not lie in expanding the rolls of families to be assisted to embrace half of America's families. To divert energy and treasury to assist families earning up to the median income is to diminish the effort which must be brought to bear to solve the housing problems of the thirteen million American families who are truly in need—those earning up to approximately $6,000.00 per year.

We recommend, therefore, that the maximum income limit of families eligible for Section 236 and rent supplement housing be not in excess of 70% of the median income with ample safeguards so that families of relatively low income, but with ample assets, not be eligible for these subsidies.

The National Apartment Association would also further like to go on record as endorsing the Bill which would encourage rental of existing housing to qualified tenants, in authorized payments, and contract payments directly by the Secretary of Housing and Urban Development. We feel that furtherance of this program, in many instances, can reduce the quantity of expenditure proposed for public housing activities.

We would like now to address ourselves to a subject which, while it is not a part of pending legislation, is nevertheless most serious and threatens the role of the private entrepreneur in multi-family construction. I refer to the increasingly prevalent custom of institutional investors requiring an equity kicker or a "piece of the action" as a condition for making a mortgage loan on the property. This practice is causing great hardship to private industry at all levels of activity within the apartment industry.

The concept of participation by mortgage lenders, both long term and short term, began several years ago. This has taken several forms. Some of these have

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been a demand for a percentage of the gross income, such as 2% of the gross; others have taken the form of a percentage of income above a defined level, such as 10% to 20% of income above 80% or 90% occupancy. Other forms have been to take a participation in future rent increases. All of these have the effect of increasing the return to the lender of the mortgage funds to an unconscionable level.

Since the advent of the initial approaches as above mentioned, new concepts have been advanced which go beyond the point of trying to get added interest and end up with *ownership* situations. One of these is an approach whereby, in addition to making a mortgage on the property, the lender buys the land out from under the owner and leases it back for a period ranging from 30 to 70 years. At the end of that period of time, the lender owns the property and the original owner—the developer—has merely been the manager of the property in the interim.

There are several other devices which have come to light recently. One, for example, involves a permanent mortgage and a percentage of the profit from any *future sale* of the property.

One problem which arises with any of these approaches is the simple fact that the borrower is having to deal with a lender from a position of weakness. There are inadequate funds in the mortgage markets today, which have placed the borrower in the position of having to pay just about anything demanded in order to obtain funds to develop his project. The lender, having control of the most desirable commodity around these days—namely money—finds that if one borrower will not go along with the requirements, others will. In a recent case, a particular insurance company proposed a real estate investment trust and said they would make $36 million available for apartment mortgages at approximately 10½% yield, plus 2% of the gross income. The insurance company had on file $100 million in loan applications and continued to issue commitments only to those who would accept the "kicker" until such time as this $36 million was exhausted.

The problem, obviously, is one of scarcity of funds in the overall market place. Unfortunately, our industry always gets dealt the severest blow in a tight money situation, and this tight money situation today is no different from most previous ones, except in the degree of severity.

Some states have laws which prohibit this type of lending, wherein an ownership participation is demanded or various other types of fringe benefits are demanded. Unfortunately, in the type of market we have, legislation at the local or state level merely makes an insurance company lend in another state. For instance, we have one large investor which will not make apartment loans in Texas today, because that State has a law which prohibits insurance companies buying the land out from under projects. Therefore, they will make these loans in other states where they can get this type of kicker. That is why national legislation is needed which places everyone on an equal footing.

Obviously, if the firm which controls the lendable funds is able to have ownership of the project, it would only seem logical that they would prefer to make loans in the areas where they will eventually obtain ownership and certainly prefer to lend to a developer who will go along with that type of situation.

We also feel that just as lending institutions switched from bonds to stocks gradually after World War II, when this tight money market eases, we will witness a greater trend toward equity participation kickers by lending institutions as opposed to straight mortgage loans, simply because they would hope to make greater profits. As we all must remember, though, once one goes to the equity side, the risk is greater and the public funds which are being invested by these institutions are in a *greater risk position* than they are in a straight loan.

It is the opinion of the National Apartment Association that Congress should enact legislation prohibiting lending institutions from using the participation and equity kicker forms of lending, which are having such an injurious effect on our industry today. Unless this is done, we are confident that the combination of the equity kicker and mortgage money scarcity will result in a sharp further decline in multi-family residential construction.

We are submitting for insertion in the printed hearings as part of this testimony an article which was published in the July issue of Fortune, entitled, appropriately, "The Future Largest Landlords in America." It focuses attention on this ominous blurring of the lines between those who lend money and those who

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need to borrow in order to construct the housing which this country needs. I commend it to the thoughtful reading of the members of the Subcommittee and the subcommittee staff.

Thank you.

(The article, "The Future Largest Landlords in America," appears at p. 536).

The CHAIRMAN. Thank you very much, sir.

I want to ask Mr. Terry a question about the Columbia project.

Is that the one between here and Baltimore? Will you expand on your remarks and tell us more about that project? How many units are contemplated for that project?

Mr. TERRY. Well, Columbia is a new town, Mr. Chairman, between Baltimore and Washington. We, The Rouse Co., with the Connecticut General in 1963 began by acquiring 14,000 acres. And we will build enough housing, 32,000 units, that will accommodate a population of 110,000 people. We further will build office buildings, shopping centers, industrial facilities that will provide jobs.

The CHAIRMAN. How did you get your loan? What is the length of term that you have a contract for on the furnishing of the money?

Mr. TERRY. Well, we finance—in our underlying financing for Columbia, which is today $80 million, we begin to retire in 1971, I believe, and it is due 10 years after it began in 1966.

The CHAIRMAN. What interest rate do you pay considering the equity participation?

Mr. TERRY. It is difficult for me to answer that, because Connecticut General owns half of the entity that is developing Columbia, which is called Howard Research and Development.

The CHAIRMAN. That is part of your deal, to get the money.

Mr. TERRY. Right. The rate we pay to Connecticut General on borrowing is 6 percent.

The CHAIRMAN. That is on your half, I assume?

Mr. TERRY. No, the entity, Howard Research and Development, began by borrowing $50 million.

The CHAIRMAN. And you paid 6 percent on the $50 million?

Mr. TERRY. The share of Connecticut General is 6 percent. The overall interest rate is 7.3 percent.

The CHAIRMAN. Since they have half the project, they do not have to pay half the expense?

Mr. TERRY. No, the borrowing entity pays the total expense.

The CHAIRMAN. Will that give them an advantage?

Mr. TERRY. No, it does not give them an advantage at all. That debt is retired via land sales, selling single family house lots or shopping center sites, or what-have-you. And we retire that debt that way. Hopefully by 1980 the city will be complete, the debt entirely paid off, and we would then equally share the profit.

The CHAIRMAN. The time I take must be confined to 5 minutes. And I yield to others. So I will not ask you other questions at this time. But if you wish to elaborate on your testimony to include the points we have been discussing, it will be satisfactory.

I think that this is a very important hearing, and you gentlemen have made a very important contribution to the committee members in trying to arrive at a fair solution. I do not know what is right about this. But by getting information from people like yourselves who are every day in the market and who know, who are engaged in

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transactions that are covered by this bill, H.R. 5700—and we are hearing testimony on both sides, of course—we hope to arrive at opinions that will be in the public interest at least, and not sacrifice anyone or any group on account of it, or to do any injury or harm to them. If we can do something which is of benefit to the industry which you represent, which is one of the finest and greatest industries in the United States, we would certainly like to do it. We know that there are charges, rather shocking charges, about what is going on. And we just want to get at the truth about it.

The housing industry, I think, is one that should be given special consideration by the Government, because, as it is now the housing industry, I think, is discriminated against. You take the big corporations and big banks. Usury laws do not apply to them. They have ways around it. They can either pay you 8, 10, 12, 15 percent interest, or they can make you pay that much interest, and not violate the law. And then whenever you have to go into the market to get your money, the homeowner, who wants to buy a home, is in competition with not only the big corporations, but the speculators.

On the New York Stock Exchange, where two-thirds of all transactions in amount and number of transactions are by institutional investors. They have a great advantage over just the ordinary person.

And then you take the high-interest loan people, finance companies. They can pay a lot more than a person can pay who wants to buy a home.

You take the gambling casinos and institutions like that, they can pay a lot more than the person who is trying to buy a home.

So I think that the Government should do something to encourage the use of funds at a reasonable rate for your industry. I really believe that. We must do it. We all talk about environmental quality. You cannot have environmental quality in this country unless you have people with homes, sanitary homes, stable homes, good homes, in which to rear and educate children. And there are a lot of things about environmental quality that are promoted by adequate housing. And you cannot have adequate housing unless you have money. The money must be available.

The discount window of the Federal Reserve banks could be used. They are letting the banker have money for 4¾ percent. Why just pick out the bankers and let them have money at 4¾ percent? They have the privilege of taking demand deposits and not paying any interest at all on them. Last year they had $225 billion free use of money. The year before the same way.

Mr. WILLIAMS. Mr. Chairman, will you yield for a question?

The CHAIRMAN. Not just now; let me finish my 5 minutes.

Mr. WILLIAMS. You have finished your 5 minutes.

The CHAIRMAN. No, I have not. You wait just a moment. Your time will come.

Mr. WILLIAMS. I would like to know, are you asking these questions for the record, or is this a housing bill we are considering, or what?

The CHAIRMAN. You cannot have housing without money.

Mr. WILLIAMS. Is it a housing bill or an environmental protection bill?

The CHAIRMAN. That is right, environmental quality. And we are all striving for it.

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So I have a feeling that we should even go to the discount lender for housing to get money at a better rate of interest. Why should we just restrict it to the banks? The Government is paying all the expense of the Federal Reserve banks. Only 40 percent of the banks get the benefit of it. And I see no reason why the housing industry should not come in one way or another. And that is what I want to get considered, too.

Mr. Widnall.

Mr. WIDNALL. Thank you, Mr. Chairman.

First, I want to welcome all members of the panel here before us today. I think you have been making a very wholesome contribution to our discussion and final decision with respect to this pending bill.

I think this is a rather unique panel, in that to my knowledge this is the first time we have brought together the person who funds the development and the developer himself. And this is in the case of Columbia, which has been an outstanding example of what can be done with a new town. We hear so much emphasis now about the fact that there should be six, eight, or 10 new towns of a hundred thousand or more throughout the United States.

I would like to ask this question of Mr. Hamilton and Mr. Fey. Has your original agreement with respect to Columbia and the financing of Columbia been abrogated or changed in any way since you began because of inflation and changes in the money market?

Mr. FEY. If I may, I will call on Mr. Bruce Hayden, who is with Connecticut General, and who is directly responsible for this.

Mr. HAYDEN. Mr. Widnall, let me answer the question first by telling you the structure that this financing took. I think it is essential to answer the question.

In the first place, when we came into this about 7 or 8 years ago we made an initial equity investment which matched a much smaller equity investment made in dollars by the Rouse Co., and a much greater equity investment in their skills and services. So that for our 50 percent we made a substantial cash investment to match their minimum cash plus their know-how and expertise.

Now, since that time we have financed it and refinanced it time and time again. And the needs grew as the program changed. One of the essential parts of this financing—and it has been in my opinion the difference financially between Columbia, which is highly successful, and Reston which is somewhat of an economic disaster—it has been that as a 50 percent equity owner we were willing to defer all capital costs. Only within the last year has interest been paid in cash; previously all interest was capitalized. As an equity investor we could do this. If we had been a straight lender we could not have or would not have. But we have rolled the financing over time and time again to fit different conditions. This financing at Columbia has been restructured regularly during the development period. The interest rate has changed regularly with changes both in market conditions and in the nature of the particular aspect being financed. Rates have been as high as 12 percent and as low as 6 percent at different times and on different types of capital investments for different purposes.

Perhaps the most significant thing in my opinion is that I can make the categorical statement that if Mr. Rouse had come to us 7 or 8 years ago and said that this thing looks great, it has great social impli-

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cations as well as financial, lend us $50 or $60 million, and if all works well you will get your money back at 6 percent, if he had come in on that basis there would be no Columbia. The thing that made it successful, outside of the genius of the Rouse organization, is the willingness to finance on a very flexible basis. And, incidentally, this financing would not be possible if section 14 had been in effect at the time this was done.

Mr. WIDNALL. Let me just stop you at that point. You say if section 14 goes into effect as proposed this would prevent the construction of any new Columbias?

Mr. HAYDEN. Well, it would prevent them from being financed with private capital insofar as we know. It effectively seems to rule out the joint venture.

Mr. WIDNALL. When the discussion was taking place earlier I was a little bit lost on the point where you are talking about a 6-percent figure in connection with it, but the effective rate was 7.3 percent. Who is paying the 7.3 percent, Rouse or Connecticut General?

Mr. HAYDEN. The development of which we are a 50-percent owner is being charged with interest at this rate. As indicated, there have been many rates at many different times. There was one instance in which a lender who came in with a participation received one rate while another lender coming in at the same time preferred a higher rate in lieu of participation. In all instances the rate is a rate paid by the entity, HRD. It is an oversimplification to say that any partial owner of HRD is in effect paying interest to himself.

Mr. WIDNALL. I think it is extremely important that members of this committee really understand the operations that take place on these big developments particularly. And I am sure that every one of us does not want to do anything to inhibit national growth or sound construction. I know I was one of those who have expressed alarm as to the use of the equity kicker. It seemed to me that there was a great deal of possibility here of considerable profit with very little risk involved at all, and that funds were being channeled there to the detriment of other areas in our housing field. I think we all are disturbed at the lack of single-family home construction, and still the lack of low-income construction.

We have been trying different means of getting at it. And it just does not seem to me, as one who has been very much interested in private enterprise in all of these things, that private enterprise has fully realized the enormity of the job, the pressing needs of the moment, and the fact that something just plain has to be done in order to make possible some new homes in the lower income class for our people.

I am somewhat familiar with Columbia. I want to be more familiar with it, and understand completely what is going on over there, and the method of financing, the method of choosing property for one purpose or another, and whether or not the healthy growth is taking place there that we seek for all of these new communities. I think that the testimony so far today has shed considerable light on this. I would like very much to ask a great many questions on this. And I am going to take advantage of the fact that we can all submit questions, and hope that you will answer these for the record.

Mr. HAYDEN. I would be happy to, sir. Do you wish any extension of Columbia at this time?

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I would like to say that Columbia is designed to house all income groups. It was an objective of the Rouse Co. which we shared that the corporate chairman and the corporate janitor could both live in the same community, and they do. It has been part of the program to sell adjacent corners, one for about $50,000 and one for about $300,000, one to be used for low-income housing and the other for moderate and higher income housing.

The whole planning has been toward the creation of a balanced, broad spread community. Mr. Rouse is very proud of the fact, for example, that the first baby born in Columbia was born of an interracial marriage. I do not think we have any statistics on the percentage of blacks and whites or other races in there. But the whole effort has been to be broad, multiracial, and the complete economic range. And we are very proud of the results achieved.

We give most of the credit to the Rouse Co. But our money had a little to do with it.

Mr. WIDNALL. Thank you very much.

Mr. HAMILTON. May I have 10 or 15 seconds, Mr. Widnall, to comment also?

Our member companies are property and casualty companies. As I have indicated, they have very little activity in the mortgage market or the real estate market. So far as I know none of our member companies has any interest in the equity participation matter. To the extent that our members may have life insurance company subsidiaries, those life insurance companies, I believe, probably would be associated with one of the associations represented by Dr. Fey. This particular subject is just outside our interest.

Thank you.

Mr. WIDNALL. Thank you, Mr. Hamilton.

(The following are written questions submitted by Mr. Widnall to Mr. Terry, along with Mr. Terry's answers:)

Question 1. Why would interest rates have to go up necessarily if participations were eliminated?

Answer. Since participation is a form of interest which is added to the fixed interest rate in any, transaction it gives a lender its desired market yield. If participations were eliminated it is clear to me that that interest rate would go up by the yield loss on participations. This would directly add to the fixed burden a developer would have to pay, which is clearly to his disadvantage.

Question 2. Since many developers "borrow-out" on a project, why is it necessary to have equity financing?

Answer. The term "borrowing-out" refers to a developer's ability to cover the total project cost via financing. Today it is virtually impossible to cover project costs through the traditional 75% loan. Typically financing in excess of 75% of value is referred to as "equity financing"; hence the term "equity participation." So, specifically answering your question, most borrowers today cannot borrow-out and because of low capitalization in our industry must seek equity financing.

Question 3. In the past two years, could you have obtained financing for the Rouse Company without equity participation?

Answer. Yes. In the last two years we have in fact received financing without equity participation. However, there was a higher fixed interest rate than we could have obtained if we chose to offer participation.

Question 4. Are equity participations a direct result of inflation?

Answer. Yes. Since construction costs and land costs have been increasing at a fantastic rate, the ability of a developer to finance via traditional methods has been difficult and in some cases impossible. When any lender takes a higher risk by choosing to finance a project in excess of 75%, they necessarily must seek a higher rate on that investment to adequately justify having taken that risk.

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(The following are written questions submitted by Mr. Widnall to Mr. Fey, along with Mr. Fey's answers:)

Question 1. On page 15 of your statement, Mr. Fey, you say that section 14 outlawing "equity participation" would adversely affect the development of real estate projects, including multi-family housing by restricting the availability of funds.

Would you please expand and elaborate upon this point?

Answer. The basic principle here is that investment funds are directed toward those outlets which offer the most attractive returns with reasonable safety. If bonds are offering a better yield than mortgage loans, investments are channeled toward bonds. If certain kinds of mortgages are more attractive than others, they will be favored by investors. In the case of life insurance companies, our investment return on policy holderfunds is a key factor in the net cost of life insurance and we feel a primary responsibility to seek the best return available in the market place.

Arrangements such as income participation or contingent interest have been one form in which investors receive a return on invested funds, alongside the fixed contract rate on an income property mortgage. If income participation were prohibited, lenders would either have to raise the fixed rate on the mortgage or re-direct their funds toward the bond market or stock market where better returns are available.

Prohibiting part of the lender's return may be compared to placing a ceiling on interest rates. When competing rates elsewhere are above the ceiling fixed on certain loans, investment funds will shift away toward the more attractive outlet. In this situation, developers would find that they could not attract the mortgage capital they seek and could not construct the apartment buildings of commercial projects they had planned. Real estate development, including residential structures would clearly suffer. This is not a hypothetical situation, but has been often seen in actual practice when FHA rate ceilings filed to keep pace with rising bond yields, or when rate ceilings on state bond issues left them stranded with no bids when market rates on competing bonds had moved higher.

Question 2. Under the projects of Section 14 dealing with "equity participations" do you believe that this would prohibit the investment by insurance companies in convertible bonds and if so, what effect would that have upon the ability of businesses in this country to secure adequate financing?

Answer. Life insurance companies acquire corporate bonds not only by purchasing publicly offered securities sold through underwriters but also through directly placed bonds arising from direct negotiations between borrower and lender. While we are uncertain whether public offerings of convertible bonds would be ruled out, it appears that directly placed convertible bonds would be, since they are loan transactions in the ordinary sense of the term.

Direct placements, as we call them, are a particularly important financing vehicle to small- and medium-sized corporations which are not in position to market a public issue because of their size or their credit standing. Convertible bonds allow such corporations to keep down their borrowing costs and debt charges, since these bonds typically carry a coupon rate well below the rate on straight bonds, depending on the attractiveness of the conversion feature.

If this traditional method of bond financing were ruled out by Section 14, the burden would fall primarily on these younger, expanding corporations which would be confined to nonconvertible bond issues with higher coupon rates and debt service or be forced into the public market where flotation costs and registration fees would add to the cost of their financing. Moreover, the inability to convert outstanding bonds into common stock would mean that they would have to raise their equity capital through separate stock issues, which is usually more difficult for a smaller, lesser-known business than for a larger, established corporation.

The very active use of convertible bonds to raise debt capital, and later provide for a stronger equity base when conversion into common stock occurs, demonstrates that this method has been an economical and desirable financing technique. Certainly, borrowers have not been forced into this approach by lenders, since corporations have been able to raise capital in a variety of ways. But it clearly serves the requirements of many firms that would find separate issuance of stocks and bonds more costly to them.

Question 3. Would you discuss the effect of outlawing "equity participations" in real estate and mortgage lending as it relates to insurance investments?

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Answer. A full answer to your question would depend upon which of the many forms of so-called "equity participations" would be prohibited by Section 14. As I have indicated, there is some uncertainty as to which of the many practices which combine debt and equity financing would be affected in the final analysis.

One thing is certain in my mind, namely, that prohibition of equity participations in commercial mortgage lending will not automatically result in a return to single-family mortgage lending by life insurance companies. It has been suggested by other witnesses that our attraction to equity participation was the basic reason for our declining interest in single-family home loans. But this is not an accurate presentation of the facts. Life insurance funds have been directed toward those areas where we can operate most efficiently with larger sums of money and receive a better return than afforded by single-family mortgages. This explains our shift in recent years toward a greater emphasis on corporate bonds and commercial mortgages, where the return is considerably higher than home loans and the expenses of originating the servicing loans are considerably less.

If Section 14 were enacted to prohibit income participation, land purchase and leaseback, and joint ventures for real estate development, it is clear to me that life insurance would shift in other directions, to the detriment of builders seeking mortgages and equity capital for apartment projects and other commercial developments. The building industry has been severely undercapitalized for years and this situation would be worsened by Section 14, in my view, which would stifle the growth of that important part of our economy.

Question 4. We have been able to finance the country for 200 years without "equity participations." Can you tell us that you can't continue to do so?

Answer. Investment funds will obviously be available for the financing of capital expansion, so long as savers are willing to put aside funds which can be loaned to borrowers through institutional channels. But I do not feel that this process is aided by prohibiting transactions which have been beneficial to both borrowers and lenders in a time-tested fashion. For example, convertible bonds and bonds with stock purchase warrants attached have been a useful and active financial technique since the start of this century, at the least. We are not saying that the capital markets would grind to a halt without equity participations, but we do contend that this prohibition would rule out many desirable and economical techniques for mobilizing capital and would reshuffle the flow of investment funds in ways that would hold back real estate development, including multi-family dwellings, at a time when there is a recognized long-term need for encouragement to this field.

Question 5. How do the States handle interest limitation laws on large real estate developments?

Answer. With two exceptions, every state has a usury law limiting interest which may be charged for a loan. In 39 states and the District of Columbia, there is some form of corporate exemption from usury limitations permitting them to borrow at rates in excess of those applicable to individuals. The idea behind the corporate exemption is that a corporation does not require the protection of an interest limitation law since the loan transaction reflects negotiations between businessmen well able to understand the nature of the transaction. Following this philosophy, a few states have recently gone beyond the formality of incorporation, so that the business purpose of the loan or the size of the loan determines whether the usury law applies.

While many developers utilize the corporate form of organization, others prefer to operate as individuals or partnerships because of tax considerations. Thus, the application of interest limitation laws on the borrowings of large real estate developers will depend on the form of organization and also whether the state recognizes an exemption for corporations or for larger business borrowings.

In the application of these usury limitations, it is important to recognize that contingent interest arrangements do not provide a circumvention of the state laws, as one witness has suggested. Payments received by lenders from income participation are included, along with the fixed interest rate, in the interest calculations applied by state usury statutes.

The CHAIRMAN. Mr. Ashley.

Mr. ASHLEY. It is not very often that I find myself in agreement with Chairman Patman on financial matters, and I do not want to distress you gentlemen overly by saying that I am somewhat persuaded by certain elements of this bill. But I confess that I am not

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dazzled by the testimony this morning with respect to equity participations.

Mr. Jackson, you say on page two of your statement: "The equity participation is a creature of inflation."

You go on to say that it is mainly during such periods that other means than the mortgage loans must be found by which money can be made available to those who wish to build large projects such as office buildings, and including hotels, motels, and shopping centers, for example. Why do we have to build these during periods of inflation? The whole point of Federal Reserve policy is to restrict credit during periods of inflation, drive up interest rates, and thereby discourage lending for, if I may say so, such activities as this. What you are saying is very much what other large corporations say when they go to the Euro market for dollars, thereby obviating the purpose of restrictive money policy. It is exactly the same thing that happens when companies make use of commercial credit almost to the point of disaster. So you say that this is the salvation during periods of inflation. I cannot think of a means of allocating credit on a more unfair basis than this. Because there is no social purpose that necessarily obtains—or is there? When we build a shopping center during periods of restrictive money policy we know the housing is taken out first. Essential public services are taken out about the same time. They are the first and the worst hit. And what I am led to gather by the testimony this morning is that this is just fine, but that there should be a continuing availability of money, through equity participation, so that we can build these unessential facilities whether we are in a period of deflation or inflation.

Mr. HOVDE. Congressman Ashley, if I may lend some examples to your remarks I would appreciate it.

Mr. ASHLEY. By all means.

Mr. HOVDE. I could not agree with you more, sir. In our city of Madison of 160,000 people housing for the past 2 years has been anywhere from 30 to 40 percent below the absorption market, be it single family or multifamily. And we have seen built and initiated in this period two of the largest shopping centers, one being 750,000 square feet, the other being a million and a half thousand square feet. All started during this period of tight money. And we will have enough retail area for shopping in that area to have—I do not know what the exact figures are, but it almost doubles, one would say, our existing space. We all recognize in our society of democracy and our belief in the free enterprise system the principle of homeownership, and the privilege and the opportunity and the right of being able to purchase a life insurance policy and establish security and cash value. Nevertheless we say that we have been dealing with an underwriting practice here of equity participation. But let us look at the overview of where this and other policies have taken us.

Homeownership has made our country what it is today. Historically some 60 percent of our country has had the right and the privilege of having their own homes. And we are seeing a rapidly diminishing percentage of this in our total. In our city this has already dropped to in the neighborhood of 51 or 52 percent. And I would dare say, gentlemen and ladies, that by the year 1975 in our city homeownership will become less than 50 percent. And I have projected figures that by

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1980 it may occupy somewhere in the 40 percent range. If our society is to maintain its position as a free democracy homeownership is a very important ingredient.

The life insurance companies are anxious to sell life insurance policies to homeowners, so that if the father, the breadwinner of the family should pass on, this home can accrue to that particular family. They think nothing of establishing substantial insurance agents through the country in order to sell their policies, in order to establish the basis for their company, that is the very foundation of the life insurance companies. They are quick to come into our area and sell life insurance policies. We commend them for it, because it is such an important element of our total society. But nevertheless the same person who has a life insurance policy goes back to that large company and asks for a mortgage policy, and there is nothing set up, nowhere can he get that type of mortgage. So he has to go to the savings and loan that is already overburdened for homeownership purposes. Or what does he do? He goes to banks and borrows on his life insurance policy, jeopardizing the very security that he has bought the policy for in the first place.

And though we have been dealing with underwriting practice here, I question the overall lending policies that have been established. We find ourselves in this country today with overbuilt office buildings, overbuilt shopping centers, overbuilt multifamilies in some areas, and a tremendous lack of single family housing in this country.

Thank you, Mr. Fey.

May I request that Mr. Murray be permitted to respond to Mr. Ashley's question?

The CHAIRMAN. Mr. Ashley's time will determine that.

Mr. ASHLEY. I seem to have time for one question, Mr. Chairman.

Mr. FEY. We feel we do have a direct answer to this question.

Mr. MURRAY. In response to Mr. Ashley's question and following Mr. Hovde's succeeding statement. I would like to comment on: (1) The shortage of single-family housing; (2) the question of equity participation being a creature of inflation; and (3) the construction of large projects at a time of restrictive credit policy—when housing is in short supply.

THE SHORTAGE OF SINGLE-FAMILY HOUSING

Single-family housing construction has languished in recent years even during periods when mortgage funds were in relatively ample supply (such as the years 1967–68). All students of the problem agree that the availability of financing and interest rates are only a part—a moderate part—of the problem.

The most important factor is that in recent years construction and land costs have risen far more rapidly than disposable income per family. Consequently, a large proportion of families find it impossible to come up with a 20 to 25 percent downpayment on a single-family home and to stay within prudent limits of carrying charges relative to disposable income.

The basic reasons for the sharp increase in construction and land costs are well known. Mass production of standard single-family houses is still in its infancy. The labor component of house production

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is very high. Construction labor is highly unionized and has obtained settlements far in excess of productivity gains and other union settlements. In addition, there are restrictive work and union admission practices. Part of the responsibility also rests with widely divergent and frequently very restrictive local zoning and building codes. As to land costs, there is the inexorable pressure of rising population on limited land supply, especially around the metropolitan areas where more and more of the population is concentrating.

Financing difficulties in single-family housing must be viewed in proper perspective. Measures designed strictly to cope with this question may simply lead to an even more rapid escalation in the average cost of such homes rather than to an increased supply of homes.

It is true that single-family home financing has faced special difficulties during periods of highly restrictive monetary policy (1966 and 1969–early 1970) when the typical mortgage lenders have been hit by disintermediation—sharply rising policy loans in the case of life insurance companies. In such periods, we have had to ration funds to all borrowers. It might be suggested that it would be desirable if mortgage flows to single-family borrrowers could be curbed only in proportion to all loans. The major difficulty with this proposition is that State usury laws often keep residential mortgage rates below the market rate on alternative loans. Such ceilings are adjusted only sluggishly, partly because the legislative process is slow. For example, during much of 1970 up to one-third of the States had unrealistic mortgage ceilings. This situation confronts the life insurance investment officer with a cruel choice. Accepting below-market rates on loans shortchanges the policyholder whose net premium payment on life insurance policies is directly related to the investment return that can be obtained from the savings component of his premium payments. Basic responsibility to policyholders and the forces of competition militate against doing so. Hence, residential mortgage loans tend to be reduced sharply. The Equitable, however, has never gone out of the new residential mortgage field entirely and has no plans to do so.

We hope for constructive solutions to the problems we have described, most of which are beyond our direct control. Undoubtedly, the inflation of construction costs—which the Government is now beginning to tackle—is the most basic difficulty. New Government programs aimed at making home mortgages a more liquid and marketable instrument are potentially very helpful.

It should be especially noted that the life insurance industry is in the midst of a $2 billion program to provide low cost housing and job opportunities in the inner cities. This special effort, in which the Equitable is fully participating, recognizes social obligations and the vital interest of the industry in the improvement of our cities. We believe that our policyholders fully recognize this special problem and our vital stake in its solution, but we cannot ask them to subsidize all sectors of the economy with some claim to social priority.

THE QUESTION OF EQUITY PARTICIPATION BEING A CREATURE OF INFLATION

I do not believe that equity participation is solely a creature of inflation. It is entirely possible for borrowers and lenders to strike

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mutually agreeable bargains consisting of a mixture of fixed interest and income or equity participation regardless of the inflation rate. It is true, however, that uncertainty and distrust about the future purchasing power of the dollar induced by accelerating inflation increases the incentive for lenders to seek partial protection through such devices.

In fact, it is once again responsibility for policyholders' funds that has lead insurance companies to seek this partial protection. It should be realized that high loan-to-value ratio mortgages at fixed-interest rates during rapid inflation are a bargain to the borrower and a serious impairment of policyholder capital values. The rise in land and building values plus the possibility to escalate rents can enable an alert real estate operator to gain additional profits while leaving the institutional lender and the small saver he represent with eroding values of principal and interest payments. Rising interest rates and income participations are basically a defense mechanism developed at a time when governmental action cast serious doubts upon the future real purchasing power of fixed-dollar contracts such as life insurance policies. With income participations, if correctly calculated, there is at least a chance that the terms of life insurance contracts can be improved to offset some of the highly adverse effects of inflation upon policyholders.

The Equitable has never sought or obtained control of a borrower through income or equity participation. Our policyholders' interest, however, requires opposition to indiscriminate legislative restraints upon all equity participations.

THE CONSTRUCTION OF LARGE PROJECTS AT A TIME OF RESTRICTIVE CREDIT POLICY—WHEN HOUSING IS IN SHORT SUPPLY

The question of overall lending policies which permit financing of large projects such as office buildings, hotels, motels, and shopping centers during periods of inflation has been raised.

The construction of large real estate projects require a substantial "lead time." Many months, sometimes years, elapse between the time that a developer acquires some land for development and the time that construction is started and completed. During these months and often years, the developer must obtain necesary zoning including construction authorization. He must design his buildings and the parking for them. He must obtain tenants who will pay enough rent to support the project (and this often involves redoing the initial plans). With some of these accomplished, he then must seek permanent financing for the project that will provide enough funds, together with his equity, to complete the project—and when the permanent financing has been committed he then must obtain construction financing. Therefore, when you see a major building being constructed at a time when the economy is on a downturn, it often results from the inability of the developer to stop once he is started. Should he stop in the midst of his planning and development, he can easily lose all he has invested to that time.

Mr. JACKSON. I will be glad to answer Mr. Ashley's questions which he addressed to me for the record later.

Mr. ASHLEY. I have some others. On page 3 of your statement you

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say the equity participation benefits the lender and the developer. What about the tenant in an apartment building? Do you mean to tell me that the lender and the developer can both benefit without it being at the expense of a tenant?

Mr. JACKSON. In order to understand what I propose, Mr. Ashley, let me make this blanket statement which I think would lead to the answer you are seeking.

Dr. Fey mentioned and outlined, and would be glad to give you some specific details, that the initial interest charge made to the developer by the lender to build an apartment building is lower as a result of the lender's ability to participate in the future increases in rents should they ever occur, than would be the case if the lender were unable to participate in those future rents.

Mr. ASHLEY. I think it might be well, Mr. Chairman, if these gentlemen feel as strongly as they appear to, for the Connecticut General people to give us the essence of the overall agreement with the Rouse Co., the Howard Research and Development, the terms of that agreement, and what the potential return will be.

The CHAIRMAN. Mr. Ashley, we will go around and come back to you.

Mr. ASHLEY. That would be fine.

(In response to the information requested by Mr. Ashley from the Connecticut General Life Insurance Co., the following information was received from Mr. Hayden for submission in the record:)

REPLY RECEIVED FROM MR. HAYDEN

Mr. Ashley, in order to answer your question, let me first give you a bit of the history of Columbia and its financing; some understanding of this is essential for a proper answer to your question.

The Rouse Company of Baltimore, with whom we had long had a mortgage correspondent relationship, began to research the feasibility in the early 1960s of building a completely new city. Mr. James W. Rouse and his associates invested many man hours and a great deal of money in studies, travel, consultant services, and site selection searches. The cost of this ultimately amounted to about $750,000 which was paid for by the Rouse Company from its working capital.

Research indicated both that the project might be feasible and that its most likely location was in Howard County, Md., halfway between Baltimore and Washington. Both as a starter and as a test of the availability of land in Howard County, the Rouse Company purchased 600 acres initially, in 1963.

Shortly thereafter, Mr. Rouse came to Hartford to Connecticut General to state that he believed that the necessary 12,000 acres could be acquired at a cost not to exceed on the average of $1500 per acre. At that time, he invited Connecticut General to join with him in the venture first as an equity partner and second as a lender (may I emphasize that this proposal came from Mr. Rouse to Connecticut General, not vice versa).

Mr. Rouse pointed out that there were very substantial risks involved:

(*a*) The land was primarily agricultural and was not zoned for new city development.

(*b*) The political climate in Howard County strongly favored its remaining rural and against any such new city development.

(*c*) The costs of all the necessary development—roads, utilities, schools, other public necessities—were unknown and not even estimated.

(*d*) Nowhere in America had a project of such magnitude been undertaken, new cities were, to be sure, already well underway in Europe but in each instance had been heavily subsidized by Government. The proposed development was not only going to be "first" on American soil, but the first anywhere financed entirely by private capital.

Mr. Rouse, however, went on to set forth not only the great potential, social benefits that might accrue from the complete planning of such a new town and

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the example it could set to the rest of the country, but also the potential profit to be achieved if such a development were successful. He was able to convince Connecticut General that the risk was worth the taking and the basic financial structure was agreed upon:

(*a*) Connecticut General would purchase 50% of the stock in the development company, Howard Research and Development (HRD), by matching the investment that Rouse had already made of $750,000. This additional $750,000, bringing the equity of the development company to $1½ million, was to be used for further planning.

(*b*) Connecticut General agreed to loan HRD up to $18 million in order to acquire the 12,000 acres of land. The rate was to be 8%, which rate was to be capitalized rather than paid in cash. The land was to be sole security for the loan.

This basic proposal was approved by the Connecticut General board in May of 1963 and HRD undertook its land acquisitions. By the fall of '63, almost 15,000 acres had been acquired. Connecticut General had agreed to increase its loan to cover the additional land purchase and to provide additional funds necessary for the planning and rezoning process.

During 1964 and 65 the Columbia plan was developed to call for 30,000 dwelling units to house a population of 100,000; it also provided land for business and employment totaling 30,000 primary jobs; some 20% of the land was to be set aside as permanent open space for the recreation and enjoyment of all future residents as well as existing residents of Howard County; there was to be a major downtown commercial and office center to serve as a nucleus for seven villages of 10,000 to 15,000 each.

At this time Mr. Rouse defined and Connecticut General approved four major development criteria:

(*a*) Columbia was to be a complete city not just another bedroom subdivision; it was to provide a full range of housing from corporate janitor to corporate chairman; it would provide all customary municipal services but improved so that each would support the others instead of being allowed to develop without regard to such mutual support.

(*b*) Columbia was to respect the land. The forests, the stream valleys, the best views, the historical structures, all were to be preserved in perpetuity.

(*c*) Columbia was to provide a better environment for the growth of people—and people of all races and economic strata. The preservation of the dignity, integrity and identity of both the individual and the family was to be uppermost; and, as a necessary means to this, the residents of Columbia were to assume responsibility for their own municipal affairs as rapidly as this could be done consistent with the orderly development process.

(*d*) The development of Columbia was to be highly rewarding—profitable—to its developers. In fact, it was recognized that if Columbia were successful in all of its other three objectives but failed in the test of proving to America that planned development to high standards was, in fact, the most profitable way to develop a new town, Columbia would itself have failed. Columbia had to be successful in the marketplace.

To focus on the profit objective and to provide discipline to meeting the other three objectives, the Columbia economic model was first developed in the spring of 1965. The model is a highly complex computerized means by which, ever since that time, the co-developers of Columbia have been able to test each decision prior to its being made by plugging into the model on a "what if" basis all proposed changes and then following through the effect of such changes on all major aspects of Columbia's development.

This model has been revised regularly and is reviewed by the Board every three months. Submission of a copy of it to this Committee would seem to serve no useful purpose, for the voluminous printout at any given time is meaningless except to those who have been involved with the Columbia process continouusly. It can be summarized, however, to say that the model indicated the need for a total of $50 million before there was any possiblity that the proceeds of the land sales could support the enterprise. This led to the bringing of Chase Manhattan and Teachers Insurance and Annuity into the picture, to provide $25 million to match a total commitment by Connecticut General of $25 million. This basic financing at an average interest rate of 7.3% is secured by a first mortgage on all unsold land owned by HRD.

In the spring of 1968, when in competition with dozens of other land owners andy many municipalities in the Northeast, Columbia's developers persuaded General Electric Company to locate a major appliance plant in Columbia, the

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economic model was instrumental in keeping the Columbia plan in balance. G.E. purchased a thousand acres, some of which Columbia had to go out and buy; HRD had to provide for bringing not one but two railroads to the site, and major new planning and provision of services had to be provided not only by HRD but by Howard County, the Metropolitan District, and the state of Maryland. The economic model indicated a need for another $30 million, of which Connecticut General provided $10 million and the remainder came from Morgan Guaranty and Manufacturers Hanover, both of New York. These latter two institutions, incidentally, were helped to make their decision to come into the Columbia picture by the tender of a small portion of the HRD stock which was given up by Rouse and Connecticut General.

A major element in the financial picture at Columbia—unique in New Town financing but absolutely essential—has been the willingness of Connecticut General and the other lenders to capitalize carrying charges on all of the debt. It has only been within the last year or so that interest has been paid in cash, and no debt has been retired as yet. In fact, in 1971, it appears that for the first time the cash flow of the overall Columbia project will turn positive. The development has been profitable as individual units developed and sold were cost accounted—but up until now it has continued to put a cash drain on the developers as costs of development outstripped sales proceeds.

It is worth noting, incidentally, that despite its pioneering and its 50% interest in the joint venture, Connecticut General has not sought nor received a preferred position in financing specific developments. Home builders, apartment builders, industries, institutions and other developers have been free to seek financing wherever they choose. Of the projects financed by HRD itself and done through its development subsidiary, financing has been provided in the amount of over $61 million by seventeen different institutional lenders. Most of these transactions include lender participation in some way in the profitability of the developments financed.

To summarize: The initial development of Columbia could not have passed beyond the bright-idea stage if Connecticut General and other institutions had been forbidden equity participation; most of the projects successfully done to date and serving a town which already numbers 14,000 people could not have been financed without equity participation. In other words, had Section 14 been enacted in 1961, Columbia simply wouldn't exist.

The CHAIRMAN. Mr. Johnson.

Mr. JOHNSON. Mr. Chairman, I too think we have a distinguished panel here today. There is so much in that bill, and it is so far reaching, and could be very devastating, so it is hard to know what question to really ask any more.

But I think I will ask Mr. Hovde a question. He seems to be quite emotional this morning.

Mr. HOVDE. We have so much at stake.

Mr. JOHNSON. You hear a lot about interlocking directorships, Mr. Hovde. You are a real estate broker. Are you a director of any bank or insurance company or anything like that?

Mr. HOVDE. Yes, Mr. Congressman, I am a director of a commercial bank, State chartered, in the city of Madison, Wis.

Mr. JOHNSON. What is the name of the bank?

Mr. HOVDE. Madison Bank and Trust, sir.

Mr. JOHNSON. How large a bank is that?

Mr. HOVDE. This bank has holdings of approximately $35 million.

Mr. JOHNSON. Would you have any idea as to how much your mortgage portfolio would amount to on homes?

Mr. HOVDE. I was appointed to the board of this bank 2½ years ago. And of course I would like to think that since my arrival on the scene that our bank, which had not previously been too heavily in mortgage loans, has seen a greater need in this area. And of course in this situation in the past 2½ years, the banks, the insurance companies, and the

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saving and loan's have all been talking about the lack of liquidity, the disintermediation of funds. But I can say with truthfulness that we have gone into some mortgage projects for which I have been personally commended and thanked for by those people that had come to the bank and requested funds. And they are economically sound, they are properly underwritten, and they are without participation. Our bank has not been in any equity participation type loan.

Mr. JOHNSON. That was my line of thought.

Now, you are on that bank board. And there are other real estate brokers, I take it, in your home city?

Mr. HOVDE. Yes, there are. And there are other real estate brokers doing business with the bank of which I am a director. And there has been no reluctance on the part of the others in the real estate business to do business with our bank, my bank, because of my being on the board. In fact, as I say, I think we have developed a greater—we are a very small bank, but we developed a greater awareness in the real estate mortgage field.

Mr. JOHNSON. So your being on that bank board, that type of interlocking device has not been any deterrent to your other brethern in the real estate business?

Mr. HOVDE. Absolutely not.

Mr. JOHNSON. Mr. Terry, I would like to in my remaining time—harking back, now, to when you first conceived the brilliant idea, I would say, of founding and building Columbia, did you have much money to start with then?

Mr. TERRY. No, we were a very poor company.

Mr. JOHNSON. So you went to various financing lending institutions, insurance companies, and so forth, with your hat in your hand, wanting to try to get hold of $15 million, didn't you, to develop this very wonderful new town you have down there?

Mr. TERRY. We chose to go to the Connecticut General. And we offered them half interest in the project.

Mr. JOHNSON. Stop right there. In other words, you invited them to be a 50–50 partner with you, and it was not the Connecticut General that demanded 50 percent of the action?

Mr. TERRY. No. The arrangement was that the Connecticut General puts up all the money, which they did, and we put up our ability to carry out the program of Columbia, which we did.

Mr. JOHNSON. Could you have developed—and I consider it a tremendously great institution that you have there—could you have even started to do it without somebody loaning you $15 million? And in view of the fact, as you say, that many housing projects, new towns have been failures and do present a considerable financial risk, could you have done it without taking in partners?

Mr. TERRY. No, we could not. And we really don't believe that we at that time had the financial capacity to even go through the process of developing the detailed plan of Columbia, excluding land acquisition, excluding zoning efforts, I do not think we could have even developed the plan.

Mr. JOHNSON. Do you feel that as a result of this 50–50 participation with Connecticut General that they shook you down, let's say? Are you unhappy about the relationship, do you feel that you were held up?

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Mr. TERRY. To my way of thinking—and you have me at a disadvantage here with one of our investors in the room—I would usually like to say that, yes, they are holding us up, but I feel very strongly that this was one of the most creative pieces of financing ever done in the country, that there was a huge risk on the part of Connecticut General. And they are getting a very fair return on that risk.

Mr. JOHNSON. I am just thinking that if you had not taken in a partner there, in view of the financial risk that other new towns like Reston and the rest of them have created, you would have never had Columbia today, isn't that true?

Mr. TERRY. That is right. And I think that is the principal reason other new towns have failed, is that they did not have the financial wherewithal to stand the type of building up of home sales and rentals and commercial sales. It takes a huge amount of time.

Mr. JOHNSON. What is the mortgage or bonded indebtedness of this enterprise today, would you say?

Mr. TERRY. It is $80 million.

Mr. JOHNSON. Eighty million dollars?

Mr. TERRY. Right. The total Rouse Co. capital investment in Columbia is $750,000.

Mr. JOHNSON. In other words, you have started out with a relatively small loan, it would appear, of some $15 million, and it has now gone to $80 million?

Mr. TERRY. That is correct.

Mr. JOHNSON. And who has loaned you the $80 million?

Mr. TERRY. The $80 million is from Connecticut General, the Chase Manhattan Bank, Teachers Insurance and Annuity Association, the Manufacturers Hanover Bank, and Morgan Guaranty.

Mr. JOHNSON. These additional lenders besides Connecticut General, they were not into the picture, then, at the inception?

Mr. TERRY. No, Connecticut General was the original lender that put up all the money to acquire all the ground in Columbia.

Mr. JOHNSON. Thank you. My time is up.

The CHAIRMAN. Mr. St Germain.

Mr. ST GERMAIN. How many housing units have you built to date in Columbia?

Mr. TERRY. I beg your pardon?

Mr. ST GERMAIN. How many housing units have you built to date?

Mr. TERRY. Right now we have 4,500 units occupied.

Mr. ST GERMAIN. How many are low income?

Mr. TERRY. Right now there are occupied 300 units under the 235 program, which is low income housing. And it is just under 300 units under construction.

Mr. ST GERMAIN. Out of 4,500 you have 300 low income?

Mr. TERRY. That is correct.

Mr. ST GERMAIN. They were built under 235, so they could not have been built except in the last year and a half or so, could they?

Mr. TERRY. The first 300 units were occupied last fall.

Mr. ST GERMAIN. That is about 7 percent. And you consider this a mix?

Mr. TERRY. No. We feel we have not done as good a job as we should have done on low income housing.

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Mr. ST GERMAIN. And 235 is a program whereby the Government pays the difference between what the owner or the purchaser of the home can afford according to his income?

Mr. TERRY. That is correct.

Mr. ST GERMAIN. So you are getting the same actually for your 235 units put in there as you are getting for your housing?

Mr. TERRY. No, these are rental units.

Mr. ST GERMAIN. You mean 236?

Mr. TERRY. I beg your pardon, these are 300 rental units. There are some single family 235 units now, I am not sure how many there are, but there are some being built now.

Mr. ST GERMAIN. I would like to ask this question of Mr. Stastny of the Home Builders. How many members do you have, Mr. Stastny?

Mr. STASTNY. Our membership presently exceeds 52,000.

Mr. ST GERMAIN. And you call yourself a homebuilder, but these members are the people who also build apartment buildings, office buildings, and shopping centers, are they not?

Mr. STASTNY. Yes, sir.

Mr. ST GERMAIN. And is it your testimony that the equity participation has been—well, it is repugnant to the homebuilders, is it not?

Mr. STASTNY. I am sorry, I did not hear that.

Mr. ST GERMAIN. In going over your testimony I gather that equity participation, or a piece of the action, as it is known, is repugnant to the homebuilders?

Mr. STASTNY. Yes, sir.

Mr. ST GERMAIN. Because you are not only home builders but you build other buildings?

Mr. STASTNY. Yes.

Mr. ST GERMAIN. Mr. Fey, you in the insurance industry, your funds come in great part from—I realize you sell a lot of big policies to corporation executives and whatnot. These are great big ones that protect the corporations. Should a man who is very valuable to the firm pass away, et cetera, but a large percentage of your policies are the $10,000, $20,000, $30,000, and $40,000 policies, are they not?

Mr. FEY. The majority of them are.

Mr. ST GERMAIN. The majority of them are?

Mr. FEY. Yes.

Mr. ST GERMAIN. You say back in 1950 you gave a figure of the number of home mortgages you had in effect. And what was that number?

Mr. FEY. We had about 68,000 FHA mortgages that averaged about $11,000 per mortgage.

Mr. ST GERMAIN. How many do you have today?

Mr. FEY. We are down to about 47,000.

Mr. ST GERMAIN. Forty-seven thousand. Don't the insurance companies feel that you should consider as a profit to your policyholders, the people who are giving you the money to work with, as a profit to them you should also consider the fact that—as was so eloquently stated by Mr. Hovde, isn't there a social obligation, but it should go even further, an obligation to your policyholders, the low-income and the middle-income people who form the majority of your investors, so to speak, to help them acquire housing, to help out in the housing market? Don't you feel that is an overriding obligation on your part?

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Mr. FEY. I do understand your question. And we do have the obligation to all of our policyholders. And this means that we must develop an investment program that will provide them risk protection at the lowest possible cost to them. This means that we may not give preferences to a particular group of policyholders. As you say, we do have a social responsibility to provide housing. And we do. The life insurance industry is providing the vast majority of the multiple dwelling units, the apartment houses that are available, and which are not just a matter of marketing to the occupant, but they are a preference of the occupant, partly because of high cost of maintenance of a single unit dwelling, and partly because of the high carrying charges of a single unit dwelling. But the fact is that two-thirds of the construction today is in the multi-unit housing. We certainly do not have the obligation to confuse our investment program with the security elements of the risk protection involved in covering our policyholders. And we must always be mindful that we did not give preferences to any particular group of our policyholders.

Mr. ST GERMAIN. The fact remains that your testimony states very clearly that you have found that you should get out of the home mortgages and go into these larger developments and apartment complexes and office buildings, is that not so?

Mr. FEY. Our industry is made up of a large number of diverse types of companies, and there are many large and small companies, companies that operate locally and companies that operate nationally. If a company that operates on a national basis as we do, for a company with our size of assets, and our investment programs, it would not be to the interest of our policyholders to invest in small units of local real estate in various parts of the country. On the other hand, there are many of our member companies, members of American Life Convention, and members of the Life Insurance Association of America, who are essentially regional or local companies——

Mr. GETTYS. Mr. Chairman, I demand regular order. Let us not have this long count on the top row and the short count on the bottom. I demand regular order.

The CHAIRMAN. Are you making a point of order?

Mr. GETTYS. I am demanding regular order. The regular order of this committe is a 5-minute rule.

The CHAIRMAN. Any member can make a point of order when the 5 minutes is exceeded.

The point of order is sustained.

Mr. Williams.

Mr. WILLIAMS. Thank you, Mr. Chairman.

I want to thank all of you gentlemen for being here this morning.

As of today we have been listening to the testimony on H.R. 5700 since a week ago yesterday. I believe the testimony we have received this morning is the most voluminous of any we have received to date.

It is my impression, after listening to this testimony on this bill, that this bill is going to hurt in some way every type of our financial institutions. The reaction of one type of financial institution is, it is all right to hurt everybody else, but let's not hurt us. A good example of this, I believe, is contained in Mr. Hovde's statement, where, after a very sweeping indictment of equity participation, on page 3 of your statement, Mr. Hovde, you make a statement against

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controlling the interlocking directorates, and at the very bottom of the page you say.

> We recommend, therefore, the deletion of these prohibitions as they apply to appraisers and brokers serving as directors of financial institutions covered by the bill.

So there you are asking for an exception in this bill for people in the same business generally as you are, is that not so, Mr. Hovde?

Mr. HOVDE. The statement has been submitted, and if that is the way it is interpreted, I would have to say yes.

Mr. WILLIAMS. Mr. Stastny, on page 3 of your statement, the last paragraph, you make the statement:

> The lender who is also a borrower in the same transaction may tend to not be as rigorous as he would otherwise be in assuring that the risks of a particular loan are reasonable.

What you are really stating there is that the lender is making higher risk loans under certain circumstances?

Mr. STASTNY. This has been our observation, sir.

Mr. WILLIAMS. In other words, you really believe that these lending companies such as insurance companies are making high-risk loans which may not be justifiable?

Mr. STASTNY. Yes, sir.

Mr. WILLIAMS. Now, Mr. Jackson, you have made some very convincing arguments in favor of equity participation. But you have also referred to the fact that equity participation is not truly equity participation. Why can't equity participation be developed which would be in effect a two-way street, where the person getting the equity participation would also participate in the losses and profits and get away from the gross income?

Mr. JACKSON. That would be possible, Mr. Williams. It is interesting to me that Mr. Stastny says that we are making high risk loans. None of his members have mentioned that when they came in to apply for a loan with us.

Mr. WILLIAMS. Thank you for that additional comment.

Mr. Fey and Mr. Terry, you have also made some very convincing arguments concerning equity participations. I am particularly interested in Columbia. Some questions were asked about housing for low-income families, and you state that you have 300 units of low-cost housing which were constructed under the 235 program. What type of units are these, and what are their sale price?

Mr. TERRY. I misstated it. There were 300 units built under the 236 program. And they are rental units.

Mr. WILLIAMS. What is their monthly rental?

Mr. TERRY. For one bedroom it is $99.

Mr. WILLIAMS. And go from there.

Mr. TERRY. It goes from there to a four-bedroom town house at $152.

Mr. WILLIAMS. Your experience of course has been too short. You have no experience on maintenance costs or anything of that nature.

Mr. Fey, section 14 of the bill forbids the lender to accept any equity participation in consideration of making any loan. One of the kinds of equity participation which would be forbidden is shadow warrants. If this provision should become law, do you have any clear

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idea of what actions on your part would be forbidden by this restriction?

Mr. FEY. To the best of our knowledge, none of our companies have ever used the shadow warrant as a credit device.

Mr. WILLIAMS. Would you define a shadow warrant for me?

Mr. FEY. I would have very great difficulty in defining it. It actually is receiving the gain on a warrant or an equity interest without actually purchasing the interest itself.

Mr. WILLIAMS. Thank you.

Mr. Hamilton, I read your testimony with great interest. Yet, you want certain exceptions made for mutual insurance companies. On page 8 of your testimony you state that there is difficulty in securing competent individuals to serve as directors. And this difficulty is being experienced by all corporations. Yet, you only asked for an exemption for mutual insurance companies under the provisions of this act?

Mr. HAMILTON. We did not undertake to express any opinion on the situation of other types of corporations. However, I think it would be entirely appropriate and in the public interest to exclude insurance companies generally from the terms of these sections covered in our statement—sections 2, 3, 4, 7, and 8.

Mr. WILLIAMS. Thank you. I have nothing more, Mr. Chairman.

The CHAIRMAN. Mr. Gonzalez.

Mr. GONZALEZ. Mr. Chairman, I do not have any questions at this time that have not already been asked.

The CHAIRMAN. Mrs. Heckler.

Mrs. HECKLER. Thank you, Mr. Chairman.

I should like to thank the witnesses today. They have really presented some of the most searching testimony I have heard in the last year. I must say I still have not perceived the situation in terms of the real role of equity participation.

I would like to ask Mr. Stastny about some of the statements that he made.

On page 4 of your testimony you referred to a study conducted by the National Association of Home Builders, 2 years ago, which indicated that developers building under an equity participation scheme were intending to hold the project for a much shorter period of time than those not giving any equity participation to the lender, therefore leaving the lenders with control of the profit after the 5 years or the short period of time in which the builder is involved. Could you make the result of that study available for the record?

Mr. STASTNY. Yes, we can, and we shall.

(The information requested follows:)

JUNE 1969.

A SPECIAL REPORT—EQUITY PARTICIPATION

Editor's Note.—Several months ago NAHB's Mortgage Finance and Specialized Housing Department, in cooperation with *The Compendium*, undertook a survey among *Compendium* subscribers on the general subject of equity participation in apartment financing. The purpose was an attempt to identify the magnitude of this relatively new type of apartment financing, as well as the various types of equity participation. The following report on the survey was prepared by Norman Farquhar, director of the department.

Equity participation on the increase.—Although a relatively small percentage of the respondents (15 percent) noted in the questionnaire that equity participation

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was a condition for securing the financing, many indicated that commitments now being negotiated called for some type of participation.

Of the 35,000 units started by the respondents, approximately 11 percent of these units involved equity participations. Nearly all of the equity participation loans originated were by life insurance companies. These loans usually did not result in a reduction in the interest rate and/or the points being charged by lenders. In the several cases where reductions were present, the points were reduced only slightly and the only real concession was a higher loan-to-value ratio and/or a longer repayment period.

Equity Participations Take Many Forms.—The most frequent found from the survey is for the developer to pay a percentage of the gross receipts from the project. The next most frequent is payment of a percentage of the net profits of the project. The leasehold (with or without option to purchase) is virtually unused, at least among respondents. The combinations of percentages of gross receipts were many. Most frequent percentage was 2 or 3 percent and a sliding scale to allow for rent increases and changes in the net receipts from the project. Those sharing an equity position based on the net profits from the project are paying between 20 and 30 percent of the net as a condition for receiving the loan.

Approximately half of those giving an equity position are planning to sell the project within five years. This is a substantially higher percentage than those developers who had not given any form of equity participation.

Nearly 130 builders responded to the survey, accounting for approximately 35,000 units, or an average of 285 per builder. These production figures indicate that the average respondent was larger than the typical NAHB builder-member. A majority (90 percent) of the units started were garden-type structures, and some 22 percent of the units started were Federally-assisted.

Several conclusions on present lending practices may be drawn from the survey. They are as follows:

1. The practice of equity participation as a condition for securing permanent financing on apartment projects is increasing.
2. No general practices may be identified and each lender has his individual preference or arrangement, arrived at through a bargaining process.
3. Basing participation on a percentage of gross rent is the most common form. Also lenders are anxious to receive, in addition, a percentage of rent increases.
4. Those builders giving an equity position are often selling the project within a five-year period.
5. Equity participations do not generally result in a reduction of financing costs, however, may occasionally result in a longer term and higher loan-to-value ratio.
6. Life insurance companies are presently the only type of lending institutions requesting equity participation.

Mrs. HECKLER. Isn't that rather a breach of good faith on the part of the borrower?

Mr. STASTNY. Not really. The question was asked earlier, just what the breadth is of the practice that I bring to your attention today. I would like to point out that the one example which has been cited of Columbia is not typical of what is going on in this practice of equity participation. In fact, it is a real exception. I represent the guys who have really been bled by this practice. And you must understand, with respect to your question, that there are a number of reasons for going into a real estate development. Two-thirds of our people historically have gone into them with the intention of keeping these developments for long-term investments. Under the circumstances which have been brought about by equity participation, frequently the interest, the investment interest of the developers, has got to be shortened.

I have with me Mr. Martin, who is a vice president of the National Association of Home Builders, who has had a great deal of personal experience in his own business with this kind of development, and has been close to the problem. If you will permit, I would like to ask him to comment.

The CHAIRMAN. Would you like to hear from him, Mrs. Heckler?

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Mrs. HECKLER. Mr. Chairman, I would like unanimous consent to have Mr. Martin submit a statement for the record of his experiences.

The CHAIRMAN. All right. Without objection it is so ordered.

Mrs. HECKLER. Since our time is so limited I would like to get on to some other things.

I am concerned about your statement, Mr. Stastny, in terms of the interest rates charged for loans in which there was equity participation. You talk about mortgage loans. I wonder what the interest rates have been in cases in which the lending party was a bank—not a bank, but an insurance company. Has there been an interest rate increase, or has there been an interest rate advantage when money was scarce through the insurance funds?

Mr. STASTNY. We have not been able to see any compensation in terms of interest rates because of equity participation. And we stated this in part of our statement. You must understand also that the practice is rampant during times when banks are simply not offering money for real estate loans, because apparently the supply is such that they do not have it available, or for other reasons which might exist. So the insurance companies, with the option which they solely control of equity participation, have exercised this force.

Mrs. HECKLER. Dr. Fey, would you like to comment on that?

Mr. FEY. Yes. I think there is, as I have said in my statement, definitely evidence—and I have studied a large number of our companies—which would indicate that there is a reduction in interest rates of anywhere from ½ to 1 percent in return for the equity participation, so-called equity participation.

Mrs. HECKLER. It is apparent, Mr. Chairman, that there is disagreement among the panel of witnesses. And if possible, with unanimous consent, I would ask that they each be allowed to answer this question, because there obviously is substantial conflict in the testimony on this point.

The CHAIRMAN. Answer the question within your 5 minutes, and then they can extend their remarks on the record.

Mr. GETTYS. Mr. Chairman, I make a point of order that the House is in session, and we are meeting without authority.

The CHAIRMAN. The point of order is not sustained. We are operating within the rules.

Mr. GETTYS. I appeal for the ruling of the Chair.

The CHAIRMAN. Under the new rules, just for the 92d Congress commencing, it is not a good point of order.

Mr. GETTYS. All right, I withdraw it.

Mrs. HECKLER. If my 5 minutes is not up, I have one further question, Mr. Chairman. I wish to have the witnesses state their positions on the effect of equity participation relating to interest rates from their respective experiences in their different fields.

The CHAIRMAN. Would you like each one of the panel to do that?

Mrs. HECKLER. Yes.

The CHAIRMAN. They can do it when they look over their transcripts.

Mrs. HECKLER. Yes.

The CHAIRMAN. That is a good suggestion, and I hope you gentlemen can comply with it.

Mrs. HECKLER. I am informed that my time has expired, Mr. Chairman.

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(In response to the information requested by Mrs. Heckler, the following replies were received for submission in the record:)

ADDITIONAL STATEMENT BY GEORGE C. MARTIN, VICE PRESIDENT-TREASURER, NATIONAL ASSOCIATION OF HOME BUILDERS

My name is George Martin. I am an apartment builder in Louisville, Kentucky, and I welcome the opportunity that was prompted by Mrs. Heckler's question about the interest rate on equity participation loans to express my views on the subject.

First, let me attempt to clarify the difference between an equity participation loan and a joint venture agreement, because I feel a lot of discussion has taken place in the Committee about the arrangement in Columbia, Maryland, with an insurance company. That arrangement has been referred to as equity participation, when it is in fact a joint venture or a partnership between the insurance company and the developer.

As was so ably stated by Mr. Stastny, we have no objection to a life insurance company, or any other lender for that matter, becoming a bona fide partner in any kind of business venture. We do, however, object to the situation where an insurance company or any other investor says that the only way you can borrow money from them is to give them an equity participation or a kicker, or a piece of the action—or one of the many other names that describe this procedure. I feel it is important to point out the difference between a joint venture and equity participation because a lot of time was given defending the practice with respect to Columbia.

The statement was made that, without an insurance company's ability to enter into this kind of agreement, Columbia would not be in existence today. I repeat we have no objection to a lender becoming a partner—a bona fide partner. The equity participation agreements that are taking place, however, are quite different than that described by Dr. Fey of the National Life Insurance Company of Vermont. He may have given the mistaken impression that in the majority of such loans the equity part of that loan only amounts to an interest increase of about ½ of 1 percent.

In my oral testimony, I described one type of loan in which a lender said that the only way they would make any loan at all would be to buy the land and lease it back to the developer. As a further requirement to making a 75% loan, they require the project owner to pay them annually 35% of the defined cash flow. To determine what this proforma or projected cash flow is, there are first deducted certain fixed expenses such as taxes, insurance, utility bills and debt service. Then there is allowed an additional 16% for all other expenses, regardless of what they in fact amount to. They then take 35% of the remaining cash flow. In addition, they require that they be given the right to put up an additional sum of money in the form of an investment and that they be given a guaranteed 12% return on this investment, plus a 50% equitable ownership in any cash flow remaining after the 35% payment and 50% of the depreciation and the equity buildup in the apartment. Of course, they already own the land. This results in a much higher increase in the return received by the lender than an effective increase of ½% in the mortgage interest rate.

Mrs. Heckler asked about specific interest rates; whether or not in fact there was a lower interest rate with participation. Let me give an example. I obtained a commitment for an apartment project loan in 1970 which called for 10¼% interest plus 2% of the gross income or 25% of the future rental increases, whichever happened to be greater. I certainly did not get any lower interest rate as a result of giving such a participation.

Let me describe a little bit what that percentage of any rental increases does. Dr. Fey described rental increases as a windfall from rent that was not projected when the project was initially built but that could be charged in the future as a result of inflation. He didn't talk about the situation where taxes are increased, insurance costs go up, maintenance costs go up, or there are other requirements which may call, for instance, for a $20 rental increase. If you then had to give 25% of this $20 rental increase to the insurance company to compensate it for having made a 10¼% loan, you would then have to add 33% to the increase projected to take care of increased costs in order to break even. In the instant case, you would have to charge the tenant $27 more in order to obtain the $20 necessary to cover increased costs.

In a percent of the gross situation, the alternative in this case, you have to give

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part of every dollar that you take in, here $2 out of every $100, to the insurance company as added income. If in this project it is necessary to have 80% of the units rented to break even, and only 70% of the units are rented, the result is paying out this amount to the lender when in fact there is a negative cash flow. If in the future the apartment complex should have difficulties, it would be compounding its difficulties as a result of having given, not a share of the profit, not a share of any net income, but a share of the gross income as an added inducement to obtain a loan.

In the hearing the practice of equity participation was defended by the representative of the insurance industry on the grounds that it was a hedge against inflation, in spite of the fact that insurance companies have been able to make residential mortgage loans for over 100 years successfully and considered them to be a good risk and a good yield. Suddenly now they are not a good risk and do not give a good yield.

It was pointed out by one of the insurance company representatives that residential income loans would not give perhaps as high a yield, or be as safe a loan, as corporate stocks or corporate bonds which have been selling in the past six to eight months to provide yields of from 7 to 9%. At a meeting which I attended with the top economists of one of the major life insurance companies with a representative at this hearing, they described their investment portfolio on which they received an 11% yield on corporate stocks from a combination of both dividends and appreciation in the value of the stocks and a 9 or 10% yield on corporate bonds which they considered a safer risk than, for instance, loans on residential income producing property. This was perhaps 24 months ago, before the stock market dropped from the 900+ level to the 600+ level and the value of some major stocks declined one-third or more.

One insurance company, which unfortunately held $145 million worth of corporate bonds in the Penn Central, I noticed in a recent issue of the New York Times had to write down this $145 million investment to a value of about $20 million. This is the type of investment which is apparently preferred to residential income property as a risk. Another major insurance company had $49 million of these bonds which they also wrote down to almost $20 million. I strongly doubt that all insurance companies put together have lost as many millions of dollars on residential apartment loans as was lost on this one transaction by these two insurance companies.

I agree completely with the statement that was made during the hearing that insurance companies that derive most of their income from their small policy holders have an obligation to put this money back into residential mortgages at a price that people can afford to pay. With insurance companies taking bigger and bigger percentages of their portfolios out of residential loans and putting them into corporate stocks and corporate bonds and other types of investment which are considered to give a better yield, it may be necessary to look into what is happening to the money so invested.

I am quite concerned about the future of our private enterprise system of producing housing. Without the access to the tremendous amounts of funds that have been available in the past through life insurance companies and savings and loan companies which I feel is being jeopardized by the practice of equity participation, the private builder, especially the smaller one, will no longer be able to produce the housing we need.

I agree with the statement made by Mr. Hovde that the equity kicker route is making a mockery of the usury laws in several states. I also agree with the statement that the insurance laws or regulations of those states which prohibit loans in excess of 75% are being circumvented by using such routes as purchase and lease back of the land. The circumvention arises from the fact that the normal loan-to-value ratio is determined by considering both the land and the improvements. Where the developer receives 100% of the value of the land through the purchase-lease back strategem and also a loan of 75% of the value of the improvements, he in effect receives more than he would have under the normal approach.

Reply Received From Mr. Hamilton

I have no comment on Mrs. Heckler's question on the effect of equity participation relating to interest rates. The member companies of the American Mutual Insurance Alliance, for which I speak today, have very small investments in mortgages and collateral loans. I have mentioned previously that the total

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investment in mortgages and collateral loans at the end of 1969 (the latest year for which figures are available) was three-tenths of 1% of their assets, or only a little more than $17 million. As property/casualty insurance companies, our members seek greater liquidity than is found in mortgage investments. So far as I can ascertain, our members do not have any mortgage investments which include equity participation or income participation. If there are any they must be in very small amounts.

Reply Received From Mr. Fey

The common observation among life insurance companies is that the contingent interest arrangement, used in combination with a fixed contract rate, has allowed the fixed rate to be held down by perhaps ½ to 1 percent below the rate required on similar mortgage loans without a participation feature.

In response to Mrs. Heckler's request, more specific data have been obtained from three major life insurance companies who have been active in making income property mortgage loans, with and without contingent interest features. These data relate to investment authorizations during calendar year 1970.

In the case of one large company, income property mortgages with contingent interest features carried an average fixed interest rate of 9.35 percent, compared with an average fixed interest rate of 10.45 percent on income property loans without contingent interest. For this company, the volume of contingent interest mortgage lending represented 43 percent of total lending on income properties during 1970.

A second major life insurance company, heavily involved in granting income-property mortgage loans with equity features, followed the practice throughout 1970 of generally limiting its contract rate on apartment deals to 8¾% while at the same time fixed rate mortgages were available at rates of up to 10% and more. Further, the investor in this instance utilizes a form of equity feature that does not generate any additional income for the investor, over and above the basic contract rate, until such time as the developer is in a profit position. The general investment policy indicated here is based on the premise that a good deal of the difference between the actual contract rates and the market rates available will be recovered during the life of the loans and that, additionally, the equity features will provide a certain degree of protection aginst further erosion of the dollar.

A third large company reported that the average fixed interest rate on income property loans during 1970 was 9.91 percent while the average coupon rate on corporate bond investments was 10.66 percent in the same period. The reason that mortgage loans could be made at that differential was that contingent interest participation was obtained on many of the mortgage loans. A closer comparison of bonds and mortgages of similar credit quality is also pertinent to the effect of contingent interest features in holding down the fixed interest mortgage rate. During 1970, this company's average coupon rate on middle-grade bond investments was 11.63 percent, while the average fixed interest rate on mortgage loans of comparable quality was 10.02 percent. Again, the contingent interest feature produced an added long-term return which would make these mortgage loans competitive with bond investment opportunities.

The Chairman. Mr. Gettys.

Mr. Gettys. Mr. Chairman, as unofficial chairman of the lower row I would like again to call attention to the long count on the top row and the short count on the lower row.

The Chairman. Each member has his own time.

Mr. Gettys. I understand.

I am going to take some action, if I can, Mr. Chairman, to change the rule a little bit, or let us abide by the rules, because we sit here all morning. And then it is a little bit discourteous, I think, to the junior members.

The Chairman. They have the same protection as a senior member.

Mr. Gettys. Mr. Chairman, I have been sitting here because I particularly wanted to ask questions on some of the testimony which concerns me so much.

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I am not impressed at all with the attempted justification of the piece of the action that the gentlemen talk about. And I think it is disgraceful.

In addition, I have been an admirer of the Columbia City. But when I come to a committee room and hear stated that the chief development so far has been the birth of a child to a mixed marriage out of an $80 million loan it disturbs me a little bit. We need cities in the country, and I do not think that is the major accomplishment that we should aim at. And I do not believe any gentlemen on the panel have submitted their daughters to that situation, although they brag about others.

Under the bill—and we have talked so little about the bill that is before us, and your testimony is splendid in that connection—but the one thing that I am most interested in relative to this bill—and you fellows are big insurance people, which is where they have most of the money in the United States, in the private sector.

Dr. Burns, chairman of the Federal Reserve Board, was before us the other day. And I would like to ask this panel—and I direct my remarks, if I may, to the Equitable man, if he will answer—first, let me repeat. One of the factors that concerns me about the impact of this bill is the moral and ethical angle, and the conflict of interest in this interlocking directorate business particularly. What is a conflict of interest? I think today the banking industry and the insurance business in the United States are in the same boat with Congress. Our image is at the lowest level in the moral aspect, I believe, that it has ever been in the history of our country. I am worried about our attempt here to legislate morals. I do not think you can do it. I think we have got still to rely on industry responsibility, individual responsibility, individual character, and that if a man breaks a law he should be punished according to the criminal laws of the country. But to start with the presumption that every person who holds an interlocking directorship, is crooked, and base our laws on that assumption, I think we have got the wrong approach.

Now, within my short 5 minutes that is left, would you comment on that phase of this bill.

Mr. FEY. You have mentioned Mr. Murray from Equitable. I do not know whether you are referring to——

Mr. GETTYS. I just see his name here.

Mr. MURRAY. On the interlocking directorship conflict of interest I would like to speak if I could. The Equitable Life of New York has 36 members on its board.

This is a highly diverse group of people from all over the United States. We have 14 States represented in addition to New York. We seek geographic representation. It seems to me that when we get an important businessman from San Francisco, or from some other major cities almost inevitably this important citizen happens to be on the board of one of the local banks. And this automatically is precluded in this bill.

Also on our board we have six educators, four presidents of leading colleges, from Princeton on down, and we have five lawyers. Actually we have only four men who are bankers by profession. So all of the other so-called interlocks are casual and really not interlocks in the true sense, they are businessmen with important business interests

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in their portion of the country. And I just do not believe that there is really a conflict that is ascribed to the mere fact that they are on some bank board somewhere.

The CHAIRMAN. Would you yield for a suggestion, Mr. Gettys?

Mr. GETTYS. I yield, Mr. Chairman.

The CHAIRMAN. Thank you, sir.

The 1968 report by this committee shows the Equitable Life Assurance Society of New York had five interlocking directors with Chase Manhattan Bank, and four with Chemical Bank & Trust Co., nine in all. Have you seen this report?

Mr. MURRAY. No, sir.

The CHAIRMAN. It was made by the committee. Our committee is the only one that has ever compiled a report on that.

Mr. MURRAY. Did you say a director from the Chemical Bank?

The CHAIRMAN. No, interlocks, four with the Chemical, and five interlocked with Chase.

Mr. MURRAY. This must be a fact, then, as of that date. Today we have one common director at the Chase Manhattan Bank and two at the Chemical Bank & Trust.

Mr. FEY. I would like to add, Mr. Chairman, if I may, that the mere presence of a director does not constitute a conflict of interest. I can take a very dramatic case——

The CHAIRMAN. We are not saying one, we are saying nine.

Mr. FEY. Let me give a very dramatic case of three directors of other life insurance companies that sat on a hospital board where our own life insurance company with no directors on that board made a presentation for a pension plan in that hospital. The hospital chose our pension plan in spite of the fact that our competitors had members on the hospital board of directors. To assume that there is a conflict of interest just because there is an interlocking relationship is an unreasonable assumption, I would submit.

Mr. GETTYS. Would you think that a lawyer should be able to serve on the Judiciary Committee, for example, would that be a conflict of interest? Or a farmer on the Agriculture Committee, is that a conflict of interest?

Mr. FEY. This is the kind of expertise and the kind of intelligent and informed leadership that we need on our various committees, and that we need on our board of directors.

Mr. GETTYS. That is one of the dangers of that bill, that it would end up that the only people who would be qualified to serve on the board would be somebody who has been a failure in everything he has tried.

Mr. FEY. We would end up with boards of directors that had no financial expertise or knowledge, or boards of directors made up of inside officers who would vote with the president.

Mr. GETTYS. Thank you.

I am sure my time has expired.

The CHAIRMAN. I assure you that we have no intention of writing such guidelines. Mr. Archer, you are recognized.

Mr. ARCHER. Dr. Fey, you made the comment that equity participation, insofar as it related to rents, only applied to the increase in rents and not to any percentage of the existing rent at the time that the loan is made. And I was left with the impression in your testimony that

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this was the only type of participation that is prevalent in this country. And I want to clear that up. Am I correct in that or not?

Mr. FEY. No. I said that the normal case was the type of participation which I pointed out. There are all forms of participation, and there are some that participate——

Mr. ARCHER. Really, we do not want to leave the impression with this committee that the only type of participation is in increases down the line, because I happen to know myself of many, many factual situations in our community in Houston, Tex., where it comes immediately in existing rents and existing income and not just increases down the line.

Mr. FEY. You are absolutely correct. However, the percentages which I stated are not the same in both cases.

Mr. ARCHER. I would like to ask one question about the Columbia situation.

Do I understand, Mr. Terry, that there was no equity capital put up initially at all, that Connecticut General furnished all of the equity capital?

Mr. TERRY. No. The Connecticut General put up all the money to acquire 14,000 acres, which amounted to $23,000,000. We put up $750,000 of equity capital.

Mr. ARCHER. How was this $750,000 raised?

Mr. TERRY. It came from the working capital of the Rouse Co. Columbia is not the only project of the Rouse Co. We are building in other parts of the country.

Mr. ARCHER. I see. So would this $750,000 then cover other installations of the Rouse Co., or is this particularly allocated only to the Columbia project?

Mr. TERRY. Only in Columbia.

Mr. ARCHER. Considering the amount of money, then, in equity capital, the only recourse that the lenders have in case of failures is against this $750,000, is that basically an accurate statement?

Mr. TERRY. Yes, that is correct.

Mr. ARCHER. So for all practical purposes in this situation, then, you have life insurance companies that are lending money to themselves, is that a basically accurate statement?

Mr. TERRY. Their financing was secured by the land, that was their principal security. Hopefully, after assembling that much land, which, as subsequently borne out by an appraisal, it is worth more than we paid for it, by virtue of the fact that we did acquire it in such large pieces.

Mr. ARCHER. I am not attempting to infer that this is morally wrong, as has happened in the situation. But I am trying to get a clear picture in my mind as to just what has happened. And it appears to me that rather than the Rouse Co. giving an equity participation to the insurance company, that it is just the other way around, that the insurance company has a project in which they are permitting the Rouse Co. to have an equity participation as consideration for the Rouse Co. running it for them. Again, I am not trying to say whether this is right or wrong—but in this situation it is very apparent that this is what is involved, because the insurance company is for all prime intents and purposes, with the exception of $750,000, lending money

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to themselves, and are going to have to look to themselves for repayment.

Mr. TERRY. They are going to have to look to performance of the project for repayment. And we are the ones responsible for the performance of the project. We make all management decisions.

Mr. ARCHER. And you are given the opportunity to have an equity participation by the insurance company in consideration of your running the project for them?

Mr. TERRY. We own half the project.

Mr. ARCHER. Which is the biggest half?

Mr. TERRY. We think ours is.

Mr. ARCHER. Thank you very much. I yield back the balance of my time.

The CHAIRMAN. Mr. Cotter.

Mr. COTTER. Thank you very much, Mr. Chairman.

I will be as brief as possible.

I can understand the responsibility of banks and insurance companies to their stockholders to get the best possible returns on their dollar. But it appears to me that by requiring equity participation you are taking sums of money which would probably go to help the poor guy who is attempting to build a home or own a home. And I can see where it could act to his detriment.

I can also understand that you could not get a project such as Columbia underway without equity participation because of the magnitude of it.

But there is one area which concerns me. And I know of specific instances in my own home town where, say, a developer of a project, shopping center, say, of $1 million or $2 million, goes out and gets a parcel of land, and gets tenants, triple A tenants and there is absolutely no risk involved. He will go to the lending institution, and they will require participation and want a piece of action. Dr. Fey, how do you explain a situation like that? To me it is unconscionable.

Mr. FEY. I could give it to Mr. Hayden, who has had a considerable amount of experience——

Mr. COTTER. Mr. Hayden?

Mr. HAYDEN. Let me say that this is a very good question. And I want to emphasize a point which has not been made today, and which should be made, and that is, insofar as any major institution I know is concerned, we never get an equity participation or a piece of action, or whatever you call it, for free in consideration for making a normal mortgage loan, when we get equity interest, whatever its nature, we pay for it.

Mr. COTTER. Mr. Hayden, I agree. I know the Connecticut General and the insurance companies in the Hartford area are not guilty of this. But some of the banks are.

Mr. HAYDEN. I cannot testify as to the banks.

Mr. COTTER. I know of specific instances. To my way of thinking there is obviously no justification for it, it is unconscionable. And it is not done in consideration of a lower interest rate either. They want a quarter, 50 percent participation. Now, how do you eliminate that abuse?

Mr. HAYDEN. I cannot really answer the question. I am really not familiar with the abuse. I certainly would not dispute your words.

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Mr. COTTER. I can document it.

Mr. HAYDEN. I think the only thing I can suggest is discussing it with the institutions in question. It has not been the practice of major lenders, however.

The CHAIRMAN. Mr. Cotter, weren't you insurance commissioner of Connecticut?

Mr. COTTER. Yes, I was, Mr. Chairman. I am quite familiar with the Columbia project because of it. I recall when they started this project reviewing the annual statement. And to the best of my recollection there was some $25 million in initial investment. And it being such a large sum, I was concerned about it. And I spoke to the officials of the Connecticut General at the time. It seemed to be a high-risk venture. At that time I was more concerned with policyholders than borrowers. But they convinced me at that time that it was a good venture, it was in the public interest. And they assured me that the company was not placed in jeopardy because of it. And I subscribed to this.

The insurance companies in my home area have been great. They have saved the city of Hartford, they have saved the urban area. But by the same token, I think this equity participation takes a lot of money away from homeowners, people who are seeking to build their homes. And I can understand the conflict, because the stockholders of both the banks and the insurance companies want a good return on their money. And you are going to get a better return by having equity participation than you are by lending it to a fellow who is attempting to build a home and build an estate. And this is what troubles me. I am not opposed to equity participation as long as there are not abuses, but I know of areas, and I can document them, where there are abuses. And this concerns me.

Mr. HAYDEN. If I can comment, first of all, we do not know of any participation in the equity of homeownership projects.

Mr. COTTER. There is none whatsoever in homeowners, no lending institution wants a piece of that. But they do have apartment houses, they do have shopping centers. And I am talking about projects up to, say, $3 million.

Mr. HAYDEN. Let us remember one thing, and this is essential, that the homebuilding and the developing business and the building business are without question the biggest industry in the country. And it is a grossly under-capitalized industry. I do not think that any of the gentlemen here from the Real Estate Board or the Homebuilders would adopt a suggestion that under no circumstances would mortgages be made in the future except where there was a 25 percent cash equity. You know very well they would be out of business. There is not that much equity money around. What has happened under new conditions—and we have new conditions—we have a period of capital shortage ahead of us for the next 30 years. We have an additional need for $5½ to $7 trillion for city building and rebuilding, and we need to finance everything else that the country has properly undertaken in health and medical care and transportation, mass transportation, inner city—the demands for capital are enormous.

Now, development has got to compete not only for equity capital, but for mortgage capital. There has to be both kinds of money available. And I can tell you that if there is not equity capital, and if we

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are not allowed to help provide equity capital, there is no way legally we can provide mortgage money. We cannot finance the development of this country on 100 percent mortgage loans. It is illegal, it is impractical, and the insurance companies and our law would not permit it.

Mr. COTTER. Mr. Hayden, I agree with you completely. And I think the industry as a rule has done a good job. They have rebuilt our city, and they have made it a better place in which to live. But by the same token, I am lookiug at the little guy who is penalized because of some of these abuses in this area. And there should be some method to clean these out.

Mr. HAYDEN. Mr. Cotter, I have to say first that section 14 is wrong in principle, for all the reasons we have cited.

If, however, this committee feels it essential that the little guy you refer to gets some protection—and I am thinking out loud here—it might be possible to afford this protection against equity participation in instances wherein the total financing involved is less than $1 million.

Developers of projects involving over $1 million are professionals. They can protect their own interests. As Mr. Terry has testified today, most of them need to be able to augment their own equity if they are to continue to grow, or even survive. Accordingly, they should be exempted from section 14 if, in fact, such a section survives.

Mr. COTTER. Thank you very much.

The CHAIRMAN. Would you like to have more time?

Mr. COTTER. No, that is all.

The CHAIRMAN. Thank you very much. We are glad to have you participate.

Now, suppose that we just have brief comments from each of you gentlemen as to just what you have in mind that you feel has not been covered sufficiently. But make it 1 or 2 minutes if you can. And that will enable us to close up at the time that we are supposed to close.

Suppose we start down here at this end. Take 2 minutes each.

Mr. MARTIN. Mr. Chairman, I am an apartment builder, and I also have had experience with equity participation loans. I would not want the impression to go forth to this committee that the only kind of equity participition, as Mr. Archer pointed out, was a percent of the increase in rent, or that it amounted to only about half a percent more, or that the interest rate was less because of this participation, because this is just not so.

Dr. Fey said something about windfall, that the lender should be entitled to a part of the windfall from increased rents. Let me say that, when you have to put a lifeguard on a swimming pool because of a new requirement, you have to raise the rents. When the utility bills go up and when the taxes go up, and overhead goes up, you have to increase your rent, say, $15 to $20. With a 25-percent participation in that increased rent, you are losing that much. Or else you have to increase your rent 25 percent more to take care of this participation in the increase.

I will let you be the judge of whether or not a half a percent is all that somebody is getting out of the transaction that I am about to describe. First, there is a purchase and lease back on the land. Then there is a loan on the property, with the lender getting 35 percent

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the defined net income from the project and a 50-percent equitable interest in the property—all for making the same size loan that would be made anyway.

The problem of some of this property going back to the lenders who are making these loans, the impending disaster, is not yet apparent. The problem is that with a percentage of defined net income being paid to the lender, the project owner is not allowed enough money for expenses. This will not really become apparent until after the 4 or 5 years when there have to be major repairs, replacement of carpets or drapes, or appliances, and so forth. At that time there is going to be a shortage felt.

In 5 to 7 years from now when all of the money has been creamed out of these projects because of equity participation through excess overrides and percents of the gross and percents of rental increases there is not going to be any money left to take care of these needed repairs and replacements.

Mr. STASTNY. May I give Mr. Martin my 2 minutes?

The CHAIRMAN. No, you go ahead and take your own.

Mr. STASTNY. I have to raise some deep concerns about equity participation, because my job is not only to represent homebuilders but also to represent the people they are concerned about, the people of this country who need homes and a continued free economic system for housing.

We have heard mentioned the need for hedges against inflation, but we have heard no mention of a provision in any of these equity kicker deals in the event of a deflation. We have heard statements by the mortgage bankers that the fact that there is an equity participation in the project by a lender is not reflected in the rent levels. That is just not so; higher rents have to be charged and we can document the statements that I make.

We have not really seen any true joint ventures in the vast, vast majority of the situations that come under the equity kicker title.

There is no suggestion that losses might be shared as well as profits, only profits, and all too often in a way that precludes the actual success of many, many a project.

We think that Dr. Fey's wish that the reference should be to equity interest participation—he used a different term, which kind of cleans it up a little—does not change the facts. We seriously object to a continuance of this practice.

The CHAIRMAN. All right, Mr. Hamilton.

Mr. HAMILTON. I would summarize very briefly, because of our feeling that I am not qualified to speak about the major subject of the panel discussion, the equity participation.

As I pointed out, our companies, to my knowledge do not have investments at all in this area. Becuase of the different character of the mutual property and casualty companies, I limited my remarks to such companies. However, I think that the same comments applies in very large degree to all insurance companies. I would urge that sections 2, 3, and 4 eliminate the reference to insurance companies. I would urge that section 7 have an exclusion at least as to affiliated insurance companies, affiliation between a life company and a property/casualty insurance company.

I would further urge that there be in section 8 an exemption as to

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insurance companies and their subsidiaries, because of the unique corporate structure of a mutual insurance company, and because of the difference in the investment programs and investment goals of property/casualty companies. I feel that such an exemption is most essential as to mutual property and casualty companies, and I think it would be fully justified in the public interest for all types of insurance companies.

Thank you, sir.

The CHAIRMAN. Mr. Hovde.

Mr. HOVDE. Mrs. Heckler requested that we cite our specific cases on equity participation interpreted in terms of rate. Dr. Fey said that we are primarily talking about income participation. Actually there is both equity participation and income participation, kicker being the acronym for income participation.

Yes, there has in fact been equity participation. And insurance companies have required upward of 40 or 50 percent of the equity in many situations. That particular policy or position on behalf of the insurance companies has become less, and they have gone more to the kicker participation.

As far as rates go, when the prime rate was at 8½ percent, the commercial rates plus equity participation required in our area of Wisconsin was 10½ percent plus equity participation. I think in those States that have—and our usury rate in our State is 12 percent—in the States that have usury rates of 6 or 8 percent, I am sure that the underlying rates were those specified rates, and the degree of kicker participation was substantially more. And as I said, it is a way of getting around the State usury laws.

As far as the ¼ to ½ percent differential, I would question that. If so, it is only an immediate type situation. Actually we have been only approximately 2½ years into this type of practice. And I think it is far too short a period to see what the long term rate differential is going to be. And really what the equity participation or income participation does, it opens the door to the future. It is an open contract, you no longer have a fixed contract, it is an open contract, the end result, and the byproduct, the end product of what we may reach in our country because of this, of properties coming back to insurance companies. I would like to submit for the record—the article in Fortune Magazine of July of 1970 which is entitled, "The Future Largest Landlords of America." They are talking about the insurance companies of this country.

Thank you.

The CHAIRMAN. Do you want to put that article in the record?

Mr. HOVDE. Yes, I do, sir.

The CHAIRMAN. Without objection.

(The article referred to follows:)

[From Fortune Magazine, July 1970]

"THE FUTURE LARGEST LANDLORDS IN AMERICA"

AGGRESSIVE LIFE-INSURANCE COMPANIES ARE USING THEIR NEW BARGAINING POWER TO BECOME PART OWNERS OF THE REAL ESTATE THEY FINANCE

(By Sanford Rose)

Life-insurance companies have long wielded mighty power over commercial real estate in the U.S. They have been the single most important supplier of long-

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term finance for the construction of housing developments, office buildings, hotels, industrial parks, and warehouses. Their portfolios hold more than $35 billion worth of mortgages on income-producing property. Traditionally, they used their financial power discreetly and were content to rent out their money on a fixed-interest basis. Over the past couple of years, however, a great strategic change has swept through the sedate offices of John Hancock, Connecticut General, Prudential, and others. Abruptly, the big life-insurance companies have turned from somnolent mortgage lenders into alert, aggressive real-estate money managers. People in the real-estate business are referring to them as "the future largest landlords in America."

The key indicator of change is that today the fixed-interest loan is dead. Exploiting the opportunities of a chaotic money market, the insurance companies are writing into every commercial real-estate loan agreement a stipulation that they will receive some form of bonus interest, or "kicker," over and above the coupon rate on the mortgage; in effect this assures them a cut of the income from the property. And to a growing extent they are also demanding an equity participation. They simply present the real-estate borrower with an ultimatum: if you want our money, you must make us part owner of the property you are building.

For most real-estate developers, the new terms are understandably disquieting. One southern builder was angry enough to remark: "When the Mafia muscles into a laundry business, it leaves its partner with more of a stake in his own business than these insurance boys are doing." But harsh words are about all the developers can muster in response. The supply of mortgage money is so limited that the bargaining seesaw is heavily weighted in favor of the lender. William F. Leahy, a vice president for real-estate financing at Metropolitan Life Insurance Co., puts the matter bluntly, if a trifle hyperbolically: "In today's market we can make just about any deal we care to."

The developer can, as the saying goes, take it or leave it. Many leave it; that is, they don't build. Others, particularly developers with high overhead expenses, cannot afford to remain idle, so they feel compelled to accept the insurance company's terms. There are, however, a few developers who actually benefit from the insurance companies' more aggressive entry into real-estate finance. Cabot, Cabot & Forbes of Boston and Taubman Co. of Detroit have such outstanding "track records" that permanent lenders compete to make deals with them. Their bargaining power is so imposing that, tight money notwithstanding, the insurance companies are unable to insist on equity participations, but must content themselves with the bonus-interest kicker. And in return for this variable reward, the insurance companies generally agree to put more money into any given deal than they did when their return was fixed by the mortgage coupon. In consequence, these developers can get involved in many more projects than they did in the days before the money crunch. Cabot, Cabot & Forbes, in fact, has quadrupled in size over the past four years. Says Mortimer B. Zuckerman, its chief financial officer: "For some real-estate developers the insurance companies' greed is a cultural shock; for others, like us, it is a boon."

When they are able to insist upon equity participation, the insurance companies are not just exploiting their strong bargaining position. They are in the process of effecting a dramatic shift in the composition of their assets. Many companies are beginning to take their first serious look at real-estate equities and are concluding that these are perhaps the best of all possible hedges against inflation. A well-managed portfolio of common stocks might yield an average annual return of about 10 percent, including capital gains. Bruce P. Hayden, vice president for real estate at Connecticut General Life Insurance, thinks his company's portfolio of real-estate equities should earn "at least 40 percent more."

Over the next five years, Hayden estimates, Connecticut General will increase its real-estate assets about 50 percent faster than it increases its total assets. At New England Mutual Life, real-estate equities now account for 3 percent of assets. According to an unofficial poll of company executives conducted by a Harvard Business School student, the proportion of assets in real estate will probably rise to 9 percent within five to ten years, and could conceivably go as high as 15 percent.

MAKING MILLIONAIRES

During the Fifties and early Sixties the insurance companies had neither the inclination nor the market leverage to attach equity participations to their real-estate loans. Mortgage money was abundant, and the companies themselves were cash rich and eager to dispose of funds. A life company is permitted to lend up to

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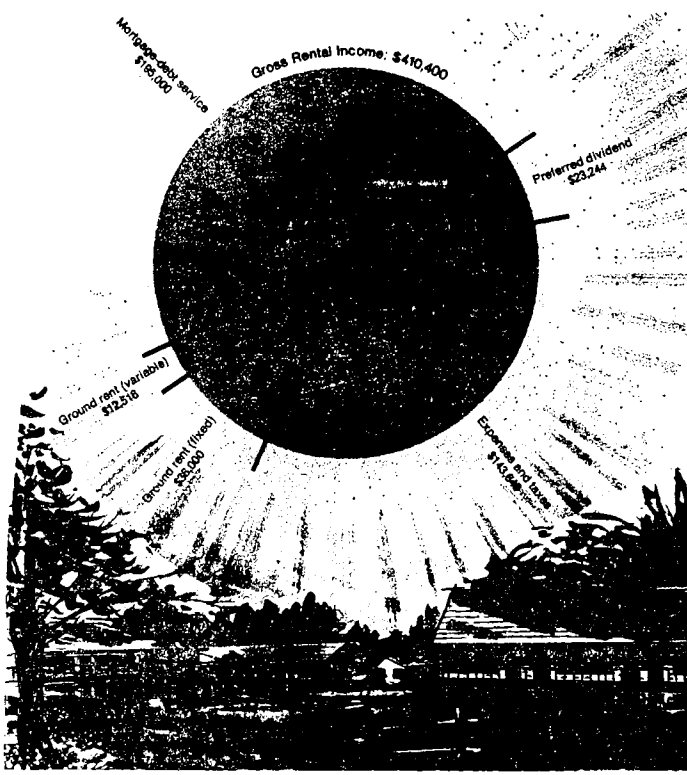
Lender Takes All



Tom Cardamone

Most insurance companies are now willing to provide 100 percent financing for real-estate ventures. But in exchange, many of them are demanding what amounts to all of the current income for at least the first four to five years of the project's life. The real-estate developer who conceives, plans, builds, and manages the venture gets no part of the cash flow. This illustration shows what happened to the first year's rental income from a 200-unit housing development recently built in Missouri. The actual numbers have been changed, but the relationships among the items are accurate. After the developer paid taxes and expenses, he turned over the rest of the rental income to the insurance company that financed the project. Payments were in the form of fixed and variable ground rent, mortgage debt service, and a dividend on the insurance company's equity interest. In fact, on this particular project the developer had a negative cash flow that year—i.e., there was not enough cash to pay the entire dividend. The deficiency was carried forward to become part of the developer's obligation in the following year.

75 percent or 80 percent of the appraisal value of a real-estate project (depending on the state law it operates under). A decade ago the insurance companies were so anxious to lend that they sometimes encouraged appraisers to overestimate the value of the project. As a result, a developer could pocket an insurance-company commitment to lend the full cost of the project—and even more. Says Gordon E. Emerson Jr., senior vice president for real estate at John Hancock Mutual Life Insurance Co.: "In those days we made more 105 percent loans, and more millionaire developers, than I care to confess."

Even when the insurance company did not tinker with the numbers, a developer with a promising venture might still get a commitment for everything he needed if he brought in a project whose value substantially exceeded its cost. If the cost of a project were $3 million but its capitalized value—i.e., net income discounted by an appropriate interest rate—were $4 million, an insurance company's 75 percent commitment would enable the developer to build without taking in any outside equity capital or using up very much of his own working capital. Armed with the commitment, the developer could arrange a full construction loan from a commercial bank. Upon completion of the project, the insurance company honored its commitment, and, in the language of the trade, the bank was "taken out" of the deal. From then on, the developer paid the fixed interest and pocketed all the net income from his building.

LESS MONEY, FEWER OPPORTUNITIES

It isn't like that any more. The world of low-cost, high-value deals no longer exists, and the life companies have turned cash poor. Within the last year and a half, those that sell insurance with high cash values have been hard hit by heavy

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demands for policy loans. With interest rates rising, many policyholders have grasped the chance to borrow on their insurance at statutory rates of 5 to 6 percent, and put the funds into triple-A bonds at 9 percent. At most major companies, policy loans have been running from 5 to 10 percent of 1969 assets. Companies that specialize in cash-value insurance, like Northwestern Mutual or National Life of Vermont, are lending out the equivalent of 15 percent and more of their assets.

Even more significant is the rising ratio of policy loans to the insurance companies' basic cash flow, that is, to funds available for long-term investment in mortgages and securities. In many large companies policy loans came close to 40 to 50 percent of cash flow during 1969. And some insurers loaned out a greater amount on policies than their net income from operations.

As a consequence, the insurance companies have less money to put into real estate. There are also fewer worthwhile projects to invest in. The cost of many proposed real-estate ventures these days is greater than their economic value. In 1965 a 300-unit housing project in California would have yielded a gross rental income of $540,000 and a net income of $324,000. Today that same development would gross $720,000 and net $432,000. Since 1965, however, capitalization rates have increased from 7 percent to 11 percent, reflecting the enhanced profitability of alternative uses of money. So, whereas that $324,000 net income made the property worth approximately $4,628,000 in 1965, today's $432,000 net translates into a value of only about $3,927,000.

While the value of the housing development has fallen, the cost of building it has risen substantially. Whereas it could have been put in place for about $3,600,000 in 1965, the current price is close to $5,400,000, or about $1,500,000 more than it is worth.

Today the 75 percent limit on insurance-company lending works the other way. A commitment to lend 75 percent of the economic value of the project would cover less than 75 percent of the cost (versus almost 100 percent five years ago). In today's market it might be wise to abandon such a project. Yet the decision in many cases is to go ahead. One reason is that developers are a breed of single-minded, incurable optimists. Lewis N. Wolff, head of corporate real-estate development at Twentieth Century-Fox, says wryly: "What we need in L.A. is a Developers' Anonymous. A guy with an idea for a project should be able to call up a half dozen friends in the middle of the night and get talked out of it."

Insurance companies, on the other hand, are supposed to be a bit more hard-headed. H. Eugene Ross, vice president for mortgages at Aetna Life & Casualty Co. of Hartford, says: "We turn down 90 percent of the deals that are currently presented. They have potential negative leverage. In other words, the return per dollar invested could work out to be less than the cost of the debt."

Some insurance companies, however, seem to be betting that the cost-value equation will be improved by a rise in rental rates or by successful efforts to bring costs under control. As a matter of fact, rates of return in real estate *are* capable of quick and dramatic escalation. A sudden spurt in the demand for office space in a particular location, for example, can push office rentals from $9 to $11 a square foot within a few months. If taxes, the most volatile of operating costs, are not increased, total expenses might stay at, say, $4 per square foot. As a result, net yield on the property will have risen from $5 to $7 a square foot, or by 40 percent. When such fortuitous economics can be predicted—which is sometimes the case—the project can be capitalized on the basis of the higher, future earnings rather than current earnings, much like a common stock.

If the insurance companies cannot find enough new ventures with such prospects, they may be able to fulfill their real-estate objectives by buying existing values rather than trying to create new ones. Connecticut General, for instance, is still financing new ventures, but it is also devoting a good chunk of its real-estate funds to buying older buildings whose potential appreciation in value is not yet fully reflected in market price. Last year the company obtained control of three large skyscrapers—the forty-two-story Mobil Building and the forty-one-story Continental Can Building in New York City and the forty-story Erieview Plaza in Cleveland. The $27,600,000 purchase was the largest deal ever made by Connecticut General and one of the biggest in U.S. real-estate history.

A THREE-COURSE SPECIAL

John Hancock Mutual of Boston, on the other hand, remains almost exclusively committed to financing new ventures. Hancock has the reputation, among

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people in the real-estate business, of being the most aggressive lender. Although it did not invent equity participation, it has refined the concept to the point of maximum sophistication. In some senses, the company has proved a model for the rest of the insurance industry.

Hancock makes two types of real-estate deals—one for the star developers who are able to resist giving up part of their equity, the other for the bit players. The company's favorite proposition for the ordinary developer is a three-part package, consisting of a ground lease, a leasehold mortgage, and an equity participation. The package works something like this: A developer has land worth $5 million on which he wants to build an office building that will be valued at $25 million. If he mortgaged land and structure together, he could raise $22,-500,000—i.e., 75 percent of the value. He can borrow more by separating the land from the building. First he arranges with Hancock to buy the land for $5 million and lease it back to him. Then he mortgages his leasehold estate to Hancock for 75 percent of the value of the building, or $18,750,000. In this way the developer gets a total of $23,750,000, or $1,250,000 more than if he had mortgaged land and building together. Moreover, he can deduct the ground rent as a business expense, whereas if he had mortgaged the land he could have deducted the interest but not the amortization of principal. Hence the first two parts of the Hancock package are all to the developer's liking.

The final part, however, is often extremely unpleasant. As a condition for making the deal, Hancock demands the right to buy, through a wholly owned real-estate subsidiary, a 50 percent equity interest in the building. Hancock would probably purchase this stake for about $1,875,000, or 10 percent of the size of its mortgage loan. The insurance company, of course, would put down no cash. As was the case with the land and mortgage money, it would pay for its equity with a commitment to provide funds once the project was completed. The developer must take this three-level commitment to a bank to pick up his construction money. Just as it might have done in the Fifties, Hancock ends up, in effect, meeting 100 percent of the cost of the project. But this is not because it has inflated its appraisal or because value is sufficiently greater than cost to justify 100 percent financing. Hancock has simply elected to supply that tier of junior capital which, in theory at least, the developer formerly had to provide himself.

Hancock is so devoted to the idea of acquiring equity that if the developer came forward with his own equity money and said, "Lend me 75 percent of the value of the building. I can put up the rest," the insurance company would refuse. So, in fact, would many other companies. In the Fifties scrupulous lenders worried that developers had too little of their own equity in projects. Today the developers are not allowed to put any in!

DEVOURING ALL THE CASH

Although Hancock's package is a three-part affair, the company's short-term reward comes in four stages. Three payments accrue to it as landlord and mortgage lender, the fourth as equity participant. Hancock usually charges 9¾ percent interest on the leasehold mortgage, and about 9 to 9½ percent of the land's value as ground rent. Then comes the kicker. After deducting mortgage and rent payments, taxes, and a predetermined amount for what it considers reasonable operating expenses, Hancock insists on 25 to 35 percent of the remaining cash flow. Moreover, this bonus interest is attached to the ground lease rather than the lease hold mortgage. (Hancock, in fact, calls it a variable ground rent.) This is because the mortgage is usually fully paid off in twenty-five years while the ground lease runs twice that long. At the end of twenty-five years, therefore, only about 21 percent of Hancock's initial land and mortgage investment remains in the deal—$5 million out of $23,750,000—but the company continues to earn a bonus interest based on its whole original investment.

The fourth short-term reward represents a return on equity. Since the ownership of the project is split fifty-fifty, one would expect the remaining cash flow to be divided in that proportion. But such is not the case. Hancock insists on a 12 percent cumulative preferred dividend. In effect, the company treats its equity just like a senior security. On an equity investment of $1,875,000, for example, Hancock takes the first $225,000 before allowing the developer any part of the cash flow. If the project throws off less than $225,000, Hancock takes all there is, then adds the difference between that amount and $225,000 to its second year's return, and so on. In practice, after expenses, taxes, ground rent, debt service, kicker, and preferred dividend have been paid, the developer usually has no

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current return. Indeed, he is unlikely to see any cash at all during the first five years of the project's life.

Although Hancock is reluctant to admit that this is so, other lenders that have on occasion applied variants of the Hancock formula are less reticent. Hayden of Connecticut General says flatly: "There are situations in which there will be no cash flow to the developer for four or five years while our equity is being repaid. But even when our equity is fully amortized, we are still a 50 percent owner, if that is the deal." Prudential, Equitable Life of Iowa, National Life & Accident of Nashville, New England Mutual, and Metropolitan Life all admit to making similar arrangements.

The developer gets to share in cash flow eventually, but his chief reason for building the project is the possibility of capital gains. Initially he may make a profit on the sale of the land. Eventually, as an equity partner, he gets 50 percent of the proceeds of the sale or refinancing of the building. Since good real estate tends to appreciate in value, the long-term gain is, of course, substantial. (The developer may get still another recompense. The insurance company sometimes pays him a sizable management fee for superintending the construction phase of the project.)

THE PACKAGE LOOKS TOO GOOD

Hancock puts a high value on the potential earning power of its three-part package. Counting ground rent, mortgage payments, kicker, and return on equity, *plus* its share of the estimated sales value of the building, the company expects to earn between 13 and 20 percent on its money. "We may settle for 13 percent on some apartment buildings," says Emerson, who does a lot of the negotiating for Hancock, "but we can get up to 20 percent on motels. Our average investment should bring us something in the middle teens."

Many others in the insurance industry are skeptical of such estimates. "This kind of return, or even a higher one, is possible on the equity portion of the package, but I doubt that it can be achieved on the package taken as a whole," says Carl H. Huebner, senior vice president for real-estate financing at Metropolitan Life. In other words, if Hancock made an equity investment that was leveraged by someone else's mortgage money, a 20 percent return is conceivable; when the company provides its own mortgage funds, even 15 percent seems ambitious.

Some real-estate developers are convinced that Hancock can get into serious difficulties by reaching for such a high return. As one developer puts it: "The Hancock-type deal is so potentially profitable for the insurance company that the only people with whom it may work are the speculative developer or the developer with a speculative project."

To be sure, several Hancock deals have already begun to founder. Emerson himself is disappointed with the results of some projects—particularly with investments in El Dorado County, California. And bad deals allegedly played a part in the downfall of Hancock's president, Robert E. Slater, who resigned last December, giving as his reason "broad policy differences" with the company's board of directors.

When it negotiates with a star developer, Hancock moderates its demands. Hancock may eventually earn as much as or even more with this kind of partner than it would with a less-known entrepreneur, because there may be more money in a modest percentage of an outstandingly sound project than in a huge stake in a border-line deal.

In its deals with Cabot, Cabot & Forbes, a firm with which it has done more than $50 million of business to date, Hancock gets a kicker in the form of a variable ground rent, but no share of the equity. The kicker usually amounts to 25 to 40 percent of net income. Cabot insists upon deducting all costs, including overhead, before figuring the bonus. It claims that Hancock's "standard" expense allowance is often so niggardly that a developer can end up paying Hancock a percentage of an income flow that he has never received.

Cabot thoroughly enjoys it relationship with Hancock. Before the advent of the kicker, it rarely was able to get 100 percent financing of its projects. Although Hancock and other lenders often agreed to make a full mortgage loan, they frequently attached a "holdback" provision. For example if an office building cost $10 million to build, the insurance company might make a nominal commitment for $10 million but "hold back" $2 million until the building had been completely leased. Since a commercial bank would only lend up to the "floor" of the commitment, or $8 million. Cabot still had to acquire the outside funds. In practice, this

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usually meant taking on partners—generally doctors and dentists with surplus cash. Rounding up these partners was hard work, living with them even harder. A knowledgeable—and remote—insurance company is certainly a more desirable money partner.

Less fortunate developers who have to accept Hancock's three-part special would also be happy with the bonus interest kicker as a replacement for the hold-back. Still, many don't mind too much giving up a share of the equity. They do object to the insurance company's demand for a preferred dividend and its refusal to put up seed or "front-end" money—i.e., spot cash with which the developer can buy the land and meet expenses during construction.

"If the lender puts its money into the project during the planning stage when there is genuine enterpreneurial risk, it deserves up to half the equity," concedes Harry Newman Jr., a prominent Los Angeles shopping-center developer. What irks developers, Newman adds, is that the lender sits back without venturing a penny, while the developer locates and buys the site, talks the tenants into leasing, and constructs the building. Then it comes in with money, but no organizational expertise, and takes most of the return.

Insurance companies contribute front-end equity only rarely and reluctantly. If the company were to become an equity partner at the beginning and the project ran over budget, it would be obliged to put up its share of the extra funds, unless it had negotiated a specific agreement to the contrary. Under current practice, any cost overrun is usually met by the developer. If he cannot get the extra cash, the insurance company can simply refuse to fund its commitments.

HOW TO PRESERVE RESPECTABILITY

When an insurance company takes an equity position, it often forms a joint-venture partnership with the developer. The company can participate in the partnership directly, but might choose to assign its partnership interest to a wholly owned real-estate subsidiary, or to a mini-sub—a subsidiary of the major real-estate subsidiary.

Most insurance companies prefer not to participate directly, since real-estate ventures carry the aroma of speculation. The companies are genuinely concerned about unfavorable policyholder reactions to their new emphasis on equity participations. By placing their real-estate interests in subsidiaries, they hope to avoid "tainting" the parent.

The subsidiary can also protect the parent in more tangible ways. Most real-estate ventures show sizable losses in the early years of operation. If the parent owned the real estate directly, these losses would show up on its balance sheet. In the insurance business this might have serious consequences. The major insurance companies actively compete for the management of corporate pension money, and corporate officials generally choose among insurance companies on the basis of their "return on new money," defined as the amount earned by an asset during the first year it was acquired. Conceivably, real-estate losses could lower a company's return on new money sufficiently to cause it to lose a fat pension account. By placing all real estate in subsidiaries, however, the parent skirts the problem. In most states the income (or loss) of an insurance company's subsidiaries cannot be consolidated with the parent's income.

The subsidiary also shields the assets of the parent from the debts of the real-estate joint venture. According to some insurance-company executives, developers are not above ordering materials for the account of the joint venture and using them on other, unrelated projects. When this occurs, creditors of the joint venture can attach the assets of the subsidiary but may not be able to "penetrate the corporate veil" to threaten the parent's assets.

A RUBBERY RESTRICTION

Finally, some insurance-company executives view the subsidiary as a handy device for circumventing legal limits on the percentage of assets that can be invested in real-estate equities. In most states insurance companies are allowed to put no more than 5 or 10 percent of total assets into real estate. Finding these limits a bit confining, companies have been lobbying the legislatures for higher ceilings—with some success. In New York, for example Governor Rockefeller recently signed a bill raising the limitation from 5 to 10 percent.

But not all legislatures have moved fast enough to suit the more ambitious insurance companies. Stock companies like Aetna, Connecticut General and National Life & Accident of Nashville have found a solution in using the holding-

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company umbrella. The life company and the real-estate subsidiary are no longer directly connected; both are now subsidiaries of the holding company. Since the real-estate subsidiary is divorced from the life company, it is unregulated and can operate without interference from the insurance examiner.

Mutual companies, however, cannot use the holding-company device, since, by definition, they are owned by their policyholders and cannot be owned by another enterprise. Instead, the mutuals set up wholly owned subsidiaries, which are subject to the scrutiny of state insurance departments. In New York the examiners have ruled that the parent life company cannot do through a subsidiary what it is prevented from doing on its own. If the parent cannot invest more than 10 percent of its assets in real-estate equities, parent and subsidiary together cannot breach this limit. But many states are more permissive. The amount that the parent can invest is regulated by statute, but the amount that the subsidiary can invest is subject to more or less informal negotiations between the company and the examiners.

Conceivably, if the parent advanced money to the subsidiary for a real-estate venture, it could label 30 percent of the money "equity" and 70 percent "debt." The examiners might charge only the equity portion of the investment against the insurance company's asset limitation, enabling it to more than triple its involvement in real estate.

HAVING THE BEST OF BOTH WORLDS

Although the subsidiary route offers many advantages, it also has a few drawbacks. The subsidiary pays the full corporate tax rate, 48 percent, whereas the life-insurance company itself pays its taxes at a much lower effective rate. And when the subsidiary passes dividends to its parent, a second tax must be paid on them. A number of insurance-company lawyers feel that the potential tax disadvantages cancel any gains in operational flexibility. They believe, moreover, that the insurance company can obtain positive tax benefits and limit its liability for debts by another arrangement—one that combines a direct parent-company interest and an indirect subsidiary interest in the joint venture.

According to this plan, an insurance company might negotiate a 50 percent equity interest and enter the joint venture itself as a 49 percent *limited* partner, while putting its subsidiary in as a 1 percent *general* partner. A general partner is entitled to participate in the management of the joint venture, but it is also liable for all the venture's debts. A limited partner has no liability, except for its initial investment, but neither has it the right to manage. By sharing its partnership interest with its subsidiary, the parent has the best of both worlds—the right to manage without exposing its own assets.

This arrangement also provides a tax bonanza. As a limited partner the insurance company has an ambiguous relationship with the joint venture. On the one hand, it is a lender to the venture, receiving interest income from its mortgage; on the other hand, as a partner, it pays out morgage interest—in effect to itself. The income it gets as lender is taxable; the interest it pays as partner is deductible. The key to the tax advantage is that, for many insurance companies, the marginal tax bite on interest income is generally about 30 percent, while deductions for for interest paid are usually worth close to the full corporate rate of 48 percent. The difference arises because the investment income of a life company is divided into two parts: the policyholders' share and the company's share. While the company pays the full corporate rate on its own share, it is not taxed on what belongs to the policyholder. So its effective tax rate is lowered substantially.

If the joint venture paid the insurance company $100,000 in mortgage interest, the company's tax liability on that would be about $30,000. But when the insurance company is a 49 percent limited partner in the fifty-fifty venture cited above, it is entitled to deduct $49,000 as its share of interest paid. That deduction would lower its tax from $30,000 to $6,480 (48 percent of $49,000 equals $23,520). If the insurance company were a 74 percent limited partner—in a seventy-five to twenty-five deal—its share of interest paid by the partnership would more than wipe out its $30,000 tax obligation on the mortgage interest it received (48 percent of $74,000 equals $35,520). In other words, the more substantial its equity position, the more the insurance company makes on its loan. And if it takes a big enough equity position, it can even raise its after-tax yield on interest income above its pre-tax yield.

A number of insurance companies have only just discovered this bizarre tax wrinkle and are planning to use it for the first time this year. If the Internal

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Revenue Service acquiesces, those companies may become even more insistent in demanding equity participation. And as long as mortgage money remains as scarce as it has been, few doubt their ability to enforce this demand.

Mr. HOVDE. One final item; in regard to interlocking directorates it would be our hope that the regulatory agencies or departments with respect to the various financial institutions would best be able to handle and set up regulations for this. We would certainly trust that you did not lose the expertise—and that goes into all fields here—that would be sitting on the board. And if the regulatory agencies can handle this, they can certainly require full disclosure be had of any debtor in any position on the loan.

Thank you, sir.

The CHAIRMAN. Mr. Jackson.

Mr. JACKSON. First, in fairness to Mr. Ashley, I would like the committee's permission to respond in writing for the record to his question. He asked me a question, and Mr. Hovde used it as an excuse to give a speech.

The CHAIRMAN. When the record comes to you—one of you will have a copy of the transcript, and you may make the corrections you want and any additions you wish.

Mr. JACKSON. Thank you, sir.

I would also like to submit later for the record specific examples of the reports that exist with respect to participation loans and nonparticipation loans, I think I can offer specific examples quoted to us by life insurance companies which would be most helpful and of direct interest to the committee.

The CHAIRMAN. You may submit that.

Mr. JACKSON. Thank you, sir.

(In response to the information requested by Mr. Ashley, the following letter with attachment was received from Mr. Jackson:)

MORTGAGE BANKERS ASSOCIATION OF AMERICA,
Washington, D.C., April 30, 1971.

Hon. THOMAS L. ASHLEY,
Member of Congress,
House of Representatives,
Washington, D. C.

DEAR MR. ASHLEY: You asked me two questions during the hearings on the equity participation section (14b) of H.R. 5700 which I agreed to answer later in writing for the record since the limits on your time did not make it possible to answer them fully during the hearing.

The first question concerned the ability of builders to continue building apartments and commercial developments during periods of credit restraint by offering equity participations to a lender. You questioned whether a social purpose was obtained by such financing when the result was to divert funds from housing.

In answer let me first commend you for looking at the whole picture of equity participation and its relationship to the economy and improvement of the country rather than the narrower view of builder and lender relationships. When money becomes tight, all real estate finance suffers disproportionately to the rest of the economy. Single family homes most of all. Apartments and commercial developments to a lesser extent because of their better ability to compete with others for available funds. This country as yet has no national board to determine who gets how much for what when money gets scarce.

One system we now have to channel funds for housing in preference to other uses is the tax advantages and other privileges given certain financial institutions such as members of the Home Loan Banks who in turn are asked to invest their funds in housing loans. Recently even these institutions, in order to secure higher returns on their investments, have received authority to invest a larger proportion of their assets in non housing loans.

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During the decade of the 1960s, demographic factors have been responsible for the substantial increase in demand for, and construction of apartments. Actually, the ability of apartment builders to engage in equity participation financing helps housing during tight money periods. For example, the proportion of multifamily to total housing starts rose rapidly in recent years because of this ability to compete for available funds. Since multifamily units generally cost less than single family ones, this aids in reducing inflationary pressures while still providing housing.

Your second question on the possible increased rental cost to a tenant as a result of equity participation financing indicates doubt that lenders do in fact lower their fixed interest costs on loans including participation features below that wanted for fixed return loans. To help resolve that doubt I am enclosing a copy of a letter from the Aetna Life Insurance Company to all of its loan correspondents which states the difference in rates quoted at that time on both fixed and participation type loans.

It is obvious from this letter that the lender will initially receive less, enabling the builder to charge less to tenants, if the lender shares in the future increased charges the *builder* makes to the tenants. Any increase in rents is under the sole control of the builder not the lender. In return for a lower interest rate the lender shares with the builder in the risk of future increased rent. This lesser fixed cost should make it economically possible to build apartments and other buildings at lower rentals than otherwise possible.

Thank you for this opportunity to answer your questions. If you wish them amplified, we will be happy to do so.

Yours very truly,

PHILIP C. JACKSON, JR.,
First Vice President.

AETNA LIFE & CASUALTY,
Hartford, Conn., February 4, 1971.

ROBERT L. PETERSON,
Regional Director, Real Estate Investment Department.

TO ALL CORRESPONDENTS: Recent changes in money market conditions permit us to reduce the rates acceptable to us for new applications for loans on income properties and enable us to advise you that, based on presently predicted cash flow, we can increase the volume of 1971 commitments over those of 1970 by about 35%. In addition, our allocation of funds to be disbursed in 1971 has just been increased. Under the circumstances we will be more inclined to approve loans at our most favorable rates if disbursement is possible in 1971.

Effective immediately and until further notice, we are willing to consider loans in accordance with the following guidelines:

(1) A gross rate of 9% with contingent interest based on 15% of rental income over stabilized gross income after vacancy allowance as established in the appraisal. We will expect a 2% standby fee, in cash or Letters of Credit, 1% of which will be returned upon execution of a "Buy-Sell Agreement" and 1% upon our disbursement of the loan, or

(2) A gross rate of 9¼% without provision for contingent interest but with a 1% non-refundable commitment fee which is to be paid to us at the time we issue our commitment. In addition to the commitment fee we will expect a 1% standby fee, in cash or Letters of Credit, returnable to the borrower upon our disbursement of the loan.

It is to be noted that these rates are to be used *only* when security and competitive circumstances do not indicate higher rates. We continue to prefer a basis providing contingent interest, particularly when the income stream from the property is likely to show continual increases in gross rentals. In instances where the income stream, due to long term leases, etc., is expected to remain static a higher contract rate with a commitment fee will be preferred. In the case of a motel loan we will require a minimum rate of 9½% with a meaningful contingent interest factor based on gross room, food and beverage sales. We will continue to require "Buy-Sell Agreements" with each loan.

We continue to encourage joint ventures with experienced developers or transactions involving the purchase leaseback of land plus a leasehold mortgage loan. Such ventures will be negotiated on a case basis but it should be recognized that the combined mortgage-equity yield (but not necessarily the mortgage yield alone) should be proportionately higher than a typical mortgage yield to offset the added risk involved.

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Generally speaking, loans less than $500,000 should be developed without the contingent interest feature.

We suggest that you contact us prior to preparing a complete loan submission, or, if you find any substantial changes in the market in your area that you keep us informed.

Very truly yours,

R. L. PETERSON,
Regional Director,
Real Estate Investment Department.

The CHAIRMAN. Mr. Fey.

Mr. FEY. First, I would like to address myself to the use of the term "equity participation." I think the confusion that apparently exists here today very graphically explains our concern for labeling a percentage income provision as an equity participation. This is a very broad and sweeping bill that includes a large number of credit transactions, as I pointed out initially, ranging from convertible bonds to debentures, notes with warrants, to joint ventures. We should not for a moment confuse a joint venture with the loose term "equity participation" used on an income participation transaction.

So I say, above all, let us keep these terms straight. If there are abuses in this particular area of lending, it is essential to approach these abuses with a clear definition of terms.

The term "shadow warrant" is a term that is not well known in financial with. It only demonstrates the fact that the use of the broad term "equity participation" as a condition to making a loan is a vague, sweeping generalization that would have a very serious impact on the flow of capital, a serious impact on our securities markets, and a very detrimental impact upon borrowers.

Now, reference has been made to the Fortune article. The Chairman has asked that this be introduced into the record. I think that one observation should be included in the record if that article is a part of the record. That is that our companies are restricted in the amount of real estate that they may own by State laws. These restrictions range generally from about 5 percent of their total assets to a maximum of 10 percent of the assets which may be invested in real estate operations. Currently of the one trillion 459 billion dollars of nonfarm real estate in the United States, one-half of 1 percent of this is owned by life insurance companies, of which one-fourth is used for home office purposes. If—and I say if as a hypothetical—if all of these companies used the upper limits of the State limitations, then the entire holdings would only be one and three-tenths percent of the real estate of the United States. So how the life insurance companies could become the future landlords of America is something far beyond me on these percentages.

Mr. Chairman, I thank you for this opportunity.

The CHAIRMAN. All right, Mr. Terry.

Mr. TERRY. Mr. Chairman, I think it is worth commenting on what business the real estate developer is in. I think we are in the business of manufacturing real estate value. That value has to be in excess of what the project costs us.

Several years ago, because of differences in money conditions, a 75-percent loan enabled us to cover the cost of a project. Today that is not true. Our choices were to stop building, or to keep moving ahead. We choose to keep moving ahead in a profitable way. Therefore we

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come around to the sale of equity to attract capital. We would prefer to attract that capital from an institutional source, banker or insurance company pension fund, rather than go the securities market.

The ability to attract long-term debt is vital to us. When we make a loan with an insurance company we are doing so for 25 or 30 years. Our corporate credit is normally not involved. We have their money for a long, long time on which to make a profit. Being motivated by inflation is to us a very understandable thing. And we do not feel really that it operates to our disadvantage to give a kicker on a loan.

Thank you very much.

Mr. FEY. May I request time for Mr. Hayden.

The CHAIRMAN. Go ahead.

Mr. HAYDEN. Mr. Chairman, the insurance companies have been beaten up pretty badly on the question of housing today. I think I would like to give you an example of what our particular company is doing right now.

We are involved in eight joint enterprises which currently would be creating a total of 18,274 dwelling units. This is joint enterprises, eight of them in number. Of these eight, seven would clearly be illegal under the provisions of section 14. The one which would be legal is one in which a developer at his own request has asked to do a job for a fee only, he wants no equity interest. Of course, this suggests the possibility that in future, if we cannot engage in joint ventures, joint enterprises as we have, we would be forced to do a much smaller number, using developers working for a fee. We do not think it is in the best interest of the developers, and we do not think it is in our best interest. I am appealing to you not to rule out the legitimate joint enterprise, because it is very important for the future growth of the country.

Just to put the figures in perspective the number of units and loans in which we have one form or another of equity participation involves a total right now of about 5,400 units.

Thank you.

The CHAIRMAN. I predict this record will be well read by Members of Congress and by people all over the Nation who are interested. The way this is handled—of course most of you gentlemen are familiar with it—this record will be approved by the witnesses who have testified, and by the Members of Congress who participated, and then it will be printed by the Government Printing Office, and thousands of copies will be made available to the libraries of the country and the interested people who write to their Members of Congress for copies. I suggest here that every citizen of this Nation has three people that he should freely write to in the event he wants something from the Congress of the United States.

First, he should write to his own local Representative, his local Congressman, or one of his U.S. Senators, or both of his U.S. Senators. And if it is a pressing thing, write to the President of the United States, because those four are elected in the election process in which you participated whether you actually voted or not, because you had a right to participate, and you have a right to call on people who are elected in the election process who represent your area. So I would suggest that you write to your own Congressman first, and either one or both U.S. Senators next.

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Thank you gentlemen, very much for your participation. I feel this has been a very fine session.

No one member wants to do any one of you wrong, we want to do right, and the only way we can do right is to know the facts. You have given us facts that we did not know. And I personally appreciate it very much.

Thank you, gentlemen.

The committee will stand in recess until 10 a.m. tomorrow.

(The following letter from Mr. Terry was received by the committee for inclusion in the record:)

JAMES W. ROUSE & CO., INC.,
MORTGAGE BANKING AND RESEARCH
May 5, 1971.

HON. WRIGHT PATMAN,
Chairman, Committee on Banking and Currency,
House of Representatives, Rayburn House Office Building, Washington, D.C.

DEAR CONGRESSMAN PATMAN: After reviewing the Report of Proceedings for H.R. 5700, held on Wednesday, April 28, 1971, I feel some clarifying statements are necessary concerning the financing of Columbia. I hope it will be possible to have the following clarifications included in the record.

We began the Columbia venture in 1963 in cooperation with the Connecticut General Life Insurance Company. Connecticut General, via a mortgage loan, advanced sufficient funds to acquire almost 14,000 acres in Howard County, Maryland. Connecticut Generals' mortgage loan eventually built to almost $23,000,000. Our original arrangement with Connecticut General was that they would own one half of the development entity in Columbia (Howard Research and Development Corporation) and we would own the other half. We were responsible for the management and affairs of HRD, and Connecticut General was responsible for supplying all the money needed in the early years. The Connecticut General financing was refinanced several years later by a $50,000,000 loan from Connecticut General, Teachers Insurance and Annuity Association, and The Chase Manhattan Bank. The interest paid on that loan is as follows:

	Percent
Connecticut General, $15 million	6
Connecticut General, $10 million	8
Teachers Insurance and Annuity Association, $15 million	6
Chase Manhattan Bank, $10 million	8

The interest cost on money borrowed from Connecticut General was arrived at as being no more than we had to pay to other investors buying part of the $50,000,000 issue. Therefore, the 7.3% overall average paid to Connecticut General is the same average as is paid to the other two investors.

It is interesting to note that the reason the Teachers loan is at 6½% is that they have an option to acquire a stock interest in HRD. The Chase Manhattan Bank choosing not to take that approach charged an 8½% interest rate. Not long ago we added to the overall Columbia financing by selling further debt to Manufacturers Hanover Trust, Morgan Guaranty, and Connecticut General an additional $30,000,000 bringing our total debt to $80,000,000.

It was a great honor to appear before the Committee, and I hope my testimony may have been of some value to you.

Sincerely,

WALTER F. TERRY III,
Vice President.

(The following are written questions submitted by the Honorable Frank Annunzio to the National Association of Homebuilders, along with their answers:)

ANSWERS TO QUESTIONS SUBMITTED TO NATIONAL ASSOCIATION OF HOMEBUILDERS BY HON. FRANK ANNUNZIO

Question 1. You bring out some shocking facts concerning equity kickers. Could you estimate how much higher rents would be for low- and moderate-income housing when equity participation is forced on the builder by the lender?

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Answer. Equity participation has to cause higher rents. Certainly the increase in rents is greater in those projects where the base rent is higher. However, we have put together three examples based on a moderate size project with rents fairly typical of those in moderate income projects being built without any subsidy assistance. These examples illustrate how the rents are forced up as a result of the equity participation on top of a 9 percent mortgage interest rate.

ILLUSTRATIONS OF EQUITY AND INCOME PARTICIPATION AND THEIR IMPACT ON RENT

HYPOTHETICAL PROJECT—ECONOMIC DATA

Type of Property: Apartment (288 units, 1,114 rooms)

Cost:	
Land	$580,000
Building	3,220,000
Total	3,800,000
First year:	
Gross income	679,920
5 percent vacancy	33,996
	645,924

Nine percent=25 years $2,800,000 mortgage.

It is assumed that net income to owner remains the same and operating expenses increase at 5% per annum.

However, effective gross income will have to increase differently for each example in order to maintain the same owner's net income over the time period. These examples assume that the market will support increased rents necessary to cover the projected increase in expenses and maintain the owner's net over the time period.

EXAMPLE 1

PERCENTAGE OF GROSS INCOME

Participation: 3% of all gross income collected. Assuming the rate of increase in gross income is 5% per annum.

	Today	In 5 years	In 10 years
Effective gross income	$645,924	$712,514	$779,104
Expenses	258,370	322,963	387,555
Debt service	282,240	282,240	282,240
Total	540,610	605,203	669,795
Net operating income	105,314	107,311	109,309
Owner's net	85,936	85,936	85,936
Equity participation	19,378	21,375	23,373
Equity participation/unit	67	74	81

EXAMPLE 2

PARTICIPATION IN PERCENTAGE OF INCREASED RENT OVER PROJECTED RENT ROLL

Participation: 20% of increases in rental income over projected rent net roll ($645,924).

	Today	In 5 years	In 10 years
Effective gross income	$645,924	$726,665	$807,405
Expenses	258,370	322,963	387,555
Debt service	282,240	282,240	282,240
Total	540,610	605,203	669,795
Net operating income	105,314	121,462	137,610
Owner's net	105,314	105,314	105,314
Equity participation	0	16,148	32,296
Equity participation/unit	0	56	112

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EXAMPLE 3

PARTICIPATION IN INCOME OVER BREAK-EVEN POINT

Assume amount of participation is 20% of all income over "break-even point", defined as expenses plus debt service.

	Today	In 5 yrs.	In 10 yrs.
Effective gross income	$645,924	$710,517	$775,109
Expenses	258,370	322,963	389,555
Debt service	282,240	282,240	282,240
Break-even point	540,610	605,203	669,795
Net operating income	105,314	105,314	105,314
Owner's net	84,251	84,251	84,251
Equity participation	21,063	21,063	21,063
Equity participation/unit	73	73	73

Question 2. Can you give us some specific cases or illustrations of the pressures put on you as builders to allow equity participation by the lender—in other words, how bad is it in specific instances?

Answer. We have mentioned some of the cases of the pressures put on builders to give an equity participation to a lender in Mr. Stastny's and Mr. Martin's statements during the hearing. What in effect occurred over the past two years was action on the part of many lenders, primarily insurance companies, conditioning making of loans for the construction of apartment projects on the granting of an equity participation to them. As a builder-borrower you either gave an equity participation to the lender or you did not build. As a result, many builders, rather than go out of business entirely, capitulated and granted an equity participation or kicker to the lender.

(The following material was submitted for inclusion in the record:)

STOCKTON, WHATLEY, DAVIN & CO.,
Jacksonville, Fla., May 5, 1971.

Re HR 5700—"Banking Reform Act of 1971".

Hon. WRIGHT PATMAN,
House of Representatives, House Office Building,
Washington, D.C.

DEAR CONGRESSMAN PATMAN: As one who has spent a lifetime in the real estate and mortgage loan business, I am greatly disturbed over Section 14 of HR 5700 as I feel it is not in the public interest for the future financing of real estate. If my interpretation of this section is correct, it would preclude any participation by any lender in any equity interest or contingency whatsoever in properties financed.

The building and development industry is probably the nation's largest and is also the most undercapitalized. Some experts have estimated that it will take somewhere in the neighborhood of $7 trillion in long-term capital if the United States is to meet its urban growth objectively by the year 2000. The most optimistic projections of our conventional savings and institutional growth and investment patterns do not come anywhere close to providing the amount needed for real estate financing, and most economists support this view in predicting that we are in for a long period of capital shortage. To meet this need in the future it will require vastly more equity investment than at any time in the past. Yet, Section 14 deprives the financial institution of the option of investing in an equity unless it is prepared to put in 100% of the equity, or it can make conventional mortgage loans but only to the extent that inadequate supplies of noninstitutional equity money are available. In my opinion, neither option is viable. From a realistic viewpoint, I do not believe that 100% equity investment will be available in a prolonged period of capital shortage, nor do I believe that institutions will go beyond normal mortgage limits.

It appears to me that if Section 14 is not eliminated from the Bill, it will concentrate all of the major real estate development and city building in the hands of major corporations and eliminate the individual and smaller developer which has made such a great contribution to the building of this great country

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of ours. My personal opinion is that the conditions which we are operating under now are very good, as the small entrepreneurs can leverage their capital, skills and talents with institutional equity capital and, as a result, continue building well-planned and cohesive developments as they are doing today. The developer deprived of an opportunity to so leverage his equity capital, talents and skills, has no other alternative than to sell out to a major corporation. From my observation, most major corporations are not well-suited to real estate development except where their roll is that of a financial partner. Under Section 14 it would make it immensely more difficult or impossible for financial institutions to be financial partners. The often preferred structuring of such a partnership is for the financial partner to inject dollar equity to match the developers equity investment of his skills and talents; thereafter, the financial partner puts in his money as a loan to the venture. Section 14 would prohibit this which I do not feel is healthy or in the public interest, as I feel the developers and builders should retain the right to leverage their equity capital and thus their skills with institutional equity money in order that the nation may enjoy the better-planned, the better-developed projects that give proper attention to amenities, open space and other environmental features.

I would urge your serious consideration in deleting Section 14 from HR 5700.

Sincerely,

JOHN A. GILLILAND,
First Vice President.

ROYAL STREET CORP.,
New Orleans, La., May 3, 1971.

Hon. WRIGHT PATMAN.
House of Representatives,
Washington, D.C.

DEAR CONGRESSMAN PATMAN: I am writing to you with reference to Section 14 of HR 5700, entitled "Banking Reform Act of 1971". It is my understanding that the purpose and intent of Section 14 is to prohibit lending institutions from accepting equity participation in consideration of making any loan. I am president of a company that has been involved in real estate development, which includes the planning of a large residential housing community, and all negro housing development some years ago, a small housing development in California, a regional shopping center, hotels, and now a major recreation oriented community near Salt Lake City, Utah. From my experience, I have some grave misgivings about Section 14, which I would like to set forth in this letter.

In making my point, I would like to use as an example our project in Utah. Our plans call for the development of a recreation oriented community, accommodating ultimately some 30,000 people. It's recreational base is skiing in the wintertime; golf, hiking, fishing, tennis, etc. in the summer. It is only some 20 minutes drive via an interstate highway to the edge of Salt Lake City itself. One of its purposes will be to augment the Salt Lake City housing supply. A second purpose will be to develop a significant tourism activity, which is very important at this time to the State of Utah. Utah, because of its geographic location, has difficulty in attracting manufacturing or distribution businesses. Its economy now depends too heavily on mining and the state has recognized that it must look to tourism as an important future industry. Our activities, therefore, in addition to being profitable we hope to us, will serve to create many new and badly needed jobs in the somewhat depressed Salt Lake City area. It has, therefore, been heartily welcomed by the governor and other state officials.

This sort of endeavor will over the years involve great sums of money and greater than average elements of risk. Projects of this sort have to be undertaken without the great pool of experience that is available for the planning of more conventional projects, such as urban housing developments, shopping centers, office buildings, etc. The markets are not nearly as well defined or as reliable. Attracting the amounts of capital necessary, therefore, becomes a serious problem. Obviously, the participation of major lending institutions is vital. In view of the risks involved, it is inequitable in my opnion to call upon lending institutions to take the exposure they must in lending to a recreational oriented project, such as ours, without giving them the opportunity to participate in the rewards should they be forthcoming. It is my opinion that if such lending institutions are prohibited from taking part in equity financing of this sort of unusual project, they would decline to participate at all, thus making the proj-

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ect impossible. While the enactment of Section 14 of HR5700 may appear to be desirable for many reasons, it will work a severe hardship on housing and real estate developments, which are novel in concept and which are in a sense exploring new ground and, therefore, where the risks are above average. Our experience in cases such as these is that the presence of a sophisticated corporate lender as an equity partner does not work a hardship on a developer. On the contrary, it is the catalyst which makes the project possible.

It is my opinion, therefore, that the enactment of Section 14 in its present form would be unwise for I believe there are many situations where it will do great harm and be a disservice to the public interest.

If I or any of my associates can be of assistance to your committee, we'd be most anxious to in this regard.

Respectfully submitted.

EDGAR B. STERN, JR.,
President.

May 5, 1971.

Hon. WRIGHT PATMAN,
Member of Congress, Chairman, House Committee on Banking and Currency House Office Building, Washington, D.C.

DEAR CONGRESSMAN PATMAN: I am worried about the implication of Section 14 of HR 5700 now being considered by your committee. This section would make it illegal for any lender to participate in any equity interest or contingency in properties financed by him.

I assure you that I have no direct personal or professional interest in the question since I neither develop nor finance development of real properties. I am worried that the effect of Section 14 will be to cut off the flow of funds to finance real estate development which the United States can ill afford in this tight property and residential market. It appears to me that the financial organization and the development organization are indeed partners—one to furnish finance and the other to provide entrepreneurial planning and development to the project. Why should not both elements share in any reward?

The building industry today is both the nations largest and the nations most under capitalized. Please consider again before providing additional penalty to the attraction of new and additional capital which is badly needed by this vital industry.

Sincerely yours,

W. M. COOPER.

PRESIDENTIAL REALTY CORP.,
White Plains, N.Y., May 6, 1971.

Hon. WRIGHT PATMAN,
The House of Representatives,
Washington, D.C.

DEAR CONGRESSMAN PATMAN: As an officer of this publicly held real estate development company, I would like to voice my opposition and the opposition of my company to section 14 of H.R. 5700 (Banking Reform Act of 1971).

To legislate against lenders' obtaining a percentage of equity in real estate in consideration of their making mortgage loans will, in our opinion, lead to a worse alternative, increasing the fixed rate of interest which lenders will charge, thereby making more hazardous to the developer the creation of new real estate. It will lead to higher fixed charges, higher rents, and an increased bankruptcy rate, especially for the medium-sized entrepreneur.

Please vote against the section.

Sincerely yours,

JOSEPH VIERTEL.

STANDARD MORTGAGE CORP.,
New Orleans, La., May 6, 1971.

Hon. WRIGHT PATMAN,
House of Representatives,
Washington, D.C.

DEAR SIR: I am very much opposed to the enactment of Section 14 of H.R. 5700, entitled Banking Reform Act of 1971. As I understand it, this bill deprives institutions such as insurance companies and mutual savings banks from investing in real estate equity unless they can put in all the equity. I feel this will

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greatly reduce the amount of money that will flow into our geographical area from these institutions.

The building and construction needs of the South and Southwest and in particular, Louisiana, are great. Our capital short area must attract capital to fulfill these needs from the institutions defined in Section 14. If Section 14 becomes law, funds from these institutions will flow into other investments and, therefore, stifle the new projects we so desperately need.

Very truly yours,

EDGAR BRIGHT, Jr.

NORTHLAND MORTGAGE CO.,
Minneapolis, Minn., May 11, 1971.

Re Banking Reform Act of 1971 H.R. 5700, section 14.

Representative WRIGHT PATMAN,
Chairman, House Committee on Banking and Currency
U.S. House of Representatives
Washington, D.C.

DEAR MR. PATMAN: Attached is a copy of a letter I have written to my Congressman, William Frenzel of Minnesota, to voice my personal opposition and that of the Minnesota Mortgage Bankers Association to the legislation contemplated by Section 14, H.R. 5700.

Our company is engaged in real estate development, mortgage banking and real estate brokerage. In no capacity do we directly benefit from a lender's ownership of real estate or their participation in income or profits from a property they have financed. On the contrary, as developers and mortgage borrowers we end up paying the lenders the additional interest; as mortgage bankers, we take on additional loan servicing burdens without additional compensation; and as real estate brokers, we may lose the commissions from selling the equity in a project if the mortgagee buys an equity position directly from the mortgagor at the time the loan is made.

Nonetheless, we oppose Section 14 because we know that it will have no positive effects on the future of real estate financing but instead will be detrimental to the borrower, the developer, the mortgage banker and the broker. The lenders won't be badly hurt—they'll simply jack-up their rate requirements, be more selective on real estate loans they make, and divert large amounts of investment funds away from real estate and into the bond, stock and private placement markets.

We also contend that institutional lenders make good partners for the knowledgeable, professional real estate developer. Lenders have plenty of money and a sound understanding of real estate economics; their yield requirements are less than private investors; they are generally satisfied at being passive partners who do not interfere with the developer's efforts; and, finally, they have a habit of requiring higher quality standards which results in better real estate developments.

Real estate equity money must come from somewhere! If we can't get it from financial institutions, we'll have to get it through expensive secondary financing or from large corporations, who will certainly make less agreeable partners.

Very truly yours,

LAWRENCE J. MELODY,
Vice President.

NORTHLAND MORTGAGE CO.,
May 11, 1971.

Re Banking Reform Act of 1971, H.R. 5700, section 14.

Representative WILLIAM FRENZEL,
Longworth Office Building,
Washington, D.C.

DEAR BILL: As a friend and constituent I would like to comment on Section 14 of the Banking Reform Act to let you know how it will affect our business as real estate developers, real estate brokers and mortgage bankers. As Chairman of the Legislative Committee of the Minnesota Mortgage Bankers Association, I also want to formally announce our Association's opposition to Section 14 of the bill.

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As a real estate developer, our company borrows money to provide most of the cost of our new real estate projects. As do most developers, we seek to leverage our investment by borrowing the most money at the *lowest* interest rate for the longest term. We certainly do not "give-away" equity participations to lenders, but we're also certainly receptive to selling to lenders all or a part of our equity interest in real estate projects on the same kind of basis as we would sell to any other individual, partnership or corporation. To legislate to prohibit lenders from being a "*buyer*" of real estate equities is to eliminate an important source of equity dollars, which are more important to the continuance of real estate development than are mortgage or debt dollars.

As mortgage bankers, our role is to attract new debt and equity financing to Minnesota. To keep new money coming to our state to finance apartments, commercial and industrial properties, we must be competitive in the national money market for available funds. Our developers *need* equity funds as well as first mortgage funds and it is often more convenient and less expensive for them to find a joint venture partner or borrow equity funds from the first mortgagee or another lender than it is for them to otherwise try to find a partner willing to put up substantial equity dollars.

Negative legislation such as that proposed by Section 14 will have a disastrous effect upon the real estate business nationally. Instead of legislating to encourage lenders to direct more funds into mortgages and real estate, Section 14 prohibits such lenders from making a valuable contribution toward solving our national housing problems; instead, it will encourage lenders to divert funds normally earmarked for mortgage and real estate investments and invest these funds in fixed-yielding bonds and common stock, where yields are equivalent, risks are lower, liquidity is higher and the mechanics of investment are simpler.

Section 14 will cause lenders to charge *higher* fixed rates and make loans for lesser amounts than is customary where the lender either owns a part of the property or agrees to participate in future profits, if available. The only party to suffer is the borrower who will be required to pay the higher rates whether or not the property is profitable. He will also be required to put up more equity funds just to get the loan. Since most real estate developers do not have large sums of equity money, they will be required to pay high rates of interest for second mortgages. As an alternative, they will be required to find equity partners—probably large corporations with little interest in the real estate—and the price they will have to pay such partners will far exceed the price expected by institutional lenders.

To illustrate the value of a lender's equity participation in a loan, I'd like to use some examples of alternative financing packages we can now offer a real estate developer of an apartment complex to cost him $900,000 and have a value upon completion of $1,000,000:

(a) A loan of $750,000 at 9% interest for 25 years with no lender participation.

(b) A loan of $750,000 at 8% interest for 27 years plus 2% of gross income as additional interest.

(c) A loan of $750,000 at 8% interest for 27 years plus 15% of increases in gross income as contingent additional interest.

(d) A loan of $750,000 at 8% interest for 30 years plus an equity contribution of $150,000 or total financing of $900,000 (100% of costs) with the developer and lender to equally share ownership and profits after payment of all expenses and debt service.

Most knowledgeable developers would pick the fixed-rate, no participation alternative last. They would prefer to have the lender get the extra 1% interest only if the project is successful.

Competition in the national money market is generally so keen that lenders must stretch to finance high-quality real estate deals. By allowing lenders to participate in profits and ownership, we encourage them to be more competitive in loan terms and more innovative in structuring various types of financing. Section 14 would, instead, encourage lenders to eliminate their competitiveness and set up similar rate structures for various types of real estate financing.

We know that you are presently participating in hearings on this bill as a member of the House Committee on Banking and Currency. We hope that you

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will oppose passage of the bill because of the potentially damaging effect of Section 14 on the future financing of real estate.

Very truly yours,

LAWRENCE J. MELODY,
Vice President.

STOCKTON, WHATLEY, DAVIN & CO.,
Jacksonville, Fla., May 12, 1971.

Hon. WRIGHT PATMAN,
House of Representatives,
Washington, D.C.

DEAR CONGRESSMAN PATMAN: I am quite concerned about the potential effect of proposed Section 14, HR 5700, "Banking Reform Act of 1971" as it may vary well greatly handicap the entire housing and real estate industry.

As you well realize there is a tremendous need at this time and in the future for housing and development to meet the needs of this growing nation. Section 14 would appear to preclude and prohibit equity interest participation by lenders in financing properties. As in many industries in this country, the individual and smaller developers have contributed greatly and this Bill would appear to restrict or eliminate their activities as they are invariably in need of capital and in many cases equity prticipations present the only method by which they can obtain such capital. If these small businessmen are eliminated from the building and development business, then such activity must inevitably be assumed or undertaken by major corporations which, by their very size, frequently do not appreciate the industry needs. The growth of this country will require that housing and development be well planned and that attention be given to the proper development of areas, particularly the environmental aspects.

I sincerely ask that you review the many implications of Section 14 and eliminate such Section from this Bill.

Very truly yours,

BROWN L. WHATLEY,
Chairman of the Board.

HOME REALTY AND MANAGEMENT CO.,
Charlotte, N.C., May 12, 1971.

Re Banking Reform Act of 1971. H.R. 5700.

Hon. WRIGHT PATMAN,
Chairman, House Committee on Banking and Currency, U.S. House of Representatives, Washington, D.C.

DEAR MR. PATMAN: We notice under Section 14 of the above bill that you and your committee are considering a politically popular reform which would eliminate equity participation by mortgage lenders. We feel that this would constitute a severe hardship for the independent mortgage banking industry as well as the independent developer. For example, we discussed this with Mr. Henry Faison of Masten, Faison and Weatherspoon on yesterday and he agrees with us completely. We have arranged mortgage loans for this firm which has actively developed shopping centers in North and South Carolina counties having populations of about 50,000 to 75,000 persons. This has been a real service to the little man of this country as these people were forced in past years to purchase only at 100% plus retail prices from old line merchants. In other words, there was not competition in the areas. During tight money periods it would have been absolutely impossible for this service to have been rendered to the general public without participation by the lender.

Further in this general connection, we feel that the life insurance industry definitely should be excluded from this provision. The life insurance industry basically creates funds for widows, orphans, children, and the aged. Most life insurance plans today have participating features as an attempt to combat inflation for these persons. It would indeed be a disservice to them to restrict inflation protection in the form of participation by life insurance lenders.

We certainly agree with you and your committee in attempting to control the financial industry. We abhor the fact that many financial institutions have created monopolistic lending practices and have entered into the general insurance, property management, property development, etc. fields. These matters

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must be controlled and we definitely need control on 18% interest charges assessed the small borrower in this country. Small businesses and the small borrower need your help in controlling these factors. Equity participation, on the other hand, is something that should be allowed particularly on loans for terms of over twelve years and on amounts in excess of $500,000.

Further in connection with equity participation, the large developer which is fast coming under the ownership of big business, will have a field day in developing through the device of convertible debentures in order to circumvent your proposed legislation. This will eventually wipe out the medium range developer who is doing the job for the small man in this country.

We hope that you will consider the contents of this letter which are written to you with our most sincere belief. This is shared by the other senior members of this firm who represent over 100 years of experience in the mortgage banking business, particularly associated with the life insurance industry.

Very truly yours,

S. T. HENDERSON,
Executive Vice President.

EQUITABLE OF IOWA,
Des Moines, Iowa, April 28, 1971.

Hon. WRIGHT PATMAN,
House of Representatives,
House Office Building,
Washington, D.C.

DEAR MR. PATMAN: It is my understanding that the House Banking and Currency Committee has begun hearings on H.R. 5700. Section 14 of this bill, relating to equity participation, contains serious long-term and far-reaching economic implications which I urge that your Committee consider.

If America is to meet its urban growth objectives during the remainder of the Twentieth Century, the long-term capital requirements are staggering. There will be a need in the future for vastly more equity investment than in the past.

Section 14 of H.R. 5700 deprives financial institutions of the option of investing in equity unless they are prepared to advance 100% of that equity. As an alternate, they can make conventional mortgage loans but only to the extent that adequate supplies of noninstitutional equity money is unavailable. In a period of prolonged shortage of capital, 100% equity investment will not be available and institutions such as life insurance companies cannot go beyond loan to value regulations prescribed by applicable state laws.

Section 14 has the strange effect of saying that two legal separate actions both become illegal if combined. The result is both harsh and unfair and detrimental to the economic well being of the nation.

In the past few years, it has been demonstrated that the developer with his "know how" and limited capital and the financial institution with its available funds can cooperatively work for that benefit of one another, as well as for the general economy and well being of the country.

I respectfully urge that your Committee give serious consideration to the removal of the restrictions inflicted on both the building and development industry and financial institutions by the provisions of Section 14.

Respectfully yours,

JAMES B. SMITH,
Mortgage Vice President.

NEW YORK, N.Y., *May 4, 1971.*

Hon. WRIGHT PATMAN,
Chairman, House Committee on Banking and Currency,
House of Representatives,
Washington, D.C.

DEAR MR. PATMAN: As a financier who has dedicated a goodly portion of his life to the financing of real estate in this country, I feel particularly qualified and compelled to present my view of Section 14 of the "Banking Reform Act of 1971", HR 5700. Clearly, this is not what I would term a "self-interest letter" as I and/or those who I may represent would seem to be the person or party which the proposed legislation is designed to protect. Uniquely, however, I cannot support this legislation as Section 14 in my judgment portends grave implications with respect to the future financing of real estate. As concisely as possible I have below sug-

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gested some of these implications and, most importantly, ask you and your colleagues if that which I suggest is that which you intend?

Over the next few decades our country is faced with staggering long-term capital needs in the trillions of dollars. I would consider it extremely conservative to estimate that over the next decade alone our country will need some $1½–2 trillion to fund its urban growth. Competition for sources of long-term funds is, in my judgment, not about to lessen for some period of time in the face of such demand. Real estate financing is a risky business which historically has, does and should justify a higher rate of return vis-a-vis other investments. If I were a trustee or lending officer of a financial institution I would obviously expect a yield differential commensurate with the added risk associated with a particular real estate loan or investment. If, for example, I could have purchased an "A" rated bond of a major U.S. corporation in the 1960's, which yielded 6% to maturity, I would have expected on a real estate transaction during that period, say, an 8% yield. Today such bonds are yielding approximately 8¾% and I would expect at least, say, a minimum of 10% return on my real estate investment. It is academic to argue what came first, high interest rates or inflation, but a greater amount of annual inflation seems to be an accepted phenomenon and I think that higher long-term interest rates have, unfortunately, come part and parcel with this acceptance. Query, during periods when our long-term markets are at present levels or higher and if lenders are prohibited from equity participations, what will happen?

Firstly, most of your small to medium size developers will either fold up their operations or be acquired by larger companies. Both results in my judgment are undesirable. It must be clearly understood that the real estate industry is not only the country's largest but also the nation's most undercapitalized. If the competitive rate for a real estate loan is, say, 11% because single "A" corporate bonds are selling at 8¾%, it is much more desirable generally from a typical developer's viewpoint to borrow at, say, 9% and give up some equity on a contingent basis which may give the lender at least another 2% return if the project works out. Clearly, the probability that a developer who is typically not overcapitalized, may fall into bankruptcy is much greater when he borrows at the 11% rate versus 9% plus an equity contingency. Accordingly, I feel that there will be a major "shakeout" within the real estate industry if Section 14 is passed as currently proposed and I strongly suggest that the result of this among other things will be a net loss of activity to an industry which is prospectively faced with practically insatiable demands.

In addition to a greater concentration of power within the real estate industry in the hands of a few companies suggested above (we are in the midst of this process already), I also foresee increased government activity in the commercial real estate field in response to any "shakeout" and the withdrawal of traditional sources of funds into more competitive securities in the form of "temporary" subsidies. It is my belief that such subsidies are never "temporary" and contradict the free enterprise system that built this country.

In summary, I petition your careful review of the broad implications for real estate financing inherent in Section 14 which could easily be lost within the complexity and breadth of H.R. 5700 in the name of reforms. If I can be of any assistance to you, I would be honored to amplify my views, answer any questions you may have and, of course, would welcome your comments.

Very truly yours,

DISQUE D. DEANE.

NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES,
Washington, D.C., May 3, 1971.

Re H.R. 5700.

Hon. WRIGHT PATMAN,
Chairman, Committee on Banking and Currency, House of Representatives, Rayburn House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: Our review of H.R. 5700, the Banking Reform Act of 1971, leads us to believe that some of its provisions may inadvertently impinge upon the organization and operations of small business investment companies licensed pursuant to the Small Business Investment Act of 1958, otherwise known as the Johnson-Patman Act.

As you know, SBICs are licensed to provide long-term loan funds and equity

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capital to small business concerns. Section 302(b) of the Small Business Investment Act of 1958 authorizes banks to acquire shares in SBICs notwithstanding the provisions of Section 6(a)(1) of the Bank Holding Company Act of 1956. Section 304(a) of the 1958 Act provides that it is a function of each SBIC "to provide a source of equity capital for incorporated small business concerns," and Section 305 of the 1958 Act permits SBICs to make loans "directly or in cooperation with other lenders, incorporated or unincorporated," to eligible small business concerns.

Pursuant to these provisions of the 1958 Act, many banks insured by the Federal Deposit Insurance Corporation have acquired stock in SBICs and have cooperated or participated with SBICs in making loans to eligible small business concerns. In the case of SBICs which are wholly owned by banks and in other SBICs where banks have investments, officers, employees or directors of those banks or of their parent bank holding companies serve in official capacities with the SBIC affiliates or subsidiaries.

It is our view that such practices are permitted and indeed encouraged under the 1958 Act, and that they have contributed to the soundness and the success of the SBIC program.

Turning to H.R. 5700, Section 8(a)(2) of the bill would prohibit a director, trustee, officer or employee of a financial institution which holds the power to vote more than 5% of any class of stock in a corporation from serving as an officer or director of that corporation. Section 9 of the bill would prohibit such persons from serving on the board of directors of any corporation which has a continuing relationship with an insured bank with respect to the making of loans, discounts, or other extensions of credit. Section 14(b) of the bill would prohibit a lender from accepting any equity participation in consideration of making a loan.

Section 14(a)(1)(A) of the bill defines "lender" as an insured bank and thus would not seem to include an SBIC subsidiary or affiliate of such bank. But Subsection (1)(C) defines "lender" as any bank holding company, "or a subsidiary of a bank holding company . . ."

Thus, H.R. 5700 may by implication cast a shadow over certain long-standing and approved practices of the SBIC industry, particularly with respect to the relationships between banks and SBICs. We respectfully submit that such a result is not intended by the bill and therefore request that a section be inserted exempting SBICs and affiliated lenders of SBICs from all provisions of H.R. 5700 insofar as they relate to the organization and operation of SBICs.

Sincerely yours,

CHARLES M. NOONE,
General Counsel.

R & B DEVELOPMENT CO.,
Los Angeles, Calif., April 30, 1971.

Hon. WRIGHT PATMAN,
House of Representatives,
Rayburn House Office Building, Washington, D.C.

SIR: I'm writing in regard to HR 5700, specifically, Section 14 (a). There was a time a year ago when I would have begged for legislation such as this. Now, after reading the proposed bill, I ask that you consider amending it to allow developers such as ourselves to continue large scale projects.

To explain: our projects are large, ranging from 500 to as many as 1300 units. The equity capital required in ventures such as these varies from $1,000,000 to as much as $3,500,000. We have found the most expedient method for obtaining this equity capital to be insurance companies. They are just about the only one's who have the sophistication to put that much money into a major apartment project. We feel it important to build these large projects to achieve the better planning and long-term management control that only large projects can give.

So often legislation is passed to correct for excesses in which it works out that an overcorrection is made. Let me trace the history of insurance company loan practices, particularly as we see it.

For years and years insurance companies were sleeping giants, very seldom owning real estate. They were known to make the most conservative investments possible so if you wanted a low interest rate and were willing to put 30 or 40% equity in a deal, you went to an insurance company. Through the late 60's the savings and loans practically ran out of money and the insurance companies

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filled the gap. During that period a new brand of management seemed to evolve in the insurance company mortgage divisions. It was a younger, more aggressive group. They became aware that higher yields were available in return for lending a larger portion of the value of a project.

Then as money tightened and inflation continued on its upward spiral the insurance companies, looking for long term inflationary protection, added small inflationary hedges into their loans. This was a point or two into their gross which we, and most of the developers that we are aware of, were not really terribly unhappy about.

As the Government's policies squeezed the money supply even more and the pressure increased for corporate, commercial and industrial loans, real estate became the orphan investment. It was during this period that the excesses developed by some, but by no means all, of the insurance companies. They took advantage of this period of tight money in the face of continued demand for real estate loans to gauge the developer, with the developer in turn, turning back the cost to the eventual consumer.

Some of the insurance companies during that period took a different route. They said, 'granted, we want a higher yield, so let's team up with developers who will provide their skill and talents and the insurance companies will provide both the equity and mortgage.' With the insurance company providing 100% of the funds and firms like our own providing the talent and the skill, we feel the American housing consumer is well served and the arrangement is indeed equitable for all parties: the consumer gets the housing, the developer gets a fair share of the profits and the insurance company gets a mortgage and a long term share of the profits which, of course, becomes his inflationary hedge. The difference here is that the insurance company is at risk—they are putting in the hard dollars.

We made several transactions of this type in the last six months and are currently pursuing the development of several thousand more units in the near future using this investment formula with at least two insurance companies.

We will grant you that there were excesses during the tightest part of the money market where some of the insurance companies demanded 30, 40 and 50% of the net income just for making a normal mortgage. That practice must be corrected, but to rule out all possibility of insurance companies taking out ownership interest in any property is so broad in scope that it rules out any possibility for favorable deals such as we have described. Therefore we urge you to kill this portion of HR 5700 in committee.

We would be most happy to provide you with any additional background or information. Please feel free to call upon us.

Very truly yours,

HOWARD F. RUBY.
General Partner.

STOCKTON, WHATLEY, DAVIN & CO.,
Jacksonville, Fla., April 30, 1971.

Hon. WRIGHT PATMAN,
House of Representatives,
Washington, D.C.

DEAR MR. PATMAN: I have been made aware that hearings on H.R. 5700, entitled, "Banking Reform Act of 1971", have been started by the House Banking and Currency Committee and it has also been brought to my attention that Section 14 contains some serious restrictions on the freedom of financing real estate in that it specifically legislates against lenders accepting equity participations in consideration of making loans.

It is not my purpose here to argue the merits nor the dangers of this practice. It is my purpose, however, to protest any restrictive legislation that is not absolutely essential to the public interests and which would restrict the free enterprise system.

Equity participations are a direct result of the supply and demand principles in the money markets. Any restriction that would inhibit this process seems to me to be more detrimental to the public than protecting the interests of the public. However, I particularly find inclusion of the definition "any insurance company", 14(a)(1)(E), onerous in that this terminology includes both stock board and mutual insurance companies.

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It would seem to me that state and national laws concerning reserve requirements, etc., are sufficient, especially on the part of stock board insurance companies, to provide the necessary protection for policyholders who are in reality suppliers of the monies being invested by these insurance companies. Additional restrictions concerning these investments, without ample reason for such restrictions, would seem to seriously limit the investment profits of these companies and therefore increase the cost of obtaining insurance through them.

This, then, would indicate that the limitations cited in Section 14 of H.R. 5700 will indeed have a detrimental effect on the general public availing themselves of the primary service of these companies (insurance) and would therefore not be in the public interest but against it.

Selected restrictive legislation that seriously limits the earning capabilities of any business or institution will, in the long run, be passed on to the consumer.

It would be my hope that your committee, in its hearings on this bill, would recognize that policyholders and other investors in insurance companies have adequate protection of their interests already through state insurance commissions, et cetera, and thus would not impose an additional restriction on the earning capabilities as is included in Section 14 of H.R. 5700.

Sincerely yours,

RICHARD B. CATON,
Vice President and Manager, Loan Administration.

FIRST FEDERAL SAVINGS & LOAN ASSOCIATION,
OF PITTSBURGH,
April 30, 1971.

Hon. THOMAS S. GETTYS,
House Office Building,
Washington, D.C.

DEAR CONGRESSMAN GETTYS: Although we are generally in accord with H.R. 5700, the "Banking Reform Act of 1971", we feel that the inclusion of Section 14 carries an enormously destructive potential for the future financing of real estate. Section 14, as you know, would preclude participation by a lender in any equity interest or contingency whatsoever in properties financed.

The building and development industry of this country is not only the nation's largest, it is also the most undercapitalized. It is an industry where "borrowing out" has been customary practice, at least as much as a matter of necessity as a matter of preference. Moreover, virtually all economists agree that we are in for a prolonged period of capital shortage. Needed in the future accordingly, will be vastly *more* equity investment than has ever been needed in the past.

Yet, Section 14 of H.R. 5700 effectively deprives the financial institution of the option of investing in equity unless it is prepared to put in 100% of that equity. Alternatively, it can make conventional mortgage loans—but only to the extent that inadequate supplies of non-institutional equity money are available. Neither option is viable. Realistically in a prolonged period of capital shortage, 100% equity investment will not be available nor will institutions go beyond normal mortgage limits as prescribed by loan to value regulations. In short, Section 14 says that two perfectly legal separate actions both become illegal if combined.

Financial institutions, as trustees of the public savings, cannot ignore existing and prospective inflationary trends. In fact, one of the principal reasons for the development of equity interest by financial institutions has been to provide savers a hedge against inflation. Denial of the direct approach must mean the development of indirect avenues such as imposition of materially higher interest rates or a reversion to the discredited old practice of writing loans for two or three year terms, requiring renegotiation regularly to adjust rates to market conditions.

We feel that the enactment of Section 14 of H.R. 5700 would be highly detrimental to the country's savings institutions and urge its elimination from the bill.

Sincerely,

HAROLD L. TWEEDY, *President.*

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TUFTS UNIVERSITY,
Medford, Mass., April 26, 1971.

Hon. WRIGHT PATMAN,
Chairman, House Committee on Banking and Currency, House of Representatives, Washington, D.C.

MY DEAR MR. PATMAN: I am writing you concerning Section 14 of H.R. 5700, Banking Reform Act of 1971, on which hearings presently are being held. It would, in my judgment, be in the public interest to delete Section 14 from this bill.

There are three reasons why deletion of Section 14 would be in the public interest.

(1) The building industry and developers are essentially undercapitalized compared with demands now on them and likely to come forth in the years ahead. If we are to get the building done and with quality then we must look to other sources to participate in the equity financing. The flexibility afforded to developers and lending institutions alike by continuing equity participations gets the job done that the country needs.

(2) Developers who do not want others to participate in the equity often have alternatives available to them. For example, developers could pay a higher interest rate for their borrowing. Moreover, additional equity capital could be raised by publicly owned corporations with greater access to the equity market. This would, of course, promote a trend toward bigness and size in this industry. The developer who wants to avoid these courses of action has an additional option under present practices by offering a participation in the equity. This permits him to grow, to prosper and to meet society's needs without becoming a publicly owned corporation or paying as high an interest rate as otherwise would be necessary.

(3) The individual savers who provide the funds which financial institutions lend also have a vital interest in the deletion of Section 14. Failure of their financial institutions to be able to participate in equity financing deprives them of a source of protection against inflation which we have experienced steadily for many years. This, too, is in the public interest.

I am writing you in my capacity as a private citizen. You may find this a trifle unusual since as a university president I might not be expected to have an interest, much less any competency or knowledge of such matters. However, I am a professional economist who for many years concentrated on monetary, banking, and financial institutions. I cut my professional teeth on the Banking Act of 1935, followed your own contributions to our legislation carefully over the years and worked on the Commission on Money and Credit a decade ago. In more recent times I have become acquainted more fully with the building industry as Chairman (for over two and one-half years until last February) of the Massachusetts Housing Finance Agency and as a trustee of a real estate investment trust.

I know that you have been a watchdog for us all over the years in financial matters, but as you analyze Section 14 more carefully I believe you will find it wise to eliminate it in Committee.

Sincerely,

BURTON C. HALLOWELL.

GALBREATH-RUFFIN CORP.,
New York, N.Y., April 27, 1971.

Hon. WRIGHT PATMAN,
Chairman, House Banking and Currency Committee,
Washington, D.C.

DEAR REPRESENTATIVE PATMAN: With respect to your proposal HR–5700 entitled "Banking Reform Act of 1971" on which hearings are now being held, permit me to advise that I am strongly opposed to this pending bill, and particularly Section 14 of the same.

From a political or theoretical approach, I can understand why you feel that such legislation would possibly benefit the American public, but on the other hand, such a bill, if passed, would prove in my opinion, detrimental to the overall economy of the country.

Galbreath-Ruffin Corporation are the owners and developers of real estate specializing in major office buildings throughout the nation. For many months, we have found it practically impossible to finance these facilities.

There are many inherent reasons why we, in this profession, are caught in an

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insurmountable dilemma. Inflation is rampant, not to mention exorbitant increases in labor contracts involving the construction unions, extreme tightness of money, excessive real estate taxes and operating costs are creating a destructive potential for the future financing of real estate.

Your bill, as I understand it, would preclude insurance companies making loans wherein they would share with the owner-developer in part of the equity financing.

Recognized leaders in our field today haven't the necessary equity that is required to finance these major operations.

The construction industry, as such, is the second largest contributor to the nation's gross national product, and therefore, it is of paramount importance to keep this segment of our economy healthy.

I trust that you will give this subject your serious consideration.

Very truly yours,

PETER B. RUFFIN.

THE MYRICK CO., REALTORS,
April 30, 1971.

Re "Banking Reform Act of 1971"—H.R. 5700.

Hon. WRIGHT PATMAN,
House of Representatives,
Washington, D.C.

DEAR SIR: The above referenced proposal has been recently brought to my attention and as this bill is coming up for consideration in the very near future I felt I should make my views on it known.

As a commercial and industrial Realtor engaged in the day to day business of negotiating with real estate developers and financial institutions, Section 14 of the above referenced proposal is of particular concern to me. It is my understanding that Section 14 precludes lender participation in equity interests in any project or properties financed by the lender. I seriously question the wisdom of this proposal and specifically request that the "Banking Reform Act of 1971"—H.R. 5700, and more particularly Section 14 be killed in the Committee as not being in the best interest of the general public for the following reasons:

1. Most financial institutions are charged with the proper investment of funds that generally belong to and flow back to the general public and therefore have the responsibility to obtain the highest possible yield. This is particularly true of life insurance companies, pension and profit sharing trusts, and real estate investment trusts which are the largest source of real estate financing.

2. Whether or not a developer should or has to give a lender an equity position in the project or property is based on the law of supply and demand but also takes into consideration the financial strength and capabilities of the borrower—developer, the economics of the real estate transaction itself and the magnitude of the project. Without equity participation on the part of the lender a good many projects would not be feasible. I can name you at least ten (10) major projects that have been very essential to the growth of the Metropolitan Atlanta Area that would not have been possible without equity participation on the part of the lenders.

3. The recent tight money conditions took its toll on real estate developers but this toll would have been much greater had some developers not been in a position to offer equity participation so that the returns flowing to the lender were competitive in a very competitive money market.

4. Passage of this bill will have a tendency to drive out the smaller locally oriented developers and replace them with large corporate and industrial concerns which in my opinion will result in higher cost for all real estate developments, all of which will be passed on to the consumer.

I would be quick to point out to you that I am a Real Estate Broker dealing with both the developer and lender and I believe that a majority of developers are against this proposal. Although the intent is to protect the consumer, if this bill is passed it will become very detrimental to the consumer and the man on the street. I urge that Section 14 be stricken in its entirety.

Very truly yours,

RICHARD S. MYRICK.

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PAINE, WEBBER, JACKSON & CURTIS, INC.,
New York, N.Y., May 3, 1971.

Hon. WRIGHT PATMAN,
The House of Representatives,
Washington, D.C.

DEAR SIR: I am writing to you concerning HR5700 entitled, "Banking Reform Act of 1971". Section 14 thereof as presently drafted would preclude participation by a lender in having an equity interest or a contingent interest in the profits of properties financed by the lender. It is, in my estimation, an exceedingly shortsighted provision.

A good part of the success of the economic system which we have developed in this country is attributable to the confidence which investors have generated in their ability to obtain an adequate return on their capital. This in turn has led investors to reinvest their capital, thereby creating an expanding and productive economy. I am sure it is apparent to all of us that the demands for goods and services, with particular emphasis on the well-publicized requirements of our great urban centers, creates a situation which for the foreseeable future will place an enormous strain on the capital resources of, even this, the most successful country in history. Inevitably, there will be a competition for such capital as there is. It seems to me that to deny financial institutions, who are perhaps the largest single source of this capital, the opportunity to earn a competitive return in certain forms of real estate investment, would only serve to channel funds away from an area which sorely needs them. Surely, this cannot be the intent of Congress.

What I have to say, I say recognizing full well the short-run advantages which Section 14 would provide real estate developers. As a matter of interest to you, I am both a stockholder and a director of a real estate development company and a portion of my business activity is devoted to assisting developers in arranging financing for the various projects which they undertake.

Sincerely yours,

JOHN DE SAINT PHALLE,
Vice President.

MOUNT KISCO, N.Y., *May 3, 1971.*

Hon. WRIGHT PATMAN,
Chairman, House Committee on Banking and Currency,
House of Representatives,
Washington, D.C.

DEAR SIR: I am writing to you regarding the bill before your committee entiled "Banking Reform Act of 1971" (HR 5700).

Section 14 of this bill contains a provision that would prohibit mortgage lenders from developing equity participation as part of the terms of any financing made by them.

The effect of such a restriction will, without question, work against those that it is designed to benefit, for it will drain off large amounts of long-term capital to other investment opportunities rather than make it available for large scale well-designed housing projects where development risk warrants a contingent bonus to the lender should the project be successful.

In New York, we have seen the disastrous results brought about by artifical control of rent, and more recently the usury law has prevented much needed capital to enter the housing market.

I urge you not to approve the foregoing provision so that capital may flow freely to those places where it is needed most.

Sincerely,

WILLIAM J. DWYER, Jr.

DALLAS, TEX., *April 20, 1971.*

Hon. WRIGHT PATMAN,
Chairman, House Banking Committee,
U.S. House of Representatives,
Washington, D.C.

DEAR MR. PATMAN: Congressman Collins today told me of your generosity in proffering the possibility of my appearing as a witness in connection with HR

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Bill 5700, hearings upon which you are presently holding. I shall be out of the country until about April 30, but should it be possible for me to appear then or soon thereafter, I would be grateful for the opportunity to do so.

I shall testify that, in my opinion, participation by the leader in the income stream and ownership of properties financed by insurance companies is of benefit to the borrowers and not a detriment to the borrowers. It is the means through which these large concentrations of capital can afford the benefits of capital strength to individual borrowers and developers such as our own company. I shall say that I think it is helpful to the small borrower and not hurtful to him.

Thank you again for this opportunity, which I hope I may receive.

Yours very truly,

TRAMMELL CROW.

SHAW, PITTMAN, POTTS, TROWBRIDGE & MADDEN,
Washington, D.C., May 5, 1971.

Re H.R. 5700.

HON. WRIGHT PATMAN,
Chairman, Committee on Banking and Currency,
U.S. House of Representatives,
Washington, D.C.

DEAR MR. PATMAN: On behalf of the Committee of Foreign-Owned Banks, the members of which are listed in enclosure B, it is respectfully requested that Section 14 of H.R. 5700 be amended to limit the restrictions on equity participations so that business and financial organizations which are not engaged in banking, but which are affiliated with banks, would be excluded from the regulatory scope of this section. Enclosure A contains a suggested form of amendment to accomplish this purpose.

The Committee of Foreign-Owned Banks is primarily composed of banking corporations organized under the laws of this country and owned by foreign banks. The Committee followed closely the development of the bank holding company legislation, suggesting changes to avoid unnecessary difficulties in international banking relations which were adopted with the approval of your Committee. We are therefore aware of the difficult process of bringing that legislation through to the point of enactment, an accomplishment in no small measure due to your leadership. For this reason, we believe that you personally and each of the members of your Committee will be cautious about inadvertently reopening major issues which were resolved in last year's amendments to the Bank Holding Company Act. In our judgment, Section 14 as presently drafted would do just that, and our proposed modification would effectively avoid overlapping those amendments and the discretion carefully granted to the Federal Reserve Board thereunder.

We take no position on the application of Section 14 to banks, which has drawn comment from the agencies regulating banks and leading spokesmen of the banking industry. However, we are not aware that any of these witnesses have focused on the result of using the Bank Holding Company Act as a vehicle for extending the scope of Section 14 beyond insured banks and mutual savings banks. We appreciate that Section 14 is designed to take full advantage of federal bank regulatory jurisdiction to extend the restrictions against equity participations, and our proposal preserves this objective. Business and financial corporations, which are active in providing the financing, vital to a dynamic and competitive economy, in which relatively high risks are taken on new and small enterprises for correspondingly higher returns, are obviously not intended to be prohibited from using the various mixes of loan and equity financing which would come within the scope of Section 14. However, Section 14(a)(1)(C) applies to non-banks which happen to be bank holding companies and non-banks which happen to be subsidiaries of bank holding companies. Such an application would presumably not restrain investment companies (venture capital investors, real estate investment companies) from taking equity participations in connection with loans but rather would extend the prohibitions of Section 4 of the Bank Holding Company Act to force divestiture or prevent acquisition of such companies by bank holding companies.

If this result is intended, it revises the recently enacted amendments of the Bank Holding Company Act by taking away the grandfathered protection

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available to existing banking affiliations of such investment companies. It also takes away from the Federal Reserve Board its discretion under Section 4(c)(8) to examine such affiliations and determine whether such investment company activities are sufficiently bank related to be exempted from the prohibitions of Section 4 of the Bank Holding Company Act. We think it possible that this result is not intended because the integrity of the banking operations are not affected by common ownership with an organization willing and able to take greater risks than a bank in exchange for correspondingly greater rewards, which could not and should not be expressed in terms of unusually high fixed interest charges.

Accordingly, it is respectfully urged that the Committee amend Section 14 in accordance with enclosure A, thereby preserving the decision taken last year in connection with the amendment of the Bank Holding Company Act to rely upon the expert judgment of the Federal Reserve Board to determine whether investment company affiliations with banks should be allowed or disallowed in the context of the purposes of the Bank Holding Company Act.

The Committee of Foreign-Owned Banks is not undertaking to comment on H.R. 5700 in general because many of its members belong to associations which have done so. It addresses this single issue solely because the point may have been overlooked in the course of hearings before your Committee. Inclusion of this letter in the record of the hearing on H.R. 5700 would be appreciated.

Respectfully yours,

SHAW, PITTMAN, POTTS, TROWBRIDGE & MADDEN
STEUART L. PITTMAN,
Counsel for Committee of Foreign-Owned Banks.

ENCLOSURE A

BANKING REFORM BILL H.R. 5700 AMENDMENT TO SECTION 14 (a)(1)(C) (RESTRICTING EQUITY PARTICIPATIONS)

"(C) [company] *bank* which is a bank holding company as defined in the Bank Holding Company Act of 1956, *or bank which is a subsidiary of a bank holding company; or a company which is* a savings and loan holding company as defined in section 408 of the National Housing Act, or a subsidiary of a [bank holding company or a] savings and loan holding company;" [Additions *italic* and deletions bracketed]

ENCLOSURE B

COMMITTEE OF FOREIGN-OWNED BANKS

Bank of Nova Scotia, 37 Wall Street, New York, New York
Bank of China, 40 Wall Street, New York, New York 10005
French-American Banking Corp , 120 Broadway, New York, New York 10005
Societe Generale, 66–68 Wall Street, New York, New York 10005
Commerzbank A. G., 55 Broad Street, New York, New York 10004
Israel Discount Bank Limited, 51 Fifth Avenue, New York, New York 10017
The Hongkong & Shanghai Banking Corporation, 80 Pine Street, New York, New York 10005
The Chartered Bank, 76 William Street, New York, New York 10005
Skandinaviska Banken, One Wall Street, New York, New York 10005
Westminister Bank Ltd., One Wall Street, New York, New York 10005
Royal Bank of Scotland, 63 Wall Street, New York, New York 10005
European-American Bank & Trust Co., 52 Wall Street, New York, New York 10005
Barclays D.C.O. 300 Park Avenue, New York, New York 10017
Bank Leumi Le-Israel B M, 60 Wall Street, New York, New York 10005
First Israel Bank & Trust Company of New York, 60 Wall Street, New York, New York 10005
Bank of Montreal, 2 Wall Street, New York, New York 10005
J. Henry Schroder Banking Corporation, 61 Broadway, New York, New York 10006

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BUILDING INDUSTRY ASSOCIATION OF CALIFORNIA, INC.,
Los Angeles, Calif., April 1, 1971.

RESOLUTION

Whereas Representative Wright Patman introduced in the 91st Congress H.R. 18676, a bill to prohibit lenders from accepting any equity participation in consideration of the making of any loans, and

Whereas the National Association of Home Builders supports the adoption of this bill, in accordance with the NAHB policy on fair and equitable lending practices, and

Whereas the Multifamily Builders of the Building Industry Association of California are in accord with the intent of the bill and with the NAHB policy on this subject: Now, therefore, be it

Resolved, That the BIA make known its support of the bill and of the NAHB policy to Congressman Patman and to the National Association of Home Builders.

Adopted March 30, 1971, Executive Committee, Building Industry Association of California, Inc.

ERIC A. WITTENBERG,
President.
GEORGE C. GALVIN,
Executive Vice President.

GREENWAY PLAZA—CENTURY DEVELOPMENT CORP.,
May 13, 1971.

HON. WRIGHT PATMAN,
House of Represenatives,
Washington, D.C.

DEAR MR. PATMAN: We recently learned of the hearings presently being held by the House Banking and Currency Committee on H.R. 5700 entitled "Banking Reform Act of 1971." As a major developer of commercial real estate in the City of Houston, we are seriously concerned about the potential disastrous effect of the provisions of Section 14 which prohibits equity participation by certain specifically designated lenders. The financing of major developments such as ours would have been impossible had we not been able to utilize the equity participation and "staying power" provided by our financial partners who are large insurance companies. The wedding of an institution's capital and a developer's expertise is a healthy marriage.

At first glance, it may appear that developers should welcome this outright prohibition and that, additionally, the public interest would be served. However, in view of the trillions of dollars of long-term capital investment required to meet the needs of urban growth in this country, it would seem that there is no realistic alternative to the equity participation and joint venture approach.

In short, where will the money come from during the present and anticipated prolonged period of capital shortage? The quality of urban life in major cities requires *responsible* development which *cannot* be accomplished solely within the financing capabilities of real estate development companies. Unless and until immediate solutions are found for the problems of inflation, high interest rates, and the resulting effect on the general public, we think that the present financing concept of institutional participation should be preserved. We, therefore, urge that the proposed bill not be reported out of committee.

Sincerely,

KENNETH SCHNITZER,
Chairman of the Board.

PROCTOR HOMER WARREN, INC.,
Detroit, Mich., May 17, 1971.

HON. WRIGHT PATMAN,
House of Representatives,
Washington, D.C.:

The passage of this Bill will have disastrous effects on the real estate and home building industry. These effects will seriously damage the entire economy of our country. The restrictions imposed by this Bill would seriously limit the flow of capital into our industry. The damage would be incalculable.

I belong to the Mortgage Bankers Association of Michigan, the National Asso-

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ciation of Home Builders and the National Association of Real Estate Boards. I have the best interest of each of these organizations in mind when I urge you to listen carefully to the arguments of the Mortgage Bankers. Their position is the correct one. It is unfortunate that NAHB and NAREB have favored the restrictions on participation in mortgage loans. They are being terribly short-sighted as would the Congress if this Bill became law.

EDWARD A. PROCTOR, Jr.,
President.

JERSEY MORTGAGE CO.,
Elizabeth, N.J., May 17, 1971.

Hon. WRIGHT PATMAN,
U.S. House of Representatives,
Washington, D.C.

DEAR MR. PATMAN: I would like to present my views as Chairman of the Board and Chief Executive Officer of Jersey Mortgage Company, one of the largest mortgage banking companies in the east, in respect of HR 5700, particularly section 14 that deals with equity participation.

To begin with, I would like to make it crystal clear that as far as diverting funds from the single family housing market is concerned, especially funds of insurance companies, most have not been in the single family housing market for almost 10 years and, from what I can gather, have no plans to return to that market in the foreseeable future.

In the past several years much progress has been made in aiding medium sized to very large building contractors in the financing of multi-family housing projects, shopping centers, office buildings and warehouses where equity participation financing became part of the total financing package. In every case with which I have any knowledge the builder did not sacrifice a part of the equity ownership without receiving adequate compensation, therefore making it possible to generate sufficient funds to finance a given project without undue financial burden on the contractor.

Equity financing of real estate transactions has been a practice since beyond the memory of all of us—the only difference now is that lenders are taking on an additional role of an equity participant. If this is prohibited, as contemplated in the legislation being considered, the volume of new construction of projects as described above, and particularly multi-family housing, will be reduced to historical depression levels.

Sincerely,

CARTON S. STALLARD,
Chairman of the Board.

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1 POST OAK PLACE,
Houston, Tex., May 14, 1971.

Hon. WRIGHT PATMAN,
House of Representatives,
Washington, D.C.

DEAR MR. PATMAN: I recently saw an article in the newspaper which indicated that your Committee would be studying legislation to regulate insurance companies with regard to the type of investments and participations in real estate which they are now engaging in.

I am in the real estate development business and have continued dealings with the insurance companies for long-term mortgages on income producing properties. It is my opinion that if some sort of regulation is not undertaken that the insurance companies in this country will end up owning a large portion of the prime real estate in the country in the very near future. I do not believe that this is a healthy situation for the country because it makes it very difficult for the developer to function in his best capacity, and will put undue power in the hands of one industry. I can give you several classic examples of insurance companies abusing the powers that they already have in this area and would be glad to appear before your Committee at any time, at my own expense, to air my views on this subject.

I would also like to point out that I own considerable amounts of bank stocks in several banks in Houston and elsewhere and have continually supported your efforts at regulating the banking industry for the same reasons that I believe

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that the insurance industry should be regulated. If these two sources of capital which dominate the American business community are not regulated, we would undoubtedly see the kind of abuses which have necessitated your continued efforts in the banking field, and which make it imperative that we have some regulations for the insurance companies.

Yours very truly,

DAN M. MOODY, Jr.

(Whereupon, at 12:48 p.m. the committee recessed, to reconvene at 10 a.m., Thursday, April 29, 1971.)

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THE BANKING REFORM ACT OF 1971

THURSDAY, APRIL 29, 1971

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND CURRENCY,
Washington, D.C.

The committee met, pursuant to recess, at 10:05 a.m. in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman, Barrett, Sullivan, Ashley, Stephens, Gonzalez, Minish, Hanna, Gettys, Annunzio, Bevill, Brasco, Chappell, Koch, Cotter, Mitchell, Widnall, Johnson, Stanton, Brown, Williams, Rousselot, McKinney, Lent, Archer, and Frenzel.

The CHAIRMAN. Gentlemen, the committee will please come to order. This morning we have before us representatives of various banking associations who will testify on H.R. 5700.

These include the following:

Mr. Clifford C. Sommer, president of Security Bank & Trust Co. Owatonna, Minn., and president of the American Bankers Association;

Mr. Donald M. Carlson, president of the Elmhurst National Bank, Elmhurst, Ill., and president of the Independent Bankers Association of America;

Mr. William S. Renchard, chairman of the board of Chemical Bank, New York, and president of the New York Clearing House; and

Mr. Edward Herbert, senior vice president, First National Bank, Montgomery, Ala., representing Robert Morris Associates.

Before we hear from these gentlemen, I would like to submit for the record several letters that I have received concerning this legislation. We have received letters both for and against. We will give consideration to them, of course. And I will place them in the record. We want to do what is right about this. The object of a hearing is to find out, and that is the reason we insist on people from both sides of the controversy.

We have heard the argument, for instance, that the interlocking directorate provisions of this bill would impair the operations of various financial institutions, especially in small towns. It may be surprising for some to learn from reading this correspondence that a number of officers and directors of small town banks and savings and loan associations support these provisions.

For example, the president of a bank in Tacoma, Wash., wrote that "although your bill would broaden the prohibition (against interlocking directorates) to include insurance companies, brokerage firms, credit unions, bank holding companies, and savings and loan companies, I can see no serious objection to such an extension."

A director of a bank in a small upstate New York community wrote

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me indicating his great concern over his bank's difficulty with an interlocking directorship involving a competing bank. The chairman of the board of a medium-size bank in New York State with total deposits of $109 million and nine branches wrote me supporting provisions which "outlaw interlocking directorships among commercial banks, savings and loan associations, et cetera."

And a longtime director of a bank in Lewiston, Maine, wrote, "In my opinion, this bill is long overdue and I hope it is enacted without any deletions." After enumerating the substantial number of interlocking directorships among commercial banks, savings banks, and bank holding companies in his State, he goes on to say, "What exists in other parts of the country I do not know. But the interlocking directorates and large blocks of stock that the savings banks own, is not, in my opinion, good banking practice."

A director of a savings and loan institution in Peoria, Ill., wrote:

In the last half dozen years, men have been elected to the board—by proxies—who were also directors of commercial banks. So now of the nine members, four are also directors of different banks. With the support of management, they exert great influence on our policies. Although we are to a degree, competitors of the banks, they are conditioned with the thinking of commercial banking, which carries over to our savings and loan.

Peoria is not an extremely large city, but this interlocking of directors exists in almost every savings and loan and bank. This city is, however, large enough so that capable men are available to serve on only one board.

I would heartily endorse your recommendation that there be no interlocking directors with savings and loans and banks.

Of course, I have also received mail opposing many provisions of H.R. 5700. However, I think that the committee ought to be aware that there is no uniformity of opinion among those in the banking industry on this matter.

(The letters referred to by Chairman Patman follow:)

PACIFIC NATIONAL BANK OF WASHINGTON,
Tacoma, Wash., April 5, 1971.

Hon. WRIGHT PATMAN,
Chairman, Committee on Banking and Currency, House of Representatives, Rayburn House Office Building, Washington, D.C.

DEAR CHAIRMAN PATMAN: Thank you for the opportunity to provide my views on your recently introduced H.R. 5700, the Banking Reform Act of 1971. As you noted, the Comptroller of the Currency's Advisory Committee on Banking, of which I was a member, recommended in its report in 1962 that "the prohibitions of the present law on interlocking directorates should be made applicable between banks, savings and loan associations, and mutual savings banks, whether chartered under Federal or State law." Although your bill would broaden the prohibition to include insurance companies, brokerage firms, credit unions, bank holding companies, and savings and loan companies, I can see no serious objection to such an extension.

I believe that Section 7 would unduly penalize many of the major corporations of this nation by depriving their boards of directors of the business acumen and wisdom afforded by senior banking officers' memberships thereon. The banking industry would be unfairly penalized to the advantage of investment advisory services, which may be less qualified to manage employee benefit accounts than the trust investment divisions of major banks. My misgivings concerning Sections 8 and 9 of your bill would follow a similar vein.

I am unconvinced regarding the value of prohibiting commercial banks, savings and loan associations, and mutual savings banks and their officers, directors, and immediate family members from controlling title companies, property appraisal firms, or companies offering services in connection with the closing of real estate transactions. It is difficult for me to imagine possible abuses sufficient to warrant such prohibition. I further feel that the provision is contrary to certain pro-

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visions in recently enacted bank holding company legislation and Federal Reserve Board rulings relating thereto which appear to appropriately enlarge legitimate commercial bank activities in these areas.

The sections of the bill dealing with the performance of legal services in certain interlocking relationships seem entirely proper to me and will, I am certain, receive the support of the legal fraternity and their authorized spokesmen.

While I support the intent contained in Section 11 of the bill, I am gravely concerned regarding its actual workings. Certainly flagrant abuses of corporate trust and responsibility for private gain should be dealt with severely, and are appropriately covered by current legislation. However, a great danger for misinterpretation of the relationships between financial institutions and the senior officers and staff of their customers exists in Section 11, and the entire fabric of relationship between a bank and the senior officers of its corporate accounts, so necessary for the proper conduct of the business of both, would be called into question. I am at a loss to discern how responsible implementation of Section 11 could occur and immeasurable damage to the financial institutions of this nation be avoided.

The provisions of Section 10 prohibiting the ownership of stock in financial institutions by mutual savings banks are indeed timely and beneficial. A real danger in restricting competition now exists which your legislation would wisely close.

I would suggest several revisions in Sections 12 and 13 of the bill which deal with the stock holdings of commercial bank trust departments. First, it would seem that any prohibition regarding stock holdings should be directed not at the holding per se, but toward the voting responsibilities related thereto. I would agree, and our bank has always followed the precept, that a trust department should not *vote* the stock of its own bank. It further seems reasonable that, in the case of a subsidiary of a bank holding company, voting prerogatives should not be exercised on any of its holding company's stock in the trust department. I most definitely feel, however, that it should be permitted to hold such stock when operating "as prudent men" in a trust fiduciary capacity. To do otherwise would place commercial banks at a great disadvantage vis a vis their trust and investment competitors.

I also feel that the provision for annual disclosure of trust department stock holdings should be tempered by the inclusion of a minimum percentage figure. To report on every stock held in the manner intended would be most burdensome and would tend to increase the price of trust services. Such disclosure has merit where a stock aggregating, say, 10% of the corporation's outstanding stock is held by a trust department, but has little significance under more diluted conditions.

The portions of H.R. 5700 dealing with loan disclosures, insider loans, and equity "kickers" cause me the gravest concern, Mr. Chairman. First, as regards equity participation of the lender, I do agree that the activity is one to be closely observed. It would appear, however, that the examining staffs of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, in coordination with state regulatory authorities where appropriate, are most capable of monitoring this activity and reporting possible abuses. Current studies by the Comptroller of the Currency indicate that the present volume of such loans is nominal, and it would not appear necessary to legislatively foreclose further development of this financial technique.

The bill's requirement of "public" disclosure of the credit relationships of bank officers, directors, their families, and so on, runs counter to the absolute necessity for confidentiality in banking relationships. I well realize, as Chairman Wille of the F.D.I.C. has pointed out, that too great a proportion of current bank failures are the result of improper credit transactions between the banks and their officers/directors. The solution, however, would seem to lie in more effective and comprehensive regulatory examination techniques rather than in the destruction of confidentiality so necessary to the appropriate functions of banking.

It should also be noted that administratively, at least, it is preferable to have the officers of a bank conduct their borrowings from their own institution so that such activity can be monitored.

The prohibition of the extension of credit by a bank to corporations where 5% or more of any class of stock of the corporation is owned by directors, officers, employees, and so on, of that bank seems to me to be the most deleterious pro-

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vision in the Act. Properly managed banks have historically sought business leaders from the communities and companies they serve to lend their expertise and acumen to the bank's board of directors. Many of these men have achieved their success in closely held corporations, or even proprietorships. To create a situation wherein these leaders could not serve on a bank's board of directors and still have their legitimate corporate banking requirements accommodated is, in my judgment, completely unwarranted. In a commercial banking system of over 14,000 banks, there will always be those instances of malfeasance and perfidy which call stern measures to mind, but we must be careful not to "toss the baby out with the bathwater." I sincerely hope that an amendatory correction is available for this provision of the bill.

Certainly the restrictions H.R. 5700 would place on "brokered" deposits as well as the use of gifts and premiums to attract deposit accounts would be healthy and in the best interest of the banking industry. Both practices are not only demeaning to the industry but contain the seeds of serious problems as frequent past experience has indicated.

The bill's extension of applicable insurance coverage to the extent of 100% of deposits of federal, state, and local governments seems to me to be both proper and timely. Certainly the taxpayers should not be penalized through the loss of such deposits in the event of failure of a financial institution when the mechanism for their protection exists and functions so well as in the cases of Federal Deposit Insurance and Federal Home Loan Insurance.

Respectfully yours,

GOODWIN CHASE, *President.*

FULTONVILLE, N.Y., *January 25, 1971.*

Hon. WRIGHT PATMAN,
Congress of the United States,
House Office Building,
Washington, D.C.

DEAR CONGRESSMAN PATMAN: On December 30, 1970, I sent to you a copy of my letter to the Comptroller of the Currency, concerning Daniel Vooys, President and Director of Mechanics and Farmers Bank of Albany, and Director, Central National Bank of Canajoharie. Also, I enclosed a copy of my letter of December 3, 1970, to Mr. Charles M. Van Horn, Regional Comptroller of the Currency, located in New York City.

I called to Mr. Van Horn's attention that contrary to a letter he had received from an officer of Central National Bank, there was a branch of Mechanics and Farmers in a township contiguous to a township in which a branch of Central National was located. Therefore, Mr. Vooys serving as a director of both banks was contrary to Section 8 of the Clayton Antitrust Act, 15 U.S.C. 19.

On January 5, 1971, more than a month after my letter was sent, Mr. Van Horn replied, saying the matter had been referred to the Federal Reserve Bank of New York for further consideration. On January 15, Mr. John D. Gwin, Deputy Comptroller of the Currency, replied to my letter of December 30 to the Comptroller of the Currency, saying their office in New York City had referred the matter to the Federal Reserve System since they had the responsibility for "interpreting this statute."

In the meeting of January 18 of the Board of Directors of Central National Bank, Mr. Vooys was not renominated for director (annual meeting in March) as a part of management's slate, but nevertheless it would seem that an answer should be received to our inquiry with reasonable promptness.

As I previously endeavored to explain, the Bank of New York Company made an offer for Central National stock; they would consolidate Central National with Mechanics and Farmers, their subsidiary, with Mr. Vooys as president of the consolidated bank.

I have a feeling there is great reluctance to make a ruling in this case. Originally both the Regional Comptroller and the Federal Reserve Bank of New York ruled favorably very promptly (within a week) on the letter sent to them by Donald C. Cartmell of Central National relative to Mr. Vooys serving on both boards. But on receipt of my letter setting forth what seems to me to be an obvious violation of Section 8 of the Clayton Anti-Trust Act, it takes months to get an answer. Why is this so?

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I was told at our last Board meeting that Mr. Vooys said that "the Federal Reserve had been in to see him," but "everything was all right." If that is the case, why don't they advise the bank?

I realize that asking for your help in getting an answer would be strictly a favor on your part, but a letter from your office would be a great help. The real issue, is, of course, saving our country bank for our local depositors and customers.

My observation is, in our area at least, the giant city banks, while interested in deposits in the rural or country areas, aren't much interested in giving these same areas good banking service. As a matter of fact, this whole matter of bank holding companies is a problem which a lot of people should be showing concern.

If you can get this matter expediated for us, the small stockholders and customers of our bank will appreciate it.

Sincerely yours,

HERBERT R. KLING.

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36 UNION STREET
FULTONVILLE, N.Y., *February 8, 1971.*

Hon. WRIGHT PATMAN,
House of Representatives,
Rayburn House Office Building,
Washington, D.C.

DEAR CONGRESSMAN PATMAN: Thank you for your letter of January 18. I delayed a little in replying to your question as I was trying to get a final answer out of the Comptroller's Office in reply to my letters of December 3 and December 30. Attached are copies of letters to Mr. C. M. Van Horn, the Regional Administrator of Regional Banks, and Mr. John D. Gwin, the Deputy Comptroller of the Currency. You will note that the matter of the Mr. Daniel Vooys directorships on both Central National Bank and Mechanics and Farmers Bank of Albany boards has been resolved to our satisfaction, but not in a manner I like.

I will be pleased to come to Washington and testify before the House Banking and Currency Committee, if you feel I can contribute anything. I would, of course, need your direction on the subject and length of statement. I am only a director of a small bank, certainly no expert on banking, and can only tell what goes on in our particular situation.

I am reasonably familiar with your efforts to improve the banking system. It would seem to need a lot of improvement! I greatly admire your tireless efforts in this direction.

A little while back one of my friends remarked that, "banking is a form of legalized larceny." He was joshing me, he knows very well of the contribution of our banking system to the general welfare. But I do strongly feel that if trends in our commercial banking system continue, then there will have to be, one way or another, better means of making retail credit available.

Recently in our State, the larger savings banks are being permitted to absorb the smaller savings and loan associations. Yet the Savings and Loan Association, in single unit size, if permitted to offer a wider range of services, might well provide more competition to the commercial banks and perhaps better service to the "retail" i.e. individual credit user, than commercial banks. Maybe this is not as true in metropolitan areas as in rural areas such as ours.

We have in our community a Production Credit Association. It doesn't have an elaborate building, its staff is small, yet it does a lot better job for farmers than any banks in our county, and probably handles more farm credit than all the banks in the county put together.

I am exceedingly grateful for your interest in our particular situation. Thanks again.

Sincerely,

HERBERT KLING,
Director, Central National Bank, Canajoharie.

LEWISTON, MAINE, *March 18, 1971.*

Hon. WRIGHT PATMAN,
Chairman, Committee on Banking and Currency,
Washington, D.C.

DEAR MR. PATMAN: Thank you for your letter of March 11th and copy of H.R. 5700.

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In my opinion, this bill is long overdue and I hope it is enacted without any deletions.

Let us look at the local situation where I was born and have lived all my life, namely Lewiston and Auburn, Maine, commonly known as the Twin Cities.

1. The First-Manufacturers National Bank of Lewiston and Auburn, Maine in which I was formerly a director, said bank being part of the Northeast Bankshare Association, a multiple bank holding company, has on its board the following directors of other banks, as follows:

(a) Mr. Philip Watson and Mr. Willis Trafton, Jr., both directors of the Auburn Savings Bank are directors of both the First-Manufacturers National Bank of Lewiston and Auburn and also directors of the bank holding company, Northeast Bankshare Association.

(b) The Peoples Savings Bank of Lewiston, Maine have as directors one Joseph Cronin and one William Lindquist who are also directors of the First-Manufacturers National Bank of Lewiston and Auburn. Mr. Cronin is also a director of Northeast Bankshare Association.

(c) The Federal Savings & Loan Association of Lewiston, Maine has as a director one Aurele Bosse who is also a director of the First-Manufacturers National Bank of Lewiston.

2. The Federal Savings & Loan Association of Lewiston, Maine has a director by the name of James Longley who is also a director of the Casco Bank & Trust Company of Portland, Maine with four or five branches in Lewiston and Auburn, Maine.

Both the Auburn Savings Bank and the Peoples Savings Bank are substantial holders of stock of the Northeast Bankshare Association having exchanged their stock of the First-Manufacturers National Bank for the multiple bank holding company stock the early part of 1970.

In addition thereto, the Mechanics Savings Bank of Auburn, Maine holds a substantial block of Northeast Bankshare Association stock and the Androscoggin County Savings Bank of Lewiston, Maine has a very substantial block of stock of the Northeast Bankshare Association, all being exchanged for original stock of First-Manufacturers National Bank.

It seems rather unusual for a country commercial bank, namely First-Manufacturers National Bank to have five interlocking directors.

What exists in other parts of the country I do not know, but with interlocking directorates and large blocks of stock that the savings banks own, it is not, in my opinion, good banking practice.

You may submit this statement to the Committee if you so desire and I will be glad to answer any questions you may request.

Some years ago, I testified before the Bank Housing and Currency Committee on the Financial Institutions Act, being personally opposed to elimination of cumulative voting in national banks.

Having been a Receiver of a closed national bank during the banking holiday, I think I am qualified to express a fairly good opinion.

With best wishes and thank you for your many courtesies, I remain

Very truly yours,

ERNEST M. SHAPIRO.

PEORIA, ILL., *April 17, 1971.*

Representative WRIGHT PATMAN,
Chairman, House Banking Committee,
House of Representatives,
Washington, D.C.

HONORABLE MR. PATMAN: This letter is to congratulate you for your consistent efforts to reform the banking system, as is exemplified in the Banking Reform Act of 1971 (H.R. 5700). It is of especial interest to me, as I have been a director of a Savings & Loan Association for over sixteen years.

During this entire period, we have always had money to lend to build homes, even in periods of depression. Perhaps this was because our policies have been quite conservative, and we have made no speculative loans, with the result that we have not grown as rapidly as some of our competitors, although we now are approximately seventy million in size.

However, in the last half dozen years, men have been elected to the Board—

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by proxies—who were also directors of commercial banks. So now of the nine members, four are also directors of different banks. With the support of management, they exert the greatest influence on our policies. Although we are to a degree, competitors of the banks, they are conditioned with the thinking of a commercial bank, which carries over to our Savings and Loan. However, I wish to make it very clear that there is no forcible action taken by them as a group, rather it is a group mentality.

Peoria is not an extremely large city, but this interlocking of directors exists in almost every Savings and Loan and bank. This city is however, large enough so that capable men are available to serve on only one Board.

I would heartily endorse your recommendation that there be no interlocking directors with Savings and Loans and banks. As for a grandfather clause, it would seem feasible for one such director to resign each year, until the situation is as it should be.

Best wishes on the success of your bill.

Sincerely,

WILLIAM R. WATSON.

The CHAIRMAN. Let us now proceed to hear the witnesses. It would be appreciated if you would give a summary of your statement in approximately 10 minutes each and then we can ask questions. And at the end, if you are not satisfied, and you feel that you must make another statement emphasizing points that you are trying to put over, let us know and we will give you additional time at the end.

The first witness is Mr. Sommer.

You may proceed, sir.

STATEMENT OF CLIFFORD C. SOMMER, PRESIDENT, AMERICAN BANKERS ASSOCIATION; ACCOMPANIED BY RICHARD P. BROWN, PRESIDENT, ABA TRUST DIVISION; AND B. FINLEY VINSON, CHAIRMAN, ABA FEDERAL LEGISLATIVE COMMITTEE

Mr. SOMMER. Thank you very much, Mr. Chairman and members of the committee.

I am Clifford C. Sommer, president of Security Bank and Trust Company, Owatonna, Minn., and president of the American Bankers Association. I am accompanied by Richard P. Brown, senior vice president and executive trust officer, the First National Bank, Denver, Colo., who is president of the ABA Trust Division; and B. Finley Vinson, chairman of the board, First National Bank, Little Rock, Ark., who is chairman of the ABA Federal Legislative Committee. We appreciate the opportunity to appear here today on behalf of the American Bankers Association, to express our views on H.R. 5700.

This is an extensive piece of legislation, embodying a series of complex proposals, some with which we agree and some with which we do not. In order to expedite this presentation, and to make the views of the American Bankers Association most clear, I thought it best to go through the legislation topic by topic. My presentation today, as you requested, is a summary of our formal statement in order to save the time of the committee. But I request that my entire statement be printed in the record.

The CHAIRMAN. Without objection it is so ordered.

Mr. SOMMER. Thank you.

Mr. Brown and Mr. Vinson will join me in answering questions the committee may have.

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INTERLOCKING MANAGEMENT

If all sections of the legislation dealing with bank interlocking management were enacted—sections 2, 7, 8, and 9—we fear that the present effective functioning of bank boards of directors would be destroyed. Banking is a broadgaged business urgently requiring the counsel of a wide range of knowledgeable and experienced individuals currently active in many segments of the economy. Banking requires their advice, if it is to adequately serve the public interest. Conversely, other corporations elect bankers to their boards to draw on their knowledge and experience in the field of finance.

This proposed legislation would eliminate most outside directors. It would damage all banks and would be especially harmful to banks in small communities.

Despite the foregoing comments, the American Bankers Association recognizes that potential anticompetitive effects may seem to result from interlocking management between directly competing depository institutions. Accordingly, we endorse the prohibition of certain interlocks among deposit-type institutions, namely: Commercial banks, mutual savings banks, saving and loan associations and credit unions.

However, we do not believe that this prohibition should be extended to cover interlocks among less directly competitive financial institutions; for example, insurance companies.

In endorsing the prohibition of interlocks between banks and other directly competing deposit-type institutions, we believe it should be limited to institutions in the "same, contiguous or adjacent cities, towns or villages," as now provided in section 8 of the Clayton Act. However, the appropriate regulatory agency should be given authority to ban interlocks beyond such areas if they might substantially lessen competition.

On the other hand, the appropriate agency should be authorized to allow interlocks even within the defined area in those very unusual cases where a scarcity of experienced financial talent makes it necessary.

Interlocks resulting from common stock ownership, including holding company and chain banking arrangements, should be specifically excluded from the prohibition.

We recommend a 5-year time period for corporations to bring their board membership into compliance with the proposed legislation.

The above represents the position of the American Bankers Association on the prohibition of management interlocks of depository institutions. We oppose all other prohibitions on interlocks with nondepository institutions; namely, interlocks between depository institutions and: insurance companies; brokerage firms; title companies, appraisal firms and settlement companies with which there is a substantial and continuing relationship; companies with a pension fund managed by the bank; corporations where the bank holds 5 percent or more of the stock; and companies with which the bank has a substantial and continuing loan relationship. We also oppose the ban on directors, officers or employees performing legal services in connection with transactions involving the bank.

The ban on interlocks with companies where there is a substantial and continuing loan relationship would force nearly all outside direc-

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tors off the board. This would seriously impair, if not virtually eliminate, the reservoir of competent talent available for all sizes of financial institutions; or, in the alternative, it would force unnatural credit arrangements—that is, borrowing from institutions other than those on which the company has board representation.

Enforcement of this provision could be chaotic to business relationships in small communities, particularly those with only one bank.

In the case of the ban on interlocks with firms which have a pension fund managed by the bank, this provision would be anticompetitive rather than increase competition. It could deprive a corporation of the advantage of a full range of competition for its pension account.

The ban on interlocks with companies in which a bank trust department holds 5 percent of the voting stock would introduce unnecessary concern about how close the trust fund is to the benchmark percentage instead of concentrating on the quality of a particular investment.

In summary, aside from interlocks among competing depository institutions, the effects of the interlock provisions of this bill on all corporations and financial institutions would be traumatic. Its impact would be especially harsh on the small communities.

INFLUENCING OFFICERS AND EMPLOYEES OF CUSTOMERS

Section 11 would, with certain qualifications, forbid a financial institution from conferring "any substantial benefit" upon an officer, director, agent, or employee of a corporation or other employee of a corporation or other employer with the intent to influence his conduct with respect to affairs between the financial institution and the employer.

We agree that conduct of this sort is reprehensible. We are certainly not in favor of improper influence. However, the language of the proposed section is so vague as to put normal business relationships in question. Therefore we cannot support this section.

MUTUAL SAVINGS BANK STOCKHOLDINGS IN OTHER FINANCIAL INSTITUTIONS

Section 10 of H.R. 5700 would prohibit mutual savings banks from owning stock in any commercial bank or any other financial institution. While we realize this could have major effects on some banks, particularly in the New England area, nonetheless our association does not oppose enactment of this section, provided it is limited to institutions within the confines of State boundaries, and a 10-year divestiture period is afforded. The latter is necessary in order to avoid adverse impact on the market for many commercial bank stocks, including such stocks held by individuals.

TRUST DEPARTMENT STOCKHOLDINGS

Section 12 would require each insured bank to report annually to the FDIC all the securities it holds in a fiduciary capacity, its voting authority with respect to such securities, and the manner in which it voted the proxies on such securities.

This reporting requirement would engulf the FDIC in a virtual

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torrent of data as 3,500 trust departments file their annual reports. The following are illustrative of the quantity of data which would be generated. One bank recently reported stockholdings in over 1,700 companies, another bank reported holdings in 13,000 separate issues and maturities of municipal bonds, 5,000 corporate and agency issues, 4,500 issues of common stocks and 500 issues of preferred stocks, and a third bank reported its holdings encompass more than 10,000 items. These figures relate to the reporting of securities held; none of the three banks is in New York.

The extent of the paperwork involved in extending this to all trust departments and including all three reporting requirements would be enormous and expensive. As far as we know neither the FDIC nor any other regulatory agency has stated and defined any problems which are to be solved by the analysis of the data required by section 12 and no programs for the analysis of such data have been established.

It is said that this reporting requirement would not invade individual privacy. However, take an example of the death of a person in a small- or medium-size community; the holdings of his estate would probably show up quite clearly in the next year's report of his executor, if it were a local bank. This would be particularly true if it were a closely held local business.

For these reasons the American Bankers Association is opposed to this section. However, we do not oppose the reporting of truly meaningful information which has significance to the national economy.

If the Congress determines such additional reporting is necessary the association would not oppose reporting to the bank regulatory agencies under regulations which they promulgate. The banking regulatory agencies should have the authority to determine what is to be reported and when. The requirements should not be frozen into statute.

Section 13 prohibits an insured bank from holding in a fiduciary capacity more than 10 percent of the stock of any corporation registered under the 1933 Securities Act, or holding in a fiduciary capacity any stock of the bank itself or its parent.

This provision strikes at the heart of private ownership and management of personal property. Absolute and arbitrary limits are placed on forms of property ownership and management.

If this provision is enacted, competition between banks will be reduced. A lifetime customer of a bank may find his wishes as to choice of trust institutions completely frustrated if forced to name a competitor of his own bank as executor or trustee.

On occasion, if this measure were enacted, some banks would find themselves unconsciously in violation of the law. The bank may qualify as an executor, not realizing the estate includes above-the-limit stock. To say the bank may sell the excess stock is not an appropriate answer. If considered as a proper investment, from which of its accounts should the bank sell—from the new one or from one of the old ones?

For the foregoing reasons we oppose this section.

PROHIBITION OF EQUITY PARTICIPATION IN LOANS

Section 14 of H.R. 5700 would prohibit commercial banks, savings and loan associations, savings banks, bank holding companies,

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savings and loan holding companies, and insurance companies from arranging for an equity participation in consideration of the making of any loan. It covers both direct equity ownership, from which-member banks and most State banks are barred, and the supplemental return or interest override type of participation.

In the latter case the lender receives additional compensation from the borrower, tied to income or the price of the stock, without taking an actual ownership position. It is used as a hedge against inflation.

Commercial banking as an industry has not been heavily engaged in making loans involving even supplemental income arrangements. In a recent survey conducted by the Comptroller of the Currency, only 42 national banks out of 520 sampled were found to have made loans which also included supplemental income arrangements. The loans involved accounted for only one-fourth of 1 percent of the total commercial and industrial loans held by those 520 banks.

We understand that the agencies believe they have the necessary authority to regulate adequately in this area, and therefore we believe this legislation is unnecessary.

In any event, if the Congress decides to legislate in this area, then we urge that section 14 explicitly state that it does not apply to bank investment in small business investment companies (SBIC's), to corporations for housing partnerships; to Edge Act corporations; to trust department acquisitions of convertible bonds or warrants, now permitted by law; nor to bank holding companies and the nonbank subsidiaries of those companies.

INSIDER LOANS

The American Bankers Association opposes section 15 of H.R. 5700, which would prohibit insured banks from extending credit to any corporation where the bank's directors, trustees, officers, employees—and members of their immediate families—own in the aggregate, 5 percent or more of any class of the corporation's stock.

We cannot realistically imagine any potential credit abuse or benefit to the public significant enough to demand such a broad and burdensome prohibition.

There are statutory tools available to the supervisory agencies for handling self-dealing by officers, directors, and employees. Examination procedures are currently adequate to identify and protect against potential "insider" credit abuses.

Moreover, the bill would prohibit, for specific example, the hiring of the daughter of an individual owning a small incorporated construction business borrowing at the bank; or hiring the daughter of the owner of a small incorporated agricultural business. Those are specific examples from my own bank.

Section 15 is so constructed that there is no way for a bank to protect itself against unintentional violation of the proposed law. A bank cannot compel the families of its personnel to disclose their stockholdings. Yet a bank would violate the proposed provision if it extended credit to a company, 5 percent of whose shares were owned by wives, children, and parents of bank employees.

Section 15 would also require all insured banks to report—and the FDIC to disclose publicly—all loans made to all insured-bank em-

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ployees and their families. Present law already prohibits all but certain specific types of loans to executive officers of Federal Reserve member banks, and requires disclosure of the permitted loans to the FDIC. Generally, State laws require such disclosures by State nonmember banks.

PROHIBITION OF BROKERED DEPOSITS

The American Bankers Association supports the prohibition of brokered deposits, at which sections 19, 20, and 21 are aimed. However, the prohibition should be limited to brokered deposits involved in link financing; that is, those arrangements in which a deposit is made contingent upon a loan being granted to a specified customer, wherein the transaction is arranged by a third-party broker.

By limiting this prohibition of HR. 5700 to link-financing arrangements, the Congress can avoid possible unintended effects of the legislation. For example, we doubt that the legislation is intended to preclude the purchase of negotiable CD's in the money markets through banks or brokers where a small commission is paid: nor to prevent money center banks from acquiring funds through brokers in the Eurodollar market; nor to prevent banks from using incentive campaigns among employees to attract new customers. All of these practices are sound banking procedures.

PROHIBITION OF GIVEAWAYS

The American Bankers Association believes that sections 22, 23, and 24 of H.R. 5700 which would prohibit "giveaways" to attract deposits, are unnecessary and undesirable.

We believe the regulatory agencies are satisfactorily handling this practice now. A recent survey of FDIC regional directors showed that the use of "giveaway" campaigns has not resulted in supervisory problems for that agency.

We believe the existing regulatory approach to giveaways is much preferred to a statutory prohibition. This permits flexibility to allow the use of this tool to encourage new savings and to enhance competition.

Historically, giveaways have been used to encourage thrift and savings, which in turn are helpful in channeling more funds into housing and other consumer areas.

100 PERCENT INSURANCE FOR PUBLIC FUNDS

The American Bankers Association opposes sections 25 and 26 of H.R. 5700 which would extend insurance coverage on public deposits, including those of Government agencies, to 100 percent. The provision would also authorize the insuring agencies to limit the amount of public funds which insured banks and savings and loan associations could legally accept.

Under present arrangements, protection of public deposits in banks is accomplished by means of pledging securities for the protection of such deposits in excess of the insurance limit. In our judgment, 100-percent insurance of such funds as provided for in H.R. 5700 could have some adverse effects on our financial system.

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It is assumed, of course, that if there is 100 percent insurance for these deposits, pledging of acceptable assets would no longer be required. Thus, banks would be freed from holding an estimated minimum of $30 billion in securities now pledged against State and local deposits, exclusive of Federal Government deposits, which I may say would add about $7 billion. Accordingly, this could adversely affect the municipal and U.S. Government securities markets.

The reduced demand for such securities could raise borrowing costs for Federal, State, and local governments.

The proposal for 100-percent insurance coverage of public accounts could open the door to pressure for similar treatment of all accounts. Private account holders, some with quasi-public responsibility, could well ask why their savings or checking accounts above $20,000 are any less important than Government funds. When the county sewer-district receives 100 percent of its deposits under Government insurance, the local hospital will come in and say, "Where is ours?" These possibilities must be weighed in considering 100-percent insurance for public units.

Should insurance coverage become complete for all types of accounts, there is little reason for depositors to rely upon the soundness, capital structure, and integrity of management of individual banks. It has been said that, as far as safety of deposits is concerned, up to the insurance limit, one bank is as good as another, so why worry about how well managed or how sound it is; the FDIC will be fully responsible.

Mr. Chairman, if, despite the arguments against 100-percent insurance for public deposits, Congress still decides it to be appropriate, we urge that the ceiling rates payable by savings and loans and banks on the share accounts and time deposits of public units be identical.

H.R. 3287, LOANS ON HYPOTHECATED BANK STOCK

Mr. Chairman, we understand your committee is also interested in our views on H.R. 3287, a bill introduced by Congressman Gonzalez to prohibit federally insured banks from making loans for the purchase of bank stock, bonds, debentures, or other obligations of any bank.

We oppose this absolute prohibition of banks to lend funds or extend credit for such purposes, particularly the purchase of bank stock.

The legislation would reduce capital flows into banking and would result in making bank stocks a less desirable investment. It would have an adverse effect on the market for bank shares, hurting individuals and instututions holding such stocks. The language of the bill is so broad as apparently to prohibit a bank loan for the purchase of even a single share of stock.

We appreciate very much this opportunity to present these views. Thank you.

The CHAIRMAN. Thank you, sir. You did a good job reading your testimony.

Mr. WILLIAMS. May I make an observation. I believe that Mr. Sommer has only read his summary of 12 pages. He has presented another statement of 20 pages. Is that not correct, Mr. Sommer?

Mr. SOMMER. Yes.

Mr. WILLIAMS. And you want that statement included in the record?

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Mr. SOMMER. Yes.

The CHAIRMAN. That request has already been taken care of.

(The prepared statement of Mr. Sommer follows:)

PREPARED STATEMENT OF CLIFFORD C. SOMMER, PRESIDENT, AMERICAN BANKERS ASSOCIATION

Mr. Chairman and members of the Committee, I am Clifford C. Sommer, President of Security Bank and Trust Company, Owatonna, Minnesota, and President of The American Bankers Association. I am accompanied by Richard P. Brown, Senior Vice President and Executive Trust Officer, The First National Bank, Denver, Colorado, who is President of the A.B.A. Trust Division; and by B. Finley Vinson, Chairman of the Board, First National Bank, Little Rock, Arkansas, who is Chairman of the A.B.A. Federal Legislative Committee. We appreciate the opportunity to appear here today on behalf of The American Bankers Association, to express our views on H.R. 5700.

This is an extensive piece of legislation, embodying a series of difficult subjects. Some of these topics relate to just one section of the bill; others involve two or three sections. In order to expedite this presentation, and to make the views of The American Bankers Association most clear, I thought it best to go through the legislation topic by topic.

If we were asked to give our views on H.R. 5700 as one package, without consideration of the individual parts, we would oppose it. However, we find in the proposed legislation sections which we can support and I will note these as I go through the presentation.

We question the implication left by the title "Banking Reform Act." A high level of performance of banks and other financial institutions is consistently achieved to maintain the necessary public confidence in our financial system.

Let me now turn to the various topics for discussion.

INTERLOCKING MANAGEMENT

If all sections of the legislation dealing with bank interlocking management were enacted—Section 2, 7, 8 and 9—we fear that commercial bank boards of directors would be decimated. Banking is a broad-gauged business urgently requiring the counsel of a wide range of knowledgeable and experienced individuals currently active in many segments of the economy. Banking requires their advice, if it is to adequately serve the public interest.

American business and industry have learned over the years that the public interest, as well as the interest of stockholders, is best served by a corporate board of directors which includes high caliber responsible people with varying backgrounds and experience.

This proposed legislation would eliminate most outside directors. It would damage all banks and would be especially harmful to banks in small communities. An all "inside" board would lack broad perspective.

In our smaller cities and towns, business and civic leaders serve on the boards of the local banks as a matter of community pride and duty. The choice of these leaders is not just a happenstance. Indeed, it is a necessity for the proper functioning of the banks in the interest of their communities. Conversely, other corporation elect bankers to their boards to draw on their knowledge and experience in the field of finance.

The most disturbing part of all this is that no need has been shown for such a drastic curtailment of the reciprocal use of talent. Bank directors are held by the courts to a higher standard of conduct than is required of other directors.

Despite the foregoing comments, The American Bankers Association recognizes that potential anti-competitive effects may seem to result from interlocking management between directly competing depository institutions. Accordingly, we endorse the prohibition of certain interlocks between banks and other deposit-type institutions; namely, mutual savings banks, savings and loan associations and credit unions. However, we do not believe that this prohibition should be extended to cover interlocks among less directly competitive financial institutions, such as insurance companies.

In endorsing the prohibition of interlocks between banks and other directly competing deposit-type institutions, we believe it should be limited to institutions in the "same, contiguous or adjacent cities, towns, or villages," as now provided in Section 8(a) of the Clayton Act. However, the appropriate regulatory agency

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should be given authority to ban interlocks beyond contiguous areas if they might tend to substantially lessen competition.

On the other hand, the agency should be authorized to allow interlocking relationships even within the defined area if such an interlock is necessitated by a scarcity of experienced financial talent.

Interlocks resulting from common stock ownership including holding company and chain banking arrangements should be specifically excluded from the prohibition no matter where the institutions are located. The regulatory agencies or State law could determine what common ownership is.

This flexible administrative approach will permit the agencies to bar interlocks where competitive harm could result, while at the same time it will permit interlocks where they are, on balance, advantageous to banks and the public they serve.

We recommend a five-year time period for corporations to bring their board membership into compliance with the proposed legislation.

With this general statement let me now make specific comments on particular sections of H.R. 5700.

MANAGEMENT INTERLOCKS AMONG FINANCIAL INSTITUTIONS (SECTIONS 2, 3 AND 4)

Subject to the limitations described above, we endorse the prohibition of management interlocks among competing deposit-type institutions. However, Sections 2, 3 and 4 of H.R. 5700 would also prohibit interlocks between deposit-type institutions and insurance companies and brokerage firms, as well as title companies, appraisal firms and settlement companies with which there is a substantial and continuing relationship with the lender. We oppose these prohibitions. These businesses and depositoy institutions are not major competitors.

Banks need the expertise of competent financial advisers in the insurance field, and vise versa. Prohibition of such interlocks would significantly diminish the supply of talent in these financial areas. If our financial institutions, both depository and others, evolve in such a way as to make insurance companies and banks more directly competitive at some time in the future, reassessment would be in order. But we firmly believe such interlocks should not now be prohibited.

With regard to depository institution interlocks with title companies, appraisal companies, and settlement companies, the barring of these individuals from depository institution boards will result in a loss of considerable knowledge in real estate matters, including the secondary mortgage market, to the detriment of the communities served.

It should be noted that the Banking Act of 1933 prohibits interlocks between banks and securities dealers. Federal Reserve Regulation R implements this provision of the Banking Act of 1933.

MANAGEMENT INTERLOCKS INVOLVING TRUST OFFICERS (SECTIONS 2 AND 8)

One particular problem arising from section 2, as well as from section 8 (discussed later) relates to closely held or family corporations, the stock of which may come to the bank as a part of the assets of an estate or a trust. Often such holdings will represent a substantial part of the outstanding shares of the company. Normally, the market for such stock would be limited and in many cases the bank may lack authority to sell the stock. Moreover, the bank's role may be only to act as a conduit, that is, to hold the stock temporarily until the estate is distributed to beneficiaries of the decedent or to hold it in trust until children are old enough to take over the business.

To deal effectively with such stock as required by its fiduciary responsibility the bank may find it necessary to place a trust officer on the board of directors. The purpose of such action is to protect the interests of the estate or trust beneficiaries.

A man who has spent his lifetime building a business, may decide in detail how a trustee bank should manage the company after his death, during the life of his widow and/or during the younger years of his children. There may be special circumstances which make such an arrangement desirable. In these cases, the bank trust department may be asked to manage his trust, including the company. Without the right to have a trust officer on the company's board, the bank would probably be unable to fulfill its duty.

In such instances the American people should not be denied access to the expertise of the corporate fiduciary. Accordingly, we oppose the provisions of Sections 2 and 8 which woulc do this.

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MANAGEMENT INTERLOCKS AND EMPLOYEE BENEFIT PLANS (SECTION 7)

The American Bankers Association opposes Section 7 of H.R. 5700.

Section 7 would prohibit a bank officer, director, or employee from serving as a director of a corporation which has a pension fund managed by the bank. The same prohibition would apply to other financial institutions handling pension plans.

This provision would be anti-competitive rather than increase competition. In many instances, it could reduce the number of banks competing for specific pension business. A large corporation may have several bank related directors. It may have several pension plans. In fact in many cases large corporations divide a pension fund among several trustee banks to see which one performs best. Section 7 could deprive a corporation of the advantage of a full range of competition for its pension account.

In some medium sized and smaller communities, corporations with pension plans trusteed by local banks might have to look to banks in other communities for trustees, giving rise to inconveniences as well as eliminating sources of competition in the field. This also applies to other financial institutions that compete with banks as investment managers for pension funds.

Corporations, of course, could place their pension funds with individual trustees, investment advisers or mutual funds without concern over Section 7. There is no justification for diverting pension business to such other investment managers. To provide full competition, banks should have the same opportunity for pension business as individual trustees, investment advisers, and mutual funds.

Before leaving Section 7, I want to comment briefly on current governmental regulation of pension funds and their management. One of the incentives for establishing pension plans is the tax benefit allowed to qualified plans. The tax law restricts self-dealing and a number of other specified practices relative to pension funds. The bank or other trustee must annually state, subject to penalty of law, whether any of the prohibited activities have or have not taken place. If they have taken place, the fund will lose its qualification and consequently its tax benefits.

The Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation scrutinize pension fund investments during their examinations of trust departments. These examinations are concerned with protecting trust beneficiaries as well as depositors. This concern is essential for the protection of the bank and its capital against possible liabilities for non-performance of its duties as trustee. The Comptroller indicates that he gives particular attention to pension funds in which stock of the employer corporation is held; and further if there is a management interlock, the examination would be even more stringent.

If employee contributions are used to purchase employer stock for a pension fund, the Securities Act of 1933 requires that the pension plan be registered with the S.E.C.; thus a third federal regulator is involved.

A fourth government agency, the Labor Department, is also involved through the Welfare and Pension Plans Disclosure Act.

Section 7 would not be in the best interest of the millions of American workers who are covered by pension plans.

MANAGEMENT INTERLOCK AND VOTING CONTROL OF SECURITIES (SECTION 8)

The American Bankers Association opposes Section 8 of H.R. 5700.

This section would prohibit an officer, director or employee of a financial institution from serving at the same time as an officer or director of a corporation if the institution holds 5 percent or more of such corporation's stock, with the power to vote. As mentioned before, this provision would cause serious problems relative to closely held or family corporations.

If the purpose of this provision relates to control, there is no evidence that 5 percent of voting stock, plus a corporate director or officer interlock, constitute control. To impose such a sweeping prohibition without such evidence is not justified.

Further, if any percentage is used the following problems clearly exist.

Section 8 would cause a real problem of policing investments and voting rights in the many individual trust accounts. A trust department would have to keep a running tally of its aggregate holdings and voting rights in corporations with which it has a management interlock. This task would be onerous not only because the stock could be held in several hundred separate accounts but the voting power could only be ascertained by reviewing each of the hundreds of trust instruments setting up these accounts.

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The enactment of this section would seriously affect investment judgment. The bank would not only have to consider whether a particular stock is a prudent and good investment for a particular trust but, if the benchmark percentage would be reached it would also have to consider whether the investment is worth forcing the resignation of an officer or director from the bank or from the corporation involved.

A similar problem would arise where the bank is designated executor of an estate which contains more than the benchmark percentage of the stock of a corporation with power to vote, or an estate which contains only a few shares of a corporation, but, when they are combined with other shares held by the bank, the benchmark is exceeded. The bank in some instances may be forced to choose between the estate of a lifelong customer and a director who has served the bank faithfully and well for many years.

Another problem would arise when a bank qualifies as an executor for an estate and subsequently learns on marshalling its assets that the limit has been exceeded. The bank would have been unknowingly in violation of the section, but how would it correct the situation—remove the director interlock; give voting rights to someone else; sell stock from the estate; sell stock from other accounts, and if so, from which ones?

Another problem would arise with regard to the securing of loans. Would the section apply to corporate stock pledged with voting rights to secure a loan? I merely raise it as a question. If it does so apply, it would certainly complicate matters.

Section 8 applies to bank holding companies as well as banks, but it allows interlocks between corporations which are part of a bank holding company group. So a bank holding company or affiliate would be allowed an interlock with a corporation if it held less than 5 percent of its stock with voting power or more than 25 percent of its stock with voting power, but not in between. Of course, Federal Reserve Board approval would be required to acquire the latter amount of stock except for nonbank stock acquired by a bank in a fiduciary capacity, in which case the company would not become a member of the holding company group and the exception would not apply.

Section 8 is an arbitrary attack on ownership and management of personal property. Both it and Section 7 vitiate fiduciary responsibility.

MANAGEMENT INTEROCKS AND LOANS (SECTION 9)

The American Bankers Association vigorously opposes Section 9 of H.R. 5700.

This Section would prohibit any officer, director trustee or employee of a commercial bank, mutual savings bank, or savings and loan association from serving at the same time on the board of directors of any corporation with which the institution has substantial and continuing loan relationships. The Federal Reserve Board and the Federal Home Loan Bank Board would make the determination of what constitutes a "substantial and continuing relationship."

This is a sweeping section that could be devastating to all financial institutions but particularly those in small communities. As I discussed earlier in my statement, banking is a broad-gauged business that requires expertise from many segments of the economy if it is to adequately serve the public interest.

As pointed out before, in many cases, perhaps a majority of cases, this would force all outside directors off the bank's board, limiting the board to insiders.

This would seriously impair, if not virtually eliminate, the reservoir of competent talent available for all sizes of financial institutions; or, in the alternative, it would force unnatural credit arrangements—that is, borrowing from institutions other than those on which the company has board representation. Enforcement of this provision could be chaotic to business relationships in small communities, particularly those with only one bank.

CONTROL OF TITLE COMPANIES, APPRAISAL FIRMS AND SETTLEMENT COMPANIES

Certain subsections of Sections 2, 3, 4 and 5 would prevent officers and directors of insured commercial banks, mutual savings banks and insured savings and loan associations, or the immediate families of such persons from controlling (directly or indirectly) any title company, appraisal company or closing company. It seems unreasonable to infringe on the activities of individuals with such broad restrictions on their rights to engage in normal business transactions.

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INTERLOCKING RELATIONSHIPS OF FINANCIAL INSTITUTIONS WITH ATTORNEYS (SECTION 2)

The American Bankers Association opposes those subsections of Section 2, which provide that a person who is a trustee, director, officer or employee of an insured commercial bank may not perform legal services in connection with a loan or other business transaction with such institution, for or on behalf of any person. Sections 3 and 6 would place similar prohibitions on savings and loan associations and mutual savings banks.

The "Study of the Savings and Loan Industry," directed by Irwin Friend, contains statistics indicating that many lawyers serve on boards of savings and loan associations. There are not comparable figures with respect to the number of lawyers on the board of directors of commercial banks, but it is a very common practice for large as well as small banks to have one or more members of law firms serving on their boards and in many cases an in-house general counsel may serve on a bank's board of directors.

Sometimes the outside lawyer who serves on the bank's board of directors is the bank's counsel or a member of that firm which acts as the bank's counsel. In other cases, the outside layer or his firm may do no legal work for the bank.

Many banks have legal staffs performing legal service for them, sometimes headed by general counsels. This in-house counsel frequently works with outside law firms, either generally or on specific types of cases.

The effect of this prohibition would be to outlaw in-house legal staffs entirely. Moreover, under the language of the bill, it would be impossible for any lawyer practicing independently to be a director of an insured bank. It seems most unlikely that the legislation was intended to have these purposes.

Before leaving the general issue of interlocks I want to repeat that the effect of this bill on all corporations and financial institutions would be traumatic. Although this is very true for all corporations, its impact is accentuated in the case of the smaller communities.

INFLUENCING OFFICERS AND EMPLOYEES OF CUSTOMERS (SECTION 11)

The American Bankers Association opposes Section 11 of H.R. 5700.

This section would forbid a financial institution, without the consent of an appropriate superior, to confer "any substantial benefit" upon an officer, director, agent, or employee of a corporation or other employer with the intent to influence his conduct with respect to the affairs between the financial institution and the employer. A financial institution violating this provision would be subject to a fine of not more than $25,000, and the recipient of the benefit would be subject to a fine of not more than $10,000 or imprisonment for not more than one year or both.

We are certainly not in favor of improper influence. The problem is that the proposed legislation is so vague as to put normal business relationships in question. Therefore we oppose it.

MUTUAL SAVINGS BANK STOCKHOLDINGS IN OTHER FINANCIAL INSTITUTIONS (SECTION 10)

The American Bankers Association is not opposed to Section 10 of H.R. 5700, which would prohibit mutual savings banks from owning stock in any commercial bank or any other financial institution.

The provisions would probably have major effects on the ownership of some banks, particularly in the New England area. For example, 21 savings banks in New Hampshire and 18 savings banks in Massachusetts own 10 percent or more of the stock of commercial banks.

Nonetheless, our Association would not object to this prohibition, with two modifications: First, the prohibition should be limited to competing institutions within a market area. For convenience we would recommend that this be the State boundaries. Second, a reasonable divestiture period should be provided. Under Section 27 of the bill, Section 10 would become effective on the first day of the fourth calendar year after enactment. This is too short. We believe ten years would be more reasonable in order to avoid adverse impact on the market for many commercial bank stocks, including such stocks held by individuals.

We would like to call to the Committee's attention a complication that will have to be resolved. The application of Section 10 to mutual savings banks in Massachusetts would involve constitutional problems, since many mutual

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savings banks in Massachusetts are not members of FDIC but belong to an insurance fund run by the Commonwealth of Massachusetts.

TRUST DEPARTMENT STOCKHOLDINGS (SECTIONS 12 AND 13)

Mr. Chairman, I now turn to the provisions of the bill which directly affect bank trust departments. The first group found in Section 12 relate to reporting and the second group found in Section 13 prohibit certain stockholdings.

Section 12 requires an insured bank to report annually to the FDIC all the securities it holds in a fiduciary capacity, its voting authority with respect to such securities, and the manner in which it voted the proxies of such securities. The American Bankers Association is opposed to this section.

This reporting requirement would engulf the FDIC in a virtual torrent of data as 3500 trust departments file their annual reports. The following are illustrative of the quantity of data which would be generated. One bank recently reported stock holdings in over 1700 companies, another bank reported holdings of 13,000 different maturities and issues of municipal bonds, 5,000 corporate and agency issues, 4,500 different common stocks and 500 different preferred stocks, and a third bank reported its holdings encompass more than 10,000 items. These figures relate only to the reporting of securities held; none of the three banks is in New York.

The extent of the paper work involved in extending this to all trust departments and including all three reporting requiremeuts would be enormous. We believe the FDIC would find it most burdensome, to cope with it in any meaningful way. Neither the bill, the FDIC, nor any other regulatory agency has stated and defined any problems which are to be solved by the analysis of the data required by Section 12 and no programs for the analysis of such data have been established.

It is said that this reporting requirement would not invade individual privacy. However, take an example of the death of a person in a small or medium size community; the holdings of his estate would probably show up quite clearly in the next year's report of his executor, if it were a local bank. This would be particularly true if it were a closely held local business.

The reporting of voting authority as to all stockholdings would impose an almost impossible burden on some trust departments because they keep no aggregate figures and would have to check each trust instrument against each holding of stock.

The American Bankers Association is aware of the important portion of the security holdings of the nation which has been entrusted to its member Trust Departments, and is devoted to the principle that the trusts which hold these significant assets shall be properly administered in the interests of their beneficiaries and in accordance with the law of the land. The Association is also aware that knowledge of the manner of the handling of these assets can have significance to the Congress and the regulatory agencies in their studies of the economy. We do not oppose the reporting of truly meaningful information which has significance to the national economy.

We do oppose most strongly, however, blanket reporting requirements covering even the most insignificant transactions, sought to be imposed without analysis or consideration of the burden which they would impose on the banks required to report, and without delineating the objectives to be accomplished by the reporting or the manner in which the information to be reported will contribute to such objectives.

If the Congress determines additional reporting is necessary the Association would not oppose reporting to the banking regulatory agencies under regulations which they promulgate. The banking regulatory agencies should have the authority to determine what is to be reported and when, and this should not be frozen by statute.

Section 13 prohibits an insured bank from holding in a fiduciary capacity more than 10 percent of the stock of any corporation registered under the 1933 Securities Act, or holding in a fiduciary capacity any stock of the bank itself or its parent. We are opposed to this section.

This provision strikes at the heart of private ownership and management of personal property. Absolute and arbitrary limits are placed on forms of property ownership and management.

These prohibitions seem to be aimed at two different issues: (1) economic concentration and (2) management perpetuating itself through trust department holdings. Some comments are applicable to both provisions.

They both prohibit the holding of stock without regard to voting authority,

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investment authority, the manner in which the stock is obtained, or the degree of judicial or administrative regulation. It makes no difference under these provisions if the stock were voted by someone else, if the investment decisions were made by someone else, if the stock came to the bank in the estate of a decedent who named the bank executor or trustee, if it came to the bank as a part of some other type account established by an individual, or if the account in which it is held is subject to judicial review.

The 10 percent limitation provision could interfere with the right of an individual to dispose of his estate or handle his property as he wishes. A person who owns a substantial portion of a public corporation might have a most difficult time finding a bank to name as executor or trustee; and once he found one, he could never be sure that the bank's position with regard to such stock might not change before his death. In fact, if his holdings exceeded the 10 percent mark he could not use a corporate fiduciary for his executor or trustee at all. Even a person with a small investment in a public corporation could never be sure but that his holding would be enough to put the bank he selects as trustee or executor over the 10 percent mark and result in the bank refusing his account. If this provision is enacted, competition between banks will be reduced. Lifetime customers of a bank may find their wishes completely frustrated as they are forced to name competitors as executors or trustees.

On occasion, if this measure were enacted, some banks would find themselves unconsciously in violation of the law. The bank may qualify as an executor, not realizing the estate contains prohibited stock. It is no answer to say the bank may sell the excess stock. If the bank considers it a proper investment, from which of its accounts should it sell—the new one or one of the old ones?

Over the years banks develop good relationships with certain families which control local businesses. These customers know the bank and want them to administer their estates and their trusts. The wishes of such persons will often be thwarted if this provision is enacted.

The complete lack of validity of this provision can be seen in the fact that no size limit is placed on individual ownerships; yet this provision applies a 10 percent limit when the stock is probably held in several, if not hundreds, of accounts, each with its own individual considerations. The bank cannot sell, buy or vote the stock without considering its impact on each account affected, and without being liable to each beneficiary affected. On occasion a bank will be buying and selling a single stock for different accounts on the same day.

Where the bank does have investment authority the provision would interfere with investment judgment once 10 percent is reached or approached.

Many of my comments on the 10 percent limitation are equally applicable to the limitation on a bank holding its own stock, or that of its parent. It would interfere with a person's right to dispose of his estate or handle his property as he wishes. A director, officer, employee or customer of the bank who owned bank stock would have to turn to a competitor bank or an individual to be his executor or trustee. This is unreasonable. If carried to its logical conclusion, each bank in a community could be controlled by its competitor. It is unlikely that the Justice Department or the Federal Reserve Board would allow this, so a person holding bank stock might have to leave his home community to find an executor or trustee in whom he would have the necessary confidence.

The bank limitation, like the 10 percent limitation, disregards the voting authority and the investment authority. Banks are precluded under the common law of trusts from buying their stock or that of their parent unless expressly authorized under provisions of a trust instrument. Similarly they sell any stock of the bank or its parent coming to the bank as a part of an estate or trust, unless there is authority to retain it.

Present law prohibits a national bank from voting its own stock at an election of directors. It is unreasonable to prohibit a bank from holding its own stock or that of its parent, if it comes to the bank in an estate or trust with authority to retain, or from a customer who opens an account of some type and directs its retention. Also it is unreasonable to prohibit a bank from buying its own stock for its employee profit sharing plan.

Thus, the A.B.A. opposes the bank limitation of Section 13.

PROHIBITION OF EQUITY PARTICIPATION ON LOANS (SECTION 14)

Section 14 of H.R. 5700 would prohibit commercial banks, savings and loan associations, savings banks, bank holding companies, savings and loan holding

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companies, and insurance companies from arranging for an equity participation in consideration of the making of any loan. The American Bankers Association opposes this blanket prohibition.

Basically, equity participations are of two distinct types. On the one hand, there are simple equity participations in which the lender receives an ownership interest in the borrowing business enterprise, in addition to the interest received on the loan. The second type of equity participation involves a supplemental return to the lender sometimes referred to as an interest override. In this case, the lender receives additional compensation from the borrower without taking an actual ownership position. This compensation may be granted as a certain percentage of specified income from the business, or it may be based on the market action of the stock, or on some other device.

Typically, banks arranging for an equity participation in connection with a loan have been restricted to the supplemental return or interest override type of participation. Laws governing national banks and most state banks prohibit commercial banks from obtaining a direct ownership in a borrower's business.

Most lenders arranging for equity participations have done so as a hedge against rapidly rising prices, which reduce the nominal yield on straight, nonconvertible debt instruments. It is not surprising, therefore, to find this practice to have grown somewhat over the past several years. We believe a supplemental income arrangement or an equity participation is essential to persuading prudent lending institutions to grant long term financing, as a hedge against inflation.

Commercial banking as an industry has not been heavily engaged in making loans involving equity participations. In a recent survey conducted by The Comptroller of the Currency, only 42 national banks out of 520 sampled were found to have made loans which also included equity participation arrangements. The loans involved accounted for only one-fourth of one percent of the total commercial and industrial loans held by those 520 banks.

Rather than prohibit banks and other financial institutions from engaging in equity participations by legislation, the matter should be left to the regulatory agencies. It is our understanding that the agencies believe they have the necessary authority to regulate in this area. If the agencies find that they need additional powers, appropriate legislation could be provided.

In any event, we urge that it be made explicit that Section 14 not apply to bank involvement with small business investment companies (SBIC's), corporations for housing partnerships, nor Edge Act corporations.

It should be made clear that it does not preclude trust department acquisitions of convertible bonds or warrants, now permitted by law. The management of equities is an inherent part of trust department business.

Further, we see no valid reason why this section of the bill should apply to bank holding companies or to the nonbank subsidiaries of those companies, since these companies operate as separate entities, whose functions do not impinge on the bank subsidiary.

INSIDER LOANS (SECTION 15)

The American Bankers Association opposes Section 15 of H.R. 5700. The final provision of Section 15 would prohibit insured banks from extending credit to any corporation where the bank's directors, trustees, officer, employees—and members of their immediate families—own in the aggregate, 5 percent or more of any class of the corporation's stock. Sections 16 and 18 would similarly restrict insured savings and loan associations and mutual savings banks.

I cannot realistically imagine any potential credit abuse or benefit to the public significant enough to demand such a broad and burdensome prohibition.

There are statutory tools available to the supervisory agencies to handle self-dealing as it relates to officers, directors and employees. Examination procedures currently identify and are equipped to protect against these potential "insider" credit abuses.

As pointed out earlier, this would have a seriously detrimental effect on the ability of banks to obtain competent directors. This would affect banks of all sizes, particularly in the small communities.

I would add that Section 15 is burdensome, if not inequitable, for present and prospective employees of banks. Under this section a bank would have to require each of its employees to disclose, as a condition of employment, his and his immediate family's holdings of all corporate securities. Further, the bank would have to require any person who accepts bank employment to report all subsequent stock transactions and those of his family. A bank would have to withhold credit

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from a corporate loan-application where the bank's employees and their families, in the aggregate, own 5 percent of the credit applicant's stock; or alternatively it would have to release, or refuse to hire, bank employees associated with such companies. This could have unanticipated effects. For example, it would prohibit the hiring of the daughter of an individual owning a small incorporated construction business which is a borrower at the bank. The same would be true of a family member of the owner of a small incorporated agricultural business.

Section 15 is so constructed that there is no way for a bank to protect itself against unintentional violation of the proposed law. While a bank can require its personnel to disclose their stock holdings, it cannot compel the families of its personnel to do so. Yet a bank would violate the proposed provision if it extended credit to a company, 5 percent of whose shares were owned by wives, children and parents of bank employees.

Section 15 would also require all insured banks to report—and the FDIC to disclose publicly—all loans made to all insured-bank employees and their families. The Association vigorously opposes this provision. Present law already prohibits all but certain specific types of loans to executive officers of member banks, and requires disclosure of the permitted loans to the FDIC. Similarly, State laws require such disclosures by State non-member banks. We believe the extension of these laws embodied in H.R. 5700 serves no reasonable purpose. To make loans for automobiles, furniture or education a matter of public record merely because the borrower chose to work for a bank or because the borrower chose to marry a bank employee, in our view amounts to an unjustified interference in his personal life.

PROHIBITION OF BROKERED DEPOSITS (SECTIONS 19, 20, AND 21)

Sections 19, 20 and 21 of H.R. 5700 would amend the Federal Deposit Insurance Act and the Federal Home Loan Bank Act to prohibit Federally insured banks and savings and loan associations or any of their officers, directors, agents or substantial stockholders, from paying or agreeing to pay any person, including a broker or finder, compensation for obtaining deposits. In the definition of the term "payment of interest," the legislation would include any payment, or agreement to make a payment, to a depositor or other person as an inducement to place a deposit, if the bank or savings and loan association either knew or reasonably should have known of the payment or agreement for payment when the deposit was accepted.

The American Bankers Association supports the prohibition of brokered deposits, at which these sections are aimed. However, the prohibition should be limited to brokered deposits involved in link-financing, that is, those arrangements in which a deposit is made contingent on a loan being granted to a specified customer, with the transaction being handled by a third party broker.

By limiting this prohibition of H.R. 5700 to link-financing arrangements, the Congress can avoid possible unintended effects of the legislation. For example, we doubt that the legislation is intended to preclude the purchase of negotiable CD's in the money markets through banks or brokers where a small commission is paid; nor to prevent money center banks from acquiring funds through brokers in the Euro-dollar market; nor to prevent banks from using incentive campaigns among employees to attract new customers. All of these practices are sound banking procedures.

We do not believe that the bill is intended to prohibit the foregoing transactions. However, this can be made certain by simply restricting the prohibition to link-financed deposits. Moreover, such a limited provision would zero in on the key problem.

PROHIBITION OF GIFT GIVEAWAYS (SECTIONS 22, 23 AND 24)

The American Bankers Association opposes Sections 22, 23 and 24 of H.R. 5700 which would flatly prohibit "giveaways" to attract deposits.

There is no need for this outright prohibition. The regulatory agencies have all stated in these hearings that they have adequate regulatory authority to control any abuses in this area. In February 1970, the Federal banking agencies and the Federal Home Loan Board issued rulings interpreting these premiums as advertising or promotional expenses rather than the payment of interest or dividends if the premium is given to a new depositor or as an addition to an existing account; is not given on a recurring basis; and the wholesale value of the premium does not exceed $5.00 on deposits up to $5,000, and $10.00 on deposits over $5,000.

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A recent survey of FDIC Regional Directors showed that the use of "giveaway" campaigns has not resulted in supervisory problems for that agency.

We believe the existing regulatory approach to giveaways is much preferred to a categorical prohibition. This permits flexibility to allow the use of this tool to encourage new savings, to enhance competition and for other good purposes. Moreover, it can prevent potentially adverse interpretations of what a gift giveaway is. For example, it should not prohibit a bank from offering such items as free checkbooks or checking account services to its customers, nor normal business relations with customers. The Association urges a continuation of the regulatory approach to this problem, and it therefore opposes Sections 22, 23 and 24 of the H.R. 5700.

100 PERCENT INSURANCE FOR PUBLIC FUNDS (SECTIONS 25 AND 26)

The American Bankers Association opposes Sections 25 and 26 of H.R. 5700 which would extend insurance coverage on public deposits, including those of government agencies, to 100 percent. The provision would also authorize the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation to set limits on the amount of public funds which insured banks and savings and loan associations could legally accept.

Under present arrangements protection of public deposits in banks is accomplished by means of pledging securities for the protection of such deposits in excess of the insurance limit. In our judgment 100 percent insurance of such funds as provided for in H.R. 5700 could have some adverse effects on our financial system. It is assumed, of course, that if there is 100 percent insurance for these deposits, pledging of acceptable assets would no longer be required. Thus, banks would be freed from holding an estimated minimum of $30 billion in securities now pledged against State and local deposits.

Accordingly, 100 percent insurance of public funds would have adverse repercussions in the municipal and U.S. government securities markets, as the inevitable result of the reduced need for pledging securities. The reduced demand for such securities could raise the borrowing costs for State and local governments. There would be similar effects on the markets for Federal Securities.

Undoubtedly, in most cases, investments would continue to be made prudently, but under 100 percent insurance of public deposits banks would have greater freedom to pursue less conservative policies in the management of their assets.

By providing 100 percent insurance for public deposits, this provision would greatly expand the ability of savings and loan associations to accept such deposits. These associations, if authorized by State law, can accept such funds only to the extent of present deposit insurance. Thus, savings and loan associations would be in a position to greatly increase their acceptance of public deposits, expecially because they are authorized to pay a higher rate of interest than banks under regulations of the Federal Home Loan Bank Board, as authorized by the Interest Rate Control Act.

These institutions are not appropriate depositories for public funds. The basic function of savings and loan associations is to channel long term savings into home mortgages. As Chairman Preston Martin of the Federal Home Loan Bank Board advised the Committee on April 20, Section 26 would run counter to this objective. The favorable taxation and regulatory structure under which savings and loan associations operate are designed to hold them to these investments. In the past, they have sometimes found themselves in a tight money position, and available statistics indicate that public time deposits may be drawn down at the same time that such institutions face large withdrawals of private deposits. Thus, the existance of large deposits of public funds would only aggravate the tight money position of savings and loan associations when it would hurt them most.

State and local government time and savings deposits, as shown by the experience of commercial banks, appear to be highly volatile. For example, from the beginning of 1968 until the end of that year state and local time deposits of weekly reporting banks increased by 27 percent. One year later, at the end of 1969, these time deposits had been cut in half. This decline coincided with the decline in savings and loan share accounts as a result of the disintermediation which accompanied the pressures of tight money and the rapid increase in market rates of interest.

Finally, 100 percent insurance coverage of public accounts could open the door to pressure for similar treatment of all accounts. Private account holders, some with quasi-public responsibility, could well ask why their savings or checking

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account above $20,000 are any less important than government funds. The test would come at the first institution failure. When the county sewer district receives 100 percent of its deposits shortly after the closing of the institution, the local hospital will come in and say "where is ours?" Then the man on the street will say, "where is mine?" These possibilities must be weighed in considering 100 percent insurance for public units.

Should insurance coverage become complete for all types of accounts, there is little reason for depositors to rely upon the soundness, capital structure and integrity of management of individual banks or savings and loan associations. It has been said that, as far as safety of deposits is concerned, up to the insurance limit one bank is as good as another, so why worry about how well managed or how sound it is; the FDIC will be fully responsible.

Mr. Chairman, if despite the arguments against 100 percent insurance for public deposits Congress still decides it to be appropriate, we urge that the ceiling rates payable by savings and loans and banks on the share accounts and time deposits of public units be identical.

H.R. 3287, LOANS ON HYPOTHECATED BANK STOCK

Mr. Chairman, we understand your Committee is also interested in our views on H.R. 3287, a bill introduced by Congressman Gonzalez to prohibit federally insured banks from making loans for the purchase of bank stocks, bonds, debentures, or other obligations of any bank.

We oppose this absolute prohibition on the ability of federally insured banks to lend funds or extend credit to a borrower for the purpose of purchasing the stock of a bank. It would have adverse effects.

The legislation would reduce capital flows into banking and would result in making bank stocks a less desirable investment. The language of the bill is so broad as apparently to prohibit a bank loan for the purchase of even a single share of stock.

Further, it would have an adverse effect on the market for bank shares, hurting individuals and institutions holding such stocks. It would make it difficult, if not impossible in some cases to transfer bank stock ownership. It may mean that only the wealthy would be able to buy banks.

We are also concerned about the impact of this legislation on an important supervisory tool, namely, the enlistment of a financially strong institution to finance the purchase of a weak one.

The CHAIRMAN. Mr. Carlson, you are recognized, sir. You may present your testimony.

STATEMENT OF DONALD M. CARLSON, PRESIDENT, INDEPENDENT BANKERS ASSOCIATION OF AMERICA; ACCOMPANIED BY ROD L. PARSCH, CHAIRMAN, FEDERAL LEGISLATIVE COMMITTEE

Mr. CARLSON. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, my name is Donald M. Carlson of Elmhurst, Ill., where I am president of the Elmhurst National Bank. I appear here today as president of the Independent Bankers Association of America, an organization representing over 6,500 banks, about one-third of which are national banks.

We appreciate the opportunity to give you our views on H.R. 5700.

This proposed legislation is directed to actual or potential abuses in several types of financial institutions, not merely commercial banks. For this reason, we feel strongly that the bill should not be titled the "Banking Reform Act of 1971."

We appreciate and understand the need to control unsound practices in all financial institutions, including conflicts of interest, self-dealing, and anticompetitive practices. However, we note that the data upon which H.R. 5700 is based largely concerns less than 50 banks in 10 large cities, and that there is no like data as to the more than 13,000

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other banks and several thousand other financial institutions throughout the country.

At present there is no evidence that similar undesirable practices exist in any significant degree in banks and other financial institutions.

In the absence of adequate information, we recommend that this committee make a general survey of the suspected practices in all financial institutions—commercial banks, savings banks, savings and loan associations, insurance companies, brokerage firms, credit unions, and financial holding companies in all of the States.

This will require time and effort, but is the best way to develop wise and sound legislation. At this point, we believe that indesirable practices on the part of any or all of the financial institutions mentioned will not be found to exist generally throughout the country as was found in the 10 large cities surveyed.

Until a national survey of all of these institutions is made and evaluated, we think it unwise to provide for such sweeping prohibitions and severe penalties as are contained in this bill. Further, we think it is unfair to place all of these institutions, which with rare exceptions are honorably operated, under severe restraints because of the wrongdoings in a few.

Some of the provisions of the bill, aimed at a few offending institutions, actually are unnecessary and are harmful to smaller institutions. The failure to make this distinction, in our view, is a major oversight in the bill. It can be cured and better ways found, if more essential data is gathered. After that, a bill could be drawn to control the varying practices to the extend reasonably required.

For the reason that we are not better informed as to the extent or nature of the supposed undesirable practices by all institutions, we feel unable at this time to offer more than the general observations of our Federal Legislative Committee.

INTERLOCKING RELATIONSHIPS

As to sections 2 through 9 of the bill dealing with interlocking relationships between financial institutions, and between these institutions and others, we agree that the type of practices described in these sections are undesirable and must be controlled. However, in each section the bill provides a flat prohibition and, in some cases, severe penalties. In some sections arbitrary standards are used.

The prohibitions apply to all deposit-type institutions, and in some cases to the other institutions mentioned above. No distinction is made between large institutions operating in major cities and smaller ones operating in medium and small-sized communities. What justification is there for a ban that would decimate boards of directors of financial institutions throughout the Nation?

Until this committee has more information, we feel that instead of outright prohibitions, arbitrary standards and severe penalties, the wiser course would be to provide adequate rulemaking power to the regulatory agencies, and await the action of the Judiciary Committee on the bill before it to expand the scope of section 8 of the Clayton Act dealing with this same subject matter.

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STOCKHOLDINGS OF MUTUAL SAVINGS BANKS

We support the principle that it is not proper for a mutual savings bank to own stock, and perhaps controlling interest in, another type of financial institution. However, we fail to understand, in the draft of section 10, how a State-chartered mutual savings bank can be prevented by Federal law from owning stock in a State-chartered insurance company. Also, section 10 fails to indicate how Federal agencies would enforce this section, and in what manner.

CONFLICT OF INTEREST AND BRIBERY

Section 11 calls for criminal penalties covering eight types of financial institutions to give, or its officers, directors or employees to accept, any substantial benefit intended to influence transactions between these financial institutions and others. We certainly agree that the conduct described in the bill should be prohibited and violators punished. However, we are not aware of any such conduct, and we are unable to assist the committee with any specific suggestions.

TRUST DEPARTMENT STOCKHOLDINGS

Sections 12 and 13 contain three subjects: (1) Bank trust departments are prohibited from holding more than a total of 10 percent of any class of stock of any corporation whose stock is required to be registered with SEC. We agree that as little as 10 percent may constitute working control of a corporation, and that if a bank, for its own advantage, through its trust department, deliberately gains and exercises working control of a commercial corporation, this would be improper. This practice is not a legitimate part of the business of banking.

On the other hand, there are many situations where a trust department holds clear control of a corporation as part of a customer's estate plan. It is often the intent and purpose of such a customer to use a trust in order to hold together in a bloc for the benefit of his family the control of his corporate business. This is often the only practical way whereby one can prevent family control of a business from becoming fragmented through a series of probates.

The bill makes no distinction between a predatory intent on the one hand and legitimate estate planning on the other.

We could offer other examples, but this illustrates that such a flat prohibition is neither wise nor workable. We would like to suggest that this problem be left to the regulatory agencies. If they require more rulemaking power to handle the problem, the bill should be modified accordingly.

(2) Trust departments are prohibited from holding their own bank stock or stock of a parent holding company. We understand the purposes of this prohibition is to prevent improper perpetuation of management. Again, however, the bill fails to recognize the legitimate purpose of holding family control of the bank together through a trust, as part of the family's estate plan.

Rather than to provide an outright prohibition, we feel the bill should be modified to give the regulatory agencies the necessary power to deal with improper situations.

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(3) The bill provides for public disclosure annually of all holdings of stock in the trust department, and how the voting rights were exercised in the previous year.

We feel this is unduly burdensome. It would appear to us to be sufficient that such disclosures be limited to the regulatory agencies. Bank examiners have the power and routinely make inquiries into these matters, and require the bank's board of directors to review the report. If necessary, the regulatory authority in problem cases can arrange an audience with the directors and, if deemed advisable, with stockholders of the bank in a special meeting.

If further regulatory power is required, the bill could so provide. We can see no useful purpose in requiring every bank trust department to make public disclosure of how voting rights are exercised as to all of the securities held, without regard as to the good or bad purpose of the creator of the trust or of the bank. In smaller communities, this would be considered a breach of confidence and could destroy a bank's trust department.

EQUITY PARTICIPATION

Section 14 prohibits financial institutions from obtaining part of the equity in a business enterprise in return for extending credit.

We support section 14. We feel that equity kickers are not a proper or legitimate condition for obtaining a bank loan.

INSIDER LOANS

Sections 15 through 18 flatly prohibit deposit-type institutions from extending credit to a company where 5 percent or more of its stock in the aggregate is owned by principals or employees of the institution. We feel that this is an arbitrary standard. We are aware of no abuses among our banking membership in this respect. We feel there is sufficient regulatory power to handle any actual problem cases, without resorting to an across-the-board prohibition. If not, the bill should provide adequate regulatory power.

These sections further require these institutions to publicly disclose the nature and amount of credit extended to directors, officers and employees, or members of their immediate families It requires disclosure to the lender of the identity of persons receiving benefit from any loan where the loan is made to an agent, trustee or nominee.

Again, we feel there is presently sufficient regulation to control any abuses in the field of insider loans. If not, the bill should provide the necessary regulatory power to handle abuses, rather than to fix an arbitrary standard and public disclosure of all such transactions. Our impression is that abuses in this area are rare.

BROKERED DEPOSITS

Sections 19 through 21 prohibit paying a broker or anyone else for obtaining a deposit, and prohibit anyone from receiving anything of value for obtaining funds of others for deposit or investment in banks or savings and loan associations.

We support these sections. We feel that it is an improper device

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for obtaining deposits and has no place in banking. This is especially true where the deposit is contingent upon the making of certain loans.

The principle should apply equally to all deposit-type institutions. We note, for example, that savings banks, industrial banks, and credit unions are not covered.

GIVEAWAYS

Sections 22, 23, and 24 prohibit financial institutions which accept deposits from offering anything of value as an inducement to obtain deposits.

We do not oppose these sections, but feel that the present regulations limiting giveaways are adequate and are working, and that no statutory law on giveaways is needed at the present time.

100 PERCENT INSURANCE FOR PUBLIC UNITS

Sections 25 and 26 provide 100 percent insurance coverage of deposits of Federal, State and local governments, and permit the agencies to limit the amount of such funds that can be accepted by insured institutions.

In principle, this appears to be a desirable objective. However, there are reasons for opposing these sections in their present form.

We note that the FDIC would place conditions upon such full coverage, namely:

(a) Limiting the public unit deposits to those located within the State of the institution;

(b) Requring uniform restrictions as to the aggregate amount of public funds that could be deposited be limited uniformly among the financial institutions in relation to criteria such as liquidity, total deposits, or capital that both insuring agencies would prescribe; and

(c) requiring that the maximum interest or dividends payable on comparable deposits be the same for all banks and savings and loan associations.

We have serious doubts as to whether these three conditions can be effectively established. For example, condition (b) assumes that the two insuring corporations would be able to agree on uniform deposit restrictions. Without amendment of several other statutes, these three conditions could not be established and enforced.

In many States savings and loan associations are not permitted to accept public unit deposits. These laws probably recognize that there is a distinct difference between demand deposits in a commercial bank and shares in a savings and loan association which can be restricted as to withdrawal, to the possible detriment of public units.

The effect of this bill is to create conditions whereby many savings and loan associations throughout the country for the first time will be permitted to accept public deposits. This considerable benefit to them does not take into account the nature of share deposits and the various State laws which regulate the acceptance of such deposits by these associations. It is difficult for us to conceive of how Federal legislation can ignore the effect of changing State laws.

Over half the States require the pledging of securities by banks against public unit deposits. Adding 100 percent insurance would

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amount to double collateral, and would be unnecessary in those States. The bill assumes the repeal of these State pledging statutes. We cannot see how this assumption is justified. It is a matter which can be determined only by those State legislatures. Some of them may not wish to depend totally on deposit insurance.

Due to the potential flaws we have pointed out, which could well make the idea unworkable, we oppose these sections in their present form.

I thank the members of the committee for their kind attention, and I would like to ask permission that my prepared statement on H.R. 5700 and the statement of Mr. Rod L. Parsch, the chairman of our legislative committee, be placed in the record to present our views on H.R. 3287, which would prohibit all bank stock loans.

The CHAIRMAN. You may extend your remarks and add anything you wish.

(The prepared statement of Mr. Carlson and statement referred to, of Rod L. Parsch on H.R. 3287, follows:)

STATEMENT BY DONALD M. CARLSON, PRESIDENT, INDEPENDENT BANKERS ASSOCIATION OF AMERICA, TO HOUSE BANKING AND CURRENCY COMMITTEE ON H.R. 5700

Mr. Chairman and members of the Committee: My name is Donald M. Carlson of Elmhurst, Illinois, where I am President of the Elmhurst National Bank. I appear here today as President of the Independent Bankers Association of America, an organization representing over 6,500 banks, about one-third of which are national banks.

We appreciate the opportunity to give you our views on H.R. 5700.

This proposed legislation is directed to actual or potential abuses in several types of financial institutions, not merely commercial banks. For this reason, we feel strongly that the bill should not be titled the "Bank Reform Act of 1971."

We appreciate and understand the need to control unsound practices in all financial institutions, including conflicts of interest, self-dealing, and anticompetitive practices. However, we note that the data upon which H.R. 5700 is based largely concerns less than 50 banks in 10 large cities, and that there is no like data as to the more than 13,000 other banks and several thousand other financial institutions throughout the country. At present there is no evidence that similar undesirable practices exist in any significant degree in banks and other financial institutions.

In the absence of adequate information, we recommend that this Committee make a general survey of the suspected practices in all financial institutions—commercial banks, savings banks, savings and loan associations, insurance companies, brokerage firms, credit unions and financial holding companies in all of the states. This will require time and effort, but is the best way to develop wise and sound legislation. At this point, we believe that undesirable practices on the part of any or all of the financial institutions mentioned will not be found to exist generally throughout the country as was found in the 10 large cities surveyed.

Until a national survey of all of these institutions is made and evaluated, we think it unwise to provide for such sweeping prohibitions and severe penalties as are contained in this bill. Further, we think it is unfair to place all of these institutions, which with rare exceptions are honorably operated, under severe restraints because of the wrongdoings of a few.

Some of the provisions of the bill, aimed at a few offending institutions, actually are unnecessary and are harmful to smaller institutions. The failure to make this distinction, in our view, is a major oversight in the bill. It can be cured, and better ways found, if more essential data is gathered. After that, a bill could be drawn to control the varying practices to the extent reasonably required.

For the reason that we are not better informed as to the extent or nature of the supposed undesirable practices by all institutions, we feel unable at this time to offer more than the general observations of our Federal Legislative Committee.

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INTERLOCKING RELATIONSHIPS

As to Sections 2 through 9 of the bill dealing with interlocking relationships between financial institutions, and between these institutions and others, we agree that the type of practices described in these sections are undesirable and must be controlled. However, in each section the bill provides a flat prohibition and, in some cases, severe penalties. In some sections arbitrary standards are used.

The prohibitions apply to all deposit-type institutions, and in some cases to the other institutions mentioned above. No distinction is made between large institutions operating in major cities and smaller ones operating in medium and small-sized communities. What justification is there for a ban that would decimate boards of directors of financial institutions throughout the nation?

Until this Committee has more information, we feel that instead of outright prohibitions, arbitrary standards and severe penalties, the wiser course would be to provide adequate rule-making power to the regulatory agencies, and await the action of the Judiciary Committee on the bill before it to expand the scope of Section 8 of the Clayton Act dealing with this same subject matter.

STOCKHOLDINGS OF MUTUAL SAVINGS BANKS

We support the principle that it is not proper for a mutual savings bank to own stock, and perhaps controlling interest in, another type of financial institution. However, we fail to understand, in the draft of Section 10, how a state-chartered mutual savings bank can be prevented by Federal law from owning stock in a state-chartered insurance company. Also, Section 10 fails to indicate how Federal agencies would enforce this section, and in what manner.

CONFLICT OF INTEREST AND BRIBERY

Section 11 calls for criminal penalties covering eight types of financial institutions to give, or its officers, directors or employees to accept, any substantial benefit intended to influence transactions between these financial institutions and others. We certainly agree that the conduct described in the bill should be prohibited and violators punished. However, we are not aware of any such conduct, and we are unable to assist the Committee with any specific suggestions.

TRUST DEPARTMENT STOCKHOLDINGS

Section 12 and 13 contain three subjects:

(1) Bank trust departments are prohibited from holding more than a total of 10% of any class of stock of any corporation whose stock is required to be registered with SEC. We agree that as little as 10% may constitute working control of a corporation, and that if a bank, for its own advantage, through its trust department, deliberately gains and exercises working control of a commercial corporation, this would be improper. This practice is not a legitimate part of the business of banking.

On the other hand, there are many situations where a trust department holds clear control of a corporation as part of a customer's estate plan. It is often the intent and purpose of such a customer to use a trust in order to hold together in a bloc for the benefit of his family the control of his corporate business. This is often the only practical way whereby one can prevent family control of a business from becoming fragmented through a series of probates.

The bill makes no distinction between a predatory intent on the one hand and legitimate estate planning on the other.

We could offer other examples, but this illustrates that such a flat prohibition is neither wise nor workable. We would like to suggest that this problem be left to the regulatory agencies. If they require more rule-making power to handle the problem, the bill should be modified accordingly.

(2) Trust departments are prohibited from holding their own bank stock or stock of a parent holding company. We understand the purpose of this prohibition is to prevent improper perpetuation of management. Again, however, the bill fails to recognize the legitimate purpose of holding family control of the bank together through a trust, as part of the family's estate plan.

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Rather than to provide an outright prohibition, we feel the bill should be modified to give the regulatory agencies the necessary power to deal with improper situations.

(3) The bill provides for public disclosure annually of all holdings of stock in the trust department, and how the voting rights were exercised in the previous year.

We feel this is unduly burdensome. It would appear to us to be sufficient that such disclosures be limited to the regulatory agencies. Bank examiners have the power and routinely make inquiries into these matters, and require the bank's board of directors to review the report. If necessary, the regulatory authority in problem cases can arrange an audience with the directors and, if deemed advisable, with stockholders of the bank in a special meeting.

If further regulatory power is required, the bill could so provide. We can see no useful purpose in requiring every bank trust department to make public disclosure of how voting rights are exercised as to all of the securities held, without regard as to the good or bad purpose of the creator of the trust or of the bank. In smaller communities, this would be considered a breach of confidence and could destroy a bank's trust department.

EQUITY PARTICIPATIONS

Section 14 prohibits financial institutions from obtaining part of the equity in a business enterprise in return for extending credit.

We support Secton 14. We feel that equity kickers are not a proper or legitimate conditions for obtaining a bank loan.

INSIDER LOANS

Sections 15 through 18 flatly prohibit deposit-type institutions from extending credit to a company where 5% or more of its stock in the aggregate is owned by principals or employees of the institution. We feel that this is an arbitrary standard. We are aware of no abuses among our banking membership in this respect. We feel there is sufficient regulatory power to handle any actual problem cases, without resorting to an across-the-board prohibition. If not, the bill should provide adequate regulatory power.

These sections further require these institutions to publicly disclose the nature and amount of credit extended to directors, officers and employees, or members of their immediate families. It requires disclosure to the lender of the identity of persons receiving benefit from any loan where the loan is made to an agent, trustee or nominee.

Again, we feel there is presently sufficient regulation to control any abuses in the field of insider loans. If not, the bill should provide the necessary regulatory power to handle abuses, rather than to fix an arbitrary standard and public disclosure of all such transactions. Our impression is that abuses in this area are rare.

BROKERED DEPOSITS

Sections 19 through 21 prohibit paying a broker or anyone else for obtaining a deposit, and prohibiting anyone from receiving anything of value for obtaining funds of others for deposit or investment in banks or savings and loan associations.

We support these sections. We feel that it is an improper device for obtaining deposits and has no place in banking. This is especially true where the deposit is contingent upon the making of certain loans.

The principle should apply equally to all deposit-type institutions. We note, for example, that savings banks, industrial banks and credit unions are not covered.

GIVEAWAYS

Sections 22, 23 and 24 prohibit financial institutions which accept deposits from offering anything of value as an inducement to obtain deposits.

We do not oppose these sections, but feel that the present regulations limiting giveaways are adequate and are working, and that no statutory law on giveaways is needed at the present time.

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In many states savings and loan associations are not permitted to accept public unit deposits. These laws probably recognize that there is a distinct difference between demand deposits in a commercial bank and shares in a savings and loan association which can be restircted as to withdrawal, to the possible detriment of public units. The effect of this bill is to create conditions whereby many savings and loan associations throughout the country for the first time will be permitted to accept public deposits. This considerable benefit to them does not take into account the nature of share deposits and the various state laws which regulate the acceptance of such deposits by these associations. It is difficult for us to conceive of how Federal legislation can ignore the effect of changing state laws.

Over half the states require the pledging of securities by banks against public unit deposits. Adding 100% insurance would amount to double collateral, and would be unnecessary in those states. The bill assumes the repeal of these state pledging statutes. We cannot see how this assumption is justified. It is a matter which can be determined only by those state legislatures. Some of them may not wish to depend totally on deposit insurance.

Due to the potential flaws we have pointed out, which could well make the idea unworkable, we oppose these sections in their present form.

I thank the members of the Committee for their kind attention, and I would like to ask the Chairman of our Legislative Committee to present our views on H.R. 3287, which would prohibit all bank stock loans. May I introduce Mr. Rod L. Parsch, who is immediate past president of our Association, and president of the Lapeer County Bank and Trust Company, Lapeer, Michigan.

STATEMENT BY ROD L. PARSCH, CHAIRMAN, FEDERAL LEGISLATIVE COMMITTEE, INDEPENDENT BANKERS ASSOCIATION OF AMERICA ON H.R. 3287, A BILL TO PROHIBIT BANK STOCK LOANS

OPENING SUMMARY

The proposal to outlaw bank stock loans, when the money borrowed is to be used to finance purchase of a bank is harsh and offers a serious hazard to the future of independent banking.

Almost without exception, a business transaction involving the transfer of assets requires financing. A primary function of banks is the lending of money. Why should they be barred from making a loan, secured by bank stock, to help an individual or corporation from purchasing a bank?

We fear that enactment of an outright prohibition against bank stock loans eventually would mean the demise of independent banking. A banker retiring because of health or age rarely is able to find a buyer with enough cash for the full price of the bank. A younger officer of the bank, or a group of such employees, would have the management skills to continue successful operation, but likely would need financing to complete the purchase.

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In this connection, tax considerations often dictate the use of a one-bank holding company when an individual or group purchases a bank. When a one-bank company is used to buy a bank, there are more after-tax dollars left with which to repay a bank stock loan. In most cases, such a loan constitutes a major part of the price of the purchased bank.

Presumably, introduction of this bill was prompted by reports of abuses in this particular area of financing. Any such abuses can be corrected by statutory authority setting guidelines for bank supervisory agencies to follow when considering applications for ownership transfer of banks.

Our proposals for standards to guide the appropriate supervisory authority include the requirement that a loan secured by the stock of a bank being purchased shall not exceed 75% of the collateral pledged to secure the loan.

FULL STATEMENT ON H.R. 3287

We understand and appreciate the author's reasons for introducing H.R. 3287. Undoubtedly, there have been abuses in this area, and these abuses must be controlled.

We have reviewed the letter from the Department of Justice concerning possible criminal offenses in connection with these loans. However, we understand that this letter is based upon the embezzlement statute, particularly that portion having to do with the misapplication of bank funds; that is, the agreement to make substantial deposits in the bank making the bank stock loan on terms favorable to the individual purchaser of a bank. We have discovered no court decision to support this letter from the Justice Department and feel that there is some doubt as to whether the embezzlement statute would apply in these situations.

In short, we agree that some control is needed, but that this need does not require the outright prohibition of all bank stock loans.

We are here today to plead the case for independent banking in regard to this subject. We are speaking of the clean and deserving case where a bank stock loan is required in order to transfer a smaller bank from one independent owner to another.

Our Association represents over 6,500 banks, mostly locally-owned banks in smaller communities. We know from the 40 years' experience in our Association that locally-owned banks serve their communities well because the local owner has a stake in the economic future and success of the community. He is responsive to their needs. He provides competition which only separately-owned banks can provide. They furnish alternate sources of bank credit and services at fair rates which only competition can provide.

LOANS NEEDED FOR OWNERSHIP TRANSFER

An outright prohibition against bank stock loans would eventually kill independent banking. A banker who retires because of health or age would rarely find a buyer with cash to pay the full price of the bank. If the buyer is a younger officer in the bank, or a group of employees of the bank, possessing the necessary management skill to operate the bank successfully, in almost every case such buyers would need a bank stock loan to purchase the bank.

In most cases the loan would cover the major portion of the purchase price of the bank. This has been a time-honored practice for generations in this country. Such loans should not be prohibited simply because there are a few abuses.

Should this bill pass in its present form, it would mean that the smaller banks of which we speak would be forced to liquidate or to sell out to a branching system by merger or to sell out to a multibank holding company. We feel sure that the author and this committee would not want to see this result. This would be like razing a house because it has a small crack in the plaster.

Our position is that this bill must be modified to prevent abuses while at the same time preserving independent banking in this country.

TAX CONSIDERATIONS A FACTOR

This problem is complicated by the fact that tax considerations often dictate the use of a one-bank holding company to service a bank stock loan involved in the transfer of a bank from one independent owner to another. The one-bank holding company's only activity in many cases is the operation of an insurance

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agency. The agency is incorporated and holds the stock of the bank. The corporation makes the bank stock loan. Under regulations proposed by the Federal Reserve Board this insurance activity would be severely restricted, making it extremely difficult for the agency corporation to service the loan.

Further, we understand there is a rule of thumb in the Federal Reserve System that the bank stock loan must not exceed 30% or 40% of the purchase price of the bank. This rule has been applied in the past with regard to acquisition of banks by a multibank holding company and, we understand, will be applied to the one-bank holding companies of which we speak. The combination of these two rules by the Federal Reserve Board, even if the bill before you did not pass, would make it extremely difficult to preserve independent banking in this country.

This Association shares with the Congress and the supervisory agencies the desire to rid the banking industry of fast buck artists and other undesirable elements. Nor do we wish to encourage any situation in which a bank lending money on bank stock would exercise any kind of domination over the policies of the bank whose stock was pledged as collateral for a loan.

DISTINCTIONS MUST BE MADE

Attitudes in this Congress that we consider unfriendly to independent banking and similar attitudes in the Federal Reserve Board are most discouraging to our members. Unless something is done to distinguish between situations which cause abuses on the one hand and which are clean and deserving on the other, Congress and the agencies may well cause the demise of independent banking.

Before we make suggestions for modifying this bill we would like to explain the practical reasons for use of a one-bank holding company for the purpose of servicing a bank stock loan needed in the transfer of a smaller bank from one local owner to another.

Assume a situation where an owner of a smaller bank desires to sell his bank to a competent officer-employee of the bank. The bank has been operating a general-type insurance agency and this also is to be sold to the buyer. The buyer is able to raise 25% of the price of the bank and needs a bank stock loan to finance the balance. He can service the bank stock loan with more after-tax money by forming a one-bank holding company whose principal activity will be operation of the insurance agency and, of course, the company would hold the stock of the bank. This structure does two things. First, it avoids the personal holding company tax penalty. Second, it provides more after-tax dollars in the hands of the holding company with which to repay the bank stock loan. Let us explain these two benefits.

The personal holding company tax penalty is 70% on undistributed income. Debt service is not considered to be a distribution of income in this computation. To avoid this penalty, more than 40% of *gross* income must be derived from an active trade or business, in this example the insurance agency; and less than 60% must be in the form of passive income, in this example, dividends from the bank (*see* Section 542 of the Internal Revenue Code).

ADVANTAGE GAINED FROM OBHC

The one-bank company in this example will have more after-tax dollars than an individual because the tax rate on a small corporation is less and the dividends from the bank can be received by the holding company 100% tax-free if it holds 80% or more of the stock of the bank, and 85% tax-free if it holds less than 80% of the stock of the bank.

In contrast, without the holding company, an individual buyer of the bank would find it difficult, if not impossible, to repay the bank stock loan because the more salary taken from the bank, the higher will be the income tax bracket, resulting in fewer after-tax dollars with which to repay the loan. (Please refer to Exhibits I and II attached for illustrations of this contrast.)

Thus, it can readily be seen that only the one-bank holding company affords the opportunity to repay the bank stock loan in a reasonable time and, without it, an individual might not live long enough to ever repay the loan.

To preserve this method of transferring bank ownership from one independent owner to another, the insurance agency operation must be of the general-type in

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order to generate enough gross income to avoid the tax penalty mentioned. If the permitted scope of this activity is limited to selling insurance only in connection with extensions of credit by the bank, the gross income in commission earnings by the one-bank company would be drastically reduced, most probably to a point where the agency operation would not produce more than 40% of the total gross income of the holding company, including bank dividends.

Exhibit I attached to our statement shows that in a typical situation where the price of the bank requires a bank stock loan of $450,000, there is a $185,000 advantage in taking the one-bank holding company route. Exhibit II illustrates what happens in the case of a bank stock loan of $900,000; the saving being $464,000 over the 15 year period for repayment of the loan when a one-bank holding company is used.

Now to our suggestions for handling this problem without an outright prohibition against bank stock loans.

We believe that the distinction between deserving situations and those which result in abuses can best be determined by promulgating regulations, rather than to attempt the distinction by statute.

SUGGESTED GUIDELINES FOR STATUTE

However, the statute should lay down guidelines for the FDIC in making its regulations. Following are standards which we believe are reasonable and should be inserted in the bill:

1. The FDIC shall have authority to make exceptions to the prohibition by regulation promulgated under the Administrative Procedures Act, which regulations shall conform with the standards following.
2. A loan secured by the stock of a bank being purchased shall not exceed 75% of the collateral pledged to secure said loan.
3. The exception shall apply in the case where a one-bank holding company is utilized for the purpose of making the bank stock loan, and where the individual purchasers guarantee repayment. (Note that this is a distinguished feature because the note is an individual obligation enforceable against the individual and his estate and creates, in effect, a personal loan while recognizing that the holding company device is used only for tax purposes.)
4. No management fees may be charged the bank by the holding company owner, and dividends payable to the holding company by the bank must be reasonable as to amount.
5. Conformance with the foregoing standards must be demonstrated to the satisfaction of the FDIC. Application must be made fully disclosing the facts as to who will be the ultimate beneficial owners, their character, financial resources, and bank management experience. The application will require an order, after investigation or hearing, approving or denying the application.
6. None of the foregoing provisions shall apply in any state whose statutes are equally restrictive.

We believe that the foregoing standards and procedures would make it possible for the FDIC to eliminate abuses.

EXHIBIT I

USE OF HOLDING COMPANY FOR FINANCED BANK ACQUISITION COMPARATIVE REVIEW—AFTER TAX RESULTS ACQUISITION DEBT INCURRED OF $450,000

ASSUMPTIONS

Banker with salary of $20,000 purchases bank with borrowed funds of $450,000 at 6½ percent, level principal payments plus interest over 15 years.

Dividend paid by bank of $26,000 per year.

Insurance agency purchased with bank earns commission income of $25,000. Expenses of $4,000 are paid to the bank for use of employee time and bank space utilized for the agency operations producing net income of $21,000.

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Federal income taxes computed on basis of rates in effect for 1969 without consideration of temporary surcharge.

	Total 15-year debt service period			
		Banker uses a holding company		
	Banker alone	Banker	Corporation	Total
Taxable income:				
Salary	$300,000	$300,000		$300,000
Insurance agency, net	315,000		$315,000	315,000
Dividends from bank	390,000			
Interest expense	(234,000)		(234,000)	(234,000)
Total	771,000	300,000	81,000	381,000
Cash flow:				
Taxable income	771,000	300,000	81,000	381,000
Dividend deduction (a noncash charge to income)			390,000	390,000
Retirement of debt	(450,000)		(450,000)	(450,000)
Federal income taxes:				
Paid to IRS	(269,000)	(66,000)	(23,000)	(89,000)
Benefits received from bank for use of losses			5,000	5,000
Total	52,000	234,000	3,000	237,000
Cash balance summary:				
Banker and corporation				237,000
Banker alone				52,000
Difference				185,000

Exhibit II

USE OF HOLDING COMPANY FOR FINANCED BANK ACQUISITION COMPARATIVE REVIEW—AFTER TAX RESULTS ACQUISITION DEBT INCURRED OF $900,000

Assumptions

Banker with salary of $30,000 purchases bank with borrowed funds of $900,000 at 6½ percent, level principal payments plus interest over 15 years.

Dividend paid by bank of $52,000 per year.

Insurance agency purchased with bank earns commission income of $50,000. Expenses of $8,000 are paid to the bank for use of employee time and bank space utilized for the agency operations producing net income of $42,000.

Federal income taxes computed on basis of rates in effect for 1969 without consideration of temporary surcharge.

	Total 15 year debt service period			
		Banker uses a holding company		
	Banker alone	Banker	Corporation	Total
Taxable income:				
Salary	$450,000	$450,000		$450,000
Insurance agency, net	630,000		$630,000	630,000
Dividends from bank	780,000			
Interest expense	(468,000)		(468,000)	(468,000)
Total	1,392,000	450,000	162,000	612,000
Cash Flow:				
Taxable income	1,392,000	450,000	162,000	612,000
Dividend deduction (a noncash charge to income)			780,000	780,000
Retirement of debt	(900,000)		(900,000)	(900,000)
Federal income taxes:				
Paid to IRS	(617,000)	(118,000)	(45,000)	(163,000)
Benefits received from bank for use of losses			10,000	10,000
Total	(125,000	332,000	7,000	339,000
Cash Balance Summary:				
Banker and corporation				339,000
Banker alone				(125,000)
Difference				464,000

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The CHAIRMAN. All right, Mr. William S. Renchard.

STATEMENT OF WILLIAM S. RENCHARD, PRESIDENT, THE NEW YORK CLEARING HOUSE ASSOCIATION, AND CHAIRMAN OF THE BOARD, CHEMICAL BANK, NEW YORK, N.Y.; ACCOMPANIED BY RICHARD S. SIMMONS, COUNSEL

Mr. RENCHARD. I am William S. Renchard, president of the New York Clearing House Association and chairman of the board of Chemical Bank. I appreciate the opportunity to appear before your committee on behalf of that association to discuss H.R. 5700.

That bill contains provisions dealing with a great diversity of subjects having farreaching consequences—too many, in our opinion, for one bill. The Clearing House does support the principle behind some provisions of H.R. 5700. However it strongly opposes other provisions. Our views on each provision of the bill are set out in detail in our memorandum of comments submitted with this statement.

Mr. Chairman I would like that included as part of the record.

The CHAIRMAN. Would you like to have that memorandum included in the record?

Mr. RENCHARD. Yes.

The CHAIRMAN. Without objection it is so ordered.

Mr. RENCHARD. We support in principle the concept that the Federal regulatory agencies should have adequate authority to deal with any abuses which might arise from the misuse of funds received as a result of brokered deposits. We concur with Chairman Martin of the Federal Home Loan Bank Board in opposing a complete prohibition against brokered deposits.

If contrary to what seems to be the case the Federal agencies do not have adequate authority to deal with the misuse of giveaways to attract deposits we would support legislation designed to confer such authority.

Further we do not object to any amendment of section 8 of the Clayton Act along the lines recommended by Chairman Wille of the FDIC at page 6 of his prepared statement before this committee on April 20 1971; however we strongly recommend that the appropriate regulatory agency be empowered to permit interrelationships among deposit institutions which do not have a significant anticompetitive effect particularly where they are in different geographic areas and even if in regional competition in a particular case where it would be helpful to the small regional bank as for example a bank formed by minority groups.

Other provisions of H.R. 5700 in our judgment could have however a seriously adverse effect on the functioning of our financial system. The bill's provisions concerning directorships are one area of greatest concern.

In restricting outside relationships of the directors of commercial banks, the bill rests on a mistaken premise. The bill then would implement that mistaken premise so extremel yas to impair the responsiveness and ability of commercial banks to compete, both of which are essential to our economy.

That mistaken premise has to do with the role of the director of

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the modern large corporation, including the large commercial banks. The bill's position as to directors is apparently founded on the idea that directors, individually or as a board, are solicitors or guardians of privileged or sinister relationships among the corporations on whose boards they serve.

This is not true. Today, the antitrust laws, the legal standards applicable to the public accountability of directors, to disclosure, and to insider preferment and self-dealing, and the general ethical norms surrounding the exercise of fiduciary functions, all make—I repeat—all make any misuse of a directorship unacceptably hazardous, likely of detection, and subject to severe penalties.

These laws and standards are rightly directed at stopping improper conduct and actual abuses. They have been effective in doing so and continue to be effective. They have not, as I believe the bill would, caused major changes in the structure of corporations because of presumed but unsubstantiated infirmities in that structure.

Today, directors of large banks are not involved in day-to-day operations. They do not allocate credit any more than the directors of a soap concern sell soap. Corporations, typically, have credit relationships with several banks. They could not, and do not need to, use a common director to reinforce the credit relationship with one bank. Given the intensive competition among the larger commercial banks—competition in seeking funds, in making loans, and providing financial services—a credit worthy company does not need a friend on the board to attract the interest of that bank or its competitors.

If not credit worthy, no such insider could prevail in causing an uneconomic use of resources to continue in the face of competition and stockholder, depositor and regulatory pressures.

If the contemporary role of the directors of a bank in a large commercial center is not, therefore, to connive to suppress competition, nor to betray the interests of one corporation to those of another, not to make loans, nor even to run the daily business of the enterprise, what then is their role? Put simply, the principal and unique role of the directors is to oversee and control, in the broadest sense, the policies of the bank and the composition and conduct of top management. It is to make sure, on a continuing basis, that we, at the top management level, are competent. It is to arrange for changes and successions in top management. It is to champion the long-term interests of the bank as a continuing institution in the rare case in which they are in danger of being subordinated to more immediate objectives of top management. At Chemical Bank, we need and rely on our outside directors for advice and counsel in the areas of their varied expertise both as to their specialized knowledge of industry and also as to new managerial techniques and concerns.

They and we know that under law their jobs as directors are not mere sinecures but are charged with real responsibilities—higher than those of a director of a nonbank corporation. For example, they must make an examination, which New York law requires, into our credit, audit, and control policies.

This report must be filed with our banking department. In that connection, I point out that, pursuant to law, our bank's directors are specifically charged with the statutory obligation of giving particular attention in such examination to the loans or discounts made

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directly or indirectly to [our] officers or directors, or for the benefit of other corporations of which such officers or directors are also officers or directors, or in which they have a beneficial interest as stockholders, creditors, or otherwise.

The public interest mandates that top management of large metropolitan banks be under that kind of supervision. But only a board of directors which, as a whole, is familiar with large organizations, with the realities of top management and with finance, can know when top management should be prodded, overruled, or replaced.

If those decisions are to be made—if the directors are to be willing and able to take on top management—they must be independent of it and must be at least equal in strength, stature, and experience.

In short, the public interest requires that large banks have strong, predominantly outside boards of directors.

Yet the present bill would bar from our boards any director or officer of another financial institution, regardless of whether it competed with the bank. It would bar any director of a nonfinancial corporation whose pension fund was managed by the bank. It would bar any director of a customer with which the bank had a substantial and continuing credit relationship.

That excludes from consideration as a director what I assure you is the broadest class that could have been selected—all those who now do business with a bank or with whom a bank in the future would wish to do business.

The practical effect would be to increase the proportion of directors who are members of the bank's management or who are retired. This will not result in a board which would be able or inclined to exercise the most effective scrutiny and control over top management. Such a result is neither in the public interest nor in the interest of a healthy and responsible banking system.

Turning now to the proposed limit on trust investments, just as the provisions of the bill on directors are based on an unrealistic premise, so also are the bill's provisions on trusts based on a mistaken premise as to banks' trust holdings. The premise is that banks can and do through such holdings bend corporations to their will. On that premise is based section 13 of the bill, which would limit a bank's holdings in a fiduciary capacity to 10 percent of any one publicly held stock.

The premise is wrong. Banks do not use their fiduciary holdings to control, let alone even attempt to dominate, corporations. The SEC has just completed a 2½-year study of precisely that question: Do institutions, in fact, exercise improper control over the corporations whose stock they hold?

That study found that although banks and other institutions sometimes have potential voting power to influence such corporations, there was no evidence to indicate that they exercised this power. Banks and other institutions simply do not use their stockholdings to try to control management of other corporations. If they lose confidence in management, they sell their stock. In view of these facts, there is no public purpose justification for the 10-percent limit and the SEC found none.

Not only would that limit serve no public purpose, it would be disruptive and unfair when applied, in practice, to banks' various fiduciary activities as executor, trustee, administrator, or guardian.

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If aggregate holdings by a bank as fiduciary in several accounts exceeded the 10-percent limit, it would be required to select those fiduciary relationships whose holdings must be disposed of, even though it considered the security in question to be an excellent investment. Selecting which of such fiduciary relationships so to disadvantage would present an insoluble quandary to the bank trying to be fair to those whose affairs are entrusted to it.

The absolute prohibition against holdings by a bank in a fiduciary capacity of its own stock appears to be based on the fear of bank management self-perpetuation. The solution does not require a blunderbuss approach. Federal law forbids national banks from voting their own stock for the election of directors. The same restriction could be placed on all insured banks and made applicable to their holding companies as well.

With respect to the proposed prohibition against equity participations, we, at Chemical Bank—and I believe our experience is true of the other clearinghouse banks—have taken equity participations rarely, and when we do they involve basically two situations.

First, where, as a result of unforeseen developments, a borrower must defer the payment of a loan and is unable to pay interest in whole or in part, we agree to such deferral and waiver of interest in the expectancy that the borrower's operations will become profitable in the future. In exchange for such deferral and waiver, we believe that we are entitled to be recompensed out of future profitability if the same occurs.

The second situation is where we are asked to make a credit-worthy loan but the long-term amortization is such that, when considered in light of almost certain continuing inflation, the rate of return becomes unattractive in comparison with other alternatives. This is particularly true in the case of the real estate mortgage area.

We wish to retain this flexibility in the future in credit-worthy situations—a flexibility to price in accordance with competitive conditions.

As to 100 percent insurance of public deposits, we oppose this provision as do Chairman Burns and Chairman Martin.

With regard to the proposed reporting requirements of section 12, we believe strongly that legislation in this area should initially be drafted and administered by the SEC. This accords with the belief of the SEC as to the importance of regulation on an overall basis for all financial institutions, of which commercial banks are only one segment.

In conclusion, let me say that time prohibits me from discussing other provisions of H.R. 5700, about which we have equally strong objections, and I hope no quantitative inference is imputed from our inability to discuss these provisions. These are detailed in the memorandum of comments, and I respectfully commend them to your attention.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, sir.

(The memorandum of comments of the New York Clearing House Association on H.R. 5700 follows:)

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MEMORANDUM
of
COMMENTS
of the
New York Clearing House Association
on
H. R. 5700

The following Comments on H. R. 5700 are appended to the statement (the "Statement") of Mr. Renchard, who is appearing before the Banking and Currency Committee of the House of Representatives to present the views of the New York Clearing House Association (the "Association") on H. R. 5700. The Comments deal with sections of the bill which are not covered in the Statement and also present additional detail with respect to other sections which are discussed in the Statement.

I. Section 2

A. *Relationships Between Insured Banks and Other Financial Institutions*

Section 2 of the bill would add a Section 23 to the Federal Deposit Insurance Act to forbid interlocking relationships between directors, trustees, officers and employees of an insured bank and certain other financial institutions.

The basic position of the Association with respect to interrelationships between banks and other financial institutions is presented in the Statement of Mr. Renchard. Briefly, the Association recommends amending Section 8 of the Clayton Act along the lines recommended by Chairman Wille at page 6 of his April 20, 1970 Statement before the House Banking and Currency Committee. We believe that any prohibitions should be confined to interlocks between deposit-taking institutions and that the Federal Reserve Board and the FDIC should be authorized to establish regulations permitting interlocks between deposit-taking institutions where there is no significant anti-competitive effect or where the benefits to the community outweigh any anti-competitive effects.

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Definite benefits can accrue through interlocks between large regional banks and small banks located outside the area in which the large regional banks may branch. The broad experience of an officer or director of a large metropolitan bank can be of great assistance to the small out-of-town bank. Even within metropolitan centers, banks formed by minority groups may require the assistance of experienced personnel which can be obtained from the large banks. Access to such personnel should not be foreclosed, but the proposed bill would effectively bar access.

When one bank acquires a controlling interest in another bank or other financial institution in satisfaction of a debt previously contracted in good faith (which is permitted, for example, by Sections 3(a)(A)(ii) and 4(c)(2) of the Bank Holding Company Act), the acquiring bank should be permitted representation on the board of the acquired financial institution for the limited period of time during which the acquiring bank is permitted to hold the stock.

The proposed prohibition against relationships with broker-dealers is quite puzzling, since, under Section 32 of the Banking Act of 1933, a member bank cannot interlock with a securities underwriter but can interlock with a concern engaged purely in the brokerage business. No justification has been offered for obliterating the distinctions presently made by Section 32.

Some bank employees with non-executive functions supplement their incomes by taking jobs at other banks or financial institutions where there could be no anti-competitive effect. The Association's position is that the prohibition should not cover employees who do not exercise executive functions.

B. *Bank Holding Company Exemption*

As H.R. 5700 recognizes, an exemption is required in connection with bank holding company systems, but interrelationships should be permitted not only with "subsidiaries" of a bank holding company but also with banks in which a bank holding company has been allowed to invest to the extent of between 5% and 25% of the stock pursuant to permission granted by the Federal Reserve Board under Section 3 of the Bank Holding Company Act.

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C. *Connections with Real Estate or Title Companies*

Section 24, as proposed to be added to the Federal Deposit Insurance Act, would prohibit every insured bank, every officer and director of an insured bank and every member of their immediate families from controlling title companies, real estate appraisal companies and companies which handle real estate closings. The prohibition is absolute, whether or not there is any conflict in the particular case and whether or not there are any abuses. In the absence of abuses, this is entirely too far-reaching an infringement on the right of the individual to engage in legitimate business activities. Can Congress constitutionally forbid a person to own stock because he is related to the assistant cashier of a bank? Furthermore, the phrase "member of the immediate family" is entirely too vague.

It is to be noted that Section 24 would, in effect, amend the Federal Bank Holding Company Act, which was amended as recently as December 31, 1970. Section 24 would re-create a "negative laundry list", which Congress specifically refused to adopt when the Bank Holding Company Act Amendments of 1970 were enacted.

D. *Prohibition on Legal Services*

Under the proposed Section 25 of the Federal Deposit Insurance Act, it would be virtually impossible for any lawyer practicing independently to be a director of an insured bank. In fact, the language of the proposed section raises some doubt as to whether an insured bank could employ house counsel. The questions of lawyers' conflicts of interest are extensively dealt with in the Code of Professional Responsibility of the American Bar Association, which has superseded the former Canons of Ethics of the American Bar Association. Section 25 would set up a special set of restrictions on professional relationships between lawyers and banks, which would not apply to lawyers' professional relations with any other type of client. This is a matter which should be left to the Code of Professional Responsibility.

II. Sections 3, 4, 5 and 6

Relationships of Other Types of Financial Institutions

These four sections contain prohibitions, similar to those in Section 2, directed against other types of financial institutions. The Association opposes these prohibitions for the reasons outlined in the discussion of Section 2.

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In subsequent sections of the bill, there are provisions which apply to other types of financial institutions similar to provisions which we oppose when applied to insured banks. We believe the same criticisms apply to the sections relating to financial institutions which are not banks, as apply to the sections relating to banks.

III. Sections 7, 8 and 9

A. *Relationships with Non-Financial Entities Generally*

These three Sections, as well as Sections 2, 3 and 4, appear to be based on a key misconception: that interlocking directors are detrimental to the banking system in particular and the economic structure of the nation in general. A single bank director, who was also a director of an outside corporation, could not, even if he so desired, control or dominate a board of 15 men—all legally liable to act in the best interests of the bank's shareholders. It is to be noted that the courts have imposed on bank directors duties of fidelity and responsibility which exceed those of directors of other corporate enterprises. *McCormick* v. *King,* 241 F.737 (9th Cir. 1917), *aff'd sub. nom. Browerman* v. *Hamner,* 250 U.S. 504 (1919); *Broderick* v. *Marcus,* 152 Misc. 413, 272 N.Y.S. 455 (1934).

Sections 7 through 9 ignore both the positive benefits of outside directors and the adverse effects of a prohibition against them. If banks cannot use employees or officials of non-financial corporations as directors, as Sections 7-9 would seemingly require, banks would virtually be restricted to inside directors and older men who have retired. Such a situation would have serious adverse effects.

Almost all corporations which are neither closely held nor very small in size use outside directors, not with the intention of restricting competition, but rather to add breadth and expertise to their boards. As Melvin T. Copeland, at the time a George Baker professor at the Harvard Business School, wrote in the *Harvard Business Review:*

> Competent outside directors serve to bring a wide range of experience and independent judgment to bear on the problems of the companies on whose boards they sit. They also have an objective view. And there are many instances in which the interests of the stockholders and employees of a company are better safeguarded by having outside men on the board.

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> The elimination of outside directors from the boards of many of our corporations would weaken substantially the private management of American industry. *The Federal Trade Commission Indicts Itself,* 29 Harv. Bus. Rev. 25, 30.

Chairman Burns also made this point in his letter of December 16, 1970 to Chairman Patman:

> [E]conomic benefits flow from a high standard of performance by corporate boards of directors. This entails a free interchange of advice, ideas, and experiences among directors of varied backgrounds. Bankers often have experience and expertise that qualify them to render valuable service in this role. Interlocking directorates, in other words, are not inherently wrong. They may be good for the corporations involved and the public they serve.*

The limitation on outside directors does more than impose federal regulation on state banks; it runs counter to the state banking policy as specifically expressed in existing law. New York, which is generally recognized as one of the states providing the most enlightened and comprehensive banking legislation, requires at least two-thirds of bank directors to be "outside" directors. New York Banking Law § 7001(4). The New York "outside" director requirement represents a legislative judgment that banks will be strengthened if the majority of the directors bring experience in other fields to bear on the problems of the bank of which they are directors.

B. *Section 7—Relationships with Welfare or Pension Plans*

Section 7 of the bill would prohibit a director, trustee, officer or employee of a financial institution from serving at the same time on the board of directors of any corporation with respect to which such financial institution manages an employee welfare or pension benefit plan. It is difficult to see even a glimmer of a "potential conflict of interest" in the situation which Section 7 would prohibit, especially since nothing is said about corporations which manage their own funds. Moreover, Section 7 would diminish competition for the management of pension

* See also, Travers, *Interlocks in Corporate Management and the Antitrust Laws,* 46 Texas L. Rev. 819,835 and 863; Towl, *Outside Directors Under Attack,* 43 Harv. Bus. Rev. 135,147; and Lombard, *The Corporate Management Interlock Bill,* 21 The Business Lawyer 879,890.

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funds, since a bank could not solicit a corporation with which it had an interrelationship except at the cost of driving a director off its own board if it were successful.

There is existing legislation which prevents abuses in this area. Section 503 of the Internal Revenue Code specifically forbids self-dealing with respect to employee welfare and pension benefit plans. The penalties are severe. An organization which engages in self-dealing or any of the other transactions prohibited by subsection 503(b) loses its tax exemption. If it is believed that the list of prohibited transactions set forth in subsection 503(b) is not sufficiently broad, then this subsection should be amended. Section 7 it too sweeping an approach to the problem, particularly in view of the considerable potential for harm which this Section entails.

Moreover, in its sweeping prohibitions, Section 7 entirely ignores the realties of the market place for management of employee welfare or pension benefit plans. Not only is there severe competition among banks themselves, but there has recently been a sharp increase in competition from investment bankers and others who claim expertise in the field. Profit and pension cost pressures have made every company acutely aware of the need for performance by its pension funds, and this awareness has made it virtually impossible to award the management of such funds on any basis other than performance or expected performance. In addition, it is a demonstrable fact that more and more pension funds are being split up among several managers so that relative performance can be judged by the corporation involved. Such a trend certainly does not indicate that any one banker can "lock-up" such business by being on the board of directors of the corporation involved, or by having an officer or director of the corporation on the bank's board.

C. *Section 8 — Relationships with 5% Owned Companies*

Section 8 of the bill would forbid any director, trustee, officer or employee of a financial institution from serving at the same time as an officer or director of a company in which the financial institution has, with power to vote, more than a 5% interest in any class of stock, making an exception for companies within the same bank holding company system. The havoc which would be wrought by the adoption of

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Section 8 is clear, but the supposed public benefit is almost impossible to discern. Consider, for example, a few of the absurdities which would be produced by Section 8:

(1) The chairman of the board of an insurance company could not serve as a director of any of the company's subsidiaries, nor could the chairman of the board of a bank which was not in a bank holding company system serve as a director of the bank's safe deposit company or Edge Act corporation.

(2) An owner of 75% of a small manufacturing company decides to name a bank as executor under his will. While he does not expect the bank to manage the corporation on a day-to-day basis, he does expect it to exercise general oversight over the estate's investments, a practice which is of course facilitated enormously if the executor bank can have one of its officers serve as a member of the board of directors of the corporation. Such service would be prohibited by Section 8.

(3) Mr. S, a retired businessman in a medium-sized city, serves as a director of one of the local banks and as a director of the local professional baseball team. Another resident of the same city owns 10% of the baseball team and wishes to borrow from the bank of which Mr. S is a director, using his 10% stock interest in the team as collateral. The pledge agreement used by any prudent bank provides that, at least after a default, power to vote the pledged securities passes to the bank. If Section 8 were to become law, Mr. S would have to resign either from the bank's board or from the board of the baseball team the instant a default occurred, although it is hard to see any public benefit which would result.

(4) A bank with a large trust department concludes that the stock of Z Corporation would be an excellent investment for a sizable number of its fiduciary accounts. Unfortunately, however, Mr. T, a university president, is a director of both the bank and Z Corporation. The bank cannot acquire more than 5% of the stock of Z Corporation until Mr. T resigns from one board or the other, and the net result of this sort of situation could be an unsatisfactorily high turnover ratio so far as bank boards are concerned.

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All of the foregoing, rather bizarre results, which are only a few of the many examples which could be given, might be put up with if there were some overriding public advantage to be gained. However, no such advantage is apparent. No one has offered a plausible explanation as to the "evils" or "abuses" which arise from interrelationship between a bank and a company whose trust department owns more than 5% of that company's stock.

D. *Section 9 — Interrelationships with Corporations with Which There Are Business Relationships*

Section 9 would forbid any director, trustee, officer or employee of any insured bank, institution insured under the National Housing Act or mutual savings bank from serving on the board of any corporation with which such bank or other institution has a "substantial and continuing relationship with respect to the making of loans, discounts, or extensions of credit". Section 9, even more than Sections 7 and 8, would dangerously weaken bank boards and thus inhibit these boards from carrying out their proper functions.

In view of the desirability of a strong outside board of directors, banks naturally and quite properly turn to officers of corporations which are present or potential customers in order to obtain such qualified persons. A complete bar on all officers of a corporation with which the bank has a substantial relationship might indeed produce anti-competitive side effects which are more drastic than the dangers against which the provisions seek to protect. If, for example, a bank selects as a director an officer of a corporation, this Section would presumably require the bank to choose between not soliciting a credit relationship with that corporation, or, if it successfully does solicit the relationship, terminating that director's position with the bank. Thus in order to preserve the integrity and continuity of its board, a bank may have to forego competing for the business of a significant number of corporations.

IV. Section 10

Limitation on Stock Ownership by Mutual Savings Banks

Section 10 of the bill would forbid mutual savings banks from owning any stock in certain named types of institutions, including in-

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sured banks and bank holding companies. It is impossible to see any public policy goal which would be served by prohibiting a New England savings bank from owning a few thousand shares of a major commercial bank, at least one which served a territory different from that served by the savings bank. While questions can perhaps be raised about the desirability of *control* of commercial banks by savings banks, proposed Section 10 proscribes an entire class of *investments*, a class which has on balance almost certainly proved profitable for the depositors of mutual savings banks.

V. Section 11

Influencing Banking Relationships

Section 11 creates a Federal crime of "commercial bribery" in connection with certain types of financial institutions. There has been no evidence presented by anyone that state legislation in this area is deficient, and, as Chief Justice Burger aptly cautioned in his 1970 address on the state of the judiciary, the federal court system is for a limited purpose, and lawyers, the Congress and the public must examine carefully each demand they make on that system.

VI. Section 12

Reporting Requirements

Enactment of Section 12 of H.R. 5700 would require banks to report on securities held in a fiduciary capacity and voting activities with respect thereto.

We believe there may be some merit to the recommendation made in the SEC's recent Institutional Investor Study for periodic reporting of security holdings by *all* institutions. Even here, the subject must be treated with some sense of discrimination. Banks lack investment or voting authority in many of their accounts, and hence reporting should be limited to significant aggregate holdings in only those accounts where this authority exists.

Any legislation in this area should be drafted by the SEC, which has made an extremely comprehensive study of the problems involved with institutional reporting. Further, any legislation should be part of one of the Securities Acts so that the expertise of the SEC together with its rule-making and exception-granting experience in this field will be

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fully applicable. The FDIC does not have the special qualifications which make the SEC such an obvious choice to administer a disclosure statute covering security investments.

We also strongly urge that legislation in this area should not be limited to banks alone. On page 3 of its letter of transmittal for the Institutional Investors Study, the SEC stressed the importance of regulation on an over-all basis for all institutional investors.

VII. Section 13

Restriction on Fiduciary Ownership of Stock by Insured Banks

Section 13 of the bill would add a Section 26 to the Federal Deposit Insurance Act to forbid any insured bank to hold in a fiduciary capacity: (1) more than 10% of any class of stock of any corporation for which a registration statement has been filed under the Securities Act of 1933*; and (2) any bank stock which it has itself issued, or stock which has been issued by its parent company.

This Section would work a distinct disservice to the public interest. Banks are uniquely qualified to handle large estates and trusts with sizable holdings in a stock of a particular issuer and should not by a blunderbuss approach be prohibited from serving this public need. We note SEC Commissioner Smith's suggestion at page 19 of his Statement before the House Banking and Currency Committee that "in considering a possible flat percentage limitation on institutional holdings, there are several reasons which weigh rather heavily against it."

The 10% limit would be disruptive and unfair when applied, in practice, to the banks' fiduciary activities. If aggregate holdings by the bank as a fiduciary in several accounts exceed the 10% limit, the bank would be required to select those accounts whose holdings should be disposed of. This problem cannot be equitably solved by simply reducing the holding in each account pro rata. For example, the income tax basis of the holdings will vary in different accounts, thus suggesting different treatment among accounts. Furthermore, some fiduciary instruments specifically require retention of a particular stock and in other cases the bank must (assuming the limitation were to apply to those situations where it acts as a co-fiduciary) obtain the consent of

* We assume the Securities Exchange Act of 1934 was intended.

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other co-fiduciaries, which may not be obtainable. Hence the potential conflicts of interest between different fiduciary accounts of the bank, with the possibility of surcharge actions, are very real.

Serious problems are raised with respect to the prohibition against a bank holding in a fiduciary capacity shares of its own or its parent's stock. Such a prohibition would be particularly onerous for smaller banks and multi-bank holding company systems which include smaller banks. The shares of such banks are frequently locally owned and local stockholders of these banks naturally utilize and will want to continue to utilize their bank as corporate fiduciary. The very factors which convince a local resident to purchase shares of a local bank would also lead him, because of his familiarity with and trust in that institution, to name it as trustee or executor of his estate. Similarly, when such banks are acquired by multi-bank holding companies, bank shares are typically converted into shares of the holding company, which the local bank continues to hold as fiduciary.

The undesirable consequences of the prohibitions contained in Section 13 are readily apparent. Presently held shares would have to be liquidated, which in the case of a small independent bank would be particularly unfair because the markets for such shares are traditionally very thin. In the future, it would also force stockholders of local banks to choose between selling their bank shares before they die or facing the possibility of a disadvantageous liquidation by the estate if the local bank is chosen as executor or trustee. The only other option available to such persons is to name as fiduciary a bank with which they may not be familiar and would otherwise not prefer to utilize.

The prohibitions in Section 13 would effectively deny to officers and directors of a bank (who can be expected to be shareholders) the ability to name their bank as executor or trustee.

Section 13 also would prohibit banks' own employee benefit plans, wherein the bank acts as a fiduciary and one of the options is to invest in the shares of the bank itself or its holding company. Similar plans are widespread in commerce and industry and are valued because of the opportunity afforded employees to have an equity stake in the company for which they work. This Section also fails to provide for the situation in which the purchase or retention of bank stock or bank holding company stock is directed by someone other than the fiduciary bank.

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The Association agrees completely with the proposition that bank management should not be able to perpetuate itself by voting stock in the bank which is held by its trust department. But the solution for this problem is already present in 12 U.S.C.A. § 61, which forbids national banks from voting their own stock for the election of directors. Similar restrictions can be placed on all insured banks and made applicable to their holding companies as well as to the banks themselves.

VIII. Section 14

Restriction on Equity Participation by Lenders

Section 14 of the bill would forbid lenders, as therein defined, from taking any equity participation in consideration of the making of any loan.

This provision goes entirely too far in regulating a field where any abuses can adequately be taken care of by the state or federal regulatory authorities. It constitutes interference with a legitimate pricing mechanism, under which a borrower is enabled to reduce initial cash outlay in consideration of future participation in income.

Section 14 does not take into account the practical situation that arises when a borrower has difficulty in meeting his payments on a loan, and it becomes necessary to relieve him in whole or in part of his obligation to pay interest at a fixed rate and at fixed installments. Frequently this relief can be effected and the loan salvaged only by giving the lender a contingent interest in the borrower's earnings.

Further, fixed rate mortgages have not demonstrated sufficiently attractive yields in comparison with other loans and investments. Increasing inflation with the accompanying constant erosion of dollar purchasing power has resulted in a declining rate of increase in mortgage portfolios. The trend to equity participation in real estate financing is a logical development to counteract the erosion in mortgage portfolios that results from the repayment of mortgage loans with progressively cheaper dollars. In the absence of equity involvement, higher interest rates would have to be charged, thus imposing a greater burden on the developer or builder and substantially increasing the cost of housing and other real estate development.

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IX. Section 15

A. *Loans to Bank Personnel*

Section 15 restricts and regulates loans by banks to their directors, trustees, officers and employees and members of their "immediate families", by adding new Sections 27 and 28 to the Federal Deposit Insurance Act. It is unnecessary for national banks and state banks which are members of the Federal Reserve System, because it merely duplicates existing statutes and regulations. With respect to state non-member banks, it duplicates state regulations and represents an unwarranted breach of the dual regulatory system. Here, again, H.R. 5700 would impose regulations on top of regulations in what is already a highly regulated area of business. In addition to the prolific regulations in this field by statute, matters of this character are normally inquired into on examination by the various supervisory authorities.

Under 12 U.S.C. § 375a, loans by member banks of the Federal Reserve System to executive officers are sharply restricted, and reports of all loans to executive officers must be made in connection with reports required for the FDIC under 12 U.S.C. § 1817(a)(3). See also Regulation O. Section 27(a) broadens the reporting requirements in that it applies to *all* employees. However, does the FDIC really want reports of all loans to bank employees, whatever the amount? A car loan for a teller would hardly endanger the bank's deposits.

The mere act of reporting, standing alone, would in no way protect the bank's deposits or call to the FDIC's attention any state of facts that would not normally be turned up by a bank examination. Consequently, there is no valid reason for the imposition of this federal requirement on state banks.

B. *Disclosure of Loans to Bank Personnel*

Section 27(b), which would require the FDIC to make public information furnished it on loans by insured banks to directors, trustees, officers and employees and members of their immediate families, would amount to an entirely unjustified invasion of privacy that would serve no useful purpose.

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C. *Extensions of Credit to Fiduciaries*

Section 27(c) would prohibit any insured bank from extending credit to a person acting in a fiduciary capacity without requiring that the identity of the person receiving the beneficial interest in the loan be revealed to the bank.

Aside from the fact that it would be impossible for a bank to enforce such a requirement, beyond asking the borrower the direct question, this provision is highly ambiguous. Who would be the person receiving the "beneficial interest" in a loan? If a loan is made to an executor to enable him to pay estate taxes, who receives the beneficial interest of that loan? All the legatees who receive fixed dollar legacies? The specific legatee of the diamond necklace? The unborn contingent remainderman of the residuary trust?

The Association recognizes that there have occasionally been supervisory problems in connection with loans to "dummies" or "strawmen", but it believes that these problems should be solved by legislation empowering the bank regulatory agencies to make rules and regulations where necessary and appropriate.

D. *Loans to Corporations Owned in Part by Bank Personnel or their Families*

The proposed Section 28 would prohibit insured banks from making loans to a company with respect to which 5% of the total outstanding shares are owned in the aggregate by bank directors, trustees, officers and employees and the members of their immediate families. There is no evidence of abuses that the proposed Section 28 would cure which are not covered by existing legislation and consequently no compelling reason for passage of Section 28.

Section 28 is so broad and vague that it would be impossible for the FDIC to administer and equally impossible for the subject banks to comply with its provisions. How can a bank of any size know whether all of its employees (and not just officers and directors) and all the members of their immediate families, taken in the aggregate, own any particular percentage of any particular company? If Section 28 becomes law, the enforceability of a loan could depend on whether a judge thought that a bank trainee's rich mother-in-law was a member of his immediate family.

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X. Sections 19, 20 and 21

A. *Brokered Deposits*

The Association supports giving the Federal regulatory authorities adequate tools with which to cope with abuses arising out of the misuse of funds derived from brokered deposits. The Association, however, concurs with the position taken by Mr. Preston Martin in his recent testimony before the House Banking Committee to the effect that an absolute ban on brokered deposits is inadvisable.

B. *Brokered Deposits-Criminal Offense*

Section 21 would make it a criminal offense for a person to solicit a commission from an insured bank for obtaining or assisting in obtaining funds for deposit with such bank. Such criminal penalties are unnecessary and should not be enacted.

XI. Sections 22, 23 and 24

Prohibition on Giveaways

Sections 22, 23 and 24 would forbid giveaway programs by insured banks and other lending institutions. We believe that there is presently adequate authority to prevent abuses.

XII. Section 25

Extension of Deposit Insurance under the Federal Deposit Insurance Act

Section 25 would extend federal deposit insurance coverage to 100% of U.S. Government, state and municipal deposits. We oppose this provision as do Chairmen Burns and Martin.

Respectfully submitted,

New York Clearing House Association

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The CHAIRMAN. The next witness is Mr. Edward Herbert.

STATEMENT OF EDWARD HERBERT, SENIOR VICE PRESIDENT, FIRST NATIONAL BANK, MONTGOMERY, ALA., ON BEHALF OF ROBERT MORRIS ASSOCIATES, NATIONAL ASSOCIATION OF BANK LOAN AND CREDIT OFFICERS

Mr. HERBERT. Mr. Chairman and members of the committee, I am Edward Herbert. I will give you a brief summary of our testimony but I do request that the entire testimony be made a part of the record.

The CHAIRMAN. Without objection it is so ordered, it will be placed in the record.

Mr. HERBERT. I appreciate this opportunity to appear before you on behalf of Robert Morris Associates. RMA is an association of commercial loan officers and credit men whose banks comprise 80 percent of the total resources of the American banking system.

A number of provisions of H.R. 5700 apply to the area in which we function. Section 9 prohibits banks, bank officers from serving on the board of directors of corporations where substantial and continuing loan relationship exists.

Gentlemen, there are times when it is essential to have an officer of the board of the bank on the board of a firm that is in financial difficulty. It is the most practical way to stay fully informed of the condition of business.

There are also times when a new business is in dire need of financial advice of an experienced bank officer. And generally these bank officers serve at the invitation of the corporation. When abuses occur in this area the examining authorities could be empowered to correct the situation. If additional authority is needed, then give it to them.

Section 14 on equity kickers is similar to our position on section 9. It is not necessarily a bad practice. And there are times when it will be the only way a business can get the needed funds. No one forces a borrower to give a lender a piece of the action. He is free to go wherever he can get the most attractive financing, and banks are not the only place he can borrow.

This too can be controlled by the examining authorities.

SECTION 15

This section prohibits directors from borrowing from their bank if they or their families own 5 percent of the stock of the corporation. This will not be much of a problem for the very large bank, but it becomes increasingly critical as you go into the smaller communities and smaller banks. These directors are generally the leaders of their communities, and in a position to contribute much to the soundness of a bank's operation.

True, some directors will use their position to their advantage. But the examining authorities can put a stop to that.

Included in every bank examination is a detailed list of all loans to directors, officers and employees. And to go a step further and require that this information be made public knowledge goes in the face of Congress' concern for personal privacy.

We are in favor of the intent of sections 19, 20, and 21 concerning

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the prohibition of brokered deposits. It should be declared illegal to make a loan where a brokered deposit is tied to it, because this is where the trouble develops.

But there are times when brokered loans are essential to the financial stability of banks. Clearly, banks should have the ability to purchase negotiable CD's, or acquire funds through brokers in the Euro-dollar market, or through their incentive campaign among employees to generate new customers and new deposits.

Gentlemen, coins have two sides. And we ask you to have an open mind. It is not necessary to put the banking business in a straitjacket to correct abuses of a few. Arm the regulatory authorities with the powers that you desire and let them make the desired corrections.

Thank you, gentlemen.

The CHAIRMAN. Thank you very much, sir.

We will place your prepared statement in the record at this point.

Mr. HERBERT. Thank you, Mr. Chairman.

(The prepared statement of Mr. Herbert follows:)

PREPARED STATEMENT OF EDWARD HERBERT, SENIOR VICE PRESIDENT, FIRST NATIONAL BANK, MONTGOMERY, ALA., ON BEHALF OF ROBERT MORRIS ASSOCIATES, NATIONAL ASSOCIATION OF BANK LOAN AND CREDIT OFFICERS

Congressman Patman, I am here as a representative of Robert Morris Associates, the National Association of Bank Loan and Credit Officers. Our Board of Directors has authorized me to appear before your Committee to present what we hope will be helpful comments upon H.R. 5700. RMA's 1,230 member banks comprise approximately 80% of the total resources of the American banking system and our 4,600 individual representatives are the decision-makers on a great preponderance of the commercial loans in those banks. We very much appreciate the opportunity to appear before you today.

Robert Morris Associates is a specialized professional organization. Our interests are solely in commercial lending, and we will try to restrict our constructive suggestions to those Sections dealing with our particular field of expertise.

We believe that banking's performance record over the past ten years has been excellent and the result has been an absolute minimum of loss to our depositors. There have been a few bank failures which have served to point up some operational discrepancies. It is our opinion, however, that the mechanism for correcting these discrepancies already exists in the form of the regulatory authorities and that they should be given whatever additional powers they deem necessary in order to accomplish this goal.

Section 9

We would like to comment first on Section 9 which prohibits officials of commercial banks from serving on boards of directors of corporations which have a "substantial and continuing" loan relationship with the bank. RMA well recognizes that there are potential abuses involved in interlocking directorships and other close ties between the corporate borrower and his bank. We agree that these abuses ought to be eliminated. On the other hand, there are times when everyone benefits from a banker serving on the board of directors of one of his corporate customers. Two types of situations in particular stand out as arguments against an absolute prohibition of these activities:

1. *Where there is a necessity for the bank to obtain absolutely current and accurate operational data in order to help prevent financial collapse of a borrowing customer.* If the bank, using the means provided by a shared relationship, is able to assist its corporate customer in turning around his business from a loss operation to a profitable one, an economic benefit is produced. This is good not only for the bank's depositors and stockholders and for the stockholders of the revitalized corporation, but also for the economic well-being of the community of which they are both a part.

2. *There are burgeoning businesses which have a need for bank credit and financial advice far beyond that which would normally be extended.* Bankers are sometimes willing to make additional loans because of a close intercorporate relationship

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which provides a complete exchange of necessary information and advice and thus reassures the bank that its customer is worthy of increased loan accommodations. As an example, a well-known franchise concern, now of gigantic proportions, freely admits today that it owes its successful launching as a national "name" to the creative lending and sound advice available to it because each of its two banks had an officer on its Board of Directors when it was just beginning to grow. It should be mentioned that in very few cases do banks request membership on a corporate customer's board of directors. On almost every occasion such a relationship is instigated by the borrower.

In summary on this point, we do acknowledge, as noted earlier, that there always exists the possibility of abuse of interlocking corporate relationships, although we do not believe there have been very many such cases. But, we also feel that the Federal and State examining authorities *now have* the capacity to scrutinize such interrelationships carefully and that they, in fact, are *presently* well aware of them. We strongly suggest that the best method of obviating these occurrences would be to give the Federal Reserve Board, the Federal Deposit Insurance Corporation, and The Comptroller of the Currency discretionary authority to require that such corporate interrelationships be dissolved if their examinations reveal any sign of favoritism or preferential treatment or misuse of confidential information on the part of the bank or its customers.

Section 14

Our position on "equity kickers" is similar to that which we have expressed regarding Section 9. We appreciate that there could be a potential conflict of interest situation when a banker finds himself in the position of creditor and investor at the same time. He might, in an effort to protect an equity investment, be tempted to advance additional loan funds beyond the limits which ordinary business prudence would dictate, thus weakening the bank's loan portfolio. We think this has been a rare occurrence, even during the most recent tight money period, however.

RMA believes that the absolute prohibition of equity participations would be detrimental to our national goals. Federal Home Loan Bank Board Chairman Martin offered a number of convincing arguments in this direction during his testimony before this Committee on April 20. In the commercial loan field, we do have borrowing customers who prefer to offer their bankers equity participations rather than, say, in interest rate which is fully commensurate with the credit risk involved. We believe that the borrower should be free to make whatever arrangements are most suitable to his own situation in order to obtain the funds he needs to finance or expand his business.

We would prefer to leave the regulation of equity participations to the examining authorities. The data on these transactions is available to them already and they should be given sufficient authority to force the bank to divest itself of an equity participation if a conflict such as the one previously described should develop.

FDIC Chairman Wille testified that "from a purely supervisory point of view, there appears to be no reason at the present time for the blanket prohibition contained in H.R. 5700." RMA supports Chairman Wille's testimony. Those banks who do not see the necessity for equity participations can elect not to employ them. On the other hand, those bankers and borrowers who decide that the equity participation route is the best method of arriving at a fair and equitable arrangement for both sides should not be arbitrarily estopped from its use.

Section 15

We would next like to comment on Section 15. This section prohibits commercial banks from extending credit to any corporation in which directors or officials of the bank or their immediate families have even a small (5%) ownership interest. We believe that such prohibition would be inimical to the best interests of the economy. The country needs strong banks, and strong banks are, among other things, a product of strong boards of directors. We can envision innumerable occasions when an able local businessman, managing a very successful family-owned firm, might decline to serve on his bank's board because his company's established borrowing relationship would have to be severed; we can also conceive of occasions when a bank would pass over the best candidate for a vacancy on its board rather than lose a good customer. A bank should not have to choose between having a good customer and a good director. This should not be an either-or concept, especially in a smaller community which might have a shortage of eligible directors and/or alternative loan sources.

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We would also like to comment on that part of Section 15 which would require that the Federal Deposit Insurance Corporation make public certain information about credit accommodations made by banks to directors, officers, employees, or their immediate families. We believe that this information should be available to the FDIC (it is usually obtained even now as a routine part of the examination process) but we also feel that public disclosure would involve an invasion of personal privacy and deny the customer the confidentiality which he has a right to expect in connection with his financial transactions. Personal privacy is already being threatened today from too many directions.

Sections 19, 20, 21

We are in favor of the legislative intent of Sections 19, 20, and 21. We believe that brokered deposits, if tied to a credit accommodation, should be prohibited and that the penalties for violating these Sections should be quite heavy, applying to the broker as well as the bank. Banks are not usually the entities which pay brokers in cases where a borrowing customer needs compensating deposits to support a loan request. Ordinarily, it is the loan applicant who pays the broker a fee, part of which eventually goes to the supplier of the funds. While the wording starting on line 11 of page 20 does extend the restriction to other parties, we feel that a clearer statement might be made which would directly prohibit the payment of fees *by anyone* to a third party as an inducement to supply depository funds to a banking institution.

I thank you once again for the privilege of speaking to you about H.R. 5700. Let me assure that Robert Morris Associates would be happy to supply you with whatever additional information you might need as you continue your deliberations on this Bill.

The CHAIRMAN. Now, then, we will have questioning by the members, going around the first time for 5 minutes.

I would like to ask Mr. Sommer a question.

I notice, Mr. Sommer, that you used the word "opposed" 21 times in your testimony. However, I would like to look on the positive side a little bit. On page 3 of your testimony you state:

The American Bankers Association recognizes that potential anticompetitive effects may seem to result from interlocking management between directly competing depository institutions. Accordingly, we endorse the prohibition of certain interlocks between banks and other deposit-type institutions, namely, mutual savings banks, savings and loan associations, and credit unions.

Do I gather from this statement that you endorse generally the prohibition against interlocking personnel among these competing financial institutions along the lines supported by Chairman Wille of the Federal Deposit Insurance Company and Dr. Burns, Chairman of the Federal Reserve Board?

Mr. SOMMER. Yes, sir; we do with respect to competing depository institutions.

The CHAIRMAN. Why did you mention credit unions? They do not receive deposits subject to check. I just wonder why you put them in.

Mr. SOMMER. They are included in the bill, but we have no objection either way on that.

The CHAIRMAN. If it were stricken out you would have no objection?

Mr. SOMMER. We would have no objection to that, sir.

The CHAIRMAN. Mr. Renchard, I gather that your organization's position is similar to the ABA's. You support some form of strengthening of the prohibition against interlocking personnel among competing deposit institutions along the lines of the testimony of Chairman Wille, is that correct?

Mr. RENCHARD. We make no objection to it, Mr. Chairman.

The CHAIRMAN. Is it not also correct that your testimony, starting

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with the last paragraph on page 2, through the bottom of page 6, does not deal with sections 2, 3, and 4 of the bill concerning interlocking personnel among financial institutions. It is concerned with the prohibition in the legislation about interlocking personnel between financial institutions and nonfinancial institutions; is that right?

Mr. RENCHARD. I am sorry, I do not follow your question, Mr. Chairman.

The CHAIRMAN. All right. Is it not also correct that your testimony, starting with the last paragraph on page 2 through the bottom of page 6, does not deal with sections 2, 3, and 4 of the bill concerning interlocking personnel among financial institutions. It is concerned about the prohibition in the legislation against interlocking personnel between financial institutions and nonfinancial institutions; is that correct?

Mr. RENCHARD. I believe my comments are confined to interlocks between deposit institutions.

The CHAIRMAN. Deposit institutions.

Mr. RENCHARD. I see no objection to some limitation on interlocks between deposit institutions, but we think it should be limited to that.

The CHAIRMAN. Thank you, sir.

On page 10 of your statement, Mr. Renchard, pages 9 and 10 of the attachment, you seem to agree that some form of disclosure of equity assets held by various financial institutions would be useful, along the lines that the SEC recommends in its financial institutions study, is that correct?

Mr. RENCHARD. Yes, sir.

The CHAIRMAN. Is it not true that today the public can find out on a quarterly basis the stockholdings of mutual funds, and on an annual basis the stockholdings of insurance companies, but there is no way that the public has access to the aggregate stockholdings of a commercial bank trust department? Shouldn't we at least keep public disclosure for trust departments on a par with mutual funds and insurance companies until some time in the uncertain future when the proposals of the SEC are adopted?

Mr. RENCHARD. I think we would see no objection to publishing such a compilation, were it limited to stocks where the bank has the control over the voting power.

The CHAIRMAN. Now, then, on the giveaways—any one of you may anwser this—it is my understanding that the four agencies involved, the Comptroller of the Currency, the FDIC, the Federal Home Loan Bank Board—and the Federal Reserve Board agreed on certain rules and regulations involving premiums or giveaways?

Mr. RENCHARD. Yes, sir.

The CHAIRMAN. What would these maximum premiums or giveaways, if used to the extreme, be?

Mr. RENCHARD. We also have a limit, Mr. Chairman, imposed by the State Banking Department in New York.

The CHAIRMAN. The State Banking Department in New York. But take the national one, that is what we are concerned with right now. How much would that aggregate in interest rate if converted from premiums to interest?

Mr. RENCHARD. I believe the maximum is a premium giveaway of $5 on deposits up to $5,000.

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The CHAIRMAN. How long a time, though, would that deposit be required to remain in the institution?

Mr. RENCHARD. As far as I know they can take it out the next day if they want to.

The CHAIRMAN. Take it out the next day if they want to.

Mr. RENCHARD. Mr. Sommer may have a different view on that.

The CHAIRMAN. Mr. Sommer, what would you consider—if you translate the premiums into interest rates, how much would it be on those accounts?

Mr. SOMMER. I don't believe there is any way of telling unless we know the length of time the deposit was made for, and the amount.

The CHAIRMAN. I thought the length of deposits was always required when a deposit was made where a premium is expected or given.

Mr. SOMMER. Mr. Chairman, I believe that depends on the rules of that bank—sometimes the deposits run for 3 months before interest is paid. And that may be from the next 3 months' date, so you would have up to 6 months. On the other hand, there are other types of accounts that pay interest daily. So I agree that it is very possible that a deposit could be made one day to get a premium and be drawn out the next day, or it could be left on deposit over a period of time. And to relate a $5 premium to a particular deposit for a short period of time could increase the rate of return substantially.

The CHAIRMAN. I do not understand why you do not have some rule of thumb where you could ascertain about how much it would be, and translate it into interest.

Mr. RENCHARD. Mr. Chairman, in cases where we have used this type of giveaway for the promotion of a branch, we have maintained a record subsequently on retention of savings deposits. And generally it has been quite impressive as to how many stay.

The CHAIRMAN. I did not understand the last phrase you used.

Mr. RENCHARD. Generally the figures are quite impressive on how much of the deposits are actually retained.

The CHAIRMAN. And you think it is worthwhile, then, to encourage thrift?

Mr. RENCHARD. Yes, sir. It can be very useful in attracting thrift deposits.

Mr. SOMMER. Mr. Renchard talks about one aspect of it, and that is the retention. In our own bank we do have premiums that we give away, always of course within the regulations and the law. We have taken two surveys over the period of the last 5 or 6 years, and have found that, at the end of the year, between 80 and 90 percent of the accounts that open through the use of premiums were still on the books; and a good share of them—I cannot tell you the exact percentage—but a good share of them were active. We feel that on the question of giveaways, if you single out banks and savings and loan associations to prohibit giveaways you are singling out these institutions as compared to the whole gamut of commercial institutions—filling stations and everybody else who is doing it. We do not think banks and savings and loan associations ought to be singled out. But we do very strongly feel that premiums are an important part of thrift and savings. And I am sure that there are many, many instances where the money goes into the savings account that might be spent some other way, thus adding to the personal assets of the individual.

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The CHAIRMAN. From the standpoint of encouraging thrift I am impressed that it could have some influence.

Mr. SOMMER. Yes sir.

The CHAIRMAN. Mr. Widnall.

Mr. WIDNALL. Thank you, Mr. Chairman.

I would like to welcome all the members of the fine panel here before us this morning. You have given some very constructive testimony, and some suggestions I am sure that the committee will work on, and will listen to.

This is a highly controversial bill, and I am afraid that the title to it is a bit misleading, the Bank Reform Act. We have not yet been shown by actual evidence in the record that reform as such is what is needed. There are certainly things that should be clarified in the operation of banks. And I think that among them two things that we have been talking about, the interlocking directorship and the equity kickers, are matters of imporance that need consideration, clarification and possibly some change.

Mr. Sommer, I appreciate your statement. And I find the basis of your objections to the provisions of H.R. 5700 relating to interlocks consistent with those voiced by previous witnesses. As I understand your statement, the American Bankers Association supports a prohibition against interlocks between depository type institutions in the same contiguous or adjacent cities or towns or villages, with authority for regulatory bodies to extend or modify the rule as they find appropriate. It seems to me that this is a good approach, sufficient to restrict interlocks which are most apt to reduce competition.

Furthermore, this would be consistent with what Dr. Arthur Burns requested for a basic rule of law to govern the majority of cases, but would give enough administrative flexibility to treat the unusual case. Do you think this prohibition would best be imposed by new law, such as we are considering, or by modifications to the Clayton Act?

Mr. SOMMER. Mr. Widnall, we have not attempted to define which regulatory authorities should take on this duty, and I understand that some feel that to suggest the exceptions would be much work. But, generally speaking modification of the Clayton Act would be satisfactory. But we have no objection to a new law.

Mr. WIDNALL. Mr. Carlson, on page 8 of your statement you comment on brokered deposits and express your support for these prohibitions. You correctly state that anyone is prohibited "from receiving anything of value or obtaining funds of others for deposit or investment in banks or savings and loans."

Mr. CARLSON. Yes, sir.

Mr. WIDNALL. That prohibition also applying to "investment" would make it impossible for an underwriter to sell a bank stock or a debt issue to obtain what may be badly needed capital. Do you really mean to support such a prohibition?

Mr. CARLSON. No, sir. That was not in our consideration.

Mr. WIDNALL. Would you clarify further your own statement?

Mr. CARLSON. When we talk about investment in banks or savings and loans, while the law provides today that when customers deposit funds in savings and loans we know those as investments, and it is not a depositor-bank relationship in a savings and loan. As we understand it they are purchasing investment shares, not actually making

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deposits. That is how I grew up in the business, and that is how you remember it.

Mr. WIDNALL. Thank you.

Mr. Sommer again, relative to your testimony on pages 11 and 12, would you care to comment on the kind of assistance your in-house legal staff provides to the public which would be prohibited by section 2?

Mr. SOMMER. Mr. Widnall, we are concerned that the in-house legal counsel would be prevented from really doing legal service for the bank in any of its transactions if the counsel were on the board of directors involving any transactions with our customers.

Mr. WIDNALL. I can see that.

On page 14 you show some interesting figures on the volume of securities which just three banks would have to report under the provisions of section 12, among the securities you mention are just stocks and bonds. However, H.R. 5700 uses the word "securities" without definition. Couldn't that definition also include mortgages, notes, warehouse receipts, or anything symbolic of an interest or something of value?

Mr. SOMMER. May I ask Mr. Brown, our trust man, to answer that?

Mr. RICHARD BROWN. I consider that it would include all holdings in trust departments with the possible exception of real estate. I do not believe you could call that a security. But certainly a mortgage is a security, and a warehouse receipt is so regarded.

Mr. WIDNALL. That would greatly increase the amount of reporting that would be necessary to the institution, isn't that so?

Mr. RICHARD BROWN. Yes, sir, that is so.

Mr. WIDNALL. Mr. Sommer, on page 6 you oppose the prohibitions of section 7 which prohibit bank directors and others from serving on the boards of companies for whom the bank manages a pension fund. I suppose if a local automobile dealer serves on the board of a bank and also the board of a local company manufacturing gravestones the bank would be precluded from managing the pension fund of the latter company?

Mr. SOMMER. May I again ask our trust representative to answer that, Mr. Widnall?

Mr. RICHARD BROWN. That would be so, Mr. Widnall.

Mr. WIDNALL. What you are saying is that that could hardly be anticompetitive or in any way against the public interest, except that the gravestone company would have to get another bank or individual to manage its pension fund, isn't that right?

Mr. RICHARD Brown. Yes, sir.

Mr. WIDNALL. That is all at this time. My time is up.

The CHAIRMAN. Mr. Barrett.

Mr. BARRETT. Thank you, Mr. Chairman.

I want to ask Mr. Carlson a question.

As I understand your statement, you oppose section 14 on equity participation, and sections 19 and 21 on brokered deposits. As for another section of the bill, you suggest further study is needed before any conclusion can be drawn. How and by whom do you suppose these studies should be undertaken? I know you are all knowledgeable men. Are you also familiar with the study of Professor Darnell of the University of Colorado?

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Mr. CARLSON. No, I am not.

Mr. BARRETT. He indicates, if you are familiar with it, that there have been detailed studies carried out by the University of Colorado on practices of chain banking. These studies cover hundreds of small and medium size banks in several midwestern cities and States. These studies disclose similar interlocks to those existing in the larger cities. How do you justify your statements indicating that further study is needed when there has been a full study made and full coverage of both small and large States in the interlocking relationship?

Mr. CARLSON. I did not know, sir, that there had been a full study of all of the States. I do know that there was a 984-page study of 50 banks in 10 cities, which I believe is a matter of record, and from which much of this bill is drawn. I know in various States there are some studies that State banking departments, State legislators and State banking associations have drawn. But I was not aware that these had been submitted, sir.

Mr. BARRETT. I think such testimony was offered here the other day—if you will look the record over.

Thank you very much, Mr. Carlson.

Mr. CARLSON. Yes, sir.

Mr. BARRETT. I have a question for you, Mr. Renchard. On page 3 of your testimony you point out that: "All make any misuse of directorship unacceptably hazardous, likely of detection, and subject to severe penalties. These laws and standards are rightly directed at stopping improper conduct of actual abuses."

On your page 3, as you stated, there are antitrust laws which "make any misuse of directorship unacceptably hazardous, likely of detection and subject to severe penalties."

Where the interlocking directorship is not in violation of the Clayton Act, could you tell us specifically what antitrust laws apply to the interlocking relationship?

Mr. RENCHARD. I am not a lawyer, Mr. Barrett, but I believe there are remedies in the antitrust laws where there is a conspiracy of any kind involved.

Mr. BARRETT. Could your legal adviser give you some help to try to embellish that statement, because we do not consider that an interlocking relationship.

Thank you very much.

Mr. Chairman, I do want to ask Mr. Sommer a short question here.

I am just a little bit confused on your page 3. You indicate in the second paragraph:

"Interlocks resulting from common stock ownership, including companies and chain banking arrangements, should be specifically excluded from the prohibition."

And in the next part of that paragraph you say:

"We recommend 5 years' time period for corporations to bring their board membership into compliance with the proposed legislation."

Do we understand this to mean that you agree that there are some irregularities in some of these banks?

Mr. SOMMER. Mr. Barrett, we are talking now about the interlocks between depository institutions. We do not say that there are any irregularities, but depository institutions are competitors in many

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ways, and sometimes very close competitors. We feel that it might seem like there could be differences of attitude and opinion, and we therefore think it wise that the director interlocks between the depository institutions be eliminated. And we think the 5 year period is necessary in order to have a smooth transition from that.

I give you an example in our own bank. When I came to Owatonna we had two directors from our bank on the board of the local savings and loan association. As these members finished their duties with us we made sure that we did not put any more directors on with a competing financial institution.

Mr. BARRETT. Thank you, sir.

The CHAIRMAN. Mr. Johnson.

Mr. JOHNSON. Thank you, Mr. Chairman.

I too want to join my colleagues here in welcoming you gentlemen here. You have certainly given us some very wonderful statements. And you have very succinctly, I would say, set forth your various positions.

I agree with Mr. Widnall, this bill is much more serious than may be even the chairman of our committee wants to realize. And if it were to pass, the banking institution as we know it now would be, let us say, a shadow of its former self. So we are going to watch this bill very carefully.

Now, I was quite surprised that you gentlemen are against the 100 percent insurance for public funds. Having been on a banking board myself for over 20 years—and I am no longer on a banking board—but it was a little country bank, and my, how we used to worry about sending these Government securities to and from the Philadelphia Reserve Bank to guarantee public deposits. And I thought this would be one thing that you bankers would say you were for. But in reading your testimony I find you take a very statesmanlike stand on it, and despite the real nuisance to the bank and all, you think it would be a bad thing for the country to fully insure public deposits. Do you want to comment on that, Mr. Sommer?

Mr. SOMMER. Thank you, Mr. Johnson. I too hear from our operating officers about this transfer of securities for the pledging of assets.

But we feel the comments that we made in our testimony really are pertinent. We think that should there be 100-percent insurance, and should all the States do away with the pledging of assets, there would be freed about $30 billion of money that is now invested in municipal bonds and Government securities pledged against State and local deposits, plus perhaps another $7 billion if the Federal Government deposits were handled in the same way, which I assume they would be. We think that this could have an impact on the municipal bond market around the country, and also on the market for Government securities, if the banks should decide to take a substantial part of this money and put it into loans or other types of investments. We think that this could have a detrimental effect. We cannot say how much, because we do not know. But it is our opinion that it would have considerable effect.

The second thing is, we pride ourselves that, as an industry, we have handled the financial affairs of our institutions well, and have worked for the good of the country and the economy as well as ourselves, of

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course. We take pride in the financial stability of our institutions. We feel that should this eventually lead to 100-percent insurance for all deposits, that much of the need for careful management or aggressive management or prudent management will ke taken out of the banking system. Again we cannot measure that. That will be an evolutionarv process. But we are concerned about it.

Mr. JOHNSON. Another thing on that point, I have always felt that in the case of the banks which have large holdings of Government bonds, the mere fact that you hold them and have them deposited as security for public deposits, and so forth, means that the Federal bond market is not depressed by the dumping of Government bonds. So I can see by reason of your testimony that the requirement that Government bonds be used to secure public deposits has a very stabilizing effect on the U.S. Government bond market, is that true?

Mr. SOMMER. Mr. Johnson, I do not know how significant we would feel if Government bonds were a part of the whole market, but they could very well have that effect. And it is very possible that in order to get Government bonds to pledge against these deposits so you do not have to change them every 3 or 6 months, we might extend our maturities somewhat, but not so far as not to be liquid.

Mr. JOHNSON. I would like to ask a question of your trust representative. Would you state your name, please.

Mr. RICHARD BROWN. My name is Richard P. Brown.

Mr. JOHNSON. Mr. Brown, my time has expired. I am sorry.

The CHAIRMAN. Mrs. Sullivan.

Mrs. SULLIVAN. Thank you, Mr. Chairman.

I would like to ask, do any of you gentlemen have an answer to Mr. Barrett's question of Mr. Renchard on which antitrust laws would cover or apply to the interlocking directorships?

Mr. CARLSON. Section 8 of the Clayton Act, our counsel tells us.

Mrs. SULLIVAN. I think he said, whether the interlocking directorship is not in violation of the Clayton Act. Could you tell us specifically what antitrust laws would apply to the interlocking directorships?

Mr. CARLSON. No, I could not.

Mr. RENCHARD. I might ask my counsel, Mr. Simmons, to comment on that, Mrs. Sullivan.

Mr. SIMMONS. Mrs. Sullivan, what we are referring to is if there is a common director, let us say, of a bank and a sales financial company, and as a result of that common director there is an agreement that the sales financial company will not compete in the market in which the bank is engaged in business, and the bank agrees not to compete in the market in which the sales financial company is engaged in business, that of course is a violation of the antitrust laws. Now, obviously a premise is that if interlocks are bad because of the effect on competition, it must flow from that that there is some tacit agreement or understanding that one party will not compete with another party. If that flows, that is a violation of the Sherman Act.

Mrs. SULLIVAN. But is it not the agreement that would be made, not just the fact that a person is a director?

Mr. SIMMONS. No, the interlock would not be a per se violation of the Sherman Act.

Mrs. SULLIVAN. I wish you would enlarge upon that when you go

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over your testimony. I think we need some more information on that from any of you on that question.

(The New York Clearing House Association declined to elaborate on the above question.)

Mrs. SULLIVAN. In an answer—this is to either Mr. Sommer or Mr. Renchard—in answer to a question that was discussed with Mr. Widnall, I want to say that Dr. Burns also supported a nationwide prohibition on interlocks among depository institutions, where their assets were more than a billion dollars. And I would like to know how you react to that.

Mr. RENCHARD. I agree with Chairman Burns that that is an arbitrary figure. And the way things are going in this country, in Washington and New York, a billion dollars is not very big.

There are, according to my figures, 76 banks in the country now which are a billion dollars or more. And I do not regard those as all competitive institutions, in the sense that they are certainly not what you would call money center banks.

Mrs. SULLIVAN. Would you comment on that, Mr. Sommer?

Mr. SOMMER. Mrs. Sullivan, I would be happy to.

Our association would prefer the more flexible approach that was given by Mr. Wille, Chairman of the Federal Deposit Insurance Corporation. We do support largely the position of Dr. Burns, as I pointed out before. But we have some concern that when you make a precise cutoff, whether it be very small or very large, that may need to be changed and would not be consistent with our position. We would opt for a more flexible approach and give the regulating authority some responsibility in this area.

Mrs. SULLIVAN. Thank you.

And this is to you also, Mr. Sommer. On page 4 of your statement you say:

> If our financial institutions, both depository and others, evolve in such a way as to make insurance companies and banks more directly competitive at some time in the future, reassessment would be in order.

The recent SEC study, I understand, shows that there is also substantial competition in the investment field between banks and insurance companies. And only yesterday we learned of three major banks cooperating with an insurance company in the financing of the town of Columbia. Is it your opinion that director interlock between banks and insurance companies should be prohibited if direct competition can be shown?

Mr. SOMMER. Mrs. Sullivan, I did not learn about these three major banks and the insurance company collaborating until this moment. But in general our statement would be that we feel there is some competition in the matter of savings, and some competition in the matter of pension plans, and the like. But, despite the comments of the SEC and the quote that you gave us, we do not feel that overall it is substantial enough yet to ban interlocks.

Mrs. SULLIVAN. Thank you.

I have another question, but my time has expired.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Stanton.

Mr. STANTON. Thank you, Mr. Chairman.

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Mr. Sommer, I have been sitting here listening to the testimony, and I cannot help but get rather personal. This is the first time I have met somebody from the American Bankers Association since I presumably received $2,500 last fall from the Bankers' Political Action Committee. And I cannot help but think—you know the reputation of your organization. I wonder if you knew that you are not living up to your reputation by your performance. I have not seen anybody in my office—I think maybe once last year—from your organization. Is this deliberate?

Anyhow, let us not change it, because I do not want to see somebody tomorrow, whatever you are doing.

You know, there is no banking organization that has contacted me on this particular bill. There were a few at the time of the One Bank Holding Company Act, individual bankers. But I have come to the conclusion that probably everybody realizes this is such a bad bill, in its present form that there is no need to contact anybody.

I cannot help but think that we have got such a conglomerate bill before us, so far reaching—it is a 27-page bill with 27 different sections covering half a dozen different subjects—I cannot begin to tell you how this committee will ever unravel it. But I want you to know we will try to do our best.

I am impressed that with the one exception of the college professors, there has been nobody from the regulatory agencies or the industry that would admit that about 10 percent of this bill should be passed and 90 percent should be referred for further study. We recognize that we will get into far-reaching ramifications if we should ever accept H.R. 5700 as it now exists.

Perhaps, Mr. Renchard, you could tell me, if you know, has your bank, for example, ever taken H.R. 5700 and applied it to your present board of directors? How many would it affect on your particular board?

Mr. RENCHARD. I think literally it would practically eliminate the whole board except the insiders.

Mr. STANTON. You could do another thing for me, Mr. Renchard. We have had some outstanding professors before this committee, people who are very knowledgeable, and who have studied the subject of interlocks in great depth. I would appreciate it if you would send them your testimony—you can get the names from the staff, or I would be glad to get them—because there is a basic difference of principle involved. These professors, almost, I think, with one exception, do not accept the basic premise of what are the duties of a director of a bank. I have never been on the board of any bank, but I have felt that the operation of a board of directors was primarily to keep an eye on and to watch the senior officers of that bank, and how they perform the day-by-day operation. Without exception the college professors did not look at that. They were more interested in more people getting a piece of the action. And I think you should send them a copy of your testimony so that the college students in the future could have a little broader outlook on life than they now get.

Mr. RENCHARD. I feel sure that the responsibilities of corporate directors have been well discussed and certainly in some of the business schools. I think they are pretty well educated on this.

Mr. STANTON. They have been educated to death with a bunch of statistics. But they have not been educated in the primary purposes,

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as far as I can see, of what you have so eloquently stated in your testimony, Mr. Renchard. This should be brought out to them just as a comparison if nothing else.

Mr. RENCHARD. I will try to do that. Thank you.

Mr. STANTON. Mr. Sommer?

Mr. SOMMER. I feel very definitely, regardless of the size of the bank, that one of the most important functions of the board of directors is to be a check on management and to see that management does what it should, and that there is good management selection to follow up and conduct the affairs of the bank, or any institution. In our own bank we have nine outside directors, two inside and nine outside. If this bill were to be passed, I would have one outside director left as of December 31, 1971, assuming the bill was effective, because I am losing two who are not affected, six are affected, I am losing two of the others who are not affected, and I would end up with one man on the board as of the end of this year, and he is a director in a company with which we do not have business, and I would very much like to get the business.

Mr. STANTON. I would say this, that if you gentlemen have some figures there as to how it would directly affect banks and how much it actually affects savings banks and credit unions throughout this country, don't put it in the record. Send it to individual members.

Mr. BARRETT (now presiding). The time of the member has expired. Mr. Stephens.

Mr. STEPHENS. Thank you, Mr. Chairman.

I have read the statements you gentlemen have made with a great deal of interest. I believe that without having read your statements that I could have said what you have testified to today anyway.

I am very much in favor of what is in Mr. Carlson's statement here, that this should not be entitled a bank reform bill unless we reform the bank reform bill, and then perhaps we could give it a title that would be helpful.

The thing that I believe you have said in most of the items dealing with sections of the bill is that we have got enough regulation now to take care of people who are crooked, people who are abusing the privileges that are inherent in the banking field, and the institutions that are dealing with finances, and that with many more details spelled out, we can make it impossible for the public to get the service that the public needs. Am I right in assuming that that is part of the criticism you are making of these?

Mr. SOMMER. That certainly would be true, Mr. Stephens.

Mr. STEPHENS. It is the public that needs to have the services performed. And if you destroy the leadership, for example, in the financial world by eliminating the brains that are bound to be in some interlocking directorate, you are not doing the public any real service by categorically prohibiting the interlocking of directorates.

Mr. SOMMER. Mr. Stephens, I personally, our association, our member banks, are very cognizant of the public interest and the service of the public. We feel very strongly about it. If anybody wishes to count the number of times we talk about the public interest in our testimony, it probably would not be quite the 21 that was referred to, but it will be quite a few times. We are very conscious of that.

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We are doing our best and we are going to continue to do our best to serve the public.

Mr. STEPHENS. Thank you very much.

Mr. BARRETT. Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman.

Mr. Sommer, in your colloquy with the chairman, the Chairman suggested—made comment upon the fact that your statement on 20-some occasions has expressed opposition to the provisions in this bill. He suggests that such opposition is somehow a bad attitude. Frankly, to the extent that your opposition amounts to objections to the almost McCarthyistic guilt by or with association which is manifested by this legislation, I suggest that your opposition is shared by many. It seems to me that this Congress, and our several regulatory agencies, should be able to appropriately, effectively, and summarily, deal with improper conduct, practices, or operations without the associations which is obvious in this legislation.

I was interested in your comments about the provision relative to 100 percent insured accounts, because this is an area where there is certainly some difference of opinion.

Hasn't there been a general objection over the years to the full coverage concept, since it tends to relieve the deposit institution from any liability exposure with respect to deposits? As a general principle isn't that true?

Mr. SOMMER. Thank you very much, Mr. Brown, for your comments.

This certainly is true. And as I mentioned, we take great pride in our financial institutions, now speaking particularly for banks and management of banks, and in our conscious public responsibilities to the public, to the economy, and of course to the governments that govern us.

We feel that 100-percent insurance would tend to say to any depositor, it does not make any difference where you do your business, the FDIC is going to take care of it anyway, and we think it would take a lot of impetus and a lot of real steam out of management to do a better and better job.

Mr. BROWN. There has been much discussion this morning about the present effectiveness of control, shall we say, which exists in the Clayton Act with respect to anticompetitive activities. I remember the hearings on the one-bank holding company legislation we held when Mr. McLaren from the Justice Department and others testified regarding this whole area. In the course of the hearings we discussed at some length the *Fortner* decision, in which case the U.S. Supreme Court held that credit can be a tie-in product, where it had not been so held before. To those who are the legal beagles, as we sometimes say in our fraternity, wouldn't you speculate that the courts will continue to extend the interpretation of the Clayton Act to many other activities which have not been considered covered before by the Clayton Act, such as the very thing we are talking about here this morning? Or do you think that the Clayton Act is so restricted that it would not permit, for instance, the consideration of other anticompetitive activities not within the coverage of the tie-in decision?

Mr. SOMMER. Mr. Brown, I am not an attorney, and I am not familiar in detail with all the laws. But my observation of court

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procedures over a period of years has been that they will take the wider viewpoint as we move through this evolutionary stage of life that we are going through. And I would think that they would take appropriate positions to cover what you suggest.

Mr. BROWN. Since my time is very limited, and I cannot go into some of the things in detail in the way in which I would like to, would any of you comment in a general way upon the possibility of legislating presumptions in the trouble areas, as you have admitted there are some trouble areas, and then leave the determination as to whether or not an anticompetitive situation exists, to the regulatory agencies? What would be your attitude toward such an approach rather than specifying the prohibitions that exist in this legislation?

Mr. SOMMER. Mr. Brown, certainly if there are things that need to be covered we would rather have broad laws and have the leeway given to the regulatory agencies.

Mr. Renchard, do you want to answer that?

Mr. RENCHARD. I may add, Mr. Brown, that even in approving, or not objecting to, some of the provisions of this bill, we are not admitting that there are any real abuses that are existing now as far as these interlocks are concerned. I know of no abuse in my personal experience where we have had an interlock between our bank and a beautiful savings bank in New York, for example. However, we do not object to it if somebody thinks that should be eliminated. We do object to more far-reaching legislation that restricts us. I think you recognize that banking is a highly regulated industry already, one of the most highly regulated. And if you look around at what has happened to some of the overregulated industries in this country, I think it should give you pause in putting another one in that position.

Mr. BROWN. Thank you very much. My time has expired.

Mr. BARRETT. I wonder if it would be an imposition to ask the panel to answer the questions as briefly as they can. We are hopeful that we can give everybody on the committee here an opportunity to ask some questions.

Mr. Minish.

Mr. MINISH. Thank you, Mr. Chairman.

Mr. Renchard, on page 7 of your statement you say that the SEC study found "that although banks and other institutions sometimes have potential voting power to influence such corporations, there was no evidence to indicate that they exercised this power." Isn't this true that the SEC studies stated that they were not looking for such evidence but only the filing of statistical data on the interlocking relationship between bank and portfolio companies?

Mr. RENCHARD. I really could not answer what they are looking for. All I know is what they concluded.

Mr. RICHARD BROWN. My name is Richard Brown, sir, from Denver.

I think what you have said as to what the SEC stated in its statement is accurate, that they were not looking for specific instances. But certainly, sir, there is no inconsistency between that and the observation that this study did not find specific instances in which they felt the voting power had been abused.

Mr. MINISH. But they did not go into it, that is the point I am trying to make.

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Mr. RICHARD BROWN. I think that is precisely correct, sir.

Mr. MINISH. Mr. Renchard, don't you believe that a bank director who is also associated with a manufacturing company would have a better chance of obtaining a loan than a man representing a competing manufacturing company who is not represented on the bank board of directors?

Mr. RENCHARD. No, sir.

Mr. MINISH. You do not?

Mr. RENCHARD. No, sir.

Mr. MINISH. You don't honestly believe that—if you were on a board of directors—and I was not on the board of directors of a bank—I would have as good a chance of getting a loan from the bank as you would?

Mr. RENCHARD. Mr. Minish, are you speaking of a personal loan?

Mr. MINISH. A corporate loan.

Mr. RENCHARD. No, sir.

Mr. MINISH. I just find it hard to believe. But that is your opinion.

Mr. RENCHARD. In an institution of our size I can tell you that that is not a factor.

Mr. SOMMER. May I answer that?

Mr. MINISH. Yes, sir.

Mr. SOMMER. I come from a smaller bank, and I would say absolutely that any customer will have an equal chance of getting loan consideration if the loan is warranted, whether a director or not. As a matter of fact, inside my own mind I scrutinize loans to directors personally and loans to the companies with which they are associated even more than others.

Mr. MINISH. That is all, Mr. Chairman.

Mr. BARRETT. Thank you, Mr. Minish.

Mr. Williams.

Mr. WILLIAMS. Thank you, Mr. Chairman.

I want to thank you gentlemen for being here this morning. Your testimony has been excellent.

Probably one of the reasons that so much of your testimony has been directed against the provisions of H.R. 5700 is because you are looking at the operations of our financial institutions as they are.

Mr. Sommer, in your statement you say, "We fear that the present effective functioning of bank boards of directors would be destroyed if sections 2, 7, 8, and 9 of this bill would be enacted." And then you go on to say, "The American Bankers Association recognizes that the potential anticompetitive effects may seem to result from interlocking management between directly competing depository institutions." Would you agree that this potential anticompetitive effect could be corrected by amending the Clayton Act?

Mr. SOMMER. Mr. Williams, yes; we feel that it can be handled by amending the Clayton Act. And to the question Mr. Widnall asked I answered that if there was another course that the Congress in its wisdom chose, that that would be satisfactory.

If I may, I want to emphasize what Mr. Renchard said. We are not saying that there are problems with interlocks with financial institutions, but we are willing to support such legislation.

Mr. WILLIAMS. You also state that the reporting requirements required by sections 12 and 13 of this bill would engulf the FDIC in a

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virtual torrent of data as 3,500 trust departments file their annual reports. Of course, the compilation of this data is very expensive. Do you believe that the benefits provided by this data would outweigh the cost?

Mr. SOMMER. May I ask Mr. Brown to answer that, sir?

Mr. RICHARD BROWN. I welcome the opportunity to respond to that, Mr. Williams.

We do not believe that any benefit which would be gained from such a massive inflow of data could match the cost.

Mr. WILLIAMS. I think that fully answers my question.

Also in section 14 which deals with equity participation, couldn't equity participation be developed to be a two-way street so that anybody obtaining equity participation would also participate in the losses as well as the increased profits, and the revenue that an equity participant would receive would not be based on gross revenue? Wouldn't this make equity participation a much more desirable thing?

Mr. RENCHARD. I think, Mr. Williams, the first requirement in making a bank loan is to be sure that you get your money back. If you add a little incentive to it where you can be fully compensated on the interest rate, that is the only purpose. But we certainly would not want to make a loan where the amount of principal were reduced.

Mr. WILLIAMS. Mr. Carlson, you do say that this bill is incorrectly entitled when it is called The Bank Reform Act of 1971. I agree with your statement. I have explained my statement in past testimony.

As far as Mr. Parsch is concerned, you stated in your testimony, which you did not have a chance to present, that you feel that an outright prohibition against bank loans would mean the demise of independent banks. I certainly think that this would be a very sad situation, and I think you have agreed with me also.

Mr. PARSCH. Thank you, sir.

Mr. WILLIAMS. And as far as the statement of Mr. Renchard is concerned, you are dealing with the fact that the regulatory agencies should have adequate authority to deal with any abuses which might arise from the misuse of funds received as a result of brokered deposits.

Now, I made the suggestion that as far as brokered deposits are concerned, we could completely separate brokered deposits from any loans that were tied directly in with these brokered deposits and, therefore, eliminate the dangers of the brokered deposits.

Mr. Burns liked my suggestion and Mr. Martin has some reservations about it. How do you feel about it?

Mr. RENCHARD. We have no objection whatsoever to the elimination of brokered deposits where it is directly tied in with the loan.

Mr. WILLIAMS. I was interested to see, Mr. Renchard, that your testimony included the word "straitjacket." I have used that same word as an adjective to describe H.R. 5700 in previous hearings.

Thank you.

Mr. BARRETT. Thank you, Mr. Williams.

Mr. Gettys.

Mr. GETTYS. Thank you, Mr. Chairman.

It is 2 minutes until the House meets.

Some years ago in a campaign down home one of my opponents was talking. He said, "You know there are a hundred ways to make a living, but there is only one honest way."

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And I jumped up and said, "What is it?"

And he said, "Oh, I knew you wouldn't know."

And so that is just about the way this bill is. As a country lawyer, I have never been on any financial institution board. But I recall one time I was chairman of the United Fund Campaign, and a deacon of my church, I was on the YMCA board, and one or two other boards, and you know, we were all competing for money, all those three. And I wondered if I had a conflict of interest.

And then another example. I doubt if there is a man in the United States who knows more about the subject of money than our chairman, Mr. Patman. He is well informed on the subject. Now, I wonder because of his expertise, I wonder if he has got any business serving on the Banking and Currency Committee, because we do not need competent men on these boards, you know, we have got to get somebody who absolutely knows nothing about a subject in order to serve on some of these financial institution boards.

I think I have got my point across. Thank you, Mr. Chairman.

Mr. BARRETT. Thank you, Mr. Gettys.

But I do think, as deeply as I love you, that it certainly would be amiss on my part if I let that go by without saying, I think Mr. Patman is the greatest representative of the public interest of the people of America since Andrew Jackson fought the British.

Mr. GETTYS. You are talking on my time, Mr. Chairman. I won't yield to anybody in my love for the chairman. But I was making a point. And if you take offense, then I would have no quarrel with that.

Mr. BARRETT. Mr. Rousselot.

Mr. ROUSSELOT. I would be glad to yield to the gentleman.

Mr. BARRETT. Do you desire to be recognized?

Mr. ROUSSELOT. I would desire to be recognized now. Consume your time.

Mr. BROWN. He yielded to the gentleman.

Mr. BARRETT. The gentleman yielded back his time. That is the reason I made the statement.

Mr. BROWN. The gentleman may yield to the gentleman from South Carolina, the House rules so provide.

Mr. BARRETT. He has yielded back his time. If the gentleman had asked me for time I would have given it to him.

But I do not think any member, whether he is on the minority side or majority side, should be condemned in absence here.

Do you want to be recognized, Mr. Rousselot?

Mr. ROUSSELOT. If it is all right.

Mr. BARRETT. It is all right. You are a very good member, you are very knowledgeable, and everybody has a great deal of respect for you.

Mr. ROUSSELOT. I would just like to comment that I do not believe our colleague was attacking the chairman, in fact he was commenting on the fact that our chairman, Mr. Patman, knew a lot about money. That is all.

Mr. BARRETT. There are many ways of commenting.

Mr. ROUSSELOT. Gentlemen, thank you for appearing. First I hope you understand that because this bill attacks banks, some of us as committee members have been greatly disturbed that you have not

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been allowed sometimes to complete your statement. Some of our colleagues have cut you off when you have tried to more fully answer questions. And I think it has been wrong and unfair.

I think it is perfectly understandable that you are here in opposition to a bill that I believe would destroy in many ways the banking system of this country. I think that you should have every right to oppose the bill without being set down. We constantly talk about free speech here, and then when we have a bill that actually attacks an industry we do not allow the witnesses to always complete their statements. And I want you to know that many of us, though we are limited by certain rules here, have felt that whenever you feel that you have to complete a statement, go ahead and complete it, because you are defending your own industry. And I think you have the right to be afforded that courtesy.

No. 2, I want to compliment each of you on very complete statements, commenting directly ot the bill. I think it needs to be done.

One of the gentlemen of our committee here has commented on the number of professors that we have here. And I would like to offer some suggestions to you as a banking industry, because I think it is needed.

If you think for 1 minute that those teaching banking in the colleges today understand banking you are absolutely wrong on the basis of what we have seen here in many cases. And I am not attacking all professors who teach banking. But for you to be so naive as to believe that the people, at least some of the ones we have seen here, understand banking you are wrong. They do not, and to live under that illusion is a mistake. We had one professor here who admitted he knew very little about banking, and yet he was testifying on this bill and said he was all for it.

I believe your industry is going to have to be alert, because a lot of us have forgotten or do not know what is being taught in the schools and colleges today. And frankly, they know little or nothing about banking. And I think we all have an obligation to see that more is done in that direction.

On the statement that was made by Mr. Sommer, regarding the 3,500 trust departments that would have to file annual reports, could you give us for the record through your association some kind of an idea of what the cost involved would be in this kind of reporting that is recommended in this bill?

Of course that cost would have to be added to all the other costs of your business. And we have a great number of complaints, especially on this committee, that interest rates are too high. Well, one reason that interest rates are too high is because, frankly, your business is so overregulated, with all the reports that you have to make to all the Government agencies at all levels that I think we on the committee should know if we do impose these restrictions on you what the cost will ultimately be to the customer. The consumer is the one that has to pay that cost.

I have no further comments. I think that you people have done an excellent job in presenting your subject, and I think you have every right to oppose this legislation, because I agree with one of our colleagues here, I think it should be named the "Bank destruction bill." That is what it is.

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Mr. SOMMER. Mr. Chairman, could I answer him briefly?

Yes, indeed; we will attempt to do that. It will have to be approximations and estimates, but we will furnish the committee with that estimation.

Thank you very much, Mr. Chairman.

(In response to the information requested by Mr. Rousselot, the following information was received from Mr. Sommer for inclusion in the record:)

REPLY RECEIVED FROM MR. SOMMER

The American Bankers Association took a brief survey of nine trust departments over the country, asking each to estimate its cost of supplying the data proposed in Section 12. The banks were chosen with an eye toward broad geographic spread—banks from Maine to California were included, with no two from the same State. Also diverse sizes were selected—from several billions in trust assets to under $50 million. Each estimate included two figures, the first being the initial expense of "tooling-up," that is, preparing the system and designing the necessary programs to provide the needed information; the second estimate was the annual expense of maintaining the system and providing the data. The costs reported were as follows:

	Startup cost	Annual
Very large trust departments ($1,000,000,000 or more in trust assets):		
Bank A	$40,000–$45,000	$10,000–$15,000
Bank B	15,000	40,000–50,000
Bank C	4,000–5,500	6,300
Medium-sized trust departments ($350,000,000 to $700,000,000 in trust assets):		
Bank D	3,000	10,000
Bank E	3,000–4,000	2,500
Bank F	2,000	7,400
Small trust departments ($100,000,000 or less in trust assets):		
Bank G	36,000	23,300
Bank H	4,000–5,000	15,000–16,000
Bank I	1,600–2,000	2,600–3,000

One small bank pointed out that its estimated annual reporting costs approximated 10 percent of last year's gross trust fees.

The great differences in costs are due to the many different systems currently in use and the varying degrees of automation of the various stocks. One general assumption was made—"Value," as used in Section 12, is defined as book or carrying value. In most cases, to report market value would substantially increase costs.

Mr. BARRETT. Do any of the other panel members want to respond to anything the gentleman said?

Mr. RENCHARD. I would like to thank him.

Mr. BARRETT. I think he is deserving of being thanked.

But I do want to say, I do not think any member of your panel has been cut off here this morning.

Mr. ROUSSELOT. There have been three or four occasions before they were allowed to complete their statements.

Mr. BARRETT. Has the gentleman finished?

Mr. ROUSSELOT. Yes; I think my position is abundantly clear.

Mr. BARRETT. Gentlemen of the panel, this is Mr. Gonzalez. He is the father of H.R. 3287. I think in your testimony you indicate that you are not for his bill. He would like to address himself to the panel. Mr. Gonzalez.

Mr. GONZALEZ Thank you, Mr. Chairman.

First, let me say this. It is good to laugh and have a good joke at the expense of the chairman and the intention of those that in good faith have offered some of this legislation. But I think it would be a

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lot funnier if you could get some of the Americans who have lost their money as a result of some of these malpractices that we are trying to correct, I think it would be a lot funnier. Maybe you can get them to laugh sometime.

But let me say this. I have read your statements. And of course they echo the sentiments predominantly expressed not only by bankers, but by some of the regulatory agencies, with respect to my specific bill that would prohibit the acquisition of banks through the hypothecation of bank shares. And what I had in mind, I think, is pretty obvious. And yet I have said all along that I am open to suggestions. I just cannot conceive of any of you gentlemen representing the tremendous enterprise that is the American banking system, nor for that matter the regulatory agencies through their spokesmen, or the Members of the Congress, saying that it is all right, for example, to have the situation you have right here in this area with the Public National Bank, which has been taken over. It has been taken over in mute. It is teetering. Everybody wants to hide what is happening. Nobody wants to say anything about it. But it has been taken over by a holding company interest in Michigan. Now, it is very interesting, why would a company in Michigan come all the way over here to this particular bank, milk it, unload bad paper on it, to the point where innocent depositors are not only hurt already, but will be further hurt, and further innocent depositors who are not being told anything about this will be hurt, simply because of this approach of a bank takeover, which seems to have no qualifications whatsoever?

I cannot understand any reasonable mind finding anything wrong with trying to control this when, if you are going to have a bank merger, you not only have to report it, you have to go in in anticipation of your bank merger and get regulatory authority and permission for it. If you are going to have a holding company formation you have to do the same thing. What is so wrong about knowing something about this in the case of a bank acquisition where most of your questionable practices have arisen?

We had the Chairman of the FDIC—and I am pretty sure that he is a little bit more concerned than he was at the beginning of these hearings, because he is the man with the bag—they are the ones that are paying out the money, they are paying out the money, Sharpstown $50 million, and in Michigan another hundred or so million.

And in the dealings with Sharpstown the FDIC record shows that on March 28, 1968, both they and the banking examiner of Texas went in and discovered that Sharpstown had diverted $22 million for the acquisition of three banks.

Less than a month and a week later, on May 7, they went back and discovered that Sharpstown had used about $875,000 in the acquisition of another bank in Illinois. No questions asked, no objections interposed.

The Sharpstown bank folded later. The FDIC is going to have to shell out $50 million. A bunch of innocent people are hurt, I have them in my district, credit unions that said, well, this is a good bank because it is an insured bank, and we have regulatory authorities on a State and national level, and surely their imprimatur means they are all right, we will deposit our money there.

But even in the face of that the regulatory authorities could not

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come up with any suggestion—your bill is no good, it will destroy us, as the discussion here by Mr. Parsch would indicate, but not one suggestion about, what do we do in lieu thereof. So your bill is too comprehensive, it is too severe, but it will offer this, because we recognize there is a problem.

Yes, I am sure that you will agree with me, unless I am wrong, that you do not approve the kind of takeovers that I have been describing. Do you think it is all right for the Sharpstown bank to go ahead and divert $23 million of its resources—for what, for bank takeovers—merely because the banking industry feels that they ought to have this right unimpeded? Is there any suggestion about what can be done if this bill I am suggesting is too harsh? I am open to suggestions. But I am saying that right now there are banks that have been taken over that are teetering. And the regulatory agencies, their philosophy is that their first duty is to the banking industry, they have got the erroneous idea that the Congress set them up to protect the banking industry, and to look out for its ease and convenience. And the truth is that they are supposed to be looking out for the public interest.

You as bankers have one of the greatest privileges that the Government can provide any class of citizens. In exchange for that you subject yourselves supposedly to regulations. All we are saying is that we as Members of this Congress have been on notice for a few years that grave abuses have crept into the system. We have a duty to do something about it. None of us wants to unduly bridle or handicap the banking industry. We are fully aware that the overwhelming majority and preponderance of the banks are OK. But I am saying to you that if you do not join us in doing something constructive, you are going to be hurt too, because confidence and trust will be eroded. And your whole operation depends on confidence and trust.

What I want to know is, besides being against the bill, what suggestions do we have.

That leaves very little room for answering the question.

I would think that if my time has expired, that the gentlemen are free to enter into the record any comment or anything by way of a response to the statements I have made.

Mr. BARRETT. Will the gentleman yield?

Mr. GONZALEZ. Certainly.

Mr. ROUSSELOT. The time of the gentleman from Texas has expired.

Mr. GONZALEZ. I ask unanimous consent that I be allowed to formulate additional questions to this array, and that they be given a chance to answer for the record.

Mr. BARRETT. In writing?

Mr. GONZALEZ. In writing.

Mr. BARRETT. Would you be kind enough to do it for us?

Mr. PARSCH. Yes, we will.

Mr. ROUSSELOT. There are two that held up their hands to answer. Will they be allowed the opportunity to answer in writing?

Mr. BARRETT. The gentleman cut his time off.

(In response to the information requested by Mr. Gonzalez, the following reply was received for inclusion in the record:)

REPLY RECEIVED FROM MR. SOMMER

The American Bankers Association sees no need for legislation to prohibit the use of bank credit to purchase bank stock. We see no difference between the

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extension of credit to purchase the stock of a bank and the extension of credit to purchase the stock of any other corporation. Prohibitions such as those contained in H.R. 3287 would have the effect of making bank stock an undesirable investment. The availability of this type of loan to buy bank shares increases both the liquidity and saleability of the equity shares of banks, particularly small banks.

As you know, insured banks are already required to disclose changes in bank ownerhsip to the appropriate bank regulatory agency, where 10 percent or more of the stock is involved. In addition, the Federal Reserve can impose margin requirements on bank stock traded on the major stock exchanges.

If necessary, we feel that the bank regulatory agencies should be given the flexibility they may need to enforce regulatory powers in this regard. As FDIC Chairman Wille noted in his letter of April 12 to this Committee:

"Changes in the remedies available to the regulatory agencies when a cease-and-desist order is violated would materially assist the agencies in curbing a variety of unsafe and unsound banking practices, including those that might arise following a change of control financed by bank stock purchase loans extended by another bank."

We can understand the concern which Mr. Gonzalez may have with regard to loans to purchase bank stock. However, we do not feel that a few isolated cases in which the failure of a bank appeared to be somehow related to use of bank credit to purchase bank stock is an adequate reason to prohibit a type of loan which is commonly and prudently used, both in banking and elsewhere in the economy.

Mr. BARRETT. Mr. McKinney.

Mr. MCKINNEY. Mr. Chairman, I am going to make a very brief statement, and then I will be glad to yield the remainder of my time for the gentlemen to answer the questions.

Mr. BARRETT. Thank you, Mr. McKinney.

Mr. PARSCH. Mr. Gonzalez, we would like to refer to the testimony that I asked to be made a part of the record that I did not have an opportunity to deliver in oral form this morning. I was going to deliver a summary. But on pages 8 and 9 and 10 of that testimony we have suggested quidelines for the statute to implement laws to the FDIC. And we in our association would be very happy to have correspondence with you. And we agree that there are abuses, and we agree that many of these should be corrected. And we would be very glad to correspond with you. You will have a chance to study these in more detail, and then we would be open to your suggestions.

Mr. BARRETT. Any other panel member? Mr. Renchard.

Mr. RENCHARD. If I may, Mr. Chairman, I would like to say that fortunately the abuses to which Mr. Gonzalez referred are few and far between.

Also under the terms of his bill, as I understand it, it would prohibit a bank making a loan against any amount of bank stock even down to one share, which I think is a little too restrictive.

There is in the Bank Holding Company Act a provision now that requires the approval, I believe, of the Federal Reserve on any acquisition of as much as 25 percent of a bank.

Also we have in New York State a law which requires anyone acquiring as much as 10 percent of a bank to submit to the sort of examination on the part of the banking authorities which is very similar to that required of people organizing a new bank.

So there are ways to handle this without such a sweeping prohibition as your bill proposes.

Mr. BARRETT. Any other panel member?

(No response.)

Mr. BARRETT. All time has expired.

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Mr. McKinney. Mr. Chairman, I do not believe my 5 minutes has expired.

Mr. Barrett. I thought you said you would give it away.

Mr. McKinney. I was going to yield the time to them to answer.

I want to say that I am delighted to hear your testimony. I consider this bill, H.R. 5700, to be a disaster to the financial community. I think your testimony pretty well backs this belief up.

There are certain things, however, that I would like to see. We have had college professors who have implied that every banker and everybody involved in business, in fact the entire free enterprise system of the United States, is full of collusion, sinister implications, and corrupt men. I do not believe that.

But we have had, I think, a lack of alternatives. There has been a great deal of suggestions made that the Clayton Antitrust Act be amended and changed. It is already a voluminous law, but I think this is one direction in which to go. We have had many suggestions that the FDIC and the SEC change some of their regulations.

You know, I think, as well as I do, that there are abuses. I agree with Mr. Gonzalez; there are abuses. We have seen them. They are documented. I think what this bill is doing now is reaching far beyond the abuses in destroying the financial community of the United States, one of the rare nations in this world where we can manufacture capital and move ahead at such an incredible rate.

What I would like to see—for instance, I am a great admirer, though not a resident, of New York State's banking laws. I consider them to be among the very best in the United States of America. But I am not knowledgeable on them. And I am sure that there are a great many members of this committee who are not knowledgeable.

You have been very nice to come here and spend this time. You have large staffs. And I would like to impose on them. I think that this committee would be well served if you could get together with a minimum of disagreement, because together you are going to swim or together you are going to sink, and come up with some ideas as to how the regulatory agencies, or amendment to existing legislation, could solve the abuses that this mammoth sledge hammer of a bill is trying to solve. And that would just be my request. I think that you could probably give us information which would be of great value to the committee as a whole. And I am sure each member on the committee would love to receive it individually by mail.

Thank you very much.

Mr. Barrett. Thank you, Mr. McKinney.

Mr. Annunzio.

Mr. Annunzio. Thank you, Mr. Chairman.

I have one question. But at the outset I would like to make a statement.

During 1970 we have all seen profits of corporations down to their lowest level. But, fortunately, for us we have seen the profits of banks the highest in the history of this industry. So, I am not ready to join any of my colleagues with a crying towel for the bankers of America, nor am I interested, as I have stated before, in discriminating against or hurting any particular industry. I think we must always realize that we are living in an era of big business. Big business is good for the country and big unions are good for the country.

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We are living in an era of bigness. And in all fairness to the staff of this committee, it has been working for over 2 years doing research on interlocking directorships and on trust funds—all under the authorization of this full committee. They did not under take the studies without authorization of this full committee.

On the basis of these studies that have been going on for the past several years, this legislation was formulated. But I do not like to see tempers flare as I have seen this morning. I think that the men who put their names on this bill—and I am one—did so in good faith. I represent LaSalle Street in Chicago, and I probably have more banks in my entire district than any other member on this committee. We did it in order to have in airing out, and when the final markup time comes, this bill will go up or down.

Each section will go up or down. A bill might never come out of this committee, but at least we will have had the benefit of a hearing and the views of the professors, the banking industry, and the associations, so that the members of this committee can be guided by your good judgment. I know that every member of this committee is sincere and honest in wanting to do what is best for the people of America. With that I want to ask one question of Mr. Renchard.

On page 4 of your statement you state that an insider on the board of directors would not secure an unwise loan in the face of competition, stockholder, depositor, and regulatory pressures. This committee must assume that these pressures did not operate in the case of the loans to the Penn Central Railroad, since substantial loans were made to the Penn Central even after their shaky financial condition became known to the bank.

And before you answer that question, I want you to know, I am not one that talks from both sides of my mouth. I have voted on the floor of the Congress to give the appropriation of moneys to the trustees in order to get the Penn Central Railroad out of hock if we can possibly do it for the good of this country. But at the same time I do not like what has happened with the Penn Central and its relationship to some of the banks and some of its fiduciaries or companies that they control.

Mr. RENCHARD. Is that a question?

Mr. ANNUNZIO. Yes. On the basis of your statement on page 4:

> A creditworthy company does not need a friend on the board to attract the interest of that bank or its competitors. If it is not creditworthy, no such insider could prevail in causing an uneconomic use of resources to continue in the face of competition, stockholder, depositor, and regulatory prices.

Mr. RENCHARD. I might say this, sir. As far as our bank was concerned, there was no interlock with Penn Central.

Mr. ANNUNZIO. I can appreciate that.

The gentlemen representing the ABA, would you like to answer that question for the record later, Mr. Sommer?

Mr. SOMMER. Yes.

Mr. ANNUNZIO. I ask unanimous consent that Mr. Sommer be requested to answer as best he can my question.

Mr. SOMMER. Later, sir?

Mr. ANNUNZIO. Yes.

Mr. BARRETT. That may be done without objection.

Mr. ANNUNZIO. When you get the written transcript.

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Thank you very much, Mr. Chairman.

(The information requested of Mr. Sommer by Congressman Annunzio follows:)

REPLY RECEIVED FROM MR. SOMMER

The American Bankers Association cannot speak for the indiyidual banks involved in making credit available to Penn Central or its affiliates. We feel confident, however, that the extension of any credit to Penn Central was made on the basis of customary prudent and sound lending practices consistent with information available at the time. As these hearings have brought out, competitive pressures, shareholder and depositor interest, and regulatory scrutiny all argue against a bank ignoring prudence in the extension of credit, even to a firm with which a member of the bank's board is associated, if that firm is not credit worthy.

We know of no loans that were made by U.S. banks between the time serious weaknesses were revealed and the Penn Central bankruptcy. Some loans were made in the early stages of need.

This should not be taken to mean, however, that it is an unusual or questionable banking practice to extend credit to a firm temporarily in need of funds and where longer-term prospects would not be considered unusually risky. Indeed, it may be sound and prudent lending, particularly if the bank had a satisfactory credit relationship with a firm, but which for one reason or another additional funds were needed to tide the company over. The bank would cooperate, obviously, only in the full expectation that the firm would remain solvent. Unfortunately, in the Penn Central case, the extension of additional credit did not have the desired effect. However, in other instances it has enabled firms to remain in business.To grant the request for additional credit to supplement an initial loan is often the most prudent decision for a lender to make. In addition, public interest aspects may have played an important role in the decision to provide additional funds to Penn Central.

In the financial crisis of the summer of 1970, after the failure of the Penn Central, the banking system of America made loans to many big U.S. corporations which were in very serious financial trouble. The chairman of the Federal Reserve Board said that the actions of the banking system in taking these risks (without publicity) was a major contributor to saving our economy from grave difficulty. In the case of Penn Central, the banks tried to save it for reasons discussed above, but they simply judged wrong,

That's the nature of the credit business. We live in a risk society. While banks judged wrong on Penn Central, they assessed correctly in dozens of other unnamed corporations which are alive and well today because banks fufilled their role as the key commercial lenders of society.

Mr. BARRETT. Mr. Frenzel.

Mr. FRENZEL. Thank you, Mr. Chairman.

Welcome to the panel, and thank you for your testimony.

Mr. Sommer, you were questioned by one of the members of this committee about your testimony in opposition to sections 2 to 9—which is of course supporting the position of the regulatory agencies with respect to the interlocks. You were asked what that would do to your board. You indicated that it would wipe your board out pretty well. I think that some of the members here may have an idea that you serve some vast octopus of a bank of which you are president. I wonder if you would tell them the size of your town and of your bank.

Mr. SOMMER. Mr. Frenzel, I would be very happy to.

Owatonna is a town of 15,000 in southern Minnesota. Our bank does happen to be the largest in the county, with total assets of $33 million.

Mr. FRENZEL. And its tentacles extend throughout the whole county?

Mr. SOMMER. Mr. Frenzel, I think that would be true. But Steele County is one of the two smallest counties in the State of Minnesota, and Minnesota is not the largest State in the United States. We have

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11 directors, two inside directors, and nine outside directors. Six of the nine outside directors would be immediately affected by this bill. There are two others who are finishing their responsibilities as of the end of this year. So if this bill went into effect, I would have to find eight new directors out of nine this year. And as I mentioned, the ninth is one whose business I would like to get.

Mr. FRENZEL. May I interpret your statement, then, to say as a small town banker that if this bill were passed in its present form that it would make it difficult for you to get directors of the same quality, and that the management of your bank would suffer?

Mr. SOMMER. It would be impossible to get that many directors of the same quality in our community. I think this very seriously affects banks in smaller communities. But I would also say that it would very seriously affect banks in any size community.

Mr. FRENZEL. Thank you.

We are also indebted to you for your discussions on the 100-percent insurance, where you have made the point that you eliminate soundness of management as a consideration for the placement of deposits, and also that it changes the competitive factors between forms of institutions. One of the things that I did not feel was brought out in the testimony was, what happens to the costs? We have just heard testimony here that indicates extra cost of reporting in trust departments that has to find its way back into the bank's schedule of charges. Is it not true also that I, as the minimum depositor who does not get advantage of the 100-percent insurance, if I borrow from the bank, or use any of its services, that I am in fact going to be paying those costs?

Mr. SOMMER. Mr. Frenzel, there is no question but what any additional regulation or reporting involves cost—and some of this reporting would involve large costs—it would be added to the costs of the banks. And despite the fact that banks did have quite a good year last year, over the long run this certainly will add to the cost of doing business, which will have to be passed on to the customer.

Mr. ROUSSELOT. Would the gentleman yield?

Mr. FRENZEL. I yield.

Mr. ROUSSELOT. I thank the gentleman. I wonder if your American Bankers Association could also give us some idea, by surveying your membership across the country, especially among the smaller banks, as to how many would be affected adversely by this law. That is, would the provision require them to eliminate bank directors and, in addition, could we have some kind of idea actually how many bank directors would be affected. I do not want to create more paperwork for you than we have already created for you in the Federal Government, but if you could give us some idea of how this legislation would affect all banks it would be helpful.

Mr. SOMMER. I would be happy to do that.

Mr. ROUSSELOT. Especially the small country banks that Mr. Patman wants to protect.

Mr. CARLSON. We would be glad to do so.

Mr. BARRETT. I wonder if the gentleman would yield?

Mr. FRENZEL. I yield.

Mr. BARRETT. On the basis of what you said, Mr. Sommer, are you associating this with the proposed legislation, or the inability due to the area in which you live?

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Mr. SOMMER. No, I am associating it with the terms of this proposed legislation if they were passed as they now are in the bill.

Mr. BARRETT. Which part of the bill and which terms? This is what I am trying to get in the record.

Mr. SOMMER. Thank you, Mr. Chairman.

In particular, the two areas where a director could not serve on a board of directors if there was a substantial and continuing lending relationship with the company with which he is a director, and also the provision that if any director, officers, employees, or trustees—or members of their immediate families—own collectively 5 percent or more of a corporation, the bank could not make loans to that corporation. As I pointed out in my testimony, this could affect a lot of small corporations.

Mr. BARRETT. You have implied that you are just about to lose two members.

Mr. SOMMER. Yes.

Mr. BARRETT. Let me ask you that question. If you took these two points out that you referred to, what effect would that have?

Mr. SOMMER. We would lose six out of our nine outside directors.

Mr. BARRETT. Yes.

Mr. SOMMER. If these two provisions were eliminated from this bill, then our board would be intact. But this might not necessarily be true in all banks, with the inhouse legal counsel and the other provisions.

Mr. BARRETT. That is what we are trying to get in the record.

Mr. FRENZEL. Mr. Chairman, I would like to address a question to Mr. Renchard.

Your testimony indicated that sections 12 and 13 of the banking trust restrictions would tend to externalize the ownership or take the control away from the management. Yet it seems to me that sections 2 through 9 have the stated intention of inbreeding the management or making the board of directors internal. Do these seem to be contradictory provisions, too?

Let me restate it. Sections 12 and 13 relate to how much of your own bank you can own or hold in some kind of a fiduciary relationship. It seems to me that would tend to externalize the ownership of any particular bank, and that therefore you would have less control internally and more control externally. Sections 2 through 9 would kick out everybody on the board except your own officers and employees. Do not these provisions contradict one another?

Mr. RENCHARD. I think in a way they do, yes, sir.

Mr. FRENZEL. Do you have any comment on them?

Mr. RENCHARD. No. Two through nine obviously are the sections that would decimate the forces of a great many banks, because they cover a variety of areas where a director would be disqualified. I do not know that there is too much of a tie-in here. This is another subject, this question of the ownership of the stock. We have a number of situations where we in a fiduciary capacity have to hold the stock of the bank because we are named executor under the will and there is a specific requirement for holding it, and you either have to observe that or the appointment would go to some other bank.

Mr. FRENZEL. Thank you very much.

If I have a trust account in your bank, could I direct you to buy under the terms of this bill, for my trust account, for my incompetent

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aunt or minor children, stock in your bank? If this bill were the law, you could not do that, could you?

Mr. RENCHARD. That is correct.

Mr. FRENZEL. If I still wanted to buy your bank's stock I would have to take my trust elsewhere, wouldn't I?

Mr. RENCHARD. Yes.

Mr. FRENZEL. So if you had a good bank and I wanted to buy your stock I could not use your good trust department?

Mr. RENCHARD. That is right.

Mr. FRENZEL. So the better you were the less able I would be to use your services?

Mr. RENCHARD. That is the way I understand the bill.

Mr. FRENZEL. That is the way I understand the bill all the way through.

Mr. BARRETT. Mr. Chappell.

Mr. CHAPPELL. Mr. Carlson, let me say that I read your statement, and in general concur with it. I want to ask you—there are two particular areas that I have considerable interest in. One is the equity participation facets of this bill, and the other is the one dealing with the brokered deposits.

Now, with reference to your comments on page 7 dealing with equity participations in section 14 of the bill, do you think that this prohibition should also extend to insurance companies?

Mr. CARLSON. Yes, sir.

Mr. CHAPPELL. You say it should extend to all lending institutions?

Mr. CARLSON. Yes, sir.

Mr. CHAPPELL. That is my view, and I appreciate that.

With reference to brokered deposits—and may I again commend your stand on that—and I assume from your statement that if the bill were limited to those two particular propositions, you would have no objection at all to the bill?

Mr. CARLSON. That is correct, sir.

Mr. CHAPPELL. With its extension to all financial institutions?

Mr. CARLSON. That is right.

Mr. CHAPPELL. With reference to your comments on page 9 on giveaways, I notice that in general you concur with the intent of the bill, but oppose those particular sections. Do you oppose the wording?

Mr. CARLSON. We do not oppose the sections.

Mr. CHAPPELL. I see.

Mr. CARLSON. But we do feel the present FDIC——

Mr. CHAPPELL. You feel that it can be controlled by regulation alone?

Mr. CARLSON. Yes, sir.

Mr. CHAPPELL. Aren't there instances of abuse today with the present regulations?

Mr. CARLSON. There have been, I have seen them.

Mr. CHAPPELL. Is that a fault of the regulations, or a fault of the enforcement of the regulation?

Mr. CARLSON. I really don't know. I would guess the enforcement. Some bankers do not report that other bankers are doing things wrong.

Mr. CHAPPELL. If these giveaways were handled inside of the statutory limitation presently existent, would there be any objection to that?

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Mr. CARLSON. No, sir.

Mr. CHAPPELL. It is only when they go outside of the limitation that you would find it objectionable?

Mr. CARLSON. Yes, sir.

Mr. CHAPPELL. And is that where you find the abuses today?

Mr. CARLSON. Yes, sir.

Mr. CHAPPELL. Then actually there would be no objection if it were spelled out in the law in that way, there would be no objection to that on your part if it were spelled out in the law?

Mr. CARLSON. That is correct.

Mr. CHAPPELL. So in these three areas of the bill you would concur with those explained changes.

Mr. Sommer, let me ask you a question, if I might.

With reference to section 11 on your page 4 you seem to concur with the intent and purpose of section 11, but disagree with the language. Do you have any proposed language which would satisfy your concurrence?

Mr. SOMMER. Mr. Chappell, this is influencing by officers and employees of customers?

Mr. CHAPPELL. Yes, sir.

Mr. SOMMER. No, we do not at this time, Mr. Chappell.

Mr. CHAPPELL. I wonder if you would submit that.

The Chairman, I would like to ask unanimous consent.

Mr. SOMMER. We would be very happy to study it and try to submit language. It is a difficult area, so I would not want to promise that we could submit exact language.

Mr. BARRETT. Without objection that may be done.

Mr. CHAPPELL. I would like to have the gentleman's suggestions on it, because that is the way we can always take the intent of what is good in a bill and protect it, and arrive at what all of us generally agree on and that which would maintain the proper amount of competition in the banking industry as well as other fields.

Mr. SOMMER. Yes, sir.

Mr. CHAPPELL. Mr. Chairman, I notice that a number of these statements in general concur with many of the intents of the bill, but disagree with the wording, and do not specify how that wording ought to be changed. I would like to request as a general thing that where these gentlemen in their statements have in general agreed with the intent but disagreed with the wording, that they each be requested or given the opportunity to submit wordings so that we might consider those, and therefore get more input from their industry.

Mr. BARRETT. In other words, you are asking them section by section to indicate what they object to and what they think they should be?

Mr. CHAPPELL. Yes; whether they agree generally with the intent but disagree with the language of the bill, to give us some alternative language.

Mr. BARRETT. Would the panel agree to comply with the gentleman's request?

Mr. SOMMER. Yes, sir; we will make every attempt to do that.

Mr. BARRETT. That may be done. Without objection it is so ordered.

Mr. CHAPPELL. That is all, Mr. Chairman.

Mr. BARRETT. All time has expired, gentlemen. You have been very

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fine witnesses here this morning. We are grateful for having you. I think, as it was pointed out here, much will be discussed in general debate in marking up the bill. And I do think we will come up with something that will satisfy everybody.

Mr. SOMMER. Mr. Chairman, on behalf of all the panel, thank you very much for your attention, your questions, and your listening to our testimony.

Mr. BARRETT. Thank you, sir.

This committee will stand in recess until 10 a.m. tomorrow morning.

Thank you very much.

(Whereupon, at 12:40 p.m. the committee recessed to reconvene at 10 a.m., Friday, April 30, 1971.)

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THE BANKING REFORM ACT OF 1971

FRIDAY, APRIL 30, 1971

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND CURRENCY,
Washington, D.C.

The committee met, pursuant to recess, at 10:05 o'clock a.m. in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman, Sullivan, Reuss, Hanna, Gettys, Chappell, Widnall, Dwyer, Brown, Heckler, and Rousselot.

The CHAIRMAN. The committee will please come to order.

This morning the witnesses are Harlan J. Swift, chairman of the Committee on Relations with Federal Supervisory Authorities of the National Association of Mutual Savings Banks; Mr. John Bryan of the Granite State Bank, Granite Falls, Wash.; Dr. Harold Oberg of Arthur Lipper Corporation; and Dr. Harley H. Hinrichs, chief economist for the Saver Incentives Premium Industry Committee.

It would be appreciated very much if each one of you gentlemen would summarize your statement and then we will proceed to questioning. We will first hear from Mr. Swift then Mr. Bryan, Dr. Oberg and Dr. Hinrichs.

So, Mr. Swift, you may proceed first, sir.

STATEMENT OF HARLAN J. SWIFT, PAST PRESIDENT, NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS, AND CHAIRMAN OF THE NAMSB COMMITTEE ON RELATIONS WITH FEDERAL SUPERVISORY AUTHORITIES; ACCOMPANIED BY EDWARD P. CLARK, PAST PRESIDENT OF NAMSB; AND P. JAMES RIORDAN, GENERAL COUNSEL

Mr. SWIFT. Mr. Chairman and members of the committee, my name is Harlan J. Swift and I am president of the Erie County Savings Bank in Buffalo, N.Y., past president of NAMSB and chairman of the NAMSB Committee on Relations with Federal Supervisory Authorities.

Accompanying me is Edward P. Clark, president of the Arlington Five Cents Savings Bank in Massachusetts, past president of NAMSB, and president of the Mutual Savings Central Fund, Inc., Massachusetts. Also appearing with us is P. James Riordan, general counsel of our national association.

We appreciate this opportunity to testify, on behalf of the mutual savings bank industry, on H.R. 5700, the Banking Reform Act of 1971.

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Mr. Chairman, in order to effect a summary, I am planning to omit sections of our complete statement, but would ask that the complete statement be placed in the record.

The CHAIRMAN. The whole statement will be placed in the record.

Mr. SWIFT. We agree with much that is in the bill. We find it impossible, however, to support the entire bill, because some provisions would have a seriously adverse impact—unintended by the sponsors, we believe—on savings banks and the depositors they serve. Specific amendments which we urge on behalf of the savings bank industry are attached to this statement.

The chairman and other members of the committee are already familiar with aspects of mutual savings banking.

Mutual savings banks, which exist in 18 of the 50 States, had their origin in this country 155 years ago.

The organizers of mutual savings banks regarded their position—and the law so treated them—as analogous to trustees of a public trust. In choosing trustees, two elements were—then as now—considered essential:

(1) That trustees be experienced in the management of money; and

(2) that trustees be willing to serve with no profit to themselves.

The Nation's mutual savings banks are still operated by men who are bound by the strictest fiduciary standards, and State savings bank statutes still refer to savings bank directors as "trustees."

While oriented fundamentally to local community needs in the 18 States where they exist, savings banks do place their excess funds in capital shortage areas throughout the Nation.

California, Texas, and Florida residents have benefited especially from the availability of mortgage credit from mutual savings banks. Our industry today holds over $8 billion of mortgage loans in these three nonsavings bank States. Billions of dollars of savings bank mortgage credit have also been channeled into Georgia, Alabama, Michigan, Illinois, Missouri, South Carolina, Mississippi, Virginia and other nonsavings bank States.

Because H.R. 5700 is intended to assure high standards for banking institutions and an absence of conflicts of interest, it is important to stress that the very foundation of mutual savings banking has been the high fiduciary standards to which it has adhered. By law and by custom, savings bank trustees and officers are held to the highest standards and are barred from self-dealing or conflict-of-interest situations.

With this introductory statement, Mr. Chairman, we would like to address ourselves to the specifics of H.R. 5700. Our industry has taken this legislation with utmost seriousness.

Section 2 of the bill would prevent savings bank trustees from serving as directors of any other financial institution. Since the enactment of the Clayton Act in 1914, mutual savings banks have been exempt from the provisions of section 8 of that act, which in general prohibits directors of member banks from serving as directors of other banks.

In spite of our conviction that interlocks have not in fact diminished competition, we would be unrealistic not to take cognizance of the increasing number of persons who have raised questions about in-

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terlocking relationships between depository institutions in the same competitive market. While not opposing such a prohibition, we regard certain amendments as absolutely necessary.

First, we request in amendment No. 1, that any prohibition apply only to interlocks between institutions accepting deposits from the general public in the same competitive area and not to nondepository institutions. There is no reason to deny the legitimate requirements of bank management in seeking competent directors in the securities or insurance industries or among companies providing service "in connection with the closing of real estate transactions." As Chairman Burns of the Federal Reserve noted in his letter of December 16, 1970, to Chairman Patman, "Bankers often have experience and expertise that qualify them to render valuable service in this role—director. Interlocking directorates, in other words, are not inherently wrong."

The second amendment we urge is that if any prohibitions against interlocks is enacted, a grandfather clause be appended, allowing those trustees which presently serve on savings bank boards to continue otherwise proscribed interlocking directorships for the remainder of their period of eligibility to serve, as limited by State law or corporate by-law.

This amendment will at least prevent the serious dislocations of the rather abrupt dissolution of management structure provided for in the bill.

Third, it is necessary throughout the bill for certain institutions to be granted technical exemptions from proposed prohibitions. Of acute importance is the situation of the savings banks in Rhode Island, where the State legislature, in order to increase the competitive ability of mutual savings bank, has authorized them to own and operate a commercial bank subsidiary. Profits of this subsidiary accrue to depositors of the mutual savings bank. Obviously dual board membership is necessary in such a case, if these banks are to continue to function.

Another technical amendment would be necessary if the prohibition of interlocking directorates between banks and insurance companies were enacted in the form proposed in H.R. 5700. It should be made clear that the term "insurance company" does not include deposit insurance associations like the Mutual Savings Central Fund, Inc. of Massachusetts, the sole function of which is to ensure the security and liquidity of Massachusetts savings banks, and the directors of which must, by law, be officers or directors of mutual savings banks.

Section 2 of the bill adds a new section 24 to the Federal Deposit Insurance Act, providing that no insured bank, officer, director of any insured bank, or member of the immediate family of such, shall control any title company, appraising company or company which provides "service in connection with the closing of real estate transactions."

Although we do not interpret the language to so require, this section might conceivably be considered as preventing mortgage companies or any real estate institution from being owned by a savings bank even though such ownership can provide great cost savings, of benefit for savings bank depositors and borrowers.

The intent of this section should be clarified so as to show that savings bank ownership of mortgage companies or other wholly owned service corporations was not intended to be prohibited.

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Section 2 adds a new section 25 to the Federal Deposit Insurance Act, which would prohibit persons who are trustees of an insured bank from performing legal services on behalf of any person undertaking a business transaction with such bank. We presume that the prohibition is directed only at an individual lawyer, and not to his entire firm. Further, the section should be clarified to make clear that a trustee would not be prohibited from representing his bank as its attorney.

Section 8 of the bill prohibits trustees, et cetera, from serving as directors of any corporation in which the bank holds more than 5 percent of any class of stock with voting rights. This provision requires technical amendments and exceptions such as are contained in amendment No. 3.

As pointed out earlier, the laws of the State of Rhode Island have specifically authorized mutual savings banks in that State to acquire the entire stock of one commercial bank and to operate such a bank as a subsidiary.

These Rhode Island savings banks have been exempted from the Bank Holding Company Act and so it is not clear that they would enjoy the exemption from section 8 set forth in section 8(b) for holding companies.

These institutions and all situations involving either wholly owned subsidiaries of a savings bank, institutions wholly owned by savings banks or institutions wholly owned by savings banks and other financial institutions should be exempted.

Section 9 prohibits directors, trustees, officers or employees of insured banks from also serving on the board of a corporation with which the bank has a "substantial and continuing" relationship with respect to the making of loans.

This section and also section 8 should provide for an exemption for "Savings Bank Trust Companies" and other organizations formed by the savings bank industry to perform services for savings banks. To illustrate, the "Savings Bank Trust Companies" are corporations organized by savings banks in the States of New York and Washington, which have as their sole purpose, the provision of services for all savings banks in the State, and which in no sense carry on a traditional banking, investment, or other business function. The stock of these institutions is held entirely by savings banks, and some of them hold more than 5 percent of that stock. The trust companies do not perform services for, nor accept deposits from, the general public.

Unless they and other savings bank-organized service companies are clearly and specifically exempted from sections 8 and 9, they cannot continue to carry out their functions.

Section 10 is a prohibition that is aimed solely at mutual savings banks and which is a cause of great concern throughout the industry. It provides that no mutual savings bank shall own stock in any insured bank, insured savings and loan, insurance company, bank or savings and loan holding company, or in any securities broker or dealer. It is a prohibition that has not been extended to commercial bank trust departments or to those State commercial banks which can own bank stock.

Savings bank holdings of commerical bank stocks represent about one-fifth of their total equity portfolio and less than 1 percent of total assets on an industrywide basis.

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This section would not only prohibit further investment, but also continued ownership of equity shares which have long been legally authorized investments for savings banks.

State statutory limitations on savings bank ownership of commercial bank stock are already sufficient to prohibit a savings bank from controlling a commercial bank. Further, in those very States where mutual savings banks may own commercial bank stock, competition remains most intense between commercial banks and savings banks. Consider, for example, the bitter confrontation between mutual savings banks and commercial banks which is occurring this legislative session on the subject of checking accounts for savings banks in New Hampshire, Massachusetts, and Connecticut, and the pending litigation between savings banks and commercial banks on the same subject in Maine.

Furthermore, in the States of Connecticut and Massachusetts, where savings banks may own insurance company stocks, the mutual savings banks, far from abandoning competition with these insurance companies, have increased it by offering the public savings bank life insurance, a service which the savings banks constantly attempt to make more competitive.

Our industry recommends that section 10 be deleted. No attempts at control have been made, nor will be made, of commercial banks and insurance companies, and State statutory safeguards are completely adequate to insure against the possibility. Our sixth amendment, in our statement would accomplish this deletion.

A technical amendment should be included in section 12 to make clear that the disclosure requirement does not include securities held under so-called "Keogh" trusts.

Section 14 of the bill prohibits lenders from accepting any "equity participation" in consideration of the making of any loan.

The term "equity participation" is used broadly here to include "income participation" loans as well, in which lenders share in the income—either gross or net—generated from the property securing the loan.

The savings bank industry as a whole engages only marginally in equity and income participation loans. We estimate that such loans represent less than 1 percent of total savings bank mortgage holdings, with the bulk of these involving payment by the borrower of a portion of income generated by the mortgaged property, rather than an outright ownership interest.

About one-half of our industry's participation loans were made on multifamily residential properties, and the other half on commercial properties, representing mainly retail and office facilities. Such loans, of course, do not involve one-family properties for home ownership.

Even though savings banks have little direct stake in participation loans, we urge that they not be prohibited. Such prohibition would be largely self-defeating, resulting in reduced lender willingness to make mortgage loans, including those on rental residential structures now in great demand, with consequent increases in interest rates to borrowers and in rental costs to apartment dwellers.

Current participation loan practices represent freely entered into agreements between lenders and sophisticated borrowers and repre-

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sent a type of variable mortgage rate practice in which returns to lenders vary with the general state of the economy and the particular experience of the property securing the loan.

Section 22 of the bill prohibits bank premiums. An important development in the area of bank premiums occurred recently when the New York Senate passed a bill which prohibits New York State-chartered institutions from offering premiums to the public except on the occasion of a branch opening. The New York bill also purports to prohibit national banks, and Federal savings and loan associations from such practices, but the efficacy of such a State provision is doubtful, to say the least. It is important that State-chartered banks in New York and elsewhere not be placed in an untenable position vis-a-vis National banks and other federally chartered competitors—including Federal credit unions.

Therefore the committee is urged to amend section 22 to direct the Federal supervisory agencies to make appropriate regulations in the area of bank premiums and to further provide that in any State where statutes or regulation limit bank premiums the Federal regulations adopted parallel their State counterparts. Equating the authority of nationally chartered institutions to State chartered institutions has ample precendent in the branching law which was enacted as part of the McFadden Act in 1927.

Mr. Chairman, I have a one-paragraph statement which is not in our statement as filed—if I may be permitted to read it to you.

Frequent mention has been made during these hearings of the bill formally introduced Tuesday by Mr. Widnall, H.R. 7809, which would authorize federally charatered mutual savings and loan associations to convert to stock institutions. The recent proposal of the FHLBB, with the support of the U.S. Savings and Loan League, to authorize the conversion of Federal mutual savings and loans to stock form does have far-reaching and very possibly adverse implications for the principle of mutuality and is, therefore, of great importance to all mutual savings banks. The NAMSB position is to urge the Congress that any legislation include restrictions which will bar windfalls or conflicts of interests in the disposal of the accumulated reserves of the converting mutual institution.

Provision must be made, such as, for example, transferring these reserves to the insuring agency, to prevent depositors, management or others from benefiting from such conversions. Because we believe this problem is so serious and because we would like to have an opportunity to be heard on this aspect of the conversion bill, we urge the members of this committee not to take action on this bill without public hearings on the issues it raises.

That completes my statement.

The CHAIRMAN. You may rest assured that we will not have public hearings on that unless we have notice to the public, and you may be a witness. We will be very glad to have you, and other people who have knowledge in this area.

This is really a big subject. I think everyone wants to do what is right about it. It is just a question of determining that we should have what we might consider a nest egg there of about $10 billion and we do not know exactly who owns it, and we must arrive at some satisfactory solution if at all possible.

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Thank you very much for your statement.

Mr. SWIFT. Thank you, Mr. Chairman.

(The prepared statement of Mr. Swift follows:)

PREPARED STATEMENT OF HARLAN J. SWIFT, PAST PRESIDENT, NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS, AND CHAIRMAN OF THE NAMSB COMMITTEE ON RELATIONS WITH FEDERAL SUPERVISORY AUTHORITIES

Mr. Chairman and Members of the Committee: My name is Harlan J. Swift and I am President of the Erie County Savings Bank in Buffalo, New York, Past President of NAMSB, and Chairman of the NAMSB Committee on Relations with Federal Supervisory Authorities. Accompanying me is Edward P. Clark, President of the Arlington Five Cents Savings Bank in Massachusetts, Past President of NAMSB, and President of the Mutual Savings Central Fund, Inc., Massachusetts. Also appearing with us is P. James Riordan, General Counsel of our National Association.

We appreciate this opportunity to testify, on behalf of the mutual savings bank industry, on H.R. 5700, the Banking Reform Act of 1971. The draftsmen are to be complimented for the great amount of time and effort which has gone into the preparation of what the Chairman has described as "comprehensive legislation concerning certain basic reforms that are vitally needed in the field of banking and finance." I request that our complete statement be included in the record.

We agree with much that is in the bill. We find it impossible, however, to support the entire bill, because some provisions would have a seriously adverse impact—unintended by the sponsors, we believe—on savings banks and the depositors they serve. Specific amendments which we urge on behalf of the savings bank industry are attached to this statement.

The Chairman and other members of the Committee are already familiar with many aspects of mutual savings banking. We hope they will bear with us if we set forth some of the background and record of achievement of our industry for other members, particularly those from non-savings bank states. This information is relevant to the bill and its effect on savings banking.

Mutual savings banks, which exist in 18 of the 50 states, had their origin in this country 155 years ago when, in 1816, the first two mutual savings banks were organized in Boston and Philadelphia. The men who organized these mutual thrift institutions were motivated by public service. Typically, they were distinguished citizens who saw the need for banking institutions which would encourage thrift among the less affluent members of society, and preserve and enhance their hard-earned savings through prudent investments. This was a vital need conspicuously unfilled by commercial banks and other financial institutions of that time.

The organizers of mutual savings banks regarded their position—and the law so treated them—an analogous to trustees of a public trust. In choosing trustees, two elements were—then as now—considered essential: (1) that trustees be experienced in the management of money; and (2) that trustees be willing to serve with no profit to themselves. The nation's mutual savings banks are still operated by men who are bound by the strictest fiduciary standards, and state savings bank statutes still refer to savings bank directors as "trustees."

The savings bank industry's performance over a century and a half of service in this country should leave no doubt as to their usefulness in the public interest. Its fundamental purpose and characteristics remain unchanged and are well reflected in a scholary study prepared by Professor John Lintner some years ago:

> "Mutual savings banks are service institutions with two essential functions . . . a responsibility to encourage habits of thrift and provide convenient, safe facilities to care for the community's savings . . . [and] a responsibility to invest those funds productively with maximum benefit to the community and economy consistent with necessary liquidity and safety, as well as a good return to their depositors." [1]

These functions—to encourage savings and to invest them safely and productively—have been the hallmarks of savings banking for the past century and a half. In fulfilling them, the industry has grown to over $80 billion in assets,

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[1] John Lintner, *Mutual Savings Banks in the Savings and Mortgage Markets*, Graduate School of Business Administration, Harvard University, 1948, p. 211.

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serving depositors having over 25 million savings accounts at 494 separate savings banks with over 1,500 banking offices. Nearly three-fourths of savings bank resources are invested in mortgages, mostly on residential properties.

In the states in which they are heavily concentrated—mostly in New England and the Middle Atlantic areas—savings banks dominate the savings and mortgage markets. In New York, Massachusetts and Connecticut for example, savings banks hold more savings deposits than all other types of deposit institutions combined. Savings banks in these states, moreover, hold about twice the amount of mortgage loans held by commercial banks and savings and loan associations.

While oriented fundamentally to local community needs in the 18 states where they exist, savings banks do place their excess funds in capital-shortage areas throughout the nation. In some particularly fast growing non-savings bank areas, savings banks have filled large housing credit gaps, and have provided for more FHA-insured and VA-guaranteed loans than have local commercial banks and savings and loan associations.

California, Texas and Florida residents have benefited especially from the availability of mortgage credit from mutual savings banks. Our industry today holds over $8 billion of mortgage loans in these three non-savings bank states. Billions of dollars of savings bank mortgage credit have also been channeled into Georgia, Alabama, Michigan, Illinois, Missouri, South Carolina, Mississippi, Virginia and other non-savings bank states.

Reflecting the orientation of mutual savings banks to people and communities our industry has compiled a notable record in financing low- and middle-income housing and community facilities. This record is evidenced, in part, by the leading position of savings banks in FHA and VA mortgage programs, which concentrate on financing the nation's middle-income families. Overall, savings banks hold more permanent FHA-insured mortgages under urban development and rehabilitation programs (Secs. 220 and 221) than any other type of lender. Savings banks are also in the forefront as lenders on nursing homes, hospitals, religious structures, shopping centers and other essential community facilities.

The savings bank industry has had a well-known and unrivaled record of safety and stability, free of scandal or other tarnish, over its long history. This is a record unmatched by other deposit-type institutions. In fact, reflecting the trust and confidence of people in mutual savings banking, savings bank deposit growth continued even during the years of depression in the 1930s, when other financial institutions were experiencing widespread failures.

This unique record has not gone unnoticed. A distinguished Congressional leader, Senator John Sparkman, in a 1963 statement made in the Senate of the United States, noted that:

> "Mutual savings banking enjoyed an eviable reputation for safety long before any system existed for insured savings through an agency of the Federal Government."[2]

And former Supreme Court Justice Reed commented in 1954 that:

> "The mutual banks have been successful in attracting a large proportion of savings deposits for over a century. They have a remarkable record for soundness in finance and profitable operation for the benefit of depositors."[3]

Professor John Lintner concluded in his exhaustive 1948 study that:

> "Savings banks have generally succeeded in offering a rather extraordinary degree of safety [reflecting] credit on the soundness of the organization of the system and its ability to enlist the continuing interest and support of able, public-spirited men as officers and trustees, as well as the general quality of financial administration the banks have enjoyed."[4]

Reflecting the universally high regard in which the savings bank industry is held, this Committee in 1967 reported out a bill to provide federal charters for savings banks, the intent of which in part was to permit the establishment of these institutions throughout the nation. This bill lacked but one vote in being reported out of the Rules Committee in 1968.

Because H.R. 5700 is intended to assure high standards for banking institutions and an absence of conflicts of interest, it is important to stress that the very foundation of mutual savings banking has been the high fiduciary standards to which it has adhered. By law and by custom, savings bank trustees and

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[2] Speech in the Senate of the United States, January 31, 1963.
[3] Associate Justice Stanley Reed in *Franklin Bank vs. New York*, 347 U.S. 373, 379, 98 L.Ed. 767, 772 (1954).
[4] Lintner, op. cit., p. 25.

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officers are held to the highest standards and are barred from self-dealing or conflict-of-interest situations. Indeed, our mutual form of organization and trustee management have been basic to the distinguished record of savings bank performance and safety in productively serving the public's thrift needs.

The late Professor Adolf A. Berle, one of the most astute and respected authorities on corporate structure, noted in a 1963 statement before a House Banking and Currency Subcommittee:

> ". . . I firmly believe that mutual savings banks organization in the long run is the safest and the best, as it has already proven the most productive . . . The mutual form is more logical when you are dealing with savings, and I think it is no accident that the mutual form has been in both the insurance and savings bank field on the whole more successful." [3]

In sum, the savings bank industry has established a long and proven record of safety, stability and high fiduciary standards. It continues to serve the nation's savings and mortgage markets effectively in competition with other types of financial institutions. Recent public and private studies are replete with evidence that the presence of savings banking has enhanced, rather than restricted, competition among financial institutions. These studies have shown conclusively that in communities where savings banks are located, mortgage interest rates are generally lower and deposit interest rates (whenever permitted by law) are higher than in areas where savings banks do not exist.

One current bit of evidence of the continued brisk competition between savings banks and commercial banks can be observed in state legislative sessions where additional powers are sought by one group and opposed by the other. There should be little fear about the diminution of competition between savings banks and commercial banks as each tries to serve more effectively markets in their areas.

One final point in this introductory material should be emphasized because it bears so directly on the proposal to deny savings banks the right to hold or acquire stock of other financial institutions. It should be recognized that from their inception, savings banks in several states were granted authority to invest in corporate equities. In authorizing such investments, state legislatures recognized the fact that savings bank often hold the life savings of modest-income individuals and families and, therefore, determined that equity investments should be limited to what were considered to be the most substantial and dependable corporations. Thus, in the early years of the industry, and for a considerable period thereafter, most states limited the equity investment authority of savings banks to the shares of commercial banks, insurance companies and utilities. This is why savings banks have come to acquire the stocks of financial institutions and not for any covert purpose of control or of minimizing competition.

Parenthetically, there are prohibitions and restrictions on mutual savings banks throughout the bill which may not apply to commercial banks because they can be avoided through the holding company device, which is generally unavailable to mutual savings banks. It is basic to our position that any activity authorized commercial bank holding companies should also be authorized to mutual savings banks.

With this introductory statement, Mr. Chairman, we would like to address ourselves to the specifics of H.R. 5700. Our industry has taken this legislation with utmost seriousness. Throughout out testimony citation of any section is meant to apply not only to the provisions affecting FDIC-insured savings banks but to their parallel provisions for non-FDIC insured banks.

Interlocking directorates—prohibition

Sec. 2 of the bill would prevent savings bank trustees from serving as directors of any other financial institution. Since the enactment of the Clayton Act in 1914, mutual savings banks have been exempt from the provisions of Sec. 8 of that Act, which in general prohibits directors of member banks from serving as directors of other banks. We do not believe that this exemption was carved out by any historical accident but rather because the Congress recognized that the danger of potential abuses was far outweighed by the countervailing considerations that savings banks must have highly skilled and experienced money man-

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[3] *Federal Charter Legislation for Mutual Savings Banks*, Hearing on H.R. 258 Before the Subcommittee on Bank Supervision and Insurance of the Committee on Banking and Currency, House of Representatives, 88th Congress, 1st Session, October 1963, pp. 304 and 309.

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agers to provide prudent stewardship, and that there are state and federal statutory and regulatory restrictions in force where savings banks operate that prevent any savings bank trustee from profiting from any conflict of interest.

Thus, *Sec. 2* of this bill would cause a significant change in the savings bank business. A change of this magnitude is bound to cause apprehension in any industry, but particularly one that has been accustomed to operating within the disciplines of the most meticulous fiduciary boundaries, and which sincerely believes that there have been no abuses because of the relationships it has had with other types of financial institutions.

In spite of our conviction that interlocks have not in fact diminished competition, we would be unrealistic not to take cognizance of the increasing number of persons who have raised questions about interlocking relationships between depository institutions in the same competitive market. A prohibition against interlocking directorates will present our industry with extraordinary problems. While not opposing such a prohibition, we regard certain amendments as absolutely necessary.

First, we request in *Amendment 1*, that any prohibition apply only to interlocks between institutions accepting deposits from the general public in the same competitive area and not to non-depository institutions such as brokerage, title and insurance companies. While interlock prohibitions between direct competitors might be thought to require restrictions, there is no reason to deny the legitimate requirements of bank management in seeking competent directors in the securities or insurance industries or among companies providing service "in connection with the closing of real estate transactions." As Chairman Burns of the Federal Reserve noted in his letter of December 16, 1970 to Chairman Patman, "Bankers often have experience and expertise that qualify them to render valuable service in this role [director]. Interlocking directorates, in other words, are not inherently wrong."

Illustrative of present day safeguards against any potential conflicts of interest arising out of service on a savings bank board and that of a nondepository financial institution is the Constitution of the State of New York, the state in which nearly 60% of the assets of the savings bank industry are located. An article in the Constitution specifically prohibits savings bank trustees from having "any interest, direct or indirect, in the profits of the savings bank."

An opinion of the New York Attorney General has interpreted this to mean that a savings bank may not purchase from, or sell to, one of its trustees real or personal property, nor may it so deal with a partnership of which the trustee is a member or with a corporation in which the trustee is a principal officer or general manager or has substantial stock holdings (*1949 Op. Atty. Gen. January 6*). The only New York exception to a trustee doing business with the bank is in the case of a real estate appraiser or the bank's attorney.

The kind of fiduciary restrictions found in the New York law have been characteristic of our industry for the past century and a half.

The second amendment we urge, (*Amendment 2*), is that if any prohibitions against interlocks is enacted, a grandfather clause be appended, allowing those trustees which presently serve on savings bank boards to continue otherwise proscribed interlocking directorships for the remainder of their period of eligibility to serve, as limited by state law or corporate by-laws. Both the Maryland and Massachusetts anti-interlock statutes provide for such a grandfather clause.

This amendment will at least prevent the serious dislocations of the rather abrupt dissolution of management structure provided for in the bill. Some savings bank boards of trustees would be severely affected by the necessity of removing virtually all directors who also serve other institutions accepting deposits from the general public in the same competitive market.

Third, it is necessary throughout the bill for certain institutions to be granted technical exemptions from proposed prohibitions. Of acute importance is the situation of the savings banks in Rhode Island, where the state legislature, in order to increase the competitive ability of mutual savings banks, has authorized them to own and operate a commercial bank subsidiary. Profits of this subsidary accrue to depositors of the mutual savings bank. Obviously, dual board membership is necessary in such a case, if these banks are to continue to function.

Amendment 3.

Another technical amendment would be necessary if the prohibition of interlocking directorates between banks and insurance companies were enacted in the

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form proposed in H.R. 5700. It should be made clear that the term "insurance company" does not include deposit insurance associations like the Mutual Savings Central Fund, Inc. of Massachusetts, the sole function of which is to ensure the security and liquidity of Massachusetts savings banks, and the directors of which must, by law, be officers or directors of mutual savings banks.

Companies proving services of title insurance, appraisal, or services related to real estate closings—prohibition

Sec. 2 of the bill adds a new *Sec. 24* to the Federal Deposit Insurance Act, providing that no insured bank, officer, director of any insured bank, or member of the immediate family of such, shall control any title company, appraising company or company which provides "service in connection with the closing of real estate transactions." Although we do not interpret the language to so require, this section might conceivably be considered as preventing mortgage companies or any real estate institution from being owned by a savings bank even though such ownership not only can provide great cost savings, of benefit for savings bank depositors and borrowers but is clearly related to the fundamental business of savings banks. The intent of this section should be clarified so as to show that savings bank ownership of mortgage companies or other wholly owned service corporations was not intended to be prohibited. Such a clarification would serve to reconcile *Sec. 2* with the Federal Reserve's tentative approval (in proposed Regulation Y under the Bank Holding Company Act) of mortgage company indirect control by commercial banks through their holding companies.

Amendment 4.

Trustee Performing Legal Services—Restriction

Sec. 2 adds a new *Sec. 25* to the Federal Deposit Insurance Act, which would prohibit persons who are trustees of an insured bank from performing legal services on behalf of any person undertaking a business transaction with such bank. We presume that the prohibition is directed only at an individual lawyer, and not to his entire firm. Further, the section should be clarified to make clear that a trustee would not be prohibited from representing his bank as its attorney.

Service on Board of Corporation for which Bank manages welfare—pension plan—prohibition

Sec. 7 of the bill provides that no trustee, etc., may serve on the board of directors of a corporation with respect to which the bank manages an employee welfare or pension benefit plan. This section has no general application to savings banks.

Service on board 5% owned corporation—prohibition

Sec. 8 of the bill prohibits trustees, etc., from serving as directors of any corporation in which the bank holds more than 5% of any class of stock with voting rights. This provision requires technical amendments and exceptions such as are contained in *Amendment 3*. As pointed out earlier, the laws of the state of Rhode Island have specifically authorized mutual savings banks in that state to acquire the entire stock of one commercial bank and to operate such a bank as a subsidiary, thus providing a complete range of services to savings bank customers and more effective competition with commercial banks. These Rhode Island savings banks have been exempted from the Bank Holding Company Act and so it is not clear that they would enjoy the exemption from *Sec. 8* set forth in *Sec. 8(b)* for holding companies. These institutions and all situations of which there are a number involving either wholly-owned subsidiaries of a savings bank, institutions wholly-owned by savings banks or institutions wholly-owned by savings banks and other financial institutions should be exempted.

Service on board of company with "substantial, continuing" relationships—prohibition

Sec. 9 prohibits directors, trustees, officers or employees of insured banks from also serving on the board of a corporation with which the bank has a "substantial and continuing" relationship with respect to the making of loans.

This section and also *Sec. 8* should provide for an exemption for "Savings Bank Trust Companies" and other organizations formed by the savings bank industry to perform services for savings banks. To illustrate, the "Savings Bank Trust Companies" are corporations organized by savings banks in the States of New York and Washington, which have as their sole purpose, the provision of services for all savings banks in the state, and which in no sense carry on a

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traditional banking, investment, or other business function. The stock of these institutions is held entirely by savings banks, and some of them hold more than 5% of that stock. The trust companies do not perform services for, nor accept deposits from, the general public. Rather, they provide depository facilities, loans, liquidity arrangements, investment advice, and research and statistical services solely for savings banks. These companies reflect the savings bank tradition of self-help in solving operational problems without government intervention. Unless they and other savings bank-organized service companies are clearly and specifically exempted from *Secs. 8 and 9*, they cannot continue to carry out their functions. In addition it seems that *Sec. 9* would prevent savings bank trustees, officers, directors and employees from serving worthy non-profit and charitable institutions in similar capacities if the institution has a substantial and continuing relationship with the savings bank with respect to credit. Surely such a result was unintended. Attached *Amendment No. 5* is designed to accomplish these changes.

Ownership of bank or insurance company stock—prohibition

Sec. 10 is a prohibition that is aimed solely at mutual savings banks and which is a cause of great concern throughout the industry. It provides that no mutual savings bank shall own stock in any insured bank, insured savings and loan, insurance company, bank or savings and loan holding company, or in any securities broker or dealer. This prohibition would abruptly reverse a tradition of decades in our industry. Further, it is a prohibition that has not been extended to commercial bank trust departments or to those state commercial banks which can own bank stock.

Savings bank holdings of commercial bank stocks represent about one-fifth of their total equity portfolio and less than 1% of total assets on an industrywide basis. Reflecting the investment considerations underlying this investment activity, savings banks generally diversify their portfolios widely among stocks of individual commercial banks.

As mentioned earlier, legislatures in savings bank states historically limited savings bank investments in equities to those issued by banks, insurance companies, and public utilities. This section would not only prohibit further investment, but also continued ownership of equity shares which have long been legally authorized investments for savings banks.

State statutory limitations on savings bank ownership of commercial bank stock are already sufficient to prohibit a savings bank controlling a commercial bank. Further, in those very states where mutual savings banks may own commercial bank stock, competition remains most intense between commercial banks and savings banks. Consider, for example, the bitter confrontation between mutual savings banks and commercial banks which is occurring this legislative session on the subject of checking accounts for savings banks in New Hampshire, Massachusetts, and Connecticut, and the pending litigation between savings banks and commercial banks on the same subject in Maine. And these very states are the major states in which savings banks can own commercial bank stock.

Furthermore, in the states of Connecticut and Massachusetts, where savings banks may own insurance company stocks, the mutual savings banks, far from abandoning competition with these insurance companies, have increased it by offering the public savings bank life insurance, a service which the savings banks constantly attempt to make more competitive against the bitter opposition of insurance companies.

Ownership of stock does not mean community of interest between savings banks and commercial banks. We sincerely believe that the potential effffect on competition alluded to by the distinguished Chairman in his introductory remarks has not come to pass. This Committee's 1967 Report on the Federal Savings Institutions Act cited independent studies showing that local savings are higher—and mortgage money more plentiful and less costly to borrowers—in areas where savings banks are present along with other types of financial institutions.[6]

Our industry recommends that *Sec. 10* be deleted because no diminution of competition between savings banks, commercial banks, and insurance companies

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[6] *Federal Savings Institutions*, Report on H.R. 13718, Committee on Banking and Currency, House of Representatives, 90th Congress, 1st Session, December 13, 1967.

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has occurred and in fact this competition constantly increases. No attempts at control have been made, nor will be made, of commercial banks and insurance companies, and state statutory safeguards are completely adequate to insure against the possibility. If there is any evidence of any combination by savings banks to control the policies of any commercial bank or insurance company, this information should be brought to the attention of the Department of Justice. *Amendment 6* attached would delete *Sec. 10.*

Acceptance or offering of "Benefits"—prohibition

Sec. 11 prohibits persons from accepting benefits from banks under an understanding that such benefit will influence their conduct vis a vis the bank. It also prohibits banks from offering persons benefits with an intent to influence the affairs between the bank and the employer of such persons. The mutual savings bank industry has no reservations as to the desirability of preventing such activities.

Fiduciaries; holding of securities—disclosure

Sec. 12 provides that banks which hold securities in a fiduciary capacity must make annual disclosure to the FDIC describing the securities so held, and how the bank has exercised proxies with respect to the voting rights of such securities. A technical amendment should be included in *Sec. 12* to make clear that the disclosure requirement does not include securities held under so-called "Keogh" trusts. (*Amendment 7.*) This would avoid the administrative burden of making myriad disclosures of relatively small trusts where the trustor selects the securities. Other than that, in the savings bank industry, only New Jersey savings banks enjoy trust powers.

Fiduciaries; holding of 10% of any SEC corporations—prohibition

Sec. 13 prohibits banks with fiduciary powers from holding in a fiduciary capacity more than 10% of the stock of any corporation registered with the SEC. The mutual savings bank industry takes no position on this provision.

"Equity Participation"—prohibition

Sec. 14 of the bill prohibits lenders from accepting any "equity participation" in consideration of the making of any loan.

The term "equity participation" is used broadly here to include "income participation" loans as well, in which lenders share in the income (either gross or net) generated from the property securing the loan.

The savings bank industry as a whole engages only marginally in equity and income participation loans. We estimate that such loans represent less than one percent of total savings bank mortgage holdings, with the bulk of these involving payment by the borrower of a portion of income generated by the mortgaged property, rather than an outright ownership interest.

About one-half of our industry's participation loans were made on multifamily residential properties, and the other half on commercial properties, representing mainly retail and office facilities. Such loans, of course, do not involve 1-family properties for home ownership.

Even though savings banks have little direct stake in participation loans. we urge that they not be prohibited. Such prohibition would be largely self-defeating, resulting in reduced lender willingness to make mortgage loans, including those on rental residential structures now in great demand, with consequent increases in interest rates to borrowers and in rental costs to apartment dwellers. Current participation loan practices represent freely entered into ageements between lenders and sophisticated borrowers and represent a type of variable mortgage rate practice in which returns to lenders vary with the general state of the economy and the particular experience of the property securing the loan.

Participation loans in the savings bank industry have not been made with the intent to share in the control and management of borrowing corporations, but rather as a method of providing equitable treatment to the lender which commits its funds to a loan for a long period of years at an interest rate which may prove—because of rising interest rates and inflation—to be quite unrealistics by the end of the term. A bank seeking to maximize its return on behalf of its depositors, is not seeking to exploit the borrower (which almost always is a corporation in such cases rather than an individual) but merely asks that if, as a result of the bank's assuming the risk of extending its credit, the borrowing corporation's profits are increased, the bank and its depositors should share in this result.

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Prohibition of equity participations could mean a lessening in the willingness of lenders to make mortgage loans (particularly long-term), including those on multifamily residential structures, with a consequent increase in interest rates to borrowers, rental costs to apartment dwellers, and a generally reduced volume of mortgage credit throughout the country.

The prohibition is so broad that it might also be held to prohibit investment in convertible bonds or in warrants. This would deny industry an increasingly popular method of acquiring capital. *Amendment 8 deletes Sec. 14.*

Loans to trustees and loans to 5% owned corporations—disclosure, prohibition

Sec. 15 requires disclosure by banks of all loans made to trustees, etc., or to any member of the immediate family of such trustee. In the savings bank industry there are generally statutory restrictions on the extension of credit to trustees. In any event the industry would have no objection to such a disclosure requirement. *Sec. 15* also provides that no bank shall make a loan to any corporation with respect to which 5% of the shares is owned by any trustee, etc., or a member of his family. The savings bank industry would have no objections to this provision.

"Brokered Deposits"—prohibition

Sec. 19 of the bill prohibits the practice of "brokered deposits." To our knowledge this practice is non-existent in the savings banking industry.

Premiums—prohibition

Sec. 22 of the bill prohibits bank premiums. We believe that restrictions on premiums should be in the form of administrative regulation rather than legislation. An important development in the area of bank premiums occurred recently when the New York Senate passed a bill which prohibits New York state-chartered institutions from offering premiums to the public except on the occasion of a branch opening. The New York bill also purports to prohibit national banks, and federal savings and loan associations from such practices, but the efficacy of such a state provision is doubtful, to say the least. It is important that state-chartered banks in New York and elsewhere not be placed in an untenable position vis a vis national banks and other federally-chartered competitors (including federal credit unions). Therefore the Committee is urged to amend *Sec. 22* to direct the federal supervisory agencies to make appropriate regulations in the area of bank premiums and to further provide that in any state where statutes or regulation limit bank premiums the federal regulations adopted parallel their state conterparts. Equating the authority of nationally-chartered institutions to state-chartered institutions has ample precedent in the branching law which was enacted as part of the McFadden Act in 1927. *Amendment 9* would accomplish these recommendations.

100% insured Government deposits—authorization

The savings bank industry is gratified with that provision in *Sec. 25* which would authorize the 100% insurance of deposits of government entities in insured financial institutions although savings banks do not typically hold large amounts of governmental deposits.

AMENDMENT NO. 1

To Limit Application of the Interlock Prohibition to Interlocks Between Institutions Accepting Deposits from the Public in the Same Market Area

Amend the amendments made in Section 2 of H.R. 5700 by deleting the semicolon at the end of the word "bank" in line 8, page 2 and inserting the phrase: "competing in the same market area as such area shall be defined by the Board of Directors of FDIC"; by removing the semicolon following the word "Act" in line 10, page 2 and inserting the phrase: "competing in the same market area as such area shall be defined by the Board of Directors of the Federal Home Loan Bank Board": and by removing the semicolon at the end of the word "union" in line 11, page 2 and inserting the phrase: "competing in the same market area as such area shall be defined by the Administrator of the National Credit Union Administration." Further amend the amendments made in Section 2 of H.R. 5700 by inserting at the end of proposed subsection 23(a) of the Federal Deposit Insurance Act the following at the end of line 2, page 3:

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"(b) In the case of a person who is a director, trustee, officer or employee of an insured bank which is a mutual savings bank, the prohibitions contained in subparagraphs 4, 5, 6 and 7 of subsection (a) hereof shall not apply."

Redesignate present proposed subsection (b) as subsection (c).

Amend § 4 of H.R. 5700 by deleting the semicolon at the end of the word "bank" in line 2, page 6, and inserting the phrase: "competing in the same market area as such area shall be defined by the Board of Directors of FDIC"; by deleting the semicolon at the end of the word "Act" in line 4, page 6, and inserting the phrase: "competing in the same market area as such area shall be defined by the Board of Directors of FDIC": by deleting the semicolon at the end of the word "Act" in line 6, page 6, and inserting the phrase: "competing in the same market area as such area shall be defined by the Board of Directors of the Federal Home Loan Bank Board"; by deleting the semicolon at the end of the word "union" in line 7, page 6 and inserting the phrase: "competing in the same market area as such area shall be defined by the Administrator of the National Credit Union Administration." Further amend § 4 of H.R. 5700 by deleting lines 8 through 23 on page 6.

AMENDMENT NO. 2

To Permit Present Directors, Officers, Trustee and Employees to Continue to Serve in Dual Capacities through Their Period of Eligibility

Amend Section 27(b) of H.R. 5700 by adding the following new sentence after the word "enactment." on page 27, line 16: "Not withstanding the effective dates set forth in the preceding sentence, any director, trustee, officer or employee of an insured bank or of a mutual savings bank other than an insured bank who on March 8, 1971 was also a director, trustee, officer or employee of another insured bank, of an insured institution defined in section 401 of the National Housing Act, of a federal credit union, of a mutual savings bank which is not an insured bank, of a company which is a bank holding company as defined in the Bank Holding Company Act of 1956, a savings and loan holding company as defined in section 408 of the National Housing Act, a subsidiary of a bank holding company or a savings and loan holding company shall be permitted to continue in such capacities for the remainder of his or her period of eligibility for service as determined either by state laws or corporate bylaws."

AMENDMENT NO. 3

To Exempt Rhode Island Mutual Savings Banks Which Own Subsidiary Commercial Banks from the Prohibitions Contained in Sections 2, 8 and 9

Amend proposed subsection 23(b) of the Federal Deposit Insurance Act contained in Section 2 of H.R. 5700 by inserting in line 7 on page 3 following the phrase "Bank Holding Company Act of 1956" the following: "or a mutual savings bank owning or controlling such a bank holding company," and by changing the period at the end of the word "company" in line 8 on page 3 to a comma and inserting the following: "or a mutual savings bank owning two-thirds or more of the outstanding voting stock of such insured bank."

Amend Section 8(b) of H.R. 5700 by inserting in line 1 on page 10 following the phrase "Bank Holding Company Act of 1956" the following: "or a mutual savings bank owning or controlling such a bank holding company" and by changing the period at the end of the word "company" in line 4, page 10 to a comma and inserting the following: "or a mutual savings bank owning two-thirds or more of the outstanding voting stock of such insured bank."

Amend Section 9(b) of H.R. 5700 by inserting in line 25 on page 10 following the phrase "Bank Holding Company Act of 1956" the following: "or a mutual savings bank owning or controlling such a bank holding company," and by changing the period at the end of the word "company" in line 3 on page 11 to a comma and inserting the following: "or a mutual savings bank owning two-thirds or more of the outstanding voting stock of such insured bank."

AMENDMENT NO. 4

To Exempt Mutual Savings Banks from the Prohibition Against Controlling Title, Appraisal or Closing Companies

Amend the amendments made in section 2 of H.R. 5700 by inserting in line 10, page 3, following the term "insured bank" the phrase "other than a mutual sav-

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ings bank;" and in line 11 following the term "insured bank" the phrase, "other than a mutual savings bank" and in line 13 following the term "insured bank" the phrase "other than a mutual savings bank."

On page 7 strike Section 5 in its entirety by deleting lines 7 through 18.

AMENDMENT NO. 5

To proclude the Application of Sections 8 and 9 of H.R. 5700 to Directors, Officers, Trustees and Employees of Savings Banks, Trust Companies and Related Organizations

Amend Section 8 of H.R. 5700 by amending line 22, page 8, to read:

"Sec. 8(a) Except as provided in subsections (b) and (c), a".

Further amend Section 8 by adding the following new subsection at the end of subsection (b) on page 10:

"(c) an individual who is a director, trustee, officer or employee of an organization all of the stock or shares of which, other than stock or shares required by law to qualify directors, is owned by a mutual savings bank, mutual savings banks, or by a mutual savings bank or banks and other financial institution or institutions, shall not by virture of subsection (a) hereof be precluded from serving as a director, trustee, officer or employee of any other financial institution."

Amend Section 9 of H.R. 5700 by amending line 5 on page 10 to read: "Sec. 9(a) Except as provided in subsections (b), (c), and (d), a".

Further amend Secction 9 by adding the following new subsection at the end of subsection (b) on page 11:

"(c) an individual who is a director, trustee, officer or employee of an organization all of the stock or shares of which, other than stock or shares required by law to qualify directors, is owned by a mutual savings bank, mutual savings banks, or by a mutual savings bank or banks and other financial institution or institutions, shall not by virtue of subsection (a) hereof be precluded from serving as a director, trustee, officer or employee of any corporation."

"(d) an individual who is a director, trustee, officer or employee of a mutual savings bank shall not by virtue of subsection (a) rereof be precluded from serving in any capacity a non-profit charitable institution as defined in section 501(c) of the Internal Revenue Code notwithstanding any relationship between the savings bank and the institution with respect to the making of loans, discounts or other extensions of credit."

AMENDMENT NO. 6

To Delete the Prohibition Against Mutual Savings Banks Owning Stock in Commercial Banks and Insurance Companies, Etc.

Amend H.R. 5700 by striking all of Section 10 by deleting lines 4 through 17 on page 11. Renumber succeeding sections.

AMENDMENT NO. 7

To Exempt "Keogh" Trusts From Any Disclosure Requirements By Fiduciaries

Amend the amendments made in section 12 of H.R. 5700 by inserting in line 16, page 13, following the word "securities," the phrase, "and securities held pursuant to trusts organized under the Self-Employed Individuals Tax Retirement Act of 1962."

AMENDMENT NO. 8

To Delete the Prohibition Against Equity Participations

Amend H.R. 5700 by striking all of Section 14. Renumber suceeding sections.

AMENDMENT NO. 9

To Direct Appropriate Federal Regulatory Agencies To Regulate Premium Campaigns Subject To State Statutes and Regulations

Amend H.R. 5700 by amending Section 22 to read as follows:

"Sec. 22. Section 18(g) of the Federal Deposit Insurance Act (12 U.S.C. 1828(g)) is amended by adding at the end thereof the following:

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'In addition to the payment of interest on deposits which is subject to limitation under this section, the FDIC is directed to prohibit or to limit, or otherwise regulate the extent to which any insured banks may offer or deliver any merchandise or any certificate, stamp, ticket, or any other memorandum which is or may be redeemable in merchandise, money, or credit or any inducement for any person to make or add to any deposit, provided that any such limitation, restriction or regulation imposed under this section shall be identical with any local state statute or regulation limiting, preventing or regulating such premiums.' "

Further amend H.R. 5700 by amending Section 23 thereof to read as follows:

"Sec. 23. Section 5B(a) of the Federal Home Loan Bank Act is amended by adding at the end thereof the following: 'In addition to the payment of interest or dividends which are subject to limitation under this section, the Federal Home Loan Bank Board is directed to prohibit or to limit or otherwise regulate the extent to which any members may offer or deliver any merchandise or any certificate, stamp, ticket, or other obligation or memorandum which is or may be redeemable in merchandise, money or credit or any inducement to any person to make or add to any deposit or account provided that any such limitation, restriction or regulation imposed under this section shall be identical with any local state statute or regulation limiting, preventing or regulating such premiums.' "

Further amend H.R. 5700 by deleting Section 24 in its entirety and renumbering all succeeding sections accordingly.

The CHAIRMAN. A letter from Rudolf P. Berle has been received by the committee and will be placed in the record at this point.

BERLE & BERLE,
New York, N.Y., April 22, 1971.

Re: H.R. 5700—Savings Banks Trust Company.

Hon. WRIGHT PATMAN,
Chairman, Committee on Banking and Currency, House of Representatives, Rayburn House Office Building, Washington, D.C.

DEAR MR. PATMAN: You will perhaps recall that at the time the Holding Company Bill (H.R. 6778) was under consideration by your Committee in 1969, I had occasion to write to you in some detail with respect to a client of this office, Savings Banks Trust Company, which would have been seriously affected by the Bill as originally drafted. It was in consequence of our exposition of the unique nature of Savings Banks Trust Company that led to your consent to the inclusion in the Bill of a clause granting specific exemption from the Holding Company Act Amendments of 1970 under Sec. 2(a) (5) (E). The exemption read as follows:

"No company is a bank holding company by virtue of its ownership or control of any State chartered bank or trust company which is wholly owned by thrift institutions and which restricts itself to the acceptance of deposits from thrift institutions, deposits arising out of the corporate business of its owners, and deposits of public monies."

The exemption describes with particularity the nature of Savings Bank Trust Company.

A study of H.R. 5700 reveals that in a number of instances in that Bill, Savings Bank Trust Company, despite its unique nature, might suffer serious consequences. It is for this reason that I take the liberty of writing to you again.

In order that this statement may be complete, may I recite again some of the facts with respect to Savings Banks Trust Company which are pertinent to the matter in hand.

Savings Banks Trust Company is a State chartered trust company under the Banking Laws of New York. It is unique in the sense that in the first place it is wholly owned by the 120 savings banks of the State of New York and its stock ownership is restricted to such savings banks. Permission for New York savings banks to hold this stock is by special provision. In the second place, it was originally designed to serve as a central liquidity agency for savings banks and has served them in that capacity since its inception in 1933. In fact, the institution was organized during the period of the Depression when savings bank assets were badly frozen and some instrumentality was necessary to assist the savings banks in this distressed situation. It does business exclusively with savings banks and savings banks agencies, meaning by that agencies such as The Savings Banks Retirement System.

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Its unique position in the New York banking structure is recognized by the fact that there are various statutory limitations imposed upon ordinary commercial banks from which the Trust Company is exempted by virtue, as the phrase appears frequently in the statute, of its being "wholly owned by 20 or more mutual savings banks. It does no business with the general public, and except for permission to act as depository for public monies, accepts deposits only from savings banks and deposits coming from savings banks corporate business.

Its service to the savings banks was never more vitally demonstrated than in providing liquidity during the "crunch" periods of 1966 and 1969–70 when the access which the Trust Company had developed to the money market through the use of its own paper supplied badly needed liquid funds to the savings banks at these times of intense financial pressure.

The problem with which we are concerned arises from the effect that Secs. 8 and 9 of HR 5700 would have upon Savings Banks Trust Company and its stockholder savings banks.

Sec. 8 would prohibit a director, trustee, officer or employee of a savings bank from serving as a director of Savings Banks Trust Company if the savings bank holds more than 5% of the Trust Company's common stock. The Company's common stock was allocated to New York savings banks in 1983 on the basis of their deposit size at that time and 3 of the 120 savings banks shareholders presently hold more than 5% of such common stock. These are: The Bowery Savings Bank (10.56%); The Emigrant Savings Bank (7.79%); and the New York Bank for Savings (5.16%).

Chief executive officers of the Bowery and the Emigrant presently serve as directors of the Trust Company and the chief executive of the New York Bank for Savings has served as director in the past. The By-Laws of the Trust Company require a minimum of 23 directors, not less than 20 of whom must be trustees of mutual savings banks of the State of New York, and at present there are 25 directors. All of the directors, with the exception of the President, are officers and trustees of share-holding savings banks. We feel certain that it is not the intention of Congress to prevent the three largest bank shareholders from being represented on the Board of Directors of a cooperative-type liquidity institution such as the Trust Company.

It is our opinion also that Sec. 9 of HR 5700 could conceivably be interpreted as prohibiting any trustee, officer or employee of a shareholder savings bank from serving as a director of Savings Banks Trust Company because the Trust Company has a substantial and continuing relationship with the savings banks as a liquidity agency engaged in making loans and extending credit to them. The language of Sec. 9 could therefore result in preventing all of the Trust Companys directors from serving with the exception of its President. This, we believe, certainly was not a result intended as one of the objectives of the Bill.

The National Association of Mutual Savings Banks has prepared and will submit to your Committee various proposed amendments to HR 5700, among them Amendment No. 5 dealing both with Secs. 8 and 9. A copy of this proposed Amendment is attached to this letter. We believe that this Amendment No. 5 would solve the Savings Banks Trust Company's problem which we have outlined above.

We should deeply appreciate consideration being given to this since absent this exemption through the language suggested by the National Association of Mutual Savings Banks, it seems to us that the 120 savings banks of New York State who own stock in Savings Banks Trust Company might find themselves deprived of the services of a cooperative institution which has served the savings banks community well for a period of nearly 40 years.

If there is any further information needed, I shall, of course, be ready to supply it.

Sincerely,

RUDOLPH P. BERLE.

AMENDMENT NO. 5—TO PRECLUDE THE APPLICATION OF SECTIONS 8 AND 9 OF H.R. 5700 TO DIRECTORS, OFFICERS, TRUSTEES AND EMPLOYEES OF SAVINGS BANKS TRUST COMPANIES AND RELATED ORGANIZATIONS

Amend Section 8 of H.R. 5700 by amending line 22, page 8, to read:

"Sec. 8(a) Except as provided in subsections (b) and (c), a".

Further amend Section 8 by adding the following new subsection at the end of subsection (b) on page 10:

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"(c) an individual who is a director, trustee, officer or employee of an organization all of the stock or shares of which, other than stock or shares required by law to qualify directors, is owned by a mutual savings bank, mutual savings banks, or by a mutual savings bank or banks and other financial institution or institutions, shall not by virtue of subsection (b) hereof be precluded from serving as a director, trustee, officer or employee of any other financial institution.

Amend Section 9 of H.R. 5700 by amending line 5 on page 10 to read:

"Sec. 9(a) Except as provided in subsections (b), (c), and (d), a".

Further amend Section 9 by adding the following new subsection at the end of subsection (b) on page 11:

"(c) an individual who is a director, trustee, officer or employee of an organization all of the stock or shares of which, other than stock or shares required by law to qualify directors, is owned by a mutual savings bank, mutual savings banks, or by a mutual savings bank or banks and other financial institution or institutions, shall not by virtue of subsection (a) hereof be precluded from serving as a director, trustee, officer or employee of any corporation."

"(d) an individual who is a director, trustee, officer or employee of a mutual savings bank shall not by virtue of subsection (a) hereof be precluded from serving in any capacity a nonprofit charitable institution as defined in section 501 (c) of the Internal Revenue Code notwithstanding any relationship between the savings bank and the institution with respect to the making of loans, discounts or other extensions of credit."

The CHAIRMAN. The next witness is Mr. John William Bryan.

We are delighted to have you, sir. We look forward to hearing your testimony.

STATEMENT OF JOHN WILLIAM BRYAN, GRANITE STATE BANK, AND THE BANK OF ARLINGTON, GRANITE FALLS, WASH.

Mr. BRYAN. Mr. Chairman and distinguished members of the committee, my name is John William Bryan. I represent the Bank of Arlington, a State chartered bank which is a member bank of the Federal Reserve System.

I have studied H.R. 5700 and am in favor of all of the provisions in the bill. But I am convinced that the five basic areas of concern are all problems mainly caused by the marginal reserve system of banking; and by abandoning this system and using a constitutional monetary system as set forth in the Constitution, these problems would be eliminated along with commercial bank failure.

While, in addition, we would have a monetary system that would give stable money and full employment from one generation to the next, with reduced taxes and interest for nearly everybody.

To accomplish this it would be necessary for Congress to occupy the monetary field and prevent the States from exercising any monetary authority as per the Constitution.

The Congress should therefore:

Repeal the amendment of H.R. 2 of February 1927 which made the Federal Reserve System perpetual, a serious mistake made without public knowledge.

Congress should then recharter the central bank with rechartering every 10 years and establish guidelines with strict standards for its operations, goals and safeguards.

All commercial banks should automatically become members of the Federal Reserve System and should keep all of their deposits with the central bank. This would eliminate our national debt under a well-ordered system. Commercial banks would make loans under criteria

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laid down by Congress for the guidance of the Federal Reserve and the commercial banks. Collateral should be held by the Federal Reserve Banks which would guarantee the loans. Commercial banks would then not be creating money.

The marginal reserve system of banking is a European system of banking and is un-American. It was never used by a republic until the American Revolution. A republic should not have a national debt. The tax exemption on municipal and State bonds should be repealed and the central bank should purchase these bonds at one-fourth of 1 percent interest if they meet the proposed criteria laid down by Congress.

Under this arrangement, there would be no need for commercial banks to have surplus and undivided profit accounts. These funds would then be paid back to their stockholders and commercial banks would still be profitable institutions under a fully competitive system.

Congress should direct the central bank to open foreign branches called for in language that made their establishment almost mandatory in the original Federal Reserve Act. This would alleviate our balance-of-payment problems and create vast opportunities for businessmen and skilled and unskilled workers, especially in the underdeveloped countries which would take a heavy load of welfare payments off the American taxpayers. The American central banks should be operated in the national and public interest.

Thank you.

The CHAIRMAN. Thank you very much, Mr. Bryan, for your testimony.

The next witness is Dr. Harold S. Oberg.

Doctor, we would be very glad to hear from you at this time. You may proceed in your own way.

STATEMENT OF DR. HAROLD S. OBERG, VICE PRESIDENT, ARTHUR LIPPER CORP., NEW YORK, N.Y.

Dr. OBERG. Thank you.

I have just a brief statement on a specific phase of the proposed legislation.

My name is Harold S. Oberg, vice president of the Arthur Lipper Corp. Our firm is an institutionally oriented New York Stock Exchange member firm, specializing in block trading of securities and a variety of investment services for institutional investors. I am here to testify on one specific aspect of the proposed legislation—the reporting of equity investing holdings by trust departments of commercial banks.

A number of our services and publications are designed to help in the understanding of investment company portfolios. One of these services, portfolio performance perspective, analyzes in depth, the portfolio composition of larger growth objective mutual funds. A forthcoming service, tentatively entitled, "Insight" is designed to provide, on a quarterly basis, a listing and crossfile of the securities held in the portfolios of all investment companies with assets of $25 million or more. Another part of this same service analyzes the investment quality aspects of all listed securities held by these same investment companies.

Our existing services and publications, as well as those which are

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at the planning stage, are based upon publicly available information such as that provided by investment companies to the Securities and Exchange Commission on a calendar quarter basis. This "N-1Q" reporting form provides us with the basic information on the number of shares held and the amount of shares purchased and sold during the quarter.

As a service organization to institutional investors, we have natural interest in the availability of data on portfolio composition of all institutional investors. Regular periodic information of this type is currently available only on the investment companies.

For other types of institutional investors, similar information has not been compiled and is not publicly available on any regular periodic basis. We feel that all such information on other institutional investors would be of benefit. It would help in providing a better basis for analyzing the various institutions in respect to the particular securities and the amounts currently held and to better understand various types and qualities of securities of interest to particular parts of the varied institutional investor population.

As commercial banks in their trust operations represent a most substantial source for such individual stock information, the proposed bill asking for the reporting of equity holdings is a step in the direction of greater information availability and, therefore, is to be recommended. It provides the ability to analyze and report even further on institutional equity investments.

The supplying of such information is in the historic pattern of the development of such data on a regular basis. As has been noted, one such major institutional group is already supplying such information regularly and the review provided in the recently completed institutional investor study gives a clear indication how such information can be analyzed and made to be of value.

Individual investors can become aware of the securities utilized to pursue particular investment objectives.

If the committee and the Congress feel it is to be in the public interest to require regular reporting by other institutional investors, we would be pleased to relate our experience in this particular area both in the preparation of collection forms and the amassing of data. We will be pleased to submit to you examples of our various services that fall in this statistical area.

Thank you very much.

The CHAIRMAN. Thank you, Dr. Oberg.

Our next is Dr. Harley H. Hinrichs of the Saver Incentives Premium Industry Committee.

Please proceed, sir.

STATEMENT OF DR. HARLEY H. HINRICHS, THE SAVER INCENTIVES PREMIUM INDUSTRY COMMITTEE; ACCOMPANIED BY JOHN F. DALY, INTERNATIONAL SILVER CO.; WILLIAM M. DALTON, W. M. DALTON & ASSOCIATES; LARRY O. EDWARDS, LINCOLN ROCHESTER TRUST CO.; AND NEIL KANNEY, GRACE CHINA CO.

Dr. HINRICHS. Thank you, Mr. Chairman.

I am Harley H. Hinrichs, associate professor of economics, U.S. Naval Academy, lecturer in economics, University of Maryland Grad-

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uate School, and associate professorial lecturer in economics, The George Washington University.

I am here today in the capacity of chief economist of the Saver Incentives Premium Industry Committee. And I am accompanied by Mr. John F. Daly, International Silver Co.; Mr. William Dalton, William Dalton and Associates, and Mr. Neil Kanney of the Grace China Co., who are members of the Saver Incentives Premium Industry Committee.

I am also accompanied by a banker, Mr. Larry Edwards, who is vice president in charge of marketing of the Lincoln Rochester Trust Co., which is a New York bank.

I should also say, Mr. Chairman, that it is a great pleasure talking to you, having worked for both you and Mr. Reuss on the Joint Economics Committee.

So it is good to see you again.

Rather than read the statement, which is very long—and which I request to be entered into the record, as well as the statements by the gentlemen accompanying me—let me simply summarize the economic facts as we economists know them, or at least as have been developed by a survey of the industry, and then let me simply summarize the major economic beneficiaries of the proposed action by the Savers Committee.

The CHAIRMAN. That will be satisfactory, sir. You may proceed.

Dr. HINRICHS. The saver incentives premium industry has a long tradition; for more than a quarter of a century it has provided a marketing media for banks and other financial institutions to compete for public funds. Various studies by the American Bankers Association, the Mid-Continent Banker, Harvard University, and a survey of this industry all tend to agree on the following points:

1. Bank customers approve premiums. The ABA survey showed that 59 percent approved and liked premiums. The Mid-Continent Bank survey showed that 78 percent approved the use of premiums.

2. I think quite importantly, premium generated accounts tend to be retained. Retention rates over a period of a year tend to be 75 percent or greater, and actually exceed the retention rates for walk-in accounts.

And this ties in with the proposition No. 3.

3. Premium generated accounts tend not to be shifted from other accounts, 78 percent of the bank customers said they would not shift accounts. This is fairly understandable. In talking with various depositors they simply do not want to go through the bother and trouble of moving from one local bank to another bank which could be on the other side of town simply for a $5 dish or some other inducement.

So that there is very little so-called churning of accounts, and therefore there is very little lost in terms of excess bookkeeping from the use of premiums.

4. Premiums tend to increase total savings. From a theoretical point of view economists have always linked marginal rates of interest and income as determinants of levels of saving. Also various econometric studies mentioned by Mr. Wallach, Gurley, and Shaw at Stanford, Harvard and Yale, suggest that the amount of savings in banks are a function of things such as the number of banks in town, marketing

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techniques, access to banks, size of minimum deposits, and so forth. So there is some econometric evidence for a relationship, however marginal, between the level of savings and institutional arrangements in the financial community.

It is also possible to see this from the ABA survey of small banks in small towns where population levels and income levels have remained the same—these small banks have experienced substantial increases in their savings deposits by the use of such premium programs. This could only be accountable as a result of the premium programs, and not by other variables. It is very difficult to do broad scale econometric research in this time of social change. But there is some positive evidence to support proposition No. 4.

5. Banks tend to approve customer premiums. This is especially true of the smaller banks, whereby smaller banks will put aside 3 percent of their advertising budget for the use of premiums while larger banks will only use 1 percent. In fact, the ABA reports that small banks tend to use premiums to catch up on some of the economic advantages of larger banks. And small banks, those with deposits below a million, are adopting premium programs 18 times faster than the very largest banks. So this has been something of a boon to small banks. which cannot afford the heavy expenditures on TV advertising and other media, which have become very expensive as of late.

6. The bank customer premium industry is larger than often realized—$100 million—long-established, characterized by small businesses and is highly competitive.

A third of the firms have been in business for a quarter of a century, over half have been in business for at least a decade. They are small businesses, most of them—80 percent—with sales of less than $10 million, in terms of their total operation. And they are highly competitive. A list is attached to my prepared statement which cites 100 firms engaged in this industry.

7. Retail firms appear to benefit from bank premium programs rather than to suffer from banks offering merchandise. This is quite interesting, because you would expect opposition to premiums from competing retailers. But apparently in the studies done by the ABA and the Mid-Continent Banker the advertising of merchandise offered has tended to stimulate sales in the nearby retail stores, which is quite interesting.

8. The total net cost of bank premium programs to banks is very small. On the average only 2 percent of the bank advertising expenditures are involved in this. This represents only 0.03 of 1 percent of operating income of banks. In 1969 the net cost to banks—and the incidence of this cost is on the bank and not on the customers, which is a pretty important distinction—the net cost in 1969 was only $8 million. The banks partially offset the greater value of the sales involved by so-called continuity programs whereby the bank customer will receive merchandise at less than retail cost, but slightly above the cost to the bank, and therefore the bank is able to in some cases almost break even.

9. Bank customers receive premiums or gifts without being penalized by the payment of a lower interest rate. In other words, given what economists would call the artificial constraint of regulation Q, the small saver is prevented from receiving a true market rate of interest in periods of tight money, as last year.

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Therefore, unlike other premium programs, the use of premiums does not result in the cost being shifted to the customer, as might be the case when you have premium programs involved with the gas stations and supermarkets, in this case, because regulation Q fixes the ceiling on interest rates, the customer really receives a marginal rate of return higher than the average rate prescribed by the law, and this is a boon to the small saver.

Let me shift to the major economic beneficiaries of bank customer premium programs. These appear to be small savers, whereby the marginal rate of return or incentive for putting money in a savings account may be two or three times higher than what regulation Q sets as the average rate of return. I think this is good for the small saver. The big saver, of course, is not really putting his money into the small savings account. He is getting two or three times that rate in something else, be it Euro-dollars or second trust mortgages, or corporate bonds, commercial paper, and so forth.

Likewise it is of benefit to small banks and new branches because it gives them a chance to compete with the bigger banks. And they do use this program proportionately more.

It also certainly benefits the premium manufacturers and their dealers, suppliers, and employees. The amount involved is $100 million, 100 firms, and it has been estimated that some 10,000 jobs are on the line in terms of the direct production, with another 20,000 depending on those 10,000. So you have roughly 30,000 people in this area. It would seem highly arbitrary for the Congress to simply eliminate 30,000 jobs in something which has a social value and cannot be criticized on that account.

So moving from the economic beneficiaries to the major economic effects, the major economic effects are advantageous relative to an improved income distribution, increased competition in the U.S. economy, and the increased social value of advertising expenditures.

The conclusion from this economic analysis of the bank premium industry is fairly obvious: all the data seem to indicate that the premium programs benefit the parties concerned—banks, customers and suppliers—and are not only a legitimate, but a long established and socially valuable means of promoting increased savings accounts in financial institutions.

Now, the savers committee feels that if the Congress wishes to act in this area to provide certainty as to future premium limits, it would best seek a limit keyed to the basic "promotion of savings" function of such premiums. Given the average unit cost of premiums of $3.53—based on the 1970 ABA survey—the typical dispersion around such a mean, and future gradual inflationary increases over the next decade, a limit of approximately $5 would serve the needs of the industry, the banking community, the small saver without allowing a legitimate promotional technique to be converted into socially wasteful expenditures. Such a limitation is provided by H.R. 5685.

On the other hand such "merchandise in lieu of interest" offers, made last year by several large New York State banks, have led to adverse publicity and editorial criticism for the premium industry as a whole.

We think this is unfair. Such prepaid interest offers give the depositor nothing more than he would have received in cash interest payments set by regulation Q, and these tend to mislead the public.

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Such advertising is not in keeping with the legitimate promotion function of the saver incentives premium industry to promote small savings. Such excesses would be prevented by H.R. 5685.

Let me conclude by simply saying a word about something I know that you and Mr. Reuss are very concerned with, and that is the increased social value of advertising expenditures.

When banks are limited by the Government in the degree of price competition they can engage in, they will find means to compete by increased advertising and marketing expenditures. The social question is the value of alternative marketing strategies while the total size of funds may not change greatly. Thus the consumer is benefited directly by receiving goods and gifts rather than by simply being bombarded by more radio, TV, or direct mail advertising where the economic benefits would accrue to advertising agencies and the various media. In the ABA survey an overwhelming percentage of bank customers, especially housewives, supported the use of bank premiums.

A further social gain from bank premiums is the initial encouragement to newly formed households, small savers and to youth in developing patterns and habits of saving. To deny the youngster in a family from receiving a free "piggybank" for opening his first savings account would seem to run against the grain of the tradition of thrift in the history of U.S. economic development.

Likewise, the inducement of a premium would tend to help consumers optimize in their placement of savings so that higher rates of return would be received—as contrasted to idle funds in checking accounts or cookie jars—so that larger purchases can be made out of savings—such as appliances, cars and houses—rather than at the exceptionally high rates of consumer credit with which the small saver is usually confronted.

This is really a program for small savers, who generally are discriminated against by the financial institutions in terms of receiving smaller amounts of money in interest on what they lend, and they pay much higher rates of interest on the amounts they borrow.

In the final analysis, it is the public who benefits most from saver premiums. There are no apparent reasons why such premiums should be arbitrarily prohibited.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, sir.

We will place your complete statement in the record at this point.

(The prepared statement of Dr. Hinrichs follows:)

PREPARED STATEMENT OF DR. HARLEY H. HINRICHS,[1] THE SAVER INCENTIVES PREMIUM INDUSTRY COMMITTEE

AN ECONOMIC ANALYSIS OF BANK CUSTOMER PREMIUMS: THE CASE FOR PRESERVATION WITH REGULATION

SUMMARY AND CONCLUSIONS

The saver incentives premium industry has a long tradition: for more than a quarter of a century it has provided a marketing media for banks and other

[1] Associate Professor of Economics, U.S. Naval Academy, Lecturer in Economics, University of Maryland Graduate School, and Associate Professorial Lecturer in Economics, The George Washington University. Prof. Hinrichs holds degrees from the University of Wisconsin, Purdue University and Harvard (Ph.D.) and was a Fulbright Scholar at the University of Melbourne, Australia. He is (or has been) a fiscal consultant to the U.S. Treasury (Office of the Secretary), U.S. State Dept./A.I.D., the Joint Economic Committee of the U.S. Congress, the World Bank, International Monetary Fund and United Nations.

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financial institutions to compete for public funds. Various studies by the American Bankers Association, the Mid-Continent Banker, Harvard University, and a survey of this industry all tend to agree on the following points:

1. Bank customers approve premiums.
2. Premium-generated accounts tend to be retained.
3. Premium-generated accounts tend *not* to be shifted from other accounts.
4. Premiums tend to increase total savings.
5. Banks tend to approve customer premiums.
6. The bank customer premium industry is larger than often realized ($100 million), long-established, characterized by small businesses and is highly competitive.
7. Retail firms appear to benefit from bank premium programs rather than to suffer from banks offering merchandise.
8. The total net cost of bank premium programs to banks is very small: only 2 percent of bank advertising expenditures and only 0.03 of one per cent of operating income.
9. Bank customers receive premiums or gifts without being penalized by payment of a lower interest rate.

Existing regulations by the FRS, FDIC and FHLBB limit the wholesale value of premiums to $5 for deposits up to $5,000, and set a limit of $10 for deposits over $5,000.

The major economic beneficiaries of bank customer premium programs appear to be small savers, small banks and new branches, premium manufacturers and their dealers, suppliers, and employees, and the users of savings funds thus generated, particularly the housing sector.

The major economic effects are advantageous relative to an improved income distribution, increased competition in the U.S. economy, and the increased social value of advertising expenditures.

The conclusion from this economic analysis of the bank premium industry is fairly obvious: all the data seem to indicate that the premium programs benefit the parties concerned (banks, customers and suppliers) and are not only a legitimate, but a long-established and socially-valuable means of promoting increased savings accounts in financial institutions.

If the Congress wishes to act in this area to provide certainty as to future premium limits, it would best seek a limit keyed to the basic "promotion of savings" function of such premiums. Given the *average* unit cost of premiums of $3.53 (based on the 1970 ABA survey), the typical dispersion around such a mean, and future gradual inflationary increases over the next decade, a limit of approximately $5 would serve the needs of the industry, the banking community, the small saver without allowing a legitimate promotional technique to be converted into socially-wasteful expenditures. Such a limitation is provided by H.R. 5685.

On the other hand such "merchandise in lieu of interest" offers, made last year by several large New York State banks, have led to adverse publicity and editorial criticism for the premium industry as a whole. Such "prepaid interest offers" give the depositor nothing more than he would have received in cash interest payments, and tend to mislead the public. Such advertising is not in keeping with the legitimate promotion function of the saver incentives premium industry to promote small savings. Such excesses would be prevented by H.R. 5685.

INTRODUCTION

This paper summarizes what data are known as to (1) the economic characteristics of bank customer premium programs, (2) existing legal regulations, (3) the economic beneficiaries of bank customer premium programs, and (4) the economic effects of such programs. One principal source of information is a survey by the American Bankers Association of nearly 10,000 member banks conducted in 1968. Additional sources of information include a survey of the major suppliers and manufacturers of bank premium products and interviews with leading bank, savings and loan, manufacturer officials as well as with economists at the Federal Reserve Board, Treasury, and congressional committees.

THE ECONOMIC CHARACTERISTICS OF BANK CUSTOMER PREMIUMS

Banks, savings and loan associations, and their Federal and state regulatory bodies look upon bank customer premiums as a legitimate form of promotion of

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advertising for the use of the consumer dollar in competition with consumption expenditures, insurance, mutual funds, the stock market, government securities, foreign investments, idle cash or other alternatives. Donald R. Peterson of the Continental Bank, Chicago, pointed out in the *Mid-Continent Banker*, May 1970, that "As we preview the '70s, there is no question that banks will more than ever be promoting their services in direct competition with non-banking firms which are highly skilled in all phases of marketing. Our banks have little chance for success in this arena if we do not feel as free as our competitors to employ techniques selected from the entire spectrum of marketing and promotional possibilities."

Bank customer premiums range from single premiums offered for opening a new account or expanding a new account to multiple premium programs (or continuity programs) which usually offer a free gift for the first deposit (or expansion) and subsequent opportunities to purchase similar merchandise (say tableware or china) at a discount from retail prices for future deposits. Such programs encourage the small depositor to return to the bank, enlarge his savings accounts, become acquainted with other banking services, and develop a savings habit. The bank generally is able to recoup part or all of its initial promotional cost by a small differential between its wholesale cost and the premium price which is up to 50 per cent less than retail. The bank typically is able to break even in such "continuity programs". Above all, the bank thus encourages a high retention rate of the initial deposit and usually experiences significant "add-ons" to the initial deposit, thus fostering a savings pattern by its customers.

Distinct from these programs is "compensation in kind" (be it a TV set or automobile) which is offered as prepaid interest for making a large deposit to be held for a number of years. These by necessity are for large accounts, require freezing deposits for a number of years, but are still subject to Regulation Q as to complying with the equivalent interest rate than can be received by such a deposit.

What are the economic effects and characteristics of legitimate bank premium programs? The American Bankers Association and the *Mid-Continent Banker*, *The Financial Magazine of the Mississippi Valley and Southwest*, and Harvard University have made studies that provide the following evidence:

(1) *Bank customers approve premiums:* The ABA survey based on returns from about 10,000 banks (more than two-thirds of the total) reports that 59 per cent favored premiums and only 28 per cent were opposed. *The Mid-Continent Banker* reported in its survey that 78 per cent of bank customers found premiums useful while only 7 per cent were negative.

(2) *Premium-generated accounts tend to be retained*: A Harvard University study showed that premium-generated accounts have a greater retention value than do walk-in accounts. Both the ABA study and the Mid-Continent Banker survey verify this finding. Retention rates typically are about three-fourths of original deposits after one year and usually greater than walk-in accounts (78 per cent compared to 65 per cent based on the ABA survey).

(3) *Premium-generated deposits tend NOT to be switched from other accounts*: The ABA survey showed that only 12 per cent of bank customers would change banks to get a premium while 78 per cent would respond to a premium by their present bank.[2] In the *Mid-Continent Banker* survey 81 per cent stated they would *not* move their funds to another bank if that bank offered an attractive premium.

(4) *Premiums tend to increase total savings:* No economist would deny that, at the margin, offering a higher price for savings deposits (via premiums) would have *some* effect on increasing total deposits relative to alternatives (such as consumption, idle cash, checking accounts, etc.). Macro-economic evidence is difficult to be demonstrated at this point because of the other more important determinants of the marginal propensity to consume in the economy. However, certain micro-economic evidence would seem to support economic theory on this point: in the ABA survey a bank in Danville, Arkansas (population: 950) during seven years of customer premiums more than trebled its deposits (demand deposits more than doubled, time deposits were up more than six-fold). The ABA

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[2] One major bank in New York State has research that reveals the following retention rates on premium-induced accounts:

	Retention percent
3 months later	96.1
9 months later	86.0
1 year later	75.7

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survey concluded: "In this seven-year interval the economy of the area did not change materially in either payrolls or population. An aggressive marketing program is almost solely responsible for the bank's growth record". Numerous other individual bank studies are documented in the ABA Survey and provide similar results. Given the customer's time, cost and reluctance involved in "switching accounts" (especially in areas where alternative banks are limited) as cited above, these data show that some increase in assets held in the form of savings accounts at banks must have taken place.

(5) *Banks tend to approve customer premiums:* On the basis of the ABA survey, about half of the banking industry (measured by deposits) have used bank customer premiums. In terms of numbers of banks, one-fourth have used premiums but the greatest growth rate in bank premium use is in small banks: banks with deposits under $1 million were adopting such incentive programs at a rate 18 times faster than banks with deposits over $100 million. The ABA survey concludes that "Contrary to some beliefs, premiums do not harm the bank's standing with the public or commercial customers. Four out of five banks that have employed premiums to build time or demand deposits consider the results either good or fair. The same success was achieved in promoting openings with premiums." Typical of this support is the experience of the Deposit Guaranty National Bank, Jackson, Mississippi, whose executive vice-president, J. Herman Hines, chaired the Special Project Committee of the ABA in conducting its extensive study of bank customer premiums. Its premium campaigns were successful in terms of increases in savings, retention rates and increases in account balances (see p. 26, *Mid-Continent Banker*, May 1970).

(6) *The bank customer premium industry (manufacturers and distributors) is larger than often realized, long-established, characterized by small businesses and is highly-competitive:* Total premium use for all purposes in the United States now exceeds $4 billion according to a survey conducted by *Incentive Marketing Facts* (May 1968) and as later revised. This survey estimated the premium sales volume for financial institutions at $69.5 million (based on 1967–68 data). Given estimated growth rates of 7–10 percent per year since then, the total volume for 1971 will probably exceed $100 million.

More than one hundred domestic suppliers and manufacturers (see list) are involved in providing bank customer premiums making the industry highly competitive with essentially low profit margins.

A 1970 survey of firms representing total sales of $21 million (about one-fifth of the estimated total industry sales) provides this economic anatomy of the industry:

(*a*) The industry is long-established: 60 per cent of the firms engaged in selling to banks have been in business for more than a quarter of a century; half of the firms have been selling premiums to banks for ten years or more.

(*b*) Firms which sell to banks rely heavily on bank premiums as a major source of income and would be highly vulnerable to the abolition of premiums: 30 per cent of the firms do bank premiums exclusively: half of the firms rely on bank premiums as their major source of sales.

(*c*) Firms which sell to banks are essentially small businesses: 80 per cent of the firms have total sales of $10 million or less; 60 per cent have sales under $5 million; and 30 per cent have sales under $1 million.

The industry is labor-intensive, employing many semi-skilled workers often in smaller cities where alternative employment is not available, especially in the 1969–70 period studied: based on total sales of $100 million and sales-labor ratios typical in this industry (based on the sample survey) about 10,000 production employees are involved (excluding transport and distribution personnel); given a typical 2–1 ratio of the multiplier effect between production earnings and related employment dependent on such earnings, a total of 30,000 jobs could be affected. This estimate excludes the effect on jobs of non-bank premium employees of companies with a critical dependence on the bank premium business. To the degree that such companies would be forced to close *all* activities because the bank premium business were eliminated, additional unemployment would result.

(7) *Retail firms appear to benefit from bank premium programs rather than to suffer from banks offering merchandise:* Mr. Donald R. Peterson, Continental Bank, Chicago, made this point in the speech cited earlier: "The ABA report, for example, points out that many banks have hesitated to use premiums because they are afraid of offending retail accounts who sell comparable items. Experience to date seems to place this constraint in the illusory category. Banks that have had the courage to proceed with premium promotions have found, indeed, that retailers' sales for comparable items have actually increased—per-

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haps because the bank promotion heightened consumer consciousness of the item and the bank's offering somehow did not fully satisfy some consumers' desires".

Mrs. Jean G. Wofford, Assistant Vice-president, First National Bank of Spartanburg, South Carolina, makes the same point in *Mid-Continent Banker*, November 1970: "One popular misconception that I have mentioned earlier is that retail merchants do not like competition from the bank. Quite the contrary. Merchants find there is a sharp increase in their sales of, say, china, silver or other premium items to residents who have been made aware of their need or desire for the merchandise by the bank's advertising; but who, for some reason or other, preferred to buy in local stores rather than participate in the bank's program.

(8) *The total net cost of bank premium programs to banks is very small:* Based on the *ABA 1970 Bank Advertising Survey* the net cost of bank premium programs represents only 2 percent of total bank advertising budgets, only 0.03 of one per cent of operating income, and only 0.002 of one per cent of total deposits. Based on the ABA survey of commercial banks, the total net cost was only approximately $8 million, exclusive of media advertising for such programs.[3] (See following table.) (The difference between this advertising cost estimate for bank premiums and the total sales value of the bank premium industry is accounted for only minorly by other financial institutions, but principally by the nature of many "continuity programs" whereby banks may recover a large share of the initial gift by subsequent sales, thus approaching a "break-even" position.) Thus, it appears that banks and other financial institutions are able to use premiums as an effective promotion technique in terms of generating new accounts, appealing to small savers, opening new branches, widening the variety of banking services but with little net cost.

BANK PREMIUM NET COST AND USAGE AMONG COMMERCIAL BANKS

	Size of bank by deposits (millions of dollars)									
	Under 1	1 to 2	2 to 5	5 to 10	10 to 25	25 to 50	50 to 100	100 to 500	500 to 1,000	Above 1,000
Number of banks	231	1,051	3,494	3,434	3,180	1,096	476	403	59	49
Total deposits (billions of dollars)	0.3	2.2	12.9	24.3	42.6	32.2	28.5	76.0	39.2	142.6
Advertising expenditure (thousands of dollars)	277	1,958	9,306	24,880	51,605	39,370	32,908	83,048	40,750	91,738
Percentage of advertising budget on customer premiums	0.5	3	3	3	3	3	2	2	2	1
Total net cost customer premiums (thousands of dollars)		59	279	746	1,548	1,181	658	1,661	815	917
Percentage of banks using customer premium (1970 ABA survey)		4	13	17	23	32	29	37	38	46
Percentage of banks having used premiums at any time (ABA 1968 survey)	5	9	17	27	37	46	54	59	[1] 71	[1] 71

[1] Aggregated in one category of all banks over $500,000,000 in deposits.

Source: American Bankers Association, Customers Premiums, 1969. American Bankers Association, 1970 Bank Advertising Survey. Deposits and numbers of banks: Federal Reserve System data and FDIC 1969 Annual Report.

EXISTING REGULATIONS ON BANK CUSTOMER PREMIUMS

In mid-February 1970 the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board issued new regulations concerning the use of premiums by financial institutions.

The new regulations limit the wholesale value of premiums to $5.00, excluding shipping and packing costs, for deposits up to $5,000, and set a limit of $10.00 for deposits above $5,000. The regulations (97 Fed Res 279) contain two other chief components: (1) Premiums can be given only at the time of the opening of a new account or for the addition in an existing account, and (2) premiums may not be given to a depositor on a recurring basis.

The Federal Reserve Board's position is based on the recognition that many banks offer premiums as a legitimate form of advertising and that such promo-

[3] Such advertising for premium programs is typically part of rather than in addition to the normal bank advertising budgets.

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tion is not a breach of Regulation Q which limits financial compensation to the customer for the use of his funds.

The shift in policy in 1970 reflected to a large degree the concern of the Federal Reserve Board (and FDIC and FHLBB) to encourage savings deposits in a period of inflation, a decline of new funds flowing into savings institutions, the resulting drop of funds available for housing starts, and the increase in interest rates faster than Regulation Q could be adjusted upward to compensate for more advantageous rates offered by competitive financial instruments. This move by the FRB, as a part of its general strategy to increase the money supply growth rate in 1970 relative to 1969, was by and large successful in turning around the funds shortage felt by financial institutions and the housing market during 1969–70.

The Federal Home Loan Bank Board has ruled that sales of merchandise, as a part of a promotional campaign, are within the incidental powers of Federally-chartered associations. Where merchandise is sold, the loss on the sale, if any, may not exceed the dollar limitation applicable to giveaways.

At the present time the expansion of the supply of money has severely curtailed the premium industry. The companies remaining in the field today are those that have for a quarter of a century lived through the "highs and lows" of the industry and are able to provide service to the financial community under a variety of economic cyclical conditions.

Economic beneficiaries

(a) *Small savers* are probably the major beneficiaries of bank premium programs. Generally the low-income household is at a distinct disadvantage in its financial relations with the banking (in its broadest sense) community: as a borrower, the interest charges typically range from double to quadruple those rates (prime rate used as a benchmark) available to more affluent businesses or households. Whereas the wealthy household or large business may borrow at 6–7 per cent, the low-and-middle income household or business may borrow at rates ranging from 12–13 per cent. Likewise, on the investing side the same financial discrimination is also true. The larger lender may receive higher legal rates for depositing larger sums in financial institutions, or as more often the case, may have both the knowledge and funds to invest elsewhere (second trust mortgages, federal-guaranteed or sponsored securities, Eurodollars, commercial paper) at considerably higher rates of return. Whereas the low income saver may be limited to rates between 4–5 per cent, the knowledgeable large investor may receive two-or-three times this return.

Bank premiums help redress this financial discrimination. Especially in periods of monetary tightness (as in 1969), government ceilings on interest rates for savings deposits limit an increasing return to small savers but not to big savers who can go elsewhere. Bank premiums provide a flexible instrument to increase such savings rates for low-income groups. Even in more normal monetary times, a bank customer premium results in a substantial interest rate increase to the small saver. This effect is actually greater than at first realized: for example, giving a $3.00 premium for opening a $100 savings account at 4 per cent interest is *not* an effective rate of return of 7 per cent but actually a return closer to 10.6 per cent (the $3 premium is at wholesale prices with the equivalent retail price equal to twice that amount, if not more: thus in reality the customer is "depositing" only $94 (the bank giving him $6 back immediately in the form of a premium) and could receive from the bank a year later $104.) Thus, under different assumptions as to the customer's valuation of the gift, the real rate of return he experiences may be *two or three times* the nominal rate of interest for small savers. Such a financial return, as the ABA study indicates, is sufficient to induce a greater savings flow in such institutions. As was discussed earlier, such a flow does not result in shifting minor amounts among banks (only 12 per cent of bank customers indicated they would change banks to get premiums) but represents a more efficient use of savings by customers to secure a higher return. In addition, no economist would deny that such an increase in the rate of return would have some increase in total savings relative to consumption. However, the chief consideration for the small saver is that bank premiums offer him some upward flexibility in his possible rate of return in the institutional context whereby wealthy savers can avoid government interest rate ceilings by alternative investing patterns not subject to the interest rate ceilings imposed on savings institutions.

(b) *Small banks and new branches* benefit in that premiums offer a means of competition with older, larger and more established banks whose size alone may tend to attract new savings accounts. The ABA 1969 survey indicated that banks with deposits under $1 million were adopting such incentive pro-

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grams at a rate 18 times faster than banks with deposits over $100 million. Likewise, 62 per cent of new branch openings reported "good" results with premium programs; this was the highest percentage of "good" results relative to other categories of the use of premium programs. In brief, as a means of competition by newer and smaller banks and branches, premiums offer an offset to the "natural" prestige advantages of larger banks and savings institutions. In the ABA 1970 Advertising Survey small and medium size banks (with deposits between $2–50 million) allotted three times as much of their advertising budget to premiums than did banks with deposits over $1,000 million. There is a paradox in the data examined in that larger banks began a more extensive use of premiums than smaller banks, thus tended to attract new savers. Thus, at the present time when smaller banks are attempting to "catch up" with the initial headstart by larger banks, the Congress is considering the prevention of such premium programs. This, at the present time, thus serves to reinforce the earlier advantage achieved by the larger banks which first adopted the programs.

In the ABA 1970 Bank Advertising Survey (covering 1969) 39 per cent of the banks experienced "better than expected results" using bank premiums, 44 per cent reported "about as expected results" and only 17 per cent reported "worse than expected results" (with 14 of these percentage points in the "slightly worse" category and 3 points in the "much worse" category). The ABA summarized that "For the most part, bankers do not appear dissatisfied with the results."

Since premiums "reflect an expenditure directly from the marking and advertising budget," the small bank is able to compete favorably with the larger bank for its share of the market. For example, Dallas sources report that the increased cost of time and space in advertising media have in some cases increased to the point where the small bank is incapable of effectively bringing its service message to the public. In the past four years, a sixty-second radio commercial has increased from a price of $14 to $46. Fourteen lines of newspaper advertising have increased from 63¢ per line in 1966 to a current rate of 84¢ per line. According to advertising specialists in Dallas, "Although bank budgets for advertising have increased 25 per cent, the new budget will pay for 20 per cent less than prior years expenditures." Television sixty-second commercials in prime time in the Dallas market cost $400. This rate all but eliminates prime time television from the grasp of the "would be" small bank advertiser. Since premiums cost exactly the same amount to the "big bank" as to the "small bank," this is the only method of equal and fair competition left to the small bank. Discriminatory legislation eliminating premiums completely would cause undue hardship and make quite difficult the task of "small bank marketing functions."

(c) Premium manufacturers and their dealers and suppliers represent a considerable amount of economic activity: production, jobs, profits and taxes that would be eliminated if bank premiums were outlawed. Total bank premium production is estimated at about $100 million representing up to 10,000 jobs (and, given some multiplier effect for changes in income, this could affect double or treble this number through economic repercussions.) The most important characteristic in the analysis of manufacturers is that, generally not widely realized, *30 per cent of the firms surveyed* (which represented about one-fifth of the total industry involved) rely on bank premiums *as their sole activity*. This would thus mean the elimination (or serious disruption) of some firms which have concentrated in this area for over a quarter of a century (the oldest firm goes back to 1945). For other firms bank premiums constitute such a large share of their total business (another 20 per cent of the firms surveyed received more than half their sales from this area) that the total business would be seriously affected with possible bankruptcy as a result. Thus 50 per cent of the firms surveyed would be seriously jeopardized by abolition of bank premiums. In a period of economic recession-and-limited-recovery such an impact on economic activity would be hardly salutary.

(d) *Employees of premium manufacturers and associated suppliers and dealers* would have much to lose if premiums were abolished. As cited above, as many as 10,000 direct jobs may be affected (excluding transport and distribution jobs). This total could be more if one considers the nonpremium employees of companies whose major economic activity is in the premium business and which might be forced to close entirely if this activity were eliminated. With the loss of every production job there would be a "multiplier" effect on other income, production and jobs that depend on the spending power generated by such initial economic activity. The nature of these jobs makes this area exceptionally vulnerable: many such jobs are located in high-unemployment areas (California, Connecticut, Pennsylvania, New Jersey, Texas) where there would be no easy shift to alternative employment. Furthermore, the semi-skilled nature of these jobs means that

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the employees are in a low-to-middle income group and thus would not have the financial resources to relocate or be retrained without severe hardship being experienced.

(e) *Users of funds, chiefly the housing sector, of savings* channeled into institutions as a result of premiums would be net losers by abolition of premiums. In the ABA survey 79 percent of bank premium programs were used in connection with savings accounts—these generally flow into the housing sector in contrast to other forms of financial intermediation. Thus, any increase in total savings (due to the rate of return effect cited earlier) or shift in the composition of savings toward the housing market that occurs because of bank premiums would be affected by their elimination. Obviously, given pressing national priorities in the Seventies for a vigorous housing sector, such an absolute and relative diminution of savings could not serve Congressional housing targets in its Housing and Urban Development Act of 1968.

ECONOMIC EFFECTS

The overall economic effects of bank premiums can be seen as advantageous as analyzed from the viewpoint of (a) income distribution and increased competition in the U.S. economy, (b) increased output and employment, and (c) the increased social value of advertising expenditures.

(a) *Income distribution* is improved to the degree that the effective rate of return is increased for small savers. Large savers do not generally use such small savings accounts, nor would they be enticed by $3–5 premiums relative to the time and bother necessitated by transfering funds. Likewise, on the output and employment side, the companies and employees *chiefly* involved comprise small and medium size businesses within a competitive framework with sales ranging from $1–8 million per firm involved for the larger firms and with half the firms surveyed having sales of under $1 million in this area.

All data indicate that the cost of such programs is borne by the banking industry and is not shifted to the customer-consumer as sometimes typical in other premium areas. For example, where premiums are used in supermarkets, gas stations, "stamp" programs, etc., the cost is often shifted to the consumer in terms of higher prices. For bank premiums there is the critical distinction that government interest rate ceilings on small savings accounts prevent the customer from receiving his "true market" return and thus premiums result in the benefits being received by him without having to pay a higher price for other goods purchased. Indeed the provision of consumer goods to him at wholesale prices enables him to benefit by amounts greater than the "nominal" value of the premium. Surveys of banks indicate that they typically "break even" by such programs and use them primarily because of the force of competition which by its very nature serves to benefit the consumer in terms of better service and greater attention.

(b) *Increased output and employment*, as indicated earlier, are an advantage to the economy especially when it is slowly recovering from an economic downturn. Significant at this time as well is that declining interest rates (and thus declining use of bank premiums) are already forcing a "recession" on the bank premium industry so that further legal restrictions on bank premiums would aggravate the declining economic position of the industry at the present time. Market forces in a free economy have already eliminated any earlier "excesses" that occurred during the severe tight money period of 1969–70.

(c) *The increased social value of advertising expenditures* is a final advantage of the bank premium programs as it has existed for the past quarter century. Where banks are limited by the government in the degree of price competition they can engage in, they will find means to compete by increased advertising and marketing expenditures. The social question is the value of alternative marketing strategies while the total size of funds may not change greatly. Thus the consumer is benefitted directly by receiving goods and gifts rather than by simply being bombarded by more radio-TV-or direct mail advertising where the economic benefits would accrue to advertising agencies and the various media. In the ABA survey an overwhelming percentage of bank customers, especially housewives, supported the use of bank premiums.

A further social gain from bank premiums is the initial encouragement to newly-formed households, small savers and to youth in developing patterns and habits of saving. To deny the youngster in a family from receiving a free "piggy-bank" for opening his first savings account would seem to run against the grain of the tradition of thrift in the history of U.S. economic development. Likewise,

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the inducement of a premium would tend to help consumers "optimize" in their placement of savings so that higher rates of return would be received (as contrasted to idle funds in checking accounts or cookie jars) and so that larger purchases can be made out of savings (such as appliances, cars and houses) rather than at the exceptionally high rates of consumer credit with which the small saver is usually confronted.

In the final analysis, it is the public who benefits most from saver premiums. There are no apparent reasons why such premiums should be arbitrarily prohibited.

Partial List of Firms in the Premium Industry

Thumbelina
Rival
Robertshaw
Randon House
Intermatic
International Silver
Rogers
Van Wyck
Capitol
Leeds
Sunbeam
Utica
Revere Ware
Emms
Websters
Kodak
Anchor-Hocking
Beacon Therma
Timex
Paragon
Munro
Melamine
V I P
Ronson
Toastmaster
Polaroid
Munsey
Proctor
Elgin Bradley
Peter Man's
Capra
Vornado
Corning Pyrex
Westinghouse
Salton
Paul Monet
Dormeyer
Paul Poiret
Dunhill
Schick
Helbros
Dominion
Clairol
Monarch
Manning Bowan
Bulova
Starflite
Naugahyde
General
Cory
Robeson
Casco
Black & Decker
Tensor
Ingraham
Wearever
Motorola
Washington Forge
Seth Thomas
General Electric
Sunbeam
Guard All
Detecto
Oneida
Big Ben
Agfa
Panasonic
Mirro
West Bend
Thermos
Enterprise
St. Mary's
Regent
Dazey
Continental
Viva
Westclox
Philco
Chilton
Shetland
Crescent
Hamilton Beach
Accent II
Roto-Broil
Universal
Emerson
Samsonite
Lifetime Cutlery
Jubilee
Stakmore
Barcalounger
S C M Electric Typewriter
Hoover
Atlas
Bell & Howell
Magnavox
Spalding
Singer
J. Edward Connelly Associates
William Dalton Associates
Premium Corporation of America
Ben Gross & Company
Ben S. Loeb & Company
Grace China Company
Salem China Company

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The CHAIRMAN. I wish you would keep in mind page 11, your table. I want to ask you about that.

Dr. HINRICHS. Right, sir.

The CHAIRMAN. Each of you gentlemen may file your statements in full. And if in the course of our proceedings here some point comes up that you would like to elaborate on, or if you want to extend your testimony in any way to make more clear your thoughts on the matter, you may do so by extension of your remarks, so as to make sure that you will be able to express yourselves fully and protect your own interest and get your viewpoint over.

First, each member of the committee will ask questions for 5 minutes, and then we will have a second go-around where there will be no limitations.

First, I would like to ask just two or three questions here of Dr. Oberg.

You say on page 2, Dr. Oberg, that one major institutional investor is already reporting publicly its equity holdings on a regular basis. Which group of institutional investors is this? How long have they been making these reports? Have they suffered any serious injury because of such disclosures? And finally, what was this industry's attitude toward being required to make such disclosures before Congress required them to do so?

Dr. OBERG. Mr. Chairman, the institutional group referred to in the statement is the investment companies that are registered with the Securities and Exchange Commission under the 1940 Investment Company Act. As far back as the time of the passage of the act there were requirements for disclosure in semiannual financial reports of various details of the holdings of these companies.

Several years ago this was extended in terms of details of portfolio composition by the introduction of the NIR and NIQ reporting forms. The NIR form is on a fiscal basis for the full year. The NIQ is on a calendar quarter basis, and in those it is required to report each of the holdings and the activity therein, if any, in each quarter.

As this series of reporting forms and procedures developed, there was discussion between the industry and the regulatory authorities—it was a give and take. The NIR has a public and private section of information supplied—my only personal view is that this information has been beneficial, and I know of no major reaction that has occurred in the disclosure of such data.

The CHAIRMAN. Thank you, sir.

Do you feel that the benefits derived by the public from such disclosures outweigh the cost to the industry?

Dr. OBERG. Mr. Chairman, I would be in the value judgment there. I would like to agree myself to the fact that in my work over the years I have found it beneficial to know more and more about the institutions.

The CHAIRMAN. Do you feel that if bank trust departments were required to make such disclosures, given their massive size and participation in the securities market, such disclosure would benefit the public?

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Dr. OBERG. In my opinion, yes. The disclosure of information which permits someone to measure the size and location of various securities holdings, the ability to look and apply quality valuations to the types of securities used, the philosophies behind the various institutional groups, is something that I as a general thing, think is most valuable.

The CHAIRMAN. This committee is the only one, I think, in Congress that has ever gotten out a report on that. About 3 years ago we interrogated all the banks and we got the correct information from them. And we discovered that about $253 billion represented the size of the trust accounts of banks. But out of the 14,000 banks only 3,000 banks had trust accounts.

Subsequent to that the figures were brought up to date showing about $280 to $290 billion, and 19 banks had over half of those trust assets. That is the reason we were going into it, just looking into it.

Now, I would like to ask Mr. Swift a question. Several States besides these six that do not permit the ownership of bank stock by mutual savings banks substantially limit such holdings. For instance, Maine and Rhode Island limit such holdings to 10 percent of the deposit of the savings banks, and Minnesota limits such investments to 3 percent of bank's assets. Several States also limit the percentage of stock owned in any one bank.

For instance, in Alaska it is 2 percent and in Minnesota it is 1 percent. In New Jersey a mutual savings bank is limited to holding not more than 2 percent of the outstanding stock of any company. The point is that at least nine of the 18 States in which mutual savings banks operate, either prohibit or severely limit the amount of commercial bank stock that mutual savings banks can own.

This does not appear to have adversely affected the operation of these banks.

On the other hand, there is substantial evidence that mutual savings banks in some States have invested heavily in bank stocks of competitor banks.

With this in mind, do you consider it to be a severe blow to the operations of mutual savings banks if they were prohibited or restricted as to the amount of bank stock that any one mutual savings bank could hold?

Mr. SWIFT. Mr. Chairman, a lot of the differences that have arisen are historical, and there would be some adverse effects, there is no question about it, in those States that have a long tradition of stock ownership in commercial banks.

I would, if I may, pass this question over to Mr. Clark, who is closer to it.

The CHAIRMAN. My time has expired. And I will have to yield to another member of the committee.

I would like to insert, if there is no objection, a table showing the mutual savings bank investment in commercial bank stock in the 18 States in which mutual savings banks operate.

Without objection that will be inserted.

(The table referred to for inclusion in the record at this point follows:)

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MUTUAL SAVINGS BANK INVESTMENT AUTHORITY IN COMMERCIAL BANK STOCK

State and authority to invest	Percentage of bank assets which may be so invested	Percentage of shares of any 1 issuer which may be owned	Geographical limitations or requirements	Other limitations or requirements
Alaska: Yes. Sec. 06.15.260, Alaska statutes annotated.	In all stocks—No more than 10 percent of assets or 100 percent of surplus and undivided profits, whichever is less; in common stocks no more than 6 percent of assets or 60 percent of surplus and undivided profits, whichever is less.	No more than 2 percent of total issued and outstanding shares of any one issuer—nor more than 1 percent of bank assets in any one issuer.	None	None.
Connecticut: Yes. Sec. 36.96(10), the banking law of Connecticut. Savings banks may also invest in the shares of bank holding companies registered under the laws of the United States.	Total investment in stock of banks and holding companies shall not exceed 6 percent of assets.	Investment in the shares of any one issuer shall not exceed 10 percent of the total equity securities of the issuer nor shall exceed 1/10 of 6 percent of bank assets.	Issuing bank must be in Connecticut or in any city designated by the Federal Reserve board as a central reserve city or a reserve city.	Issuring bank must have paid dividends in cash in each of the last 5 fiscal years at the rate of at least 49 percent on its common capital stock, and provided that the combined capital, surplus, and undivided profits of any such bank located outside Connecticut shall be at least $20,000,000.
Delaware: Yes. Prudent man rule	No limitation	No limitation	None	None.
Indiana: No authority	None	None	None	None.
Maine: Yes. Sec. 629, Maine revised statutes. Also in stocks of bank holding companies, provided 60 percent of the company's gross revenues are from banking operations.	No more than 10 percent of deposits may be invested in bank stocks or bank holding company stocks.	Investment in the shares of any 1 issuer shall not exceed 10 percent of the capital stock of the issuer nor shall it exceed more than 1 percent of the deposits of the bank.	The issuing bank must be located in Maine, except that if outside Maine, it must be a member of the Fed and have total capital funds of $50,000,000.	None.
Maryland: Yes. Prudent man rule	No limitation	No limitation	None	None,

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Massachusetts: Yes. Sec. 47, annotated laws of Massachusetts. Also in stocks of bank holding companies.	No more than 66 ⅔ percent of total guaranty fund and surplus may be invested in bank stock (or stock of bank holding companies or fire insurance stocks).	Investment in the shares of any 1 issuer shall not exceed 15 percent of the issuer nor shall it exceed 1/15 of the total guaranty fund and surplus of the bank.	The issuing bank must be located in Massachusetts. If not, it must be a national bank, have a combined total of capital stock, surplus, undivided profits, and reserves for contingencies of at least $40,000,000 and also equal to at least 6 percent of its deposits and which for last 10 years has paid a cash dividend of at least 4 percent on its common without having reduced the aggregate par value.	A Massachusetts issuing bank must have paid dividends in cash of last 5 years of not less than 4 percent on its common stock without having reduced the aggregate par value thereof within such 5-year period, and which has surplus at least equal to 50 percent of its capital stock.
Minnesota: Yes. Sec. 50.146, Minnesota statutes annotated.	No more than 3 percent of savings bank's assets may be invested in bank stocks.	Investment in the shares of any 1 issuer shall not exceed in amount, ½ of 1 percent of the assets of the savings bank; in number of shares, 1 percent of the total outstanding and issued shares of the issuer.	The issuing bank must not be located in the 9th Federal Reserve District.	No investment shall be made in any corporation with assets of less than $10,000,000.
New Hampshire: Yes. Sec. 387.13, New Hampshire revised statutes annotated. Also bank holding companies. (Registered).	No more than 15 percent of deposits may be invested in preferred or common stocks. (387.3(2).)	Investment in the shares of any 1 issuer shall not exceed 25 percent of the total capital stock of such issuer.	The issuing bank must be located in New Hampshire, or if not, must be a national bank or State member bank of the Fed, located in a city of not less than 500,000, and provided capital stock, surplus and undivided profits are at least $10,000,000; combined surplus and undivided profits are at least equal to its capital stock, and a cash dividend shall have been paid in each of the last 5 years.	None.
New Jersey: Yes. Sec. 17:9A-180.5(3) N.J.S.A.—National bank stock only.	No more than 75 percent of savings bank surplus may be invested in stocks.	Investment in the shares of any 1 issuer shall not exceed 2 percent of the outstanding stock of the issuer nor 3 percent of the surplus of the savings bank, whichever amount is less.	None	Issuer must be a member of the Fed, must have a combined total of capital, surplus reserve for contingencies and undivided profits equal to at least $40,000,000 and also equal to at least 6 percent of its deposit liability, and which in each of the last 5 years paid cash dividends of at least 4 percent on its common stock without reducing the par value thereof.

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MUTUAL SAVINGS BANK INVESTMENT AUTHORITY IN COMMERCIAL BANK STOCK—Continued

State and authority to invest	Percentage of bank assets which may be so invested	Percentage of shares of any 1 issuer which may be owned	Geographical limitations or requirements	Other limitations or requirements
New York: No authority	None	None	None	None.
Ohio: No authority	None	None	None	None.
Oregon: No authority	None	None	None	None.
Pennsylvania: Yes. 7 P. S. 504	No more than the lesser of 7½ of the assets of the savings bank or 75 percent surplus, unallocated reserves, undivided profits and subordinated securities.	Investment in the shares of any 1 issuer shall not exceed 5 percent of the total issued and outstanding shares of such issuer nor ⅙ of 1 percent of the assets of the savings banks.	None	None.
Rhode Island: Yes. Sec. 19-19-7, laws of Rhode Island. Also registered bank holding companies with total invested in affiliated banks of $100,000,000 which have paid dividends of at least 4 percent on its common for the last 5 years and at least ⅔ of the holding company's assets shall consist of bank stocks.	No more than 10 percent of the savings banks deposits may be invested in bank stocks.	Investment in the shares of any 1 issuer shall not exceed 5 percent of the total outstanding voting stock of the issuer nor shall it exceed 3 percent of the deposits of the savings bank.	The issuing bank must be located in New England or New York or be a national bank doing business in said States, except if located outside the above, must be a member of the Fed, have its principal office in a city of at least 200,000 people, have aggregate capital, surplus and undivided profits of at least $5,000,000 and have been in business for at least 10 years.	None.
	An exception to the above restrictions provides that notwithstanding such restrictions, Rhode Island savings banks are authorized to organize or purchase one (1) bank and trust company or national bank and to own all or a majority of its capital stock.			
Vermont: No authority, except for retention of stock held on date of enactment (1969) (see sec. 1157(2)).	None	None	None	None.
Washington: Yes. Sec. 32.20.380, RCWA	No more than 50 percent of total of guaranty fund, undivided profits and unallocated reserves, or 5 percent of deposits, whichever is less, may be invested in prudent man securities.	No provision	The home office of the issuer must be located outside the State of Washington.	None.
Wisconsin: No authority (see sec. 222.13, W.S.A.).	None	None	None	None.

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The CHAIRMAN. Mr. Widnall.

Mr. WIDNALL. Thank you, Mr. Chairman.

I want to welcome all the members of the panel this morning. And we appreciate your being here and giving us the benefit of your views on this proposed important piece of legislation.

Mr. Swift, I do not know who drafted H.R. 5700, but I cannot help but be a little bit amused, noting the compliments you paid to the draftsman on page 1 of your complete statement, after which you make it quite evident he either did not research State laws affecting savings banks or that he chose to ignore them. In view of the extensive body of State laws governing all aspects of savings bank activities, do you really see any need for the provisions of H.R. 5700 affecting savings banks?

Mr. SWIFT. Well, Mr. Widnall, I think in effect our statement has indicated that we do not feel that there is evidence in our industry of the problems that are being attacked here in this bill. So far as our own industry is concerned, we do not think there have been serious abuses. We do not feel that there is a need for this kind of legislation generally.

Now, I am not in a position or would not want to say that there is not some potential need perhaps for some standardization in some of these areas. As you point out, there are great differences among the States, and so it affects our industry in many different ways, depending upon their geographical location, and the charters under which they operate. But it is hard for me to say just out and out that I would agree with you on it.

Mr. WIDNALL. Dr. Oberg, I have a series of questions that I would like to have you answer. I am not going to have time to offer the questions now and wait for your answer. But I would like to submit them for the record at this time.

(The following are written questions submitted by Mr. Widnall to Dr. Oberg, along with Dr. Oberg's answers:)

1. Is your firm a partnership or a corporation?

Answer. Arthur Lipper Corporation is a Delaware corporation.

2. Does your firm file an annual statement with the New York Stock Exchange?

Answer. Yes. We are, by choice, one of the few firms to be audited by Certified Public Accountants twice a year: once—without prior notice to us—in accordance with New York Stock Exchange regulations and once as of the end of our fiscal year.

3. Is this statement made available to the general public?

Answer. At least once a year we send to our clients and offer to institutions a certified statement of our financial condition. In addition, monthly statements sent to customers advise the customers that a current financial statement is available for their inspection at our office or that a copy will be mailed to them upon their written request.

4. Are you required to file with the New York Stock Exchange or the SEC a list of every security other than government securities that the firm owns?

Answer. We are required to file at least three reports annually listing the securities owned by us as of the date of the reports. Copies of such reports are either made available to the SEC or sent to the SEC directly. The New York Stock Exchange may also request a list of such securities at any time.

5. Is this list of securities owned made available to the general public?

Answer. No. We generally do not purchase securities for investment and, accordingly, these securities constitute a relatively small portion of our total capital. We also own securities by reason of our trading and arbitrage activities, but these securities are generally held for very short periods of time. If investment securities ever became a significant portion of our total assets, we believe

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that our auditors would require more detailed disclosure of such securities in our financial statements.

6. Would you provide a list of the securities owned by the firm so that the list could be inserted in the record of this hearing?

Answer. A list of securities owned by Arthur Lipper Corporation as of a recent date is listed below. The list primarily consists of securities in which we are trading and/or are engaged in arbitrage.

Marketable Securities Owned by Arthur Lipper Corporation as of April 30, 1971

U.S. Treasury Bills, due April 29, 1971		$20,000
U.S. Treasury Bills, due June 3, 1971		60,000
U.S. Treasury Bills, due August 26, 1971		270,000
U.S. Treasury Bills, due October 7, 1971		80,000
U.S. Treasury Bonds, due May 15, 1974		35,000
Continental Mortgage Investors due June 1/4, 1990		454
Itel Corp. July 1995		600
King Resources Co., May 3/4, 1988		1,000,000
Bank of Tokyo of California	shares	800
Berger-Kent Special Fund	do	2,000
British Petroleum Co., Ltd	do	47,600
Cowan Group Holdings	do	34,850
Fuji Photo Co	do	1,630
Fundex, Inc	do	1,124
Menasco Manufacturing Co	do	19,100
Newmont Mining $4.50 Preferred	do	13
Plessy Co., Ltd	do	97,914
Louisiana Land & Exploration Co	warrants	21,780

7. Do you make the list of the securities owned available to your customers?

Answer. No. However, where we deal directly with our customers and sell (buy) or (from) them, we inform them that we are acting for our own account; and if such is the case, that we make a market in the securities.

8. If so, do you sell the list to them?

Answer. No.

9. Does your firm generally vote proxies on securities held with management of the corporation?

Answer. For securities beneficially owned by us, we generally vote our proxies for management. For securities owned by our customers, we follow their instructions. Where customers fail to give us voting instructions, we would vote the proxies for management on routine questions, but where there is a proxy fight or a question of importance, such as a merger, we abstain from voting in the absence of customer instructions.

10. How important is routine proxy voting and what are the questions you vote upon?

Answer. Routine proxy voting is important in order for a company to obtain enough votes to have a quorum present at a meeting. Two matters which are usually voted on are the appointment of auditors and the election of directors.

11. Have you ever known of a proxy contest to be won with 5 percent of the vote? 10 percent? 25 percent? 50 percent?

Answer. We are not knowledgeable in this area.

12. Do you advise your customers or the general public on what your voting rights are and how you voted on each of the securities held in your firm's portfolio?

Answer. No.

Mr. WIDNALL. The reason I have asked these questions is to get your reaction as an institutional investor to complying with the same requirements you are asking to be imposed on bank trust departments. Thank you.

Now, a question for your corporation. This I would like to have answered now.

There are approximately 3,500 bank trust departments holding up to thousands of securities in their individual trust departments. If this average only amounted to 1,000 items—and I would guess that would

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be on the low side—that would be 3½ million items to be correlated in arriving at your list of bank trust department holdings. Most of the information of course will be completely meaningless, and without significance, except for somebody who might be compiling an investor tout list. It would be equally useless to eager beaver investors probing the evils of real or imagined monopolistic control of American business. If we are to impose a disclosure requirement on bank trust departments holdings, what would you think of placing reasonable limitations on the disclosure requirements, for instance, confine the limit to the 50 largest dollar value holdings of stock for which there is a readily available public market?

Dr. OBERG. I certainly agree that there would have to be some limitations placed on the extent of the collection. Practical considerations have to be taken into account.

The basic thought I have is the problem of the lack of periodic available data in this particular area which permit analysis from an economic and investment point of view, where those securities are, who holds them, what are the habit patterns with them, and the like. It is not practical in my opinion to get the parameters of every one of these departments on any practical basis.

Mr. WIDNALL. Then how would you narrow it down?

Dr. OBERG. I would like to study the question of just how far it should be narrowed down and make a suggestion, if I may?

Mr. WIDNALL. Mr. Chairman, can we have unanimous consent that he submit an answer to that?

The CHAIRMAN. It will be satisfactory that you submit an answer for the record on the question that has been asked.

Dr. OBERG. I will be pleased to do so.

Mr. WIDNALL. My time is up.

(In response to Mr. Widnall's request the following information was received from Dr. Oberg for inclusion in the record:)

REPLY RECEIVED FROM DR. OBERG

At the Hearing, Congressman Widnall asked me to comment on practical considerations in the collection of periodic data from bank trust departments. In my opinion both the securities to be covered and the number of units supplying information would have to be limited.

The staff report on *Commercial Banks and Their Trust Activities* of July 8, 1968 of your Subcommittee on Domestic Finance indicates $161.7 billion, or 64.4 percent of trust assets invested in stocks as of April 1, 1968. Coverage of this area would be significant and could largely be accomplished by collection of holdings of issues traded nationally on exchanges and in the over-the-counter market.

In like manner, a substantial portion of those stocks would be found in trust assets of a relatively small number of trust departments. As the number of trust departments covered increases, the larger would be the percentage of stocks covered (Volume 11, Table 8):

Trust Departments	*Percent*	*Trust Departments*	*Percent*
First 50	72.3	First 300	93.0
First 100	82.0	First 350	94.0
First 150	86.7	First 400	94.8
First 200	89.5	First 450	95.4
First 250	91.5	First 500	95.9

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The CHAIRMAN. Mrs. Sullivan.

Mrs. SULLIVAN. Thank you, Mr. Chairman.

I would like to question Mr. Swift.

In commenting, Mr. Swift, on section 10 of H.R. 5700 prohibiting mutual savings banks from owning stocks in other financial institutions, you say State statutory limitations on savings bank ownership of commercial bank stock are already sufficient to prohibit any possibility of a savings bank controlling the commercial bank. Could you tell the committee in general exactly what these limitations are,

Mr. SWIFT. Yes; Mrs. Sullivan. They do vary. In other words, they go from the States that prohibit ownership of commercial bank stock outright to those which impose limits. And then variations that have grown up over the years. And again because Mr. Clark is very closely associated with this problem, can I have him speak to the question?

Mrs. SULLIVAN. Yes; for a moment.

Mr. CLARK. Thank you, Mr. Swift.

First, I would wish to ask to be stricken from the record, with your permission, Mr. Swift, the words "any possibility." I think those two words are perhaps a little unrealistic.

The limitations basically for the States which do permit the investment in bank stock are that in Connecticut no savings bank can purchase more than 10 percent of the stock of any one issuer, in Massachusetts 15 percent, Maine 10 percent, New Hampshire 25 percent, New Jersey 2 percent, and Pennsylvania 5 percent.

In the State with which I am most closely associated, Massachusetts, did not at one time permit a savings bank to invest in anything else but bank stock, and did not permit until 1950, the investment by a savings bank in any bank stock that was not located in either Massachusetts or New England. The principal question of the State legislatures was the prudence of the investment by the savings banks. The legislature also provided limitations as to having too much of an investment in any one bank.

There are also limitations on the total amount of bank stock and other stock which may be held.

And more recently, there have been limitations which relate to the duration of dividend payments and continuity, and indeed in the latest legislation which permits the nationwide investment in bank stocks, limitations on the minimum size of the bank invested in.

Mrs. SULLIVAN. I want to ask you some followup questions, and you may want to enlarge upon your answers later.

Isn't it possible for a holder of less than a majority of the shares of stock in a commercial bank to substantially influence that bank's activities?

Mr. CLARK. I should think it would be possible to do so. But in my experience savings bank holders of bank stock have not done so.

Mrs. SULLIVAN. Either you or Mr. Swift, how can you reconcile your statement with the facts set forth in our 1967 study? I have it before me. You mention that Massachusetts must be less than—what did you say, what percentage?

Mr. CLARK. Fifteen percent.

Mrs. SULLIVAN. We have Worcester North Savings Institution, shares of which are held by the Safety Fund National Bank at Fitch-

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burg, Mass., owning 51 percent of the shares of the mutual savings bank. Then we have three of them that are over 20 percent, and three just reaching 15 percent, and others 16 percent and over in Massachusetts.

Mr. CLARK. I have no specific knowledge of the cases you state. I would speculate that perhaps in those cases, which were unknown to me until you mentioned them, they may have been acquired prior to the occurrence of applicable limitations in the very early days of the savings bank history.

Mr. HANNA. Would the lady yield for a clarification on what the gentleman is speaking about?

Mrs. SULLIVAN. Yes.

Mr. HANNA. There would be a limitation in terms of the amount of stock in any one given bank, a differential between that requirement and the requirement of a total bank stock acquisition. Of which are you speaking?

Mr. CLARK. The ownership by a savings bank of stock in one commercial bank.

Mr. HANNA. In one commercial bank, and this does not refer to a limitation of any one savings bank's total amount of bank stock, right?

Mr. CLARK. No, sir; that is a different limitation.

Mr. HANNA. Thank you.

Mrs. SULLIVAN. Couldn't it be that these banks, that I have mentioned here, have been grandfathered in under the law?

Mr. CLARK. That is a distinct possibility. I am speculating that that is the case.

Mrs. SULLIVAN. My time has expired. But I would like to refer you to the committee report of July 31, 1967. I do not have the report number. It is "Control of Commercial Banks and Interlocks Among Financial Institutions." You can get it here from the committee. On page 24, if you look at that, you can probably enlarge on your information to me.

Mr. CLARK. Counsel has made a note of the reference, and I would hope to look into it. If I can give you further information I would be delighted to do so.

Mrs. SULLIVAN. Thank you. That is all, Mr. Chairman.

(In response to the information requested by Mrs. Sullivan, the following letter was received from Mr. Clark:)

ARLINGTON FIVE CENTS SAVINGS BANK, INC.,
626 Massachusetts Avenue, Arlington, Mass., May 5, 1971.

REPRESENTATIVE LEONOR K. SULLIVAN,
House of Representatives,
Washington, D.C.

DEAR REPRESENTATIVE SULLIVAN: During questioning of me as a witness before the Committee on Banking and Currency concerning H.R. 5700 on Friday, April 30, you inquired concerning ownership of 51% of the outstanding shares of stock of Safety Fund National Bank by Worcester North Savings Institution, and the ownership of 21% of the shares of that Bank by Fitchburg Savings Bank, all three Banks having principal offices in Fitchburg, Massachusetts. This has particular relevance in view of the Massachusetts Statute which provides that a Savings Bank may not acquire more than 15% of the shares of any one Commercial Bank.

I did not at the time have adequate specific information to respond thoughtfully to your question and requested an opportunity promptly to inquire and

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answer. You helpfully referred me to Page 24 of the Staff Report for the Subcommittee on Domestic Finance of the Committee on Banking and Currency filed July 31, 1967 entitled "Control of Commercial Banks and Interlocks Among Financial Institutions."

The answer to your question is that the Staff Report to which you referred is incorrect with regard to ownership of shares of Safety Fund National Bank by the two local Mutual Savings Banks. Using as a starting date, December 31, 1965, neither of the Savings Banks owned more than 5.1% of the shares and together they owned no more than 7.2%. Further the percentage ownership has declined since that time.

In inaccuracy of the Staff Report is quite understandable in the light of the following facts developed by Mr. Albert Conrad, Executive Vice President of Mutual Savings Central Fund, Inc., of which I am President. His sources include the President of First Safety Fund National Bank, communications with the two Savings Banks involved, and others. I am satisfied that the information is correct.

On December 31, 1965 there were outstanding 10,000 shares of Safety Fund National Bank of which 510 shares or 5.1% were owned by Worcester North Savings Institution, and 210 shares or 2.1% owned by Fitchburg Savings Bank. On March 9, 1966 Safety Fund effected a five for one stock split plus a 100% stock dividend with the result that 100,000 shares were then outstanding. Without further investment Worcester North was the owner of 5100 shares, the same 5.1% and Fitchburg was the owner accordingly of 2100, the same 2.1%.

On December 16, 1966 Worcester North sold 2600 shares and continued to hold 2500 shares or 2.5% of the total. On November 1, 1968 the total number of shares of Safety Fund National Bank was increased from 100,000 to 131,500 shares. The additional 31,500 shares were issued to acquire the First National Bank of Gardner, Massachusetts and were distributed to the shareholders of that Bank in exchange for all of their shares. Neither Fitchburg Mutual Savings Bank received any shares in that transaction. As part of this acquisition the name was changed from Safety Fund National Bank to First Safety Fund National Bank.

In consequence of this transaction the 2500 shares of First Safety Fund National Bank then and now held by Worcester North Savings Institution amounted to 1.90% of Safety Fund shares and the 2100 shares held by Fitchburg Savings Bank amounted to 1.59% of total shares of Safety Fund.

It is important that you raised this question so that a Committee Report indicating absolute control by a Mutual Savings Bank of a local Commercial Bank be rebutted when such is not the case. I submit that the facts suggest in this case very small stock ownership in proportion to the whole and a declining portion at that. I request that this letter be entered in the record of this hearing proximate to your question and my reply.

In view of the interest expressed by Representative Heckler at the hearing I am sending her a copy of this letter and of course also a copy to Chairman Patman.

Very truly yours,

EDWARD P. CLARK.

The CHAIRMAN. Mrs. Dwyer.

Mrs. DWYER. Thank you, Mr. Chairman.

This question is directed at Professor Hinrichs.

Do you have any idea of what prompted this proposed prohibition against premiums?

Dr. HINRICHS. I really do not know. I would suspect from hearsay evidence that there might have been maybe some groups or banks in the banking community that may be afraid of excessive competition. And second, since the cost is borne by the banks and not by the customers of the banks, if there are any losers—and I do not think there are, because the banks generally favor this as a marketing device—if there are any losers, there may be some banks which are in a semi-monopolistic position which might have to bear the cost of this program, because essentially, given a ceiling on interest rates, they are the ones that would bear the cost, and not the saver. Because it really

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means an increase in the marginal rates of interest to the small saver. If a person, for example, gets a $5 gift for opening a $100 savings account, this is wholesale value, and it really represented merchandise equalling maybe $10 or even more.

Now, this means that under certain assumptions the customer really puts in $90 instead of a hundred dollars, and then a year later he gets back $105. This really means a marginal inducement of 15 percent rather than the fixed rate of 5 percent on average savings. It is something like an apartment landlord who might give the first month's rent in an apartment building free in order to get a tenant.

Mrs. DWYER. Another question. Do you know of any instance where this practice has jeopardized the soundness of a financial institution?

Dr. HINRICHS. Since, as I mentioned, it only accounts for between 1 to 3 percent of the bank advertising budget, and since it only accounts for .03 of 1 percent of the operating income of banks, I think any bank operating that close on the margin that could be destroyed by a fraction of 1 percent of operating income probably would have failed for some other reason. But this is very small potatoes. It is really a case of economic freedom under the American system of economics. Do we take piggybanks away from children? It is essentially a case of economic freedom and flexibility. And with the Fed putting on a ceiling by regulation Q, that, if anything, is the culprit in the whole thing. Diversity and freedom—the customers like it. People are really human. They respond to a dish or a billfold more than being told, your interest has gone up from 4.6 to 4.7. Wives want the dishes, they do not want the 0.1 percent. It is psychological.

Mrs. DWYER. This question may be repetitious, but I am going to ask it anyway. Have you ever incurred any premium program which resulted in adverse effect on competing institutions sufficient to have any adverse economic effects?

Dr. HINRICHS. I think, as Chairman Patman so well pointed out last year, that you did have in 1970 some excesses which once more were, I think, the result of the Federal monetary policies rather than the result of the industry, which has been around for 25 years. So that in the New York episode I think you did go to extremes. The group I represent is concerned that we do not have such excesses which is why the industry by and large approves of some limit to keep this as a promotional device, rather than giving away Cadillacs if you tie up your money for 25 years, rather than exploding the program into something which would result in socially wasteful expenditures. So I think the New York case was an extreme example. But I think this is a nonrepeatable case, because right now the premium industry is in a serious recession, because with falling interest rates—now the true market rate has fallen down approximately the regulation Q ceiling, so that the industry now is in serious trouble, and if we prohibit premiums, you would seriously affect at least half of the firms which rely upon this business as their major activity.

Mrs. DWYER. One more question. Do you think the awarding of premiums in addition to interest stimulates that increase in savings?

Dr. HINRICHS. Once more, in terms of theory, no economist would deny that if you increase a reward for activity, there will be some increase in that activity. In other words, the savings function is not

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totally interest inelastic—there is some marginal increase. Obviously there are more important factors such as macroeconomic policies, fiscal policies, monetary policies, the state of national accounts, and many variables. But in a macroeconomic sense there is some slight increase.

Secondly, there is an increase in the form of savings whereby funds will tend to go into savings banks offering these programs. This money would therefore have a greater tendency to go into housing, which would be better than, let us say. Other competing financial institutions which can offer higher premiums in the form of money for savings, and therefore money would be channeled into other activities than housing. So the form of savings is changed as well as the total amount.

In certain microeconomic cases ABA studies showed that in several small towns certain banks were able to increase their savings deposits substantially, even though there were no other variables that would have explained why the banks should have grown that rapidly. These were praised by the small town bankers themselves, and they primarily said, their growth was in response to a premium program.

Mrs. DWYER. My time is up. But I am going to ask you a quickie. How many mutual savings banks are there in the country? Did I hear testimony that there were just 19 States?

Mr. SWIFT. Eighteen States, and it is a total of approximately 500 savings banks.

Mrs. DWYER. Have you increased in the States, or are you just standing still?

Mr. RIORDAN. I would say standing still in terms of the number of banks.

Mrs. DWYER. My time is over.

The CHAIRMAN. Mr. Reuss.

Mr. REUSS. Dr. Oberg, I was interested in your testimony.

Am I right in thinking that the reason for your service in connection with the investment performance of investment companies, where you do have accurate portfolio information, is so that a prospective purchaser of an investment company may have a standard of comparison as to how this company performs compared with other investment companies? That is the reason for the Arthur Lipper Corporation's services?

Dr. OBERG. That is a basic purpose, to have an ability to evaluate one investment company as against the other in qualitative factors, the S and P rating of securities, for example. But also, with the periodic availability of this information on a quarterly basis, we can compare one investment company with itself over time, and they do have a tendency to change over that time period.

Mr. REUSS. You approve the section of the bill before us which would require the reporting of equity holding by bank trust departments?

I have a question to ask you on that. Bank trust departments have different sorts of portfolio holdings. Some of the poor fellows have been received under a will, and the equity investment may be a absolute dud, but for one reason or another, the trust department may for a time at least be compelled to carry it. It would not seem to me fair, therefore, to rate banks on their total across-the-board trust department performance, nor do I gather that you would want to do that.

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How can you sort out, however, that portion of a bank trust department's activities, such as management of pension funds, and so on, or common trust funds which are really competitive, and where it would be a good idea for the public to be able to read some service like yours so it can figure out whether to keep its funds in the trust department of bank A or the trust department of bank B? Can you give me some help on that?

Dr. OBERG. Sir, I was thinking in terms of economic and investment analysis. And the interesting thing as you view an institutional group over time, comparing period against period, is to characterize the various institutional forces which are interested in the equity field. And they are interesting in different ways.

For example, I understand that the institutional investor study—at least in conversations about it—has noted that there are certain greater concentration factors among banks than against other institutional investors such as investment companies. It is beginning with these qualitative factors, and the quantitative use of various securities, and particular securities, that I think has economic and investment value. I am not addressing myself to the performance area here.

Mr. REUSS. Do you think the public interest in being able to make a comparison would be adequately served only by a total disclosure of bank trust company portfolios, or could it be served by disclosure of something less than that? By which I mean, could you sort out two piles of trust company activities, one deserving of full public disclosure, and the other in which public disclosure does not really serve any particularly useful purpose?

Dr. OBERG. I am not familiar enough to evaluate the bank trust department activities.

Mr. REUSS. What I am thinking of is the example I have put before. I do not see whether it does your service any particular good to know that X bank has a trust under a will under which it is trustee continues to hold stocks in certain closed or family business corporations which it got under the will. It does not seem to me that you can compare that branch of the business with any other bank. Indeed, the will may require them to hold that stock, good, bad or indifferent. While I am interested in the full disclosure, I do not want to impose burdens on banks or anybody else that does not serve any public purpose.

Would it serve any purpose for your institutions to know about those holdings under wills and trust companies?

Dr. OBERG. As to specifically wills and the like, the form in which the securities are held could in general be of interest.

I might refer to what our experience has been in the investment company with the availability of such data. A number of services have developed in the investment company area in which they report on the 50 largest holdings by the industry as a whole, for example, or give an alphabetical sort of all securities held by the investment company industry. Now, these serve as bases for learning where the supply is.

Mr. REUSS. Are you talking about investment companies?

Dr. OBERG. I am talking about investment companies, yes.

Mr. REUSS. But they do not get into the business of holding duds the way bank trust companies' portfolios do. I think it would be

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great for your service to be able to tell unions, for example, which are shopping around looking for a trustee for their pension funds, which bank does the better job. You now cannot tell them that, is that not so?

Dr. OBERG. We cannot.

Mr. REUSS. I certainly want to put you in a position where you and your competitor can do that. But at this stage of the game I cannot see any reason for a total disclosure of bank portofolios. That is why I keep asking you, are there not two piles or categories of what bank trust companies do, one that ought to be publicly disclosed and the other which really need not be?

Dr. OBERG. I wish I could clarify that, but I cannot. I am really not that familiar with the breakdown of the bank trust function operations. I am thinking more of institutional investment securities.

Mr. REUSS. Thank you, Doctor.

(The following letter was received from Arthur Lipper, III, president, Arthur Lipper Corp., in response to the questions above of Mr. Reuss:)

ARTHUR LIPPER CORP.,
May 17, 1971.

Reference: Hearings on H.R. 5700.
Hon. HENRY S. REUSS
U.S. House of Representatives,
Washington, D.C.

DEAR MR. REUSS: During the testimony of Dr. Harold S. Oberg of our firm before your committee on April 30, 1971, you asked several questions to which an additional comment by me, as Chief Executive Officer of Arthur Lipper Corporation, may be helpful.

I agree with you in that if Congress requires some type of disclosure of Bank Trusth Department holdings, practical limitations as to what must be reported should also be included in the bill or in the legislative history.

Since any data disclosed could be used either by a firm such as our own or, for that matter, by the banks themselves to demonstrate the relative investment performance of one Trust Department versus anoher, it is my view that disclosure should be required in those cases where the bank has full management responsibility and authority. No real purpose would be served in studying trust accounts which include holdings of non-public companies or holdings which are not freely marketable at the bank's sole discretion.

We appreciate the opportunity to present our views on this matter of public interest.

Sincerely,

ARTHUR LIPPER III,
President.

The CHAIRMAN. Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman.

Mr. Swift, in your statement and in your testimony you have indicated that there are certain exemptions, in the provisions regarding interlocks, for bank holding companies. You also mentioned the Rhode Island statute specifically authorizes mutual savings banks to have a subsidiary commercial bank. Enactment of H.R. 5700 would therefore tend to push many financial institutions into the holding company route, would it not?

I think you can speak more objectively, possibly, from a savings bank standpoint than can commercial banks, because you are not quite so intimately affected.

Mr. SWIFT. I think that would probably be true, since there is the

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exemption to all bank holding companies. But you have got the same regulation and control on the other side of the holding company itself. So I am not certain that that effect would necessarily follow or be stimulated.

Mr. BROWN. But there is regulation under the holding company law, not prohibition, wouldn't you agree?

Mr. SWIFT. Yes.

Mr. BROWN. In these areas?

Mr. SWIFT. Yes, sir.

Mr. BROWN. So that under the holding company route there would be no necessity to divest many of these relationships, rather they would be regulated?

Mr. SWIFT. That is correct.

Mr. BROWN. In your statement you also have singled out many areas and pointed out that if they were to be enacted they should be amended. Would you mind briefly reviewing for me what you feel are those provisions as written in H.R. 5700 that are necessary and desirable?

Mr. SWIFT. That are desirable to be enacted?

Mr. BROWN. Necessary and desirable.

Mr. SWIFT. As I stated to Mr. Widnall, we do have a sincere feeling of a high standard of trusteeship in savings banking generally that has not only arisen out of tradition, I think, but has also been reenforced by State laws in all the States where savings banks operate which limit and restrict self-dealing and conflicts of interest that could be adverse to a bank. So there is nothing in the act that I think seriously covers a problem that we would recognize, and that therefore is deemed to be needed or necessary.

Mr. BROWN. Could I rephrase your answer and say that there is nothing in the act that covers a serious problem.

Mr. SWIFT. Insofar as it relates to our industry, I think I would agree with that.

Mr. BROWN. I have no further questions, Mr. Chairman.

The CHAIRMAN. Mr. Hanna.

Mr. HANNA. Mr. Gettys was here when I came in, and I think under the rules——

The CHAIRMAN. I called on you, Mr. Hanna.

Mr. HANNA. I just want to ask one question, and you may comment on it afterward.

I am interested in not only how to correct the institutions of banking, but how to use them. It occurs to me that one of the great problems this country has in in capital collection for the many jobs that need to be done. We do not have effective saving impetus any more in the land. Has anybody covered the possibility of what would happen if we made deposits in savings, for, say, a 5-year period, tax free until the savings were drawn out, and if kept in a 5-year account, they would then be taxable on a capital gains basis rather than on a straight income basis?

It seems to me that what we need to have is some innovative thinking about how to get the problem of America straightened out. The Japanese are saving at an overall rate of about 40 percent, and the Swedes at about 28. When you consider all the forms of savings in

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the United States, it comes up to about 17 percent. It would seem to me that if we could in any way, in talking about bank reform, suggest some ways in which we can create and better utilize savings, it would be desirable. I am not against correcting things that are wrong, but I think we need to think affirmatively, and if you have any suggestions as to what we ought to be thinking about in this line, I would certainly be pleased to hear from you.

Mr. SWIFT. Mr. Hanna, that is a very broad question. We have been before the Congress before with proposals that we felt would assist in accomplishing this purpose. We were here a number of yours ago urging Federal chartering of savings banks, because independent studies show that the more institutions that are in a market competing with each other for savings, the higher is the rate of savings.

Now, this is one approach that we felt would be of assistance in this regard.

On your specific suggestion of a tax incentive, I suppose a tax incentive would always be of some assistance and help.

Mr. HANNA. I just think that the old-fashioned approaches for thrift have run out of gas, and that you have got to have some new incentives for thrift. I think any thoughtful person looking at our situation would have to agree that if we are going to get dynamics back into our society we have to have a greater degree of accumulation of capital in order to apply it to the jobs that we want to get done. I just feel that this is rather a central problem. I would hope that if any of you have any ideas you will put them in the record following this question.

Mr. RIORDAN. My name is James Riordan. I am counsel for the savings bank industry.

The savings bank industry sought to offer income tax deferred savings accounts, but the IRS under recently proposed regulations has made that impossible.

Mr. HANNA. That is why I think the Congress should act, because I think they are being myopic. I think that you are not going to generate tax income unless you generate economic activity. You cannot have economic activity without capital application. I am not very smart, but that seems fairly elementary to me.

Thank you very much.

The CHAIRMAN. You could add to your laundry list, no debt, no money.

Mrs. Heckler.

Mrs. HECKLER. Thank you, Mr. Chairman.

I would like to address my questions to Mr. Clark, a distinguished savings bank manager from Massachusetts, whom I welcome, as well as the other members of the panel.

In Mr. Swifts' statement he states on page 2:

"The organizers of mutual savings banks regarded their position"—and the law so treated them—"as analogous to trustees of a public trust."

So obviously they are bound by the doctrine of the prudent investor. And I wondered from your experience, Mr. Clark, the experience you have had in recent years, particularly with the stock market plunge, with your bank stock investments, how has your stock account compared to your bond account in terms of market volatility?

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Mr. CLARK. In dealing with the bank stock as compared to some other stocks that are owned—last summer, for example, the bank stocks showed much less volatility on the down side than the other stocks. And the bond market at that time was so horrible it hardly deserved comment. Certainly bank stocks were less volatile than bonds. Historically savings banks have found that bank stocks are valuable media for investing depositors' money in limited amounts, because they appear to have characteristics of reduced volatility, greater price stability, accompanied by, over time growth in earnings and growth in value, which make them particularly adaptable to investing savings depositors' funds.

Most investors in the stock market, I think, consider bank stocks as rather pedestrian vehicles. But we have found them to be quite otherwise.

Mrs. HECKLER. Why is it, in view of the fact that savings banks can invest in all types of common stock, that you are atracted to an investment in commercial banks?

Mr. CLARK. Partly, I suppose, because a savings banker feels more comfortable in his ability to appraise the present situation and future situation of a bank than perhaps some industrial concern.

It also arises because historically, until 1950, approximately, we were never allowed to buy any stocks except Massachusetts bank stocks.

At that time the savings banks felt the need of greater authority, and were able to persuade the legislature that it would indeed be prudent to invest in the stocks of banks all over the country, with certain historical income and dividends patterns, and indeed with limitations on the size of the bank, leaning toward the investment only in the larger banks of the country.

Mrs. HECKLER. Could you tell me, Mr. Clark, what your experience has been, in terms of the effect on competition due to the fact that savings banks do invest in commercial banks and insurance stock, what has been the competitive effect?

Mr. CLARK. It has had no negative competitive effect. I have observed absolutely none. The competition between commercial banks and savings banks in Massachusetts with which I am most familiar, but also New Hampshire, Connecticut and the other New England States, and New York, has been in recent years intense, and it has been getting fiercer.

I might cite three things directly of my own knowledge. Mr. Swift referred to our effort this year to increase competition by obtaining the power to operate personal checking accounts for individuals. Over the years we have successively, in Massachusetts, obtained the power to make personal loans, unsecured, for consumer purchases in relatively small amounts.

In the recent controversy in Massachusetts about the control of interest rates we pay our depositors, again we had an actue controversy. On the other side of each one of those controversies, as powerfully as they could summon the strength, were the commercial banks of the State. And with the factual information in my experience about economic competition, and the ability of the commercial banks to oppose savings banks in all areas that they considered might increase the com-

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petitive climate, we have been deeply opposed. So that I cannot see any evidence at all of any reduction in competition from what it might have been without any ownership of commercial bank stocks.

Mrs. HECKLER. Could you for this committee tell us what supervisory agency would oversee the requirement of 15-percent limitation of ownership of commercial banks by savings banks?

Mr. CLARK. The State banking department in connection with their annual examinations.

Mrs. HECKLER. So therefore the question that Mrs. Sullivan asked earlier related to the holdings of 51 percent by a Worcester bank would have been studied and evaluated on the basis of the usual State audit, and therefore must have come under a grandfather clause. Is that your conclusion?

Mr. CLARK. I would conclude that whatever ownership they had was entirely proper, the banking department, which I must say in Massachusetts I consider one of the better banking departments of the country, would have moved on it quite appropriately had there been some irregularity.

Mrs. HECKLER. My time has expired, but I just wanted to fit in one quickie. Is this 15 percent strictly observed?

Mrs. CLARK. Yes, indeed.

Mrs. HECKLER. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Gettys.

Mr. GETTYS. Mr. Swift, Mr. Clark and Mr. Riordan, this is a well prepared statement. I have not studied it very closely, but the impression I get is that these proposed reforms are wonderful, and should become law, if it includes all the financial institutions except mutual savings banks, is that correct? It is a good bill if it includes everybody except mutual savings banks, but it is a poor bill if it is going to include your industry? Is my impression right?

Mr. SWIFT. I was not attempting to say it was a poor bill, no. This is what I guess made my answers a little longer than perhaps they needed to be, but I do not think we feel it is a poor bill. We do feel ——

Mr. GETTYS. But I notice all the amendments that you suggest—maybe if the bill is going to be passed it is a good bill, but all these amendments that you suggest would eliminate the application of the reforms to the mutual savings bank.

Mr. SWIFT (continuing). I do not think we feel that that is so.

Mr. GETTYS. Then you would be willing to pass the bill without the exemptions?

Mr. SWIFT. Oh, no; the general concept, for example, relating to interlocking directorates, and relating to stock ownership and giveaways——

Mr. GETTYS. Do you think it is a good thing that mutual savings banks are not included?

Mr. RIORDAN. If I may, we framed our amendments in our testimony on the basis of changes that we thought were appropriate for mutual savings banks. We did not attempt to include commercial banks or savings and loan associations or other financial institutions in our amendments, thinking that they probably should bear their own burdens, and know more about their own problems than we do. So we

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sought to address ourselves only to the bill as it affected mutual savings banks, and as such perhaps our amendments are too narrowly circumscribed.

Mr. GETTYS. But I do get my point across, don't I?

Mr. RIORDAN. Yes, I would say you did.

Mr. GETTYS. Dr. Hinrichs, in brief, you say that the premiums are all right, and it is really a good social issue as well as a financial issue provided that they are reasonably restricted?

Mr. HINRICHS. Tht is quite true.

Mr. GETTYS. Mr. Bryan, no one has questioned you. Your statement intrigues me. But I know time does not permit a discussion of it. But as I understand your statement, you would do away with the whole thing, wouldn't you, and start over fresh?

Mr. BRYAN. Not quite.

Mr. GETTYS. And what other time left I have, Mr. Chairman, I would turn over to Mr. Bryan to discuss his proposal.

The CHAIRMAN. He filed his statement and made a statement.

Mr. GETTYS. I saw it, and if I have 30 seconds or 25, with that great timekeeper we have got—he is a short counter—then I would——

The CHAIRMAN. You have 2 minutes.

Mr. GETTYS. Mr. Bryan, would you discuss your proposal. It intrigues me.

Mr. BRYAN. In what way, Congressman?

Mr. GETTYS. You would do away with the whole Federal Reserve System?

Mr. BRYAN. No; I think it would have to be rechartered. You have to have some kind of a system.

Mr. GETTYS. You would have a central bank?

Mr. BRYAN. I believe the central bank with a director from Congress should create all the money instead of the bank creating the money.

Mr. GETTYS. I believe you have a sympathetic person in our Chairman. Mr. Chairman, aren't you and Mr. Bryan in some ways——

The CHAIRMAN. I have known Mr. Bryan for a long time. He is a very sound businessman and banker.

Mr. GETTYS. I am sure of that.

But I just wish that we had time to go deeply into your suggestions. They really are intriguing.

The CHAIRMAN. I do not know of any person who has studied the Banking Act more than Mr. Bryan. I think he has come nearer answering the question than any man I know.

Mr. GETTYS. That is why I would like at some time to have a great opportunity to question him.

Thank you, sir.

The CHAIRMAN. Mr. Rousselot.

Mr. ROUSSELOT. Thank you, Mr. Chairman.

Gentlemen, we appreciate your being here and discussing in some detail this bill. It certainly has created a lot of discussion, and we appreciate your adding your comments about it.

Dr. Oberg, I noticed in your statement that you refer to equity holdings. And you seem to be quite interested in the disclosure requirement. I can understand, being in the business that you are in, why you would

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like lots of disclosure, maybe even at Government expense. But section 12 applies to— and let me quote—"all securities other than Government securities." Because Government securities are capitalized, that means it would be only applicable, as I understand the laws as we write them here, to U.S. securities. So this perhaps, as it is now written, and if it would remain this way, would include individual home mortgage notes and debt obligations as well as many, many other types and forms of securities. Don't you think that such broad coverage would be—and I know you have already partially commented on this—unneded and really undesirable even from your standpoint? You are familiar with section 12, I assume you have read it?

Dr. OBERG. Yes, as you have described it, indicating that it goes beyond the equity field. The equity investment is our basic interest, it is the area in which there appears to be more excitment, more change. The limitation of the collection, I think, has to have practical limits. I do not think myself qualified—

Mr. ROUSSELOT. Would you submit for the record what you think those practical limitations would be? Because this is very all-inclusive as it is presently written, and we are still trying to find out who wrote it.

Dr. OBERG. I say I do not feel qualified to evaluate in specifics other type securities in the application of analysis, in that particular area. My specialty happens to be in the equity area.

Mr. ROUSSELOT. You were testifying on that section, I thought maybe you would have some suggestions.

(The following letter was received from Arthur Lipper, III, president, Arthur Lipper Corp., in response to the question above of Mr. Rousselot:)

ARTHUR LIPPER CORP.,
May 17, 1971.

Reference: H.R. 5700.

Hon. JOHN H. ROUSSELOT,
U.S. House of Representatives,
Washington, D.C.

DEAR MR. ROUSSELOT: During the testimony of Dr. Harold S. Oberg of our firm before your committee on April 30, 1971, you asked several questions to which an additional comment by me, as Chief Executive Officer of Arthur Lipper Corporation, may be helpful.

With regard to your question concerning practical limitations which should be imposed if Congress requires disclosure of Bank Trust Department assets, I agree with you that no purpose is served by including debt and home mortgage obligation investments in a study of relative investment performance. I do believe, however, that there should be some mechanism established for monitoring Trust Department debt portfolios as to net yields, loss ratios, and maturity schedules.

Any data disclosed could be used either by a firm usch as our own or, for that matter, by the banks themselves to demonstrate the relative investment performance of one Trust Department versus another. It is my view, therefore, that disclosure should be required in those cases where holdings are freely marketable at the bank's sole discretion.

From the standpoint of measuring investment performance, it would not be equitable to include in such a study portfolios which contain holdings of nonpublic companies or mandated positions.

Our firm appreciates the opportunity to present our views on this matter of public interest.

Sincerely,

ARTHUR LIPPER, III, *President.*

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Mr. ROUSSELOT. Mr. Swift, as I am sure you are aware, the provisions in this bill regarding the prohibition of certain type of people belonging to boards is rather broad. Would you be willing to submit for the record what the effect would be on your mutual associations if these provisions were passed and became law? In other words, how many people would you have to terminate, and so fast? Could you do that?

Mr. SWIFT. Specific information with regard to our industry—we can certainly provide the kind of information that would approximate, I think, the answer to that.

Mr. ROUSSELOT. And on the basis of that survey, some brief comment as to what the effect might be on the general management of the associations as a result of having to terminate that kind of talent. I think it might be helpful to us.

Mr. SWIFT. Clearly, in many instances, I think it could have an extremely disruptive effect.

Mr. ROUSSELOT. Disruptive effect?

Mr. SWIFT. In terms of the requirement of probably substantial numbers of resignations from our boards, and then of course the throes of replacement, and so on.

Mr. ROUSSELOT. Because we are so concerned about unemployment here these days, we do not want too many people unemployed.

If you could do that I think it would be helpful. Some of the other groups that have appeared have said that it would have some kind of a disruptive effect in some instances on the kind of management personnel they are trying to attract to their boards of directors. I think that it would be helpful if you would describe specifically what might cause substantial numbers of resignations.

Mr. SWIFT. I might just add that in our particular case, in the largest number of instances it was savings bank trustees also serving as commercial bank directors. And these men, given the decision to choose between the two banks I am sure we would find in most instances that they would find a closer personal interest in the commercial bank directorship than they would in the savings bank, either because of a business association or a connection with a corporation doing business with the commercial bank. So we do feel that perhaps we might suffer in this regard more than others would.

Mr. ROUSSELOT. I thank the gentleman.

(In response to the request of Mr. Rousselot, the following information was submitted by Mr. Swift:)

NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS

OBSERVATIONS ON INTERLOCKING DIRECTORATES OF MUTUAL SAVINGS BANKS

Approximately seven-tenths of the savings banks have trustees on their boards who are affiliated, generally as directors, with other types of financial institutions or financial businesses. These institutions and businesses include commercial banks, life insurance companies, other insurance companies, security brokerage and investment banking firms, savings and loan associations and mortgage companies.

Interlocking relationships with commercial banks are more common than those

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involving any other type of financial institution. In this regard, about three-fifths of all savings banks have trustees who are connected with commercial banks.

To measure the extent of interlocking relationships it is necessary to consider not only the number of savings banks having such relationships as above, but also the number of trustees involved. It appears that about one-sixth of the total number of savings bank trustees are connected with other financial institutions. This includes trustees affiliated with commercial banks, who represent approximately one-eighth of all savings bank trustees.

It should be noted that these figures refer to both FDIC-insured and non-FDIC-insured mutual savings banks. Currently, 328 savings banks are FDIC-insured, while the remaining 165 are not members of FDIC. Furthermore, the data on the number of trustees refer to individual members of savings bank boards, rather than to the number of interlocking relationships. Thus, an individual savings bank trustee who is affiliated with other financial institutions has been counted only once, regardless of whether that individual is connected with only one or with a larger number of other institutions. As a result, the figures presented above may differ somewhat from any tabulations based on a segment of the savings bank industry, such as FDIC-insured banks, or on the total number of interlocking relationships with other financial institutions.

The proportion of a savings bank's trustees who are connected with other financial institutions varies widely among individual savings banks. Blanket prohibitions against interlocking relationships, therefore, would have varying effects on different savings banks. Aside from possible "grandfather" provisions permitting present interlocks to continue, such prohibitions would require few changes in some instances, but wholesale changes in the board membership of other individual savings banks. Trustees affected by such a prohibition would, in all probability, choose to terminate their connection with the savings bank.

As noted earlier, interlocking relationships with commercial banks most frequently take the form of directorates. Thus, directors represent approximately four-fifths of the total number of commercial bank interlocks on savings bank boards; the remainder are salaried officers or trustees who are both officers and directors. Commercial bank directors on savings bank boards represent some seven-tenths of the total number of director-interlocks with all types of financial institutions. Legislation prohibiting commercial bank interlocks, but permitting affiliations with other institutions, would, therefore, eliminate the bulk of the interlocking relationships presently existing in the savings bank industry as a whole.

Mr. Chairman, If I have any time left, Mr. Brown had an additional question. So I will yield to him.

The CHAIRMAN. Two minutes.

Mr. BROWN. I thank the gentleman for yielding.

Dr. OBERG. Following up on Mr. Rousselot's questions, the last sentence of section 12, of course, reads:

"The Corporation"—meaning the FDIC—"shall make available for public inspection the contents of all this and all reports filed under this subsection."

I assume that I am correct in assuming that you would not be quite as enamored of this section if that sentence were either eliminated or if a "not" were inserted after "shall," in other words, "The Corporation shall not make available for public inspection?"

I am sorry, it is not clear to me—the FDIC, or a private corporation?

Mr. BROWN. I say, section 12 provides for the disclosure, et cetera, but then the last sentence says the corporation, meaning the FDIC, shall make available for public inspection the contents of all lists, and

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so on. I am saying that I did not think you would be quite as enthusiastic in your support of that section if that sentence were changed so that instead the FDIC would not make available for public inspection?

Dr. OBERG. Yes, sir.

Mr. BROWN. Just one final question, if I may.

Where would you turn, Mr. Swift, to find the competency, experience, expertise, et cetera, for your directors, trustees, officers and employees, if practically everybody within your geographic area would have a conflict insofar as this legislation is concerned?

Mr. SWIFT. Well, this is one of our concerns, that it does cover too many—this is why we would like it limited to at least competing depository type institutions, and not mortgage bankers and real estate men, realtors, securities dealers, and so on. When it does get extended out to that point, I guess we are down to college professors and doctors and dentists. It would be an extremely difficult job to get the kind of competence and the kind of talent that is experienced in money management and investment. This would be hard to find.

Mr. BROWN. One final question——

Mr. ROUSSELOT. I had one additional question. I think it will require a very simple answer. Are the mutual savings banks allowed to act as trustees?

Mr. SWIFT. No—I should modify that. In two States, New Jersey and the State of Washington. But they are modestly sized trusts, I believe, in experience.

The CHAIRMAN. Your time has expired.

Mr. Chappell.

Mr. CHAPPELL. Mr. Swift, I just wanted to ask you a question with reference to your remarks on page 18, where you say that, speaking of participation loans:

"Even though savings banks have little direct stake in participation loans, we urge that they not be prohibited. Such prohibition would be largely self-defeating, resulting in reduced lender willingness to make mortgage loans, including those on rental residential structures now in great demand, with consequent increases in interest rates to borrowers and in rental costs to apartment dwellers."

Are you talking about actual equity participation, the ownership of stock kickers, and so forth?

Mr. SWIFT. To my knowledge, our industry has not been involved to any significant degree in actual equity ownership or partial equity ownership. Such participation loans as have been made have usually involved a participation in income from the property.

Mr. CHAPPELL. I see, then do I take it that you would not object if it was talking about actual stock ownership or this sort of thing as kickers for the making of a loan, that you would have no objection to that?

Mr. SWIFT. In principle I think perhaps I would object, because I do not see any real distinction. As a matter of practice, it would not be material to our industry's operations today.

Mr. CHAPPELL. Don't you think in any of the banking institutions it

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is a dangerous proposition to get into this idea, particularly when a man really needs money pretty badly, to hit him up with a part of the ownership or an equity position in the business just for the purpose of making a loan?

Mr. SWIFT. Well, Mr. Chappell, on the other side of the coin, this has been in many respects the only way a businessman could get the money. In other words, this has provided the protection, if you will, or the hedges to the bank, particularly in recent years, during a period of rapidly increasing interest rates, when lenders were hesitant to make large housing—apartment house loans, and so on, unless they had some sort of protection over a long term, and this certainly goes to the term of the loan. Without that hedge, and without that protection against rising future interest rates, lenders might be reluctant to make the loan at all.

It is not a matter of sharing the profits with any distasteful or greedy attitude at all, it is purely a matter of trying to protect against a possibly poor investment in a very stringent economic climate.

Mr. CHAPPELL. Don't you think, though, that there ought to be some length as it relates specifically, we will say, to deposit institutions?

Mr. SWIFT. No, I really do not, Mr. Chappell.

Mr. CHAPPELL. You would put these institutions in the same category with insurance companies, I assume, and other lenders?

Mr. SWIFT. In this respect, yes.

Mr. CHAPPELL. I am sorry I cannot share your view on that.

Thank you very much.

The CHAIRMAN. It is now time for me to ask some questions and I would like to do it.

Dr. Hinrich, you have a very interesting table right after your page 11, I believe. That is about premiums, net cost and usage among commercial banks. And of course that will be in the record. Will you also place in the record the statistics about the mutual savings banks by States and size and so forth. Would it be proper to ask you that? Are you familiar with it, or do you have the correct information?

Dr. HINRICHS. As far as I know these are not available, but maybe some of the mutual savings bankers might be able to help us.

I should mention as well that the gentlemen with me also have statements which I assume the chairman would like to be placed in the record.

The CHAIRMAN. Identify them individually.

Dr. HINRICHS. Mr. John F. Daly, Mr. Neil Kanney, and Mr. William M. Dalton have statements. I have brought with me the statement of Mr. Larry Edwards of the Lincoln Rochester Trust Co., Rochester, N.Y.

The CHAIRMAN. It will be perfectly all right for them to insert their statements.

(The statements referred to appear on pp. 723–731.)

Dr. HINRICHS. As far as I know these data are not available.

The CHAIRMAN. I will ask Mr. Swift.

Mr. SWIFT. I am not certain it is available. We may be able to obtain such information.

The CHAIRMAN. It is in your publications, isn't it?

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Mr. SWIFT. I think as far as I know we do have available the total market cost, but whether it is broken down or not I do not know.

(The following information was submitted for the record by Mr. Swift:)

SAVINGS BANK ACTIVITY IN PREMIUM CAMPAIGNS IN 1970

	Total	Size of bank by deposits (millions of dollars)						
		Under $10	$10 to 24.9	$25 to 49.9	$50 to 99.9	$100 to 199.9	$200 to 499.9	$500 and over
1. Number of banks	353	27	74	82	77	34	36	23
2. Total deposits (billions of dollars)	48.5	.2	1.5	3.1	5.7	4.9	11.1	22.0
3. Total advertising expenditures allocated for 1970 (thousands of dollars)	32,352	108	756	1,616	3,008	2,402	8,134	16,328
4. Premium advertising expenditures as percent of total advertising expenditures	22	2	1	1	4	5	21	31
5. Cost of premiums (thousands of dollars)	5,295	11	13	33	254	147	1,543	3,294
6. Percentage of banks conducting premium campaigns, 1st 9 months of 1970	30	22	12	17	29	35	64	87

NOTES

1. Sample banks represent 72 percent of the total number of savings banks.
2. Total deposits of sample banks represent 68 percent of total savings bank industry deposits.
3. Refers to total advertising and promotional expenditures allocated for calendar 1970. Excludes salaries and contributions to State savings banks association advertising programs and to any formal group advertising programs.
4. Ratio of premium advertising expenditures to total advertising expenditures.
5. Cost of premiums used during the 1st 9 months of 1970. Excludes advertising expenses, salaries and other expenses associated with the campaign.
6. Based on the banks in the 353 bank sample which reported having conducted premium campaigns during the 1st 9 months of 1970.

Source: National Association of Mutual Savings Banks.

The CHAIRMAN. My impression is that two or three States have most of the mutual savings, don't they? How much does Massachusetts have?

Mr. RIORDAN. Massachusetts, Connecticut and New York.

The CHAIRMAN. Massachusetts, Connecticut and New York. Massachusetts has the most of them, I believe.

Mr. RIORDAN. It has the most banks.

The CHAIRMAN. And then New York and Connecticut.

That would constitute a large percentage of the total number, wouldn't it?

Mr. SWIFT. About 70 percent of assets, I believe.

The CHAIRMAN. Seventy percent of the assets.

Now, then, Mr. Swift, you mentioned about conversion of savings and loan and mutuals into stock companies. We had a bill a few years ago that affected your savings banks, didn't it, and it came within one vote of passing?

Mr. SWIFT. That was our Federal chartering bill, which provided for mutual institutions.

The CHAIRMAN. That is right. That came within one vote of passing here on the committee.

Mr. SWIFT. That is correct.

The CHAIRMAN. I do not think it has been brought up since.

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I think a very distinguished gentleman by the name of Grover Ensley had a lot to do with that. Isn't he your——

Mr. SWIFT. He is the executive vice president of the association.

The CHAIRMAN. He wanted to be here today, but he had to go to Geneva in connection with an important conference that he is chairman of.

Mr. SWIFT. Yes, sir.

The CHAIRMAN. Mr. Ensley is held in very high regard here too, on the Hill. He was director of the staff at the Joint Economic Committee for many years. And I know he was the one, I think, that suggested that particular bill. And I know he had a lot to do with getting consideration of it. And it came within one vote of passing.

You mentioned about the depository type of institutions that you have referred to in your testimony.

Mr. SWIFT. Yes.

The CHAIRMAN. Of course commercial banks would come under that category.

Mr. SWIFT. Correct.

The CHAIRMAN. Would savings and loans?

Mr. SWIFT. Yes, sir, in our view, they should be included.

The CHAIRMAN. They do not have checking accounts?

Mr. SWIFT. No. Nor do we, Mr. Chairman, in most States where we do business.

The CHAIRMAN. Would you be included?

Mr. SWIFT. Oh, yes.

The CHAIRMAN. The savings and loans would be included and the credit unions would not be included?

Mr. SWIFT. I think we should include the credit unions too, although I do not know that we have mentioned them specifically.

The CHAIRMAN. They were mentioned yesterday, and I asked specifically about it. The ones at the table said they did not have in mind credit unions. The one who had it in his statement said he would strike it out, that he would not consider that a credit union was a depository institution. Of course, it is a matter of opinion, I guess. It has not been passed on.

Dr. Hinrichs, I thought only the small banks were engaging in this premium business. But your statement here indicates that the large banks are, also.

Dr. HINRICHS. I say all banks are engaged in this. But as I mentioned, the small banks use a larger share of their advertising budgets in the premium use. Likewise the increase in the use of these premiums is much greater by the small banks than by the large banks, primarily catching up. I think the large banks first started using these extensively and the small banks in order to compete have attempted to catch up, because they do not have the prestige or the buildings or the other advantages that the large banks have. So the small banks have now caught on and found it to be very efficient for their purposes as a means of competition.

The CHAIRMAN. I notice here the billion dollar banks had been engaged in using premiums at one time or another, 71 percent of them.

Dr. HINRICHS. Quite true, yes.

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The CHAIRMAN. The percentage of banks using customer premiums, according to the 1970 ABA survey, was 46 percent of the billion dollar banks, and only say 4 percent of the banks $4 million and under.

Now, of course there is no direct relationship between the premium that is received—say it is a wig or an alarm clock, a blender, something like that—there it is no relationship between that premium and the amount of interest that the person receives, if you were to try to relate it to interest rates?

Dr. HINRICHS. Except for the ceiling in terms of $5.

The CHAIRMAN. The ceiling fixed by the regulatory agency?

Dr. HINRICHS. That is right.

The CHAIRMAN. They did not have any ratio of costs, did they?

Dr. HINRICHS. Up to $5. So that one bank might only give away maybe a one-dollar piggybank and another bank might give away a $5 wig, it is wholesale cost, and therefore the wig might represent maybe $10 or $15 if it were purchased at a retail store.

The CHAIRMAN. Isn't it your understanding that the banks generally objected to that because they were just not in that kind of a business, they just hated to do it, and at the same time they wanted to meet competition if it were required or permitted or tolerated?

Dr. HINRICHS. Actually quite a few banks now, I think, view the banking industry as one in which they are prevented from competing for funds with insurance companies, mutual funds and so forth. And quite a few of the leaders of the bank industry have argued that for the banks to really compete effectively they must engage in twentieth century marketing practices as do other organizations.

The CHAIRMAN. May I ask a question of you gentlemen at the table there. How many of you believe that we should continue allowing these premiums to be paid? Would you indicate by holding up your hands? I am not trying to put you on the spot, I would not even put your names in the record the way you vote, but I just want to get the sentiment. How many would favor continuing the premium giveaways?

Mr. SWIFT. Would you rephrase the question?

The CHAIRMAN. I am not trying to phrase it accurately, and I am not trying to get any persuasive arguments either way from you gentlemen. But how many of you would favor continuing the method of premium giveaways by financial institutions? Any of you?

(No response.)

The CHAIRMAN. All right, we will keep that in mind.

But if you are going to continue it why don't you relate it in value some way? Even green stamps are related to the value of the merchandise you buy. Would you be in favor of relating it the same way? In other words, if you would give a person a value not exceeding a certain percent of interest annually, would you be in favor of that, rather than the premiums if you wanted to dispense with the premiums? That would be more equitable, I would think. I do not feel strongly about this. And really the pressure that I have gotten from different organizations has been from the people who are selling these wigs and different things, they did not want to be stopped.

Mr. BROWN. Will the gentleman yield?

The CHAIRMAN. Let me finish.

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Mr. BROWN. I was just going to comment that I heard over the radio that a filling station here in town is giving out postage stamps instead of trading stamps.

The CHAIRMAN. They could give out pennies or anything else or some of these new Kennedy dollars that just came out a few days ago.

Mr. Clark, may I ask you a question? As for checking account privileges for the mutual savings banks in Massachusetts, what has been the position of the large Boston commercial banks in which mutual savings banks hold substantial stocks?

Mr. CLARK. They have participated in the opposition as members of the Massachusetts Bankers Association.

The CHAIRMAN. They did participate?

Mr. CLARK. In the organized opposition. I think they have taken no public position as individual institutions.

The CHAIRMAN. No public position that they were against it?

Mr. CLARK. That is right.

The CHAIRMAN. I think the bill was put on the back burner or something. It did not come to a test, did it?

Mr. CLARK. It is still, I believe, before the legislature, and before the Committee on Banks and Banking. I have not heard that it has been reported. I must admit, the issue is in very great doubt.

The CHAIRMAN. Yes, sir.

I will get back to these premiums. I noticed an advertisement in the New York Times one time where some bank was offering, I believe, a Cadillac car if a certain amount were deposited in the bank. Didn't that relate to an exact time that it would have to remain on deposit? And wasn't it related to a certain amount of interest on the amount of money that was required to be on deposit?

Dr. HINRICHS. Right. This actually is not the type of premium that I have been referring to. We have tried to distinguish the prepaid interest in terms of merchandise as separate from the promotional premium for the small savings account that you have. And the Federal does require that, under regulation Q if you give away a Cadillac it must, in fact, really represent the legal rate of interest the customer would have received over this period of time. We think this is somewhat misleading advertising, and too confusing since we want to have truth in lending, truth in borrowing, et cetera.

The CHAIRMAN. I am very much in favor of thrift, of course. In fact, I have been trying to get the credit unions to have sort of an economic education in the high schools over the country to set up credit unions so they could handle actual money and draw on it, and also get interest on it. And they have started it down at Fort Knox, Ky., in the high school. It has a good credit union, and encourages thrift. It teaches children how to handle money. Very few school teachers who first start out know anything about handling money. They do not know how to make a deposit, they do not know how to apply for a loan, and just the normal things that a person should know when they become of age, they do not all know them. And if the banks or mutual savings banks, the savings and loans, credit unions, would engage in that activity to encourage thrift I think it would be fine. It teaches the boys and girls something when they should know it. They grow up with it, and they would have knowledge of it, and they would certainly be more sophisticated in many ways.

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Don't you think that would be a good idea, Dr. Hinrichs?

Dr. HINRICHS. Absolutely. And that is why, as I have pointed out, these customer premiums in a sense are designed to encourage thrift in more people, members of the family—two of my children, for example, opened up small savings accounts. And they were induced by the fact that they could get—as an example, a free football, they see the free football, and they say, "Dad, take us down to the bank. We want to open up a savings account and get a football."

In a sense they ask this. When I go to the bank, my tiny daughter 3 years old, goes in with me. She likes the lollipops that the bank gives away; so she comes along.

I think this is fine, bring them into the banks so they learn. I explain then about opening up a savings account and how the system works. I think these devices are designed for human psychological needs and do provide some incentives to encourage more members of the same family, and especially young people to open up their own savings accounts.

The CHAIRMAN. Under these supervisory agency rules, if they allow $5 for a $100 deposit, how long must that deposit remain in the bank?

Dr. HINRICHS. Let me refer to Mr. Edwards here. I would like to have him speak, since he came down from New York, and he knows more about banking than I do.

There is no legal time limit as such, but the actual retention rates have been 90 percent for 3 months, and 75 percent for 1 year, so in fact most of the customers do keep their funds in the bank. The continuity programs have a great advantage, because then it induces the customer to return.

So he comes back maybe once a month to put in a little money and then buy a dish at half the price.

The CHAIRMAN. In other words, when a depositor was given a premium for putting in $5 or $10 he could draw it out the next day if he wanted to, couldn't he?

Dr. HINRICHS. That is true, sir. Although basically the evidence is that people do not act in that fashion.

The CHAIRMAN. But generally 75 percent of them keep it for 90 days and a large percentage up to a year?

Dr. HINRICHS. As a matter of fact, there is a higher retention rate for premium programs than simply walk-in accounts.

The CHAIRMAN. I think it is very persuasive from the thrift side and is encouraging thrift.

Mr. Bryan, you brought out a good point on the Federal Reserve. You said that a mistake was made in 1927 in the McFadden Act when the charter was renewed and made perpetual. If my recollection is correct, and I believe it is, the original charter of the Federal Reserve was 25 years?

Mr. BRYAN. Wasn't it 20, sir?

The CHAIRMAN. It was 20, sir.

Mr. BRYAN. Yes, sir.

The CHAIRMAN. I thought it was right in there. I had not looked at the act for a long time, but I knew it was a shorter period than perpetual, and I was opposed to that too. I was not in Congress then. I was elected to Congress the next year. But I knew all about that

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McFadden Act. I felt that was a terrible mistake, because if they had left the Federal Reserve Act for near the 20 years, they would have had a lot more experience, and probably have made some good additions to the act. I agree with you that a mistake was made at that time. In fact, it is not a bad idea to have these important and very lucrative as well as exclusive franchises to expire now and then anyway, so that people can show that they are rendering public service in order to get them renewed.

Now, the trust accounts, I would like to make one comment on that. Our reports have been revealing on the trust accounts. Now, a bank within 50 miles of Washington, D.C. was about 285th in size as banks are ranked by deposits. It had trust accounts aggregating $2.3 billion, and for decades that bank was never examined. It was not insured. It was never examined by any Federal banking authority. But in the Holding Company Act at the end of last year, the 91st Congress, under that Holding Company Act of course they are now—they must be insured, and of course they are examined.

But there are a lot of things that are sort of laws in the monetary system as well as all other systems involving Federal law that we find out in these different investigations. But I think something should be done about the trust accounts. I do not want to unduly restrict them or unduly harm them, I want to encourage them. But I think that full accounting and auditing should be required at certain times.

That is the reason I have always been in favor of the Federal Reserve being audited. The Federal Reserve has never been audited by the General Accounting Office. It has always gotten an exemption. Of course, they carefully audit the Defense Department and the Atomic Energy Commission and all other departments of the Government. But the Federal Reserve has never been audited by the General Accounting Office. The things that have happened under that of course would require too much detail. But I believe in these audits myself, and I think they should be done at certain intervals and reports made at certain times.

The regulatory agencies have gotten rather careless in their reporting. I know over the years we have had difficulty and problems getting a report from the Federal Reserve. It is due at the end of the year, such as at the end of 1970, we should have had the report in 10 days. We have not gotten it yet. We have got a little bobtailed report that does not mean too much, and the other report will come in later.

But the other agencies are the same way, I mean the Comptroller of the Currency and the FDIC and the Federal Loan Board as well as the Federal Reserve, they are late in getting in their reports.

Now, the importance of that is that if the Congressmen got their reports immediately soon after a session of Congress starts, why if there is anything in there that is shocking or astounding or bad or wrong, something can be done about getting a correction made. But if the report is not filed until the end of that Congress, like near the end of this Congress, the 92d Congress, why it would be next year before consideration could be given to it, and there would not be as much interest in it at that time. And therefore I look with great disfavor on these agencies delaying their reports.

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This morning I received a report from the Credit Union National Board. General Nickerson is in charge of it, a very fine man, and he has gotten the report out. Even though it is not as early as it should be according to my feeling about it, it is at least in. But the others are not in. And I hope that they will be inspired to make those reports more quickly and more carefully, and at certainly the right time.

Does anyone else want to ask any questions?

Mr. WIDNALL. Yes; Mr. Chairman.

The CHAIRMAN. Mr. Widnall.

Thank you, Mr. Chairman.

Mr. Swift, I would just like to ask you this one question. With the changes made in regulations by the regulatory agencies, so that $10 today is the top that can be spent for a premium, as I understand it, don't you admit that this is a reasonable amount, and it is not going to be anything that is going to affect adversely the operation of an institution?

Mr. SWIFT. I think the way the regulation was drawn it did have some serious adverse effects, not necessarily because of the amount set as the limit, but because of the two-tiered effect. In other words, the $5 limit on amounts under $5,000 and the $10 limit on amounts over $5,000. I think these premiums, the $10 premiums for the large amounts over $5,000, is what really created the churning of money from bank to bank. This was not really thrift promotion, because anybody who has got $5,000 or more dollars has already presumably learned thrift. It wound up in a situation where people were taking money out of one bank and putting it in to another for the sake of this premium. And the $10 amount gift was apparently attractive enough to make this all worthwhile, even though it may have caused this person to leave a bank with which he had a long association and had developed a loyalty and satisfaction with. But it was enough to cause him to make that switch. And this, then, forced other banks into running similar campaigns, and before long it was just moving around in circles.

Mr. WIDNALL. Mr. Swift, it is my understanding that this moving around took place when they are offering more than $10 gifts, where there were television sets offered, and toasters, and the Cadillac by the New York bank. All that is out the window now.

Mr. SWIFT. I cannot remember the date that that regulation was effective—but all of the excesses of the last half—I guess it was most of 1970—were all under that regulation with the $10 limit. There were millions of dollars that were moving around from bank to bank.

Mr. WIDNALL. Then what we should do is ban any kind of premium in connection with any kind of business so that you can't go to a gas station and accumulate glasses or dishes or things like that by adding a few pennies, or by direct gifts originally and everything like that? You are against the premium business itself? You would like to see the price of gas reduced and no premiums?

Mr. SWIFT. There are many bankers, of course—you have different views on this. But I think the consensus of our industry—and our statement so States—is that we feel that a moderate priced giveaway for opening new branches or celebrating particular events for the bank does in effect have some beneficial results in terms of starting people

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on the road to thrift and as an initiation to a new office. It does not have an adverse impact on another bank, because the amounts involved are not sufficient to create that problem. So we are not opposing necessarily premiums in all cases, but we do feel that some regulation and restriction is almost essential if we are to avoid the excesses that develop.

Mr. WIDNALL. The banks that I have just named, primarily thrift institutions, have been offering blankets, electrical equipment and everything else at the opening of a new branch or in connection with some special event at the institution. I do not quite see how you distinguish between that and the general offering of premiums.

Mr. SWIFT. It depends really on how it is offered. You see, this regulation permits you to offer a $10 gift if the deposit is more than $5,000. Now, this is going to be the most attractive one. And this is the one that creates the problem. If it was a $10 limit on all deposit amounts, and the bank could set their own amount, this, I think, through competition would bring it down to where it would not have this adverse impact. If you want to spend the money, give a $10 gift for opening a $25 account, fine, if that is what they want to do.

The CHAIRMAN. Would you yield?

The gentleman keeps referring to a $10 limit. Didn't you say that it was wholesale?

Mr. SWIFT. That is right. The $10 limit on the bank is wholesale, that is right.

The CHAIRMAN. Well, there are certain articles in the jewelry line—sometimes a $10 wholesale could be a $20 or $25 item, couldn't it?

Mr. SWIFT. I think so, based on the testimony we have here this morning.

The CHAIRMAN. Mr. Brown.

Mr. BROWN. Just one question.

Your statement, Mr. Swift, is replete with suggestions that interlocks, insofar as they apply to mutual savings banks, are really in the public interest and the bank and customer interest, rather than detrimental. Of course, Dr. Burns has said that he thinks there is nothing inherently wrong.

Mr. SWIFT. That is right.

Mr. BROWN. The specific reference in your statement to which I wish to direct a question involves the interlocks which have the bank participating or someone associated with the bank participating in a title company transaction, real estate closing, and things of this nature. I think in your statement you indicate that you think this kind of relationship is not anticompetitive, but rather is in the public interest, because it benefits the customer and the depositors of the bank, is that not correct?

Mr. SWIFT. This is correct.

Mr. BROWN. Wouldn't the testimony that you have given, although you have related it only to mutual savings banks, wouldn't you say it could be equally applicable to other depository institutions?

Mr. SWIFT. Yes, I believe so.

Mr. BROWN. Thank you very much.

The CHAIRMAN. We appreciate the testimony that you gentlemen have presented. It will be very helpful to us.

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I do not know of any member that feels strongly about this, certainly to the extent that he would be biased or prejudiced on any of these issues. These issues have arisen from time to time. We have been asked to have hearings on them. So we just put as many of them as possible in this whole bill. When the committee meets—we expect to have the first meeting just as an informal session as soon as we complete the hearings. We expect to finish on Tuesday when Mr. McLaren of the Department of Justice will be our witness. Mr. David Rockefeller will be here on Monday, and then we will attempt to find out how the committee feels about these different issues and act accordingly sometime, and get up a bill and present it or not get up a bill. We do not know how it will come out. But anyway we thank each and every one of you for your attendance here, and for the committee I sincerely want to thank you.

So you are dismissed. Thank you very much.

We will continue our hearings on H.R. 5700 on Monday, May 3, 1971, at 10 o'clock a.m.

(The statements referred to by Dr. Harley H. Hinrichs on p. 714 of John F. Daly, International Silver Co.; William M. Dalton, W. M. Dalton & Associates; Larry O. Edwards, Lincoln Rochester Trust Co.; and Neil Kanney, Grace China Co. follow:)

STATEMENT OF JOHN F. DALY, INTERNATIONAL SILVER COMPANY

The International Silver Company has been in the bank premium business for 23 years. The company pioneered in the continuity premium field beginning about 1955. I personally have had the immediate responsibility for the improvement and expansion of the company's business in this area for 14 years and feel I can speak with some expertise. Incidentally, in that period the company has participated in continuity and one-time programs with literally thousands of banks and savings and loan associations.

We are opposed to the anti-premium portion of H.R. 5700. Obviously, it would eliminate a very necessary merchandising tool for small and medium financial institutions. A merchandising tool that already has real and realistic dollar limitations imposed by the various regulatory agencies. (I think we must be careful not to be confused by so-called abuses such as prepaid interest. An example would be an automobile "free" with a large interest-free deposit for a period of several years.) This is not a premium offer, but rather a manipulation of the payment of interest. As such, we feel it must come within the purview of the regulatory agencies.

We at International are concerned seriously with the precedent anti-premium legislation would certainly set. The premium industry is a four to five billion dollar business. Premiums are used by grocery stores, by gasoline stations, by industry broadly * * * to move their products. The abolition of premiums would have an appalling impact on our entire economy.

Low-cost premiums in good taste can be an effective merchandising tool in the financial field. Continuity programs are self-liquidating to the financial institutions. The savings accounts opened during these programs will still be retained a year later by 80–86% of the savers. We can prove that a saver being given the first place setting and purchasing additional place settings with additional deposits, will have his or her money in there a year after signing up as a club member. We have surveyed this time after time and found that the percentage ranges from 80–86% of the savers. Therefore, the allegation that money deposited because of premium offers flows from bank to bank is *simply not supported by fact*. I challenge anyone to prove the allegation that such money does flow from bank to bank.

We can conclude from the above that premium programs by banking institutions are good for the supplier. They are just as obviously good for the bank using the premium. But there is good to the saver or consumer, if you will, that many tend to overlook.

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For example, a savings bank with $100-million in assets will generate literally thousands of *new* accounts in a year-long program. Old savers, also, will have a much larger savings account. In many instances, the *new* savers will have a savings account for the first time. The immediate social implications for good in a bank incentive program are enormous. The community has hundreds, if not thousands, of new savers for the first time. The banking institution has more money for home building, etc. Savings help the overall economy by being an anti-inflationary influence. In summary, the saver, the bank, the community and the nation all benefit from low cost premiums.

This bill, if passed with provisions banning premiums, would do irreparable harm to International Silver Company and to a countless number of other consumer goods manufacturers. It would mean the immediate lay-off of hundreds in the Meriden-Wallingford area * * * already an acutely depressed employment center. It would mean the immediate lay-off of thousands in other consumer goods industries and related industries, such as transportation. It would have a devastating effect on that segment of our economy * * * consumer goods manufacturing * * * which must be emphasized as we de-emphasize defense oriented production.

Statement of William M. Dalton, President, W. M. Dalton & Associates, Inc.; Bank and Saving & Loan Customer Premiums

Introduction

This paper is a recapitulation of the effect and benefit of continuity savings account promotions utilizing such merchandise as place settings of china, stainless steel flatware and leaded crystal in which our Company has specialized for the past 11 plus years.

Continuity Promotions

What are continuity promotions.—Continuity promotions are cost promotions where a place setting of merchandise such as china, stainless steel, leaded crystal, etc. is given away free to a new account opened for twenty-five dollars or more; or with the first twenty-five dollars added to an existing account. Additional units of the same merchandise are sold to the customer at a special low price such as $2.95 with each twenty-five dollars added to the account. This type of promotion makes it easy and inexpensive for the customer to acquire a set of excellent quality merchandise at his own pace, easily, inexpensively and tends to encourage and build a steady savings habit among large numbers of bank and savings and loan customers.

Deposit requirements for the free gift are deliberately kept low ($25) so as to make it possible for almost all income groups to participate. If a customer can only add one dollar to his account, he is allowed to accumulate these deposits and when he reaches a total of twenty-five dollars he can get his free gift.

The major beneficiary.—The major beneficiary is the small passbook saver. The average customer opening a new account opens with an average deposit running between three hundred to four hundred dollars. The average existing account will add two hundred to three hundred dollars to his account to get the free gift. For units sold the average deposit runs between fifty and one hundred dollars.

Benefits of.—These programs offer the benefit of:

A. A free gift to the consumer.

B. Additional units being sold at a very low price while the customer builds a steady savings habit.

C. Lower income families enjoy some of the better things of life easily and inexpensively.

D. Make saving more enjoyable rather than being a task.

Sources of savings gained.—The greatest savings gains traditionally come from existing accounts. These gains over normal deposits represent 2/3 to 70% of total gains during the campaign. The balance of gains largely come from uncommitted customers and the dissatisfied customer who is looking to change.

Marketing benefit.—Continuity promotions give the small banks and savings & loans an effective marketing tool against major competition. Philadelphia is an excellent case in point—we currently have four savings & loans with assets of 18 million, 61 million, 72 million and 115 million all running continuity promotions.

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These four associations have as competition five banks with total assets of 10 billion dollars total—plus four savings banks with assets from 450 million to over 2 billion dollars. Additionally, there are other banks and many savings & loans in the Philadelphia market. All of these four savings & loan associations are using continuity as a marketing tool to off-set huge competitive ad budgets. Since their budgets are of necessity smaller than much of their competition, it is critical for them to receive the maximum amount of new business from each dollar expended. Therefore all of them have turned to continuity.

Our Company sold about 150 new promotions last year and in almost every single instance our new customer was one of the small banks or savings & loans in town.

Retention benefits.—Continuity promotions show a greater customer retention factor than regular walk-in business. Many banks and savings & loans have done studies on retention of continuity premium generated accounts and I know of no instance where retention of these accounts was as low as or lower than regular walk-in business. In every case, retention of continuity premium accounts was higher.

Cost.—Continuity promotions cost the bank $2.00 to $2.50 on each free unit given away. On units sold, the bank makes a small profit usually 30 to 40¢ to help cover the freight and handling cost. Banks and savings & loans do not recover cost of free units—full and unliquidated costs are generally charged to the ad budget. An excellent case in point is a 20 million dollar savings & loan in North Carolina. In a period of 5 months they reported 814 new accounts, savings increases of $702,000 at a net cost to the bank of $1,957.90.

These programs are deliberately tailored to keep prices to the consumer low, to make the program a real inducement and keep bank and saving & loan margins on units sold low so that banks and savings & loans do not enter into the china or stainless business but really look on these items as strictly a marketing tool to induce new business with net costs applied to the ad budget. This concept has been especially appealing and useful to small institutions.

Deposit churning.—A number of banks and savings & loans have made studies of competitors deposits while a continuity promotion is at work. Conclusions reached have been that the competitor not using promotions tends to continue to gain deposits at the same pace as before the promotion started, but the bank and saving & loan running the promotion gains deposits at an accelerated pace. This is a further indicator that the bank or saving & loan running a promotion is getting his major benefit from inducing a better share of his customers' income into savings with new business coming from the uncommitted customer or dissatisfied customer looking to make a change.

Difficult marketing situation applications.—A number of states such as Florida, Texas, Illinois have "unit bank" laws which do not permit bank and savings & loan branches. As communities change and customers move away, it becomes more difficult for many banks and savings & loans to hold old customers. Continuity promotions have been effectively used to retain old accounts and have provided the added incentive to old accounts to add to savings by mail.

An excellent case in point is one of our oldest customers, a commercial bank in Jacksonville, Florida. This bank started a china promotion in June 1961. This bank is out of the downtown district in a residential area, is blocked off from the downtown district by a river and has a high number of military personnel in its marketing area. This bank is faced with a changing neighborhood, constant turnover of military personnel and since Florida does not permit branch banking, this bank has a difficult marketing problem. In 1961 when the deposits of the bank were $28 million, savings account balances were not growing. They were in fact stagnant. The bank turned to fine china for a promotion and in the first 9 months of the promotion, increased savings by almost one million dollars. The campaign is still active today because it has worked effectively in producing repeat savers, has kept customers coming back from all over the area and has even produced deposits from military personnel in different parts of the world. This bank is today about $82 million in assets and is still running a fine china continuity savings account campaign.

Retail sales.—Each customer by acquiring a new set of china or stainless steel or crystal helps to popularize that item in his residential area and among his friends and neighbors. A number of retailers have found that this popularization promotes new sales for retailers since most banks use only one or two patterns and many consumers do not want the same thing as their neighbors. Additionally,

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customers with new sets provide the stimulus for neighbors to add to incomplete sets and unmatched sets. Aggressive retailers have found that a customer getting a new set of china for instance becomes a prospect for other table-top accessories such as center pieces, candlestick holders, linens, crystal, etc. and some retailers have taken this opportunity to promote sales of related items. An acknowledgment of the accuracy of new markets being created by the sale of one item is the simple fact that there is a tendency for America's china manufacturers and sterling manufacturers to acquire manufacturers in a related field so that today manufacturers such as Lenox China and Gorham silver have become complete table-top conglomerates.

Almost all, if not all, suppliers in bank and saving & loan continuity promotions use special trade-marks and patterns which are not sold in retail stores to avoid interference with regular retail distribution and price structures.

We have found that most of this merchandise goes into latent or untapped markets and does not in any way interfere with retail distribution.

SUMMARY

The bank and saving & loan savings account promotion business using continuity merchandise such as fine china, stainless steel flatware and leaded crystal has been a tremendous force for good in this country. The customers like it, and respond to it; banks and savings & loans like and use it and premium suppliers such as ourselves have built highly successful businesses with it. Therefore, the benefits to all concerned far out-weigh any disadvantages and the bank continuity business should be allowed to continue.

STATEMENT OF LARRY O. EDWARDS, VICE PRESIDENT IN CHARGE OF MARKETING LINCOLN ROCHESTER TRUST CO., ROCHESTER, N.Y.

My purpose, hopefully, is to give you a better understanding of the role of premium and giveaway promotions in banking from a banker's point-of-view. So that my remarks may be put in perspective, it is appropriate to give you a frame of reference by describing who I am and something about the bank I represent. I am the vice president in charge of the Marketing Department of Lincoln Rochester Trust Company, Rochester, New York. Lincoln Rochester, as of December 31, 1970, had total assets of $929,332,000 and total deposits of $818,770,000. At year end, we had 39 branch offices located in the six counties of New York's Eighth Banking District. We are the largest bank in our banking district and a part of an almost two-billion dollar multi-bank holding company with principal banks in the cities of White Plains, Syracuse, Jamestown, Binghamton and Rochester, New York.

While our bank's premium promotions have been successful, by the measures we place on them, we also recognize that there have been some difficulties and abuses in the use of premiums and giveaways by banks. As a result, we believe that bank use of premiums and giveaway items needs more definitive regulation—but certainly not prohibition. While I cannot presume to identify for the Committee, all positive and negative aspects of banks' premium involvement, I am hopeful that awareness of our experience with premiums can be helpful to you, the Committee, in determining the legislative issues involved.

In 1966, when our bank first conceived of using a premium as an inducement to opening new savings or checking accounts or adding to existing ones, there was a natural reluctance on the part of our senior management to be the first bank to engage in such activities in our market. Specifically, there was a fear that depositors we would gain through such a promotion, would switch their accounts from another bank, and later, other banks could similarly entice the same customers away from us just as easily as we got them. Attendant to this fear was the disturbing thought that the basis for customer loyalty might shift from that which was related to giving good financial service to a temporary allegiance based only upon a customer's fleeting impression of which bank was offering the best merchandise deal. In the spirit of trying new marketing techniques, and despite our fears, we tried a so-called "self-liquidating premium promotion on a bankwide basis." The essence of our consumer offer was this: If you make a deposit to an existing savings account or open a new deposit account at Lincoln Rochester, you can buy this Kodak Hawkeye Instamatic

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Camera for less than you would expect. We promoted this offer with an amount of advertising and promotion dollars which were the same as we would normally spend for advertising over the period of promotion. Additionally, the purchase arrangement we made on the cameras was in sufficient volume so that we could arrange delivery of a good comparable value to the customer by simply charging him "our cost" for the merchandise including handling and transportation.

The results were not startling by today's premium standards, but we did open almost 5,700 new accounts. The number of new accounts is not what is important here, but rather, how long the savers we got from this promotion have stayed with us since 1966. Normally, without the benefit of special inducements, we find that three out of four, or 75%, of the accounts we open will still be open one year later. Three months after we opened new savings accounts with the camera promotion, we still had 96.1% of those savers with us. Nine months after account opening, 86% were still maintaining the premium opened account. One year after account opening, we had 75.7% retention of those same accounts. These retention rates are very nearly equal to the retention rates of regular walk-in savings accounts opened without the benefit of special premium inducement. And, this retention rate for premium induced accounts occurred despite the fact that a number of other banks ran premium programs after we announced our first one.

Our bank has run a premium program in all one of the succeeding years, with similar analysis of account retention. The figures for each of these successive campaigns do not differ materially from the ones quoted. We continue to run these campaigns because we have proved to ourselves that savings accounts induced by the use of premiums create customers with just as much loyalty to our bank as we experienced without premiums. We also find that such customers are not prone to switch their accounts easily to other banks, just because a better premium offer is being promoted elsewhere.

Throughout our five year experience with bank premium and giveaway promotions, there has been another element of concern—the role of banks as financial institutions in the "merchandise business". In other words, is the proper role of banking served when banks become purveyors of merchandise in addition to the traditional function of supplying financial service? Here again, our own senior management was the first to bring this question up, in our case. They wondered if many of the good commercial customer relationships we had taken years to develop, would be jeopardized by our involvement with premium merchandise. Even if our current customers in the merchandise business didn't leave us, we wondered if they would be inclined to look upon us as new competition rather than as a financial consultant. Because of this concern, our bank has always taken steps to pre-alert our major merchandise customers to our plans to promote a premium as an incentive to gain new deposit accounts. With our very first premium promotion, we elected to work through a local photo finisher and retailer for delivery and sale of the Kodak cameras rather than purchasing and handling the cameras and the distribution of them ourselves. While our motivation was to avoid potential conflict with retailers and wholesalers by implementing such an arrangement, we found, after the fact, that by so doing we did not compromise the promotional value of our premium offer. As a result of our successful experience with our first premium, we have continued to use regular distribution channels established by the manufacturers for handling premium campaigns. Sometimes we use premium distributors and other times we use retail distributors. We have never inventoried and warehoused merchandise ourselves. In some cases, we have even avoided a direct customer-to-bank transaction for the payment of purchase price on premiums, but rather, have encouraged customers to remit directly to the premium supplier and expect delivery direct from the supplier once the customer has qualified with us and is entitled to purchase or receive the premium. Since we have established that we need not handle any merchandise on bank premises, excepting that merchandise needed for display purposes, and we can still conduct successful premium campaigns, we have concluded that there is no need for us to perform all the functions of a retailer and run the risk of being considered direct competition to him. With the above policies during the five year period of our experience with premium campaigns, we have received very few complaints from retail merchants of other businessmen concerning our premium activities. Apparently, the communication before a campaign is run and the merchandise relationship we use, have helped us avoid problems in this area.

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Federal Reserve Bank of St. Louis

A third concern which, I must say, was shared not only by our senior management but by we marketing people, was the very essence of the strategy behind premium incentive deposit campaigns. Unless the public wanted premiums from their bank, no amount of advertising, promotion or selling effort was going to result in a successful new deposit campaign. We have done research to determine what our customers and prospective customers' attitudes are towards our bank's offerings of premiums in deposit campaigns. We interviewed customers both on and off bank premises. The results show a clear majority of our customers express a positive overall reaction to this type of promotional activity. In addition, the customer response to premium campaigns also tends to support the public acceptance of our premium activities.

Last year, we at Lincoln Rochester noted the emergence of a special kind of premium program in the New York City market, wherein banks were offering merchandise, such as appliances and automobiles, in lieu of interest. Typically, a depositor who qualified with a rather substantial deposit, would be delivered the merchandise before the interest was earned, but would also be required to leave his money on deposit for a stated period of time. Frankly, we looked upon this as a unique promotional scheme that clearly had some promise as an incentive, but in our view, this kind of activity violates the spirit of the New York State Banking Department Guidelines published on premium promotions by banks, and, in a sense, also violates the spirit of the Federal Reserve's Regulation Q. Merchandise in lieu of interest, we think, is simply payment of interest in a different form.

In our premium activities, we generally run what is known as self-liquidating premiums, wherein we arrange for a certain volume of merchandise at a lower than suggested retail price to be offered to our customers. The essence of this is that we offer our customers an opportunity to buy an item through established distribution channels at a price which is generally below the price at which most retailers would sell the same or similar items. The price paid by the customer, who qualifies in our deposit campaign, is equal to the cost of the merchandise plus any direct handling or transportation charges associated with getting the merchandise to the customer. We choose not to make a profit on such transactions, but to pass the whole merchandise saving on to the depositor. Our premium advertising states our price and compares it to a comparable retail value, using suggested retail prices established by manufacturers, or it includes a general statement suggesting the customer will save money on the purchase. We do not use artificially inflated or unpublished prices. It is possible, and has happened, that a customer can find one retailer selling the same merchandise at or near the price we are quoting and, infrequently, we have been challenged by customers who interpret our advertisements as deceptive or misleading. Since we have familiarized ourselves with the regulations with respect to deceptive and misleading advertising, we can generally answer directly to the customer to his satisfaction. Section 217.6 of Regulation Q of the Federal Reserve Board states that "no member bank shall make any advertisement, announcement or solicitation relating to the interest paid on deposits which is incorrect or misleading." This has been interpreted by the Federal Reserve Board to apply to premium items. Furthermore, there are already laws at the state and federal level to guard the consumer against fraudulent claims by manufacturers and retailers. We assume these laws also apply to us and we comply with them.

Over the course of running premium campaigns, our bank has received customer questions about whether or not the money spent on such programs is depositors money, and as such, represents an unjustified use of it. First of all, the promotional money we spend on premium campaigns is budgeted for and controlled, as part of our overall advertising and other marketing expenses. With a prudent management, the risk of depositor loss, therefore, is minimal. We've often felt that beneath the surface of this question, however, is the issue as to whether these various expenditures increase the availability of new deposit dollars. Our actual experience is that a premium promotion advertising expenditure of from $50 to $70 thousand dollars, brings in $3 to $8 million dollars in new deposit money. It does not seem logical, therefore, to focus our attention on the expenditure when the real test of appropriateness is the result measured in terms of the amount of new funds generated which can be directed back into our community in the form of mortgages, personal loans and business loans. Premium campaign expenditures are one of our most cost-efficient devices for securing new deposit flows. In the absence of such promotions, banks like ours

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Federal Reserve Bank of St. Louis

would have to spend far more in advertising and other promotion expense to get the same results. Further, at our bank, we indirectly relate the amount of our mortgage portfolio to the total amount of dollars on deposit in regular savings accounts. As we generate new savings deposit dollars, more money becomes available for mortgages. Since our experience with premium promotions has been that they are most effective in the area of regular savings deposit dollars, then it follows that our ability to make more mortgages in our communities is partially a function of our success in attracting new deposit dollars through such premium promotions.

Another of our internal concerns over the period of time we have been involved in premium promotions, has been the question as to whether deposit funds resulting from such programs are not only new to our bank, but are also new to the banking system. In other words, it would be difficult for us to argue that we can create new loans as a result of premium campaigns, if the deposits we gained represented switches from our own savings accounts, switches from other banks' savings accounts, or would have been deposited in another bank anyway if we had not run the premium campaign. Our research evidence in the following table suggests that for premium campaigns, we have less switching from either our own or other banks' savings accounts than we experience for non-premium activated accounts. The table also shows that the source of money for premium accounts is predominately cash—suggesting that there is greater probability that we are creating new deposits with premium offers, than is the case for our normal, non-premium induced account openings.

Source of funds used in opening new savings accounts	Percent of deposit dollars generated from a premium offer	Percent of deposit dollars generated from nonpremium account openings
Cash	72	11
Checking accounts from bank offering premium program	13	13
Savings accounts from bank offering premium program	4	30
Checks drawn on other banks, including commercial mutual savings and savings and loans	7	35
All other sources	4	11

STATEMENT OF NEIL KANNEY, PRESIDENT, GRACE CHINA CO., SOUTH HACKENSACK, N.J.

Gentlemen, my name is Neil Kanney and I'm president of the Grace China Company in South Hackensack, New Jersey.

We are a small company engaged exclusively in the sale of tableware products as premiums to the banking community. My personal credentials have been developed as a result of approximately eight years in the sale of such tableware products on a retail and wholesale basis and an additional seven years experience in the development of savings account building continuity programs for financial institutions.

Some of my testimony will be my own personal opinions formed by my experience in the bank marketing field, in addition to the experiences of customers, properly documented, showing the attitudes of financial institutions and their customers to the offering of a gift, along with some of the benefits derived.

First of all, it might be helpful to understand who is interested in premium offers. Without exception, the small pass book saver, generally the housewife or youngster starting a new savings account, is the ultimate consumer of the premium products we offer. Usually their deposits are not large and they're very rarely intrigued by the various differences in interest rate that are so effectively used to induce deposits from the large private or commercial depositor.

The housewife is often stimulated by a premium to open or add to a savings account primarily because the premium we offer appeals to her, she becomes a "saver", in order to complete her set of fine china or similar product.

Probably one of the greatest advantages of premiums in general, and certainly some in particular, is that premium offers bring in pass book deposits at the lowest possible cost to the financial institution using them.

A small bank in southern New York in January, 1968, wrote me, "Our final costs, not including advertising costs, etc., was just $200.30." This $25,000,000

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Federal Reserve Bank of St. Louis

bank received in deposits during the campaign, over $500,000 from both new and present customers. Another medium size savings & loan association in North Carolina, in 1966, a year in which premiums were desperately needed to help stem the out-flow of savings dollars, wrote to inform me that, "During the year the savings attributable to the china program had exceeded $4,200,000. The total cost of the program to us including freight, use tax, and miscellaneous expense has been about $13,500. Thus the costs of the program is less than ⅓ of 1% of the savings generated" . . .

A most significant contribution to the financial community is the fact that premiums definitely increase traffic and new accounts, stimulate business, and tend to help create a savings habit on the part of people who originally begin an account because of the premium offered.

A commercial bank in Congressman Widnall's district in northern New Jersey, wrote me, in 1964, "Without any extraordinary openings in July, we opened 1609 new accounts, an increase of some 500% which we attribute to the china program. Other benefits which seem to have come from this program were an increase in regular checking accounts of 100% above normal expectancies and an increase of 50% in our convenience checking accounts". It might be pointed out that the other benefits mentioned in this letter came as a by-product of the original campaign offered. No inducement was offered to make deposits in regular or special checking accounts at that time.

A small savings & loan association in Roanoke, Virginia, at the end of a promotional campaign said, "We have had terrific results with the china program. I'm sure it brought us a lot of business when money was scarce, but there is no way to tell for sure just how much. At least we created a lot of traffic which is definitely needed in every business".

And in 1969, a savings bank running it's first account building program wrote, "The results have been most gratifying. We took in over $5,000,000 in deposits that were directly attributed to the promotion. Compared to the same 30 day period last year, our new accounts increased 182%, there was a 9.5% increase in new account deposits and 13.7% increase in total deposits" . . .

An advertising agency in Greensboro, North Carolina, wrote describing a promotional campaign of ours, "When one can start a savings in-flow program 12, December, 1966, and find it still going full steam 31, May, 1967, without any evidence of let up and with average deposits per set of china, averaging almost $300 instead of the advertised $25, you've got something!" . . .

Premiums are a decisive factor in the growth and development of small banks and savings & loan associations.

In southern New Jersey, a small bank writes, "Without a doubt, growth from $32,00,000 in assets, November, 1966, to May, 1969, $87,000,000 is attributed in large part to premiums programs".

Again, in 1966, an experience brought out during a severe "tight money situation" shows a small $10,000,000 savings & loan association commenting on one of our programs: "We have opened a total of 379 new accounts for total deposits of approximately $172,000 with activity on all of our savings accounts pertaining to china, amounting to 2300 accounts being effected for total deposits in excess of $615,000". I might like to point out that at this time there were only 4000 accounts registered with the association. It's significant to note that better than ½ of the people at the association were participating. Continuing on, "Our area of the state is predominately that of farming and thusly provides for income of a seasonal nature. We are at this time entering into the period of the greatest wealth and income of the county and we are looking forward to a real effected as well as deposits placed with us between now and the end of the calendar year".

The most significant internal advantage to the small bank and savings & loan association is that premiums give them an opportunity to compete on an equal level with the larger and more heavily funded institutions.

Competing in an age where advertising costs for production and media are high, is very difficult for the small institution in a large market. A good example was pointed out to me recently by advertising people in Dallas, Texas, in which they state that the increased cost of time and space in advertising media have in some cases risen to the point where thes mall bank is incapable of effectively bringing it's service message to the public. In the past four years, the 60 second radio commercial has increased from a price of $14 to $46. Fourteen lines of newspaper advertising has increased from 63c per line in 1966, to a current rate of 84c per line.

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According to these specialists, "Although bank budgets for advertising have increased 25%, the new budget will pay for 20% less than the prior years' expenditures."

Television 60 second commercials in prime time in the Dallas market, cost $400. This rate all but eliminates prime time television from the grasp of the would-be small bank advertiser.

Since premiums cost exactly the same to the "big" bank as to the "small" bank, gifts become the only method of equal and fair competition left to the small bank or savings & loan association. It's obvious that discriminatory legislation eliminating premiums completely would cause undo hardship and make quite difficult the task of small bank marketing functions.

Gifts or premium items certainly give more meaning to the advertising dollar spent by financial institutions. Although cost of premiums represent only 2% of the bank advertisting budget, it's significant to note that their offer does have an impact on the public.

Since a gift is a direct expenditure from the institution's advertising budget, it comes as a very pleasant surprise to the small saver to be able to receive something immediately tangible when making a deposit in place of more exposure to T.V., radio, and newspaper copy.

I know many of your constituents would tell you that one thing they don't need more of now, "over and above a new wash-day detergent," is another remainder that "they have a friend at so and so bank" * * * "that they'll find a banker at our bank" * * * or "at so and so bank, we do more for your money." A useful gift, many times, indeed is quite a pleasant surprise.

Perhaps it was all said better by a savings & loan customer of ours who wrote in November, 1969, "In planning our Anniversary Promotion, our aim was to find a premium that would reflect a tone or prestige to the institution and, at the same time, attract quality accounts on a continuing savings program. We succeeded in reaching our objective in the selection of the new International goldenware place settings. We are very grateful to you for your excellent cooperation and service in supplying us with this very attractive and appealing premium for our special 80th Anniversary program."

Some of the testimony you hear today will, I'm sure, prove to you that premium generated deposits are retained. Customers who's accounts were originally started as part of a premium campaign have proven to be both valuable and loyal customers.

A New Jersey savings bank kept tabs of new acounts generated for one of our stainless steel flatware campaigns. They determined that 3300 new accounts were brought in to the bank as customers as a direct result of the campaign. These 3300 new accounts generated approximately $3,500,000 in deposits. At the end of a year's time, of the 3300 new acounts originally opened, there remained at the bank 3200 and that the $3,500,000 had grown to $4,500,000. These kind of statistics, along with others I'm sure you will hear, can prove the value of premium generated dollars and customers.

It must be pointed out that in the final analysis, the public is the ultimate beneficiary. The depositor is not penalized with a lower interest rate offer because he or she accepted a premium, but rather is given an additional reward for practicing thrift.

In today's marketing society, banks and savings and loan associations must be conscious of their place in competition for the "consumer dollar." These institutions are no longer characterized by the "marble counter-iron cage," syndrome, and we must all recognize that premiums have their place in this field as a marketing tool (as they have for the past 30 years) along with all the selling techniques being used now and in the future by these institutions.

Bill #H.R. 5700 calls for the abolition of gifts as a means of inducing deposits in financial institutions.

I believe that in the testimony you will hear and read, you will find that this rash "solution to a problem" would eliminate more "good than bad." We would all certainly agree that "curing a toothache by cutting off the patient's head" would surely be an improper use of surgical license.

Mr. James Hanley of New York, has introduced Bill #H.R. 5685 which offers a more moderate approach. His recommendations regarding bank premiums are an effective means of insuring proper use of these marketing tools for financial institutions. May I ask you to support Representative Hanley's bill #H.R. 5685.

Thank you for your consideration.

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(The following material was received by the committee in regard to H.R. 5700 for inclusion in the record:)

SPECIALTY ADVERTISING ASSOCIATION,
Chicago, Ill., April 28, 1971.

Hon. WRIGHT PATMAN,
U.S. House of Representatives,
Washington, D.C.

DEAR CONGRESSMAN PATMAN: This letter sets forth the views of the Specialty Advertising Association International on H.R. 5700 and H.R. 5685, which are currently the subject of hearings before the House Banking and Currency Committee. We respectfully ask that the letter be made part of the record of those hearings.

The Specialty Advertising Association International (SAAI), of which I am President, is a trade association whose 1300 members are engaged in the manufacture or distribution of specialty advertising products. Specialty advertising products are used for advertising purposes. They consist of a large variety of useful articles which have imprinted on them the name and address of the advertiser and usually some advertising message. A few typical examples of such products are matchbooks, ballpoint pens, calendars and ashtrays. Such products are widely used by banks and savings and loan institutions to advertise their services.

SAAI'S VIEWS ON H.R. 5700 AND H.R. 5865

SAAI's sole concern is with Sections 22–24 of H.R. 5700 and H.R. 5685, which seek to prohibit financial institutions from giving merchandise as an inducement to make deposits. We express no opinion on other provisions of these bills.

Sections 22–24 of H.R. 5700 provide that no financial institution subject to federal banking laws may "offer or deliver any merchandise . . . as an inducement to any person to make, open or add to any deposit or account." Sections 22–24 of H.R. 5685 state that no such institution may "give away any merchandise" to induce the making of deposits. H.R. 5685 would permit the distribution of merchandise valued at less than $5.00, if given at the time of opening a new account and not on a recurring basis. The title of the bills provide, among other things, that the measures would "prohibit the use of giveaways in the solicitation of deposits" (H.R. 5700), or "limit" such use of giveaways (H.R. 5685).

We believe that the language in Sections 22–24 and in the titles of both bills is too broad, since such language could be construed to prohibit financial institutions from distributing specialty advertising products.

Strictly speaking, specialty advertising products are not offered to customers of a financial institution on condition that they make deposits in that institution. The purpose of specialty advertising is to advertise and promote the services or products of the advertiser. When distributed by a financial institution, however, the purpose is to create goodwill and in a broad sense to "induce" customers, actual or potential, to patronize the institution and make deposits.

Specialty advertising products are frequently used by banks or savings and loan associations as part of a direct mail advertising program. Items such as ballpoint pens and calendars containing the name and address of the financial institution may be mailed to potential customers in the area served by that institution. It can be fairly said that such products are used to "induce" the recipients to make deposits, and even more clearly are used "in the solicitation" of deposits.

Broadly construed, therefore, both H.R. 5700 and H.R. 5685 would appear to prohibit such activities.

We seriously doubt whether such a result is intended. A prohibition against the use of specialty advertising by financial institutions would be unnecessary and unreasonable, since it would deny such institutions a valuable and legitimate means of advertising their services. Moreover, such a prohibition would unfairly discriminate against the specialty advertising medium, in favor of competing advertising media, such as newspapers, television and radio.

We therefore urge that any final version of the proposed "Banking Reform Act" contain a provision which would expressly permit banks and other financial institutions to distribute specialty advertising products. We suggest that the wording of such a provision be based on Section 274(b)(1)(A) of the Internal Revenue Code, which concerns the deductibility of gifts. Section 274(b) of

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the Code denies a deduction of expenditures for business gifts to one recipient in excess of $25.00 in a taxable year. Section 274(b)(1)(A) provides that the term "gift" does not include:

"(A) any item having a cost to the taxpayer not in excess of $4.00 on which the name of the taxpayer is clearly and permanently imprinted and which is one of a number of identical items distributed generally by the taxpayer."

We ask that H.R. 5700 and H.R. 5685 be amended to provide a similar exclusion for specialty advertising products. We suggest the following wording for such an amendment:

"Provided that the Act shall not prohibit member banks (insured banks, member) from offering or delivering any item having a cost not in excess of $4.00 on which the name of the member bank (insured bank, member) is clearly and permanently imprinted and which is one of a number of identical items distributed generally by the member bank (insured bank, member)."

If you desire any further information concerning our recommendations, we shall be pleased to furnish it.

Sincerely yours,

R. C. ROLLINGS,
President, Specialty Advertising Association International.

PREMIUM ADVERTISING ASSOCIATION OF AMERICA, INC.,
New York, N.Y., April 29, 1971.

Hon. WRIGHT PATMAN,
Chairman, House Committee on Banking and Currency, Rayburn House Office Building, Washington, D.C.

DEAR MR. PATMAN: HR 5700 for a Banking Reform Act is before your distinguished committee for public hearings. Please accept this brief statement in lieu of personal hearing testimony.

Section 22 of the bill amends Sec. 18(g) of the Federal Deposit Insurance Act to introduce a prohibition of all merchandise premium promotions used to attract bank deposits. Section 23 amends Sec. 5B(a) of the Federal Home Loan Bank Act to similar effect, as does Section 24 with respect to mutual savings banks.

Enactment of this drastic rule will completely destroy an important market for our premium suppliers throughout the country. This is a substantial small business community which is already struggling to survive economic difficulties of the present time. Our members are dedicated to high standards of ethical conduct in developing and fulfilling premium promotions which are particularly appropriate for banks and consistent with the dignity of those institutions. In the absence of any deception, lottery or other violations it seems to us that Congress should not enact a premium advertising prohibition law which has such detrimental consequences for this industry.

Appropriate forms of premium promotion have been specially developed for use by banks in attracting depositors. We understand that such promotions have been effective to create savings and have thus operated to lower interest rates generally. We ask your committee to consider that such practice serves public policy and that it should not be outlawed.

The Premium Advertising Association of America has consistently supported the enactment of sound regulation of advertising and promotion, and it endorses vigorous enforcement of law to prevent violations. May we therefore urge that the committee substitute regulation for prohibition; for example, at least to permit a limited number of promotions during the year, subject to a monetary limit upon the premium offer.

Respectfully yours,

WILLIAM C. BATTLE, *President.*

D F S INC.,
CHADDS FORD, PA., *May 6, 1971.*

HON. WRIGHT PATMAN, *United States House of Representatives, Rayburn House Office Building, Washington, D.C.*

DEAR SIR: Last week, we attended the public hearing on the Banking Reform Act of 1971 (H.R. 5700 and H.R. 5685). The testimony we heard regarding premiums did not, in our opinion, point up the most basic reasons for permitting the continued use of this marketing technique. We offer the following comments in

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the hope that they will give you and your committee members a better understanding of how premiums should fit into the marketing activities of financial institutions. If possible, we would like to have our comments made part of the record.

A bank or savings and loan association has a product (or service) to market just like any other business. Available to it are several promotional techniques or strategies. The institution must decide which combination will be most effective in reaching its objectives. A manufacturer of a consumer product faces a similar marketing problem. He must define his sales objectives and then select a combination of marketing tools that will be most efficient in reaching his sales objectives. In making this selection, he must answer many questions, such as do we have adequate product distribution, is the consumer aware of product advantages, what is our share of market, is our pricing right? Under certain conditions, he may need sampling, couponing, discounted pricing, premiums, advertising, or a combination of these. There are at least three marketing situations in which premiums, couponing or discount pricing are efficient merchandising techniques. These are:

1. When marketing a new product;
2. When marketing a basic product improvement; and
3. When the product or service has a very small share of market.

Because of the nature of a bank's service, couponing and discount pricing are not appropriate, but premiums do provide a financial institution the opportunity of offering prospective customers a temporary inducement to try its services without upsetting its price structure (interest rate paid to customers).

The theory behind couponing, discount pricing or premiums is that there are in the market place enough people to whom it is a matter of some indifference as to whether they buy one product or another that a temporary inducement is the slight nudge they need to try the service being promoted. Experience shows that of those who try a bank's service, induced by a premium offer, a very high percentage like the service well enough to continue. We have many studies, many case histories and lots of research to demonstrate that retention of premium motivated accounts is equal to, if not better than, retention of non-premium motivated accounts.

In short, when a financial institution is offering a new service or an improved service by modernizing or relocating an existing office or opening a new office, premiums play an important role in introducing that new or improved service to the public. Such new or improved facilities require substantial investments. Properly promoting these new facilities can make these investments pay off at a much earlier date. We estimate, based on the results of several hundred promotions, that a bank will open four or five times more new accounts with the help of a premium than without this aid. Using premiums is simply one more way of guaranteeing the success of the bank's investment.

Likewise, a bank with a small share of market can use premiums efficiently because the temporary inducement is offered to prospects and customers alike, and a relatively small part of the total cost goes toward buying back old business. On the other hand, a bank with a large share of the market cannot use premiums as efficiently because most of the cost of premiums would go for gifts for present customers, most of whom would be depositing to their accounts anyway.

In conclusion, premiums, in combination with other marketing tools, are a valuable method of promoting new or improved facilities, or for making competitive gains for an institution with a relatively small share of its market. It would not be in the public interest to prohibit financial institutions from using this legitimate marketing technique.

Very truly yours,

MELVILLE H. SMITH, *President.*

LEHIGH VALLEY INDUSTRIES, INC.,
New York, N.Y., May 5, 1971.

Hon. WRIGHT PATMAN,
Chairman, Committee on Banking and Currency, House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This letter has reference to Sections 22, 23 and 24 of H.R. 5700, which Sections relate to so-called "giveaway" programs of banks and other financial institutions. We are grateful for the opportunity to submit our comments.

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It is our fear that the proposed "giveaway" provisions of H.R. 5700 might prohibit promotional programs offered to banks and financial institutions by certain of our subsidiaries and, to that extent, might put those subsidiaries out of business. The subsidiary companies to which we refer are known as the "Weigl Companies" and they operate as a part of the motivational marketing division of Lehigh Valley Industries, Inc.

The Weigl Companies have been engaged in promotional activities servicing financial institutions for many years, going as far back as 1947. Their operations involve the sale of promotion programs and items of merchandise to financial institutions for the purpose of stimulating increased bank deposits and increased visits to financial institutions. All the Weigl programs operate well within the existing rules and regulations of the federal agencies having jurisdiction.

Their programs, known as continuity programs, usually offer a free gift for opening a new account or adding to an existing account, and subsequent opportunities to purchase similar merchandise (for example, tableware or china) at attractive prices upon the making of further deposits during the length of the program. Such programs tend to encourage the small depositor to return to the bank, to increase his savings and to become more familiar with the variety of banking services provided by modern-day financial institutions.

The parent company, Lehigh Valley Industries, Inc., is a diversified firm with operations in two major areas: industrial and consumer. Our industrial operations include the manufacture and sale of metal and electrical products, such as automatic safety devices, electrical wiring systems, zinc and steel castings. The consumer operations include the manufacture and sale of women's shoes and shoe ornaments, textile products, and the creation and sale of motivational marketing programs, including the sale of the products involved.

Lehigh is not now, nor has it been for many years past, in the railroad or coal business, although its corporate beginnings were associated with those industries.

We agree with the views of the federal agencies involved to the general effect that the proposed legislation concerning "giveaways" is neither necessary nor desirable. We join in the view of those agencies that the interests of the financial institutions, and of the communities served by them, are presently fully protected under existing regulations and can be best provided for in the future by the continuation of regulation and control through the federal agencies having jurisdiction.

We urge these views upon the Committee as a basis for deleting Sections 22, 23 and 24 from the proposed legislation. For your ready convenience, there are attached excerpts from statements furnished to the Committee on behalf of the federal agencies involved, which excerpts we believe fully reflect the substantive comments of those agencies as respects the Sections of the Bill with which we are concerned.

Should it be the desire of the Committee to legislate standards for so-called "giveaway" programs rather than to rely upon existing regulations and authority, it is submitted that the exceptions set out in counterpart provisions of H.R. 5685 (i.e., Sections 22, 23 and 24 of H.R. 5685) would meet this requirement by adding to each of the prohibitions set out in Sections 22, 23 and 24 of H.R. 5700 substantially the following language:

"*Provided, however*, That the foregoing limitation shall not apply where said merchandise, certificate, stamp, ticket, obligation or memorandum (a) is given to a depositor only at the time of the opening of a new account or an addition to an existing account; (b) is not given to any depositor on a recurring basis; and (c) has a value of, or in the case of articles of merchandise, wholesale cost (excluding shipping and packaging costs) does not exceed, $5. A member* bank shall be permitted to sell merchandise to a depositor as part of a promotional program."

The provisions of H.R. 5700 as amended by the language from H.R. 5685 would make clear that the Weigl Companies may continue to provide the same service to financial institutions which has thus far proven desirable in the public interest and consistent with the best judgment of the regulatory bodies of the Federal government.

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*(Substitute "insured" for "member" in Section 22 dealing with Section 18(g) of the Federal Deposit Insurance Act (12 U.S.C. 1828(g)).)

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In conclusion, we must repeat that we join in the views of the regulatory agencies as expressed to this Committee. We agree with the comment of the Chairman of the Federal Home Loan Board when he states:

"The Board presently has authority to regulate giveaways and has issued regulations implementing that authority. It is the view of the Board that its present authority is adequate to control any abuses in his area."

And we agree with the comment of the Comptroller of the Currency, as follows:

"It is our view that the existing regulatory approach to the giveaway problem is preferable to a flat prohibition since it provides a measure of flexibility to permit at least minimal competition to the benefit of the small depositor . . ."

It is respectfully requested, therefore, that Sections 22, 23 and 24 be deleted from H.R. 5700 and the supervision of these matters be left in the administrative agencies that admittedly have full control of the situation and are adequately protecting the public interest.

Should the Committee or any of its members desire further information from Lehigh or clarification of its views as expressed herein, we should be pleased to furnish same on request.

Respectfully submitted.

RICHARD H. GRIEBEL, *President.*

EXCERPTS FROM STATEMENT OF PRESTON MARTIN, CHAIRMAN, FEDERAL HOME LOAN BANK BOARD REGARDING H.R. 5700 AND H.R. 3287

"Sections 22, 23 and 24 of H.R. 5700 deal with the practice of giveaways. It is not entirely clear to the Board whether the intention of these sections is to prohibit completely every form of giveaway or to prohibit only certain types of giveaways. The Board presently has authority to regulate giveaways, and has issued regulations implementing that authority. It is the view of the Board that its present authority is adequate to control any abuses in this area. The Board coordinates the issuance and modification of its giveaway regulations with the other financial agencies. It appears to the Board that the present authority and regulations carry out the intent of sections 22–24 of H.R. 5700."

EXCERPTS FROM STATEMENT OF WILLIAM B. CAMP
COMPTROLLER OF THE CURRENCY ON H.R. 5700 AND H.R. 3287
APRIL 21, 1971

"§ 22. *Gifts to Attract Deposits.*

This section would prohibit the practice of offering merchandise or other premiums to depositors as an inducement to make or add to any deposit.

The use of merchandise premiums promoting retail deposits is presently closely limited by rulings of all the federal banking agencies. The banking agencies Coordinating Committee agreed some time ago to restrict the value of such premiums to a wholesale cost of $5 in connection with deposits of under $5,000 and $10 if the deposit is $5,000 or more.

It is our view that the existing regulatory approach to the giveaway problem is preferable to a flat prohibition since it provides a measure of flexibility to permit at least minimal competition to the benefit of the small depositor who at present is restricted to a much smaller percentage of interest than are depositors possessing over $100,000."

EXCERPTS FROM STATEMENT BY FRANK WILLE, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION, BEFORE THE COMMITTEE ON BANKING AND CURRENCY, HOUSE OF REPRESENTATIVES, APRIL 20, 1971

"Tight-money conditions during recent years have increased competition among financial institutions for funds, encouraging, in turn, the greater use of promotional campaigns. Constrained by interest-rate ceilings, banks have been persuaded to compete for funds through premium offers primarily because withdrawals by a large number of depositors could have impaired their liquidity positions and might have necessitated the sale at depreciated values of bank-owned securities or other assets.

Promotional "giveaways" can serve as an effective means for encouraging thrift. They can also be useful in promoting goodwill among customers and in promoting the opening of new institutions or new branches. Bank and savings

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and loan association customers seem to like them, although many managements and retailers oppose the practice. Moreover, while numerous "giveaway" campaigns by different institutions in geographic proximity may result in the "churning" of accounts by smaller depositors, we have reason to believe that the dollar retention rate is high enough, nevertheless, to make such campaigns worthwhile to the institutions that engage in the practice.

According to the Corporation's Regional Directors, the use of promotional campaigns by insured banks varies from FDIC Region to FDIC Region. The extent of the practice is limited in most places, but large banks in major metropolitan areas appear to make fairly widespread use of the practice. The survey showed rather unequivocally that the use of "giveaway" campaigns has not resulted in supervisory problems.

Existing regulations of the Corporation now prohibit the payment of interest on demand deposits by insured nonmember banks and prescribe maximum rates of interest or dividends that may be paid on time and savings deposits by insured nonmember commercial and mutual savings banks. As a supplement to those regulations, the Corporation adopted a statement of policy, most recently reissued in February 1970, announcing that, in applying those regulations, a premium given to a depositor—whether in the form of merchandise, credit, or cash—will be regarded as an advertising or promotional expense rather than as a payment of interest or dividends if the premium is given to a new depositor, is not given on a recurring basis, and the value of the premium (or in the case of articles of merchandise, the wholesale cost excluding shipping and packaging costs) does not exceed $5.00 except that, if the amount of the deposit is $5,000 or more, the wholesale cost of the premium may be not more than $10.00. This policy is enforced by our review of invoices and by our investigation of the complaints of competitors who call abuses to our attention. The Board of Governors of the Federal Reserve System and the Federal Home Loan Bank Board have adopted similar statements of policy, while the Comptroller of the Currency permits national banks to offer such premiums if they are "normal" in value.

For all of these reasons, the Corporation opposes the enactment of legislation that would categorically prohibit the types of giveaways now permitted by agency regulation."

BIG BONUS STAMP CO.,
Houston, Tex., April 21, 1971.

Hon. WRIGHT PATMAN,
Chairman, House Committee on Banking and Currency, Rayburn House Office Building, Washington, D.C.

DEAR CONGRESSMAN PATMAN: We take this means to respectfully urge you to eliminate from H.R. 5700, Section 22 which reads in part: ". . . no insured bank may offer or deliver any merchandise or any certificate, stamp, ticket, or other obligation or memorandum which is or may be redeemable . . . to any person to make or add to any deposit."

Our company has operated in the upper Texas Gulf Coast area and parts of Louisiana since 1960. As all business, we pay our rightful share of all applicable taxes and provide jobs for some 200 people. We handle, at full retail value, $12–$14 million worth of goods annually, and feel we have some economic impact upon our area. In this process, we serve a substantial number of savings and loan institutions and banks; and while most of them are not the largest in the area, they have learned through practice that furnishing incentives of one kind or another helps them grow and promotes thrift.

These small firms have to pay the same for advertising that larger institutions do, and therefore are at a disadvantage in buying recognized media space and time. Premiums are part of their answer to this problem. As these small businesses grow, their economic impact in more jobs, profits and payment of taxes also grows. Thus, to a marked degree, Section 22 if voted into H.R. 5700 would greatly lessen competition.

Why should the Congress of the United States curtail any distribution method which legitimately stimulates the savings habit?

Surveys during the last several years by banks and savings and loan companies, indicate: Customers approve premiums 59%, oppose 28% (American Bankers Association survey) . . . 78% of bank customers found premiums useful, with only 7% negative (*Mid-Continent Banker*) . . . Premium-generated accounts have greater retention value (meaning they stay active after one year) than "walk-in" accounts (Harvard University study).

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Our sale of stamps to these financial institutions is substantial, and any curtailment would measurably affect the size of our employee family and profitability. The premium-trading stamp firms and their suppliers are, collectively, a sizable part of American business. Unless you eliminate Section 22 from H.R. 5700, great harm will be done not only to this industry, but also to the large numbers of consumers who benefit from these programs in the savings and loan institutions and banks, mostly of the small-to-medium variety, using this method of distribution to attain general growth.

Thank you for your consideration.

Very truly yours,

IRVING M. AXELROD.

HENNEPIN FEDERAL SAVINGS AND LOAN ASSOCIATION,
Minneapolis, Minn., April 6, 1971.

Hon. WRIGHT PATMAN,
House of Representatives, Washington, D.C.

DEAR REPRESENTATIVE PATMAN: I understand the House Banking Committee will begin hearings on April 20, 1971 on the Bank Reform Act (H.R. 5700). I understand that among other comprehensive legislation, the act bans give-away premiums.

The Hennepin Federal Savings and Loan Association with its home office based in Minneapolis, is the smallest of five associations that have their home office located in Minneapolis. As of December 31, 1970, the assets of said associations were as follows:

Twin City Federal Savings and Loan Association	$820, 504, 278. 26
Midwest Federal Savings and Loan Association	596, 881, 129. 48
First Federal Savings and Loan Association	223, 941, 988. 04
Home Federal Savings and Loan Association	143, 493, 000. 00
Hennepin Federal Savings and Loan Association	47, 824, 587. 16

Without quoting exact figures, I am sure you can imagine the tremendous advertising budget that these large Savings and Loan Associations have in relation to our advertising budget. In addition, we have many banks as competitors for the savings dollar including the two giant banks, namely the First National Bank and the Northwestern National Bank, whose assets as of December 31, 1970, were respectively $1,171,263,592,00 and $1,112,115,466.00. Let me assure you that it is not by coincidence that the smaller banks and smaller savings and loans located in the Metropolitan areas have more "give-away" programs and stamp programs than the large banks and large savings and loans. and Minneapolis is no exception to this statement. The principle reason for this is that the large financial institutions completely dominate the area with newspaper, radio and T.V. advertising with their respective multi-million dollar budgets. Also, "give-away" programs are one method the small savings and loans have of being somewhat on an "even footing" with the large savings institutions regarding at least one small area of advertising because of the limit that can be paid by savings institutions for any one "give-away" item. In my opinion, if "give-aways" are completely banned, it will force many relatively smaller savings and loans in Metropolitan areas to discontinue staying in business and possibly merge with larger savings institutions.

I respectfully urge you not to take away the right of smaller savings and loans to have "give-away" programs.

Also, we have a very large inventory of "give-away" items. If your committee feels that it must eliminate all "give-away" items, please make the effective date of no "give-aways" far enough in advance in order that we and other smaller financial institutions with large inventories of "give-aways" may have the opportunity to dispose of said inventories. I would like to suggest six to nine months.

Thank you and your committee for giving this matter your consideration.

Very truly yours,

E. W. VENZKE.

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SAVINGS ASSOCIATION LEAGUE,
OF NEW YORK STATE,
Scarsdale, N.Y., April 13, 1971.

Re Sec. 23. Section 5B(a) Federal Home Loan Bank Act—H.R. 5700.

Hon. WRIGHT PATMAN,
Chairman, House Banking and Currency Committee, Rayburn House Office Building, Washington, D.C.

DEAR CHAIRMAN PATMAN: With reference to the subject portion of your Bank Reform Act of 1971, (H.R. 5700) relating to the use of "give-aways" (premiums), we in New York deplore the broad abuse inherent in such promotional programs as exemplified over the past two years by a great many financial institutions operating in major metropolitan areas. As a result of the indignities heaped upon this business arising out of that activity, this League sponsored a resolution before the U.S. League Convention in Chicago in 1969, which was unanimously supported recommending a complete prohibition of the use of premiums in the solicitation of savings.

However, since that time, we have done some rethinking and concluded that within reasonable bounds limited use of premiums could be a valuable means of inculcating thrift habits and still not open the door to the broad abuses which merely shift money from one financial institution to the other.

There is currently a bill before the New York State Legislature which initially called for a complete prohibition but which has been amended to provide such limited use of premiums in connection with branch openings. We understand that the bill will be further amended to cover the use of self-liquidating-continuity programs provided such provisions are incorporated in your bill.

I have reviewed Congressman Hanley's bill which we consider far too liberal and have had the occasion to discuss it with his chief AA. I believe we have a tacit understanding in that quarter that Mr. Hanley might go along with a moderate modification incorporating the use of premiums for branch openings and continuity programs.

What we propose is an amendment to Section 23 of your bill which would permit the use of premiums not in excess of the wholesale cost of $5.00 as a means of developing rapidly a volume of savings in the opening of a new branch, such promotion not to exceed 30 days. We would also support the development of savings habits through continuity programs that are self-liquidating provided they are carried on at no cost to the sponsoring institution or impose on savers the necessity of meeting a minimum savings requirement.

In conclusion, I feel that the modifications we offer would completely satisfy any of the objections raised thus far to a complete prohibition and we sincerely hope your Committee will give them serious consideration.

Sincerely,

WILLIAM H. BODINE, *President.*

(Whereupon, at 12:20 p.m. the committee recessed, to reconvene at 10 a.m., on Monday, May 3, 1971.)

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THE BANKING REFORM ACT OF 1971

MONDAY, MAY 3, 1971

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND CURRENCY,
Washington, D.C.

The committee met, pursuant to recess, at 10 o'clock a.m. in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman, Sullivan, Stephens, Gonzalez, Hanna, Gettys, Rees, Hanley, Chappell, Koch, Widnall, Dwyer, Williams, McKinney, Lent, Archer, and Frenzel.

The CHAIRMAN. The committee will please come to order.

We have a communication here from Mr. Edgar F. Kaiser, chairman of the board, Kaiser Industries Corp., Oakland, Calif., who would like to testify, but is unable to be here today.

Without objection, we will insert his statement in the record.

(The statement of Mr. Kaiser follows.)

STATEMENT ON H.R. 5700 OF EDGAR F. KAISER, CHAIRMAN OF THE BOARD, KAISER INDUSTRIES CORP., OAKLAND, CALIF.

My name is Edgar F. Kaiser. I am Chairman of Kaiser Industries Corporation and its affiliates, Kaiser Aluminum & Chemical Corporation, Kaiser Steel Corporation and Kaiser Cement & Gypsum Corporation. I also serve as a Director of BankAmerica Corporation, the bank holding company which owns all the shares of Bank of America National Trust and Savings Association.

My personal respect and admiration for this Committee's Chairman goes back many years. He is not only a dedicated public servant but also one who holds deep concern for the welfare of his fellowmen. In the early years of World War II, when my father's relatively small construction company was trying to persuade the Government that we had the capabilities to build air bases and ships and to produce steel, the Chairman was ready to listen and to support our position when he was convinced it was in the public interest. More recently, when the President's Committee on Urban Housing, of which I served as Chairman, proposed new measures for involving our nation's leading industrial and financial institutions in the production of housing for low to moderate income families, the Chairman took the lead in Congressional enactment of our proposals as part of the Housing Act of 1968.

In any bill that the Chairman introduces, I firmly believe that he has our nation's best interests in mind.

While H.R. 5700 unquestionably in my mind is intended to accomplish constructive change, I do have serious concerns about the provisions of Sections 7, 8 and 9, and I am grateful for this opportunity to express my viewpoints.

As I understand these provisions, they would in effect prevent any industrial firm from having on its Board of Directors any officer or Director of a bank from which that firm obtains significant banking services, such as commercial loans or management of an employees' benefit plan, or of any bank whose trust department holds for its own customers an aggregate of more than five percent of that firm's marketable securities. Furthermore, whenever one of these relationships exists, the bill also would prohibit the bank from electing one of that industrial firm's officers or Directors to its own Board of Directors.

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There is no question in my mind but that these provisions were intended to be in the public interest. Based on my own experiences and those of our companies, however, I sincerely believe these provisions would seriously impair many business firms and commercial banks in their efforts to obtain the quality of outside judgment and advice we need on our Boards of Directors.

For example, if these provisions became law, Mr. Rudolph A. Peterson, a Director and former President of the Bank of America, would have to resign from the Boards of our companies, and I would be required to resign as a Director of BankAmerica Corp.

Having served on that Board and previously on the Bank's Board for several years as one of a number of outside Directors, I believe that outside Directors bring an added perspective about a bank's business problems. They bring a knowledge and understanding of business conditions and trends which guide the Bank in making its major financial planning decisions. In my opinion, a bank with outside businessmen on its Board is more responsive to the needs of its business customers and better understands the problem of industry. I am concerned that Sections 7, 8 and 9, if adopted, would cause banks to have Boards on which there is no substantial outside business representation. I do not think this development would be beneficial for either the business community or the general public.

For our own Kaiser Companies, and I can speak about this subject with much more familiarity and conviction, it would be a very serious loss if Mr. Peterson had to resign immediately from all of our Boards of Directors.

As the Chairman knows, our companies have established their current position in the nation's highly competitive economy not only because of my father's leadership and the principles he taught to all of us on the management team, but also because of the support and confidence we could depend upon from outside sources at critical times in our growth and development.

Long before any other banks would lend my father large sums of money to enter new businesses, A. P. and Mario Giannini were ready to back us—not so much on our balance sheet as on their personal confidence in Henry J. Kaiser's integrity and ability. Their confidence and their financing provided us with the resources we needed to grow, and enabled us to reach a point where many of the nation's other leading commercial banks and the investing public now participate in providing capital to our companies.

Ever since we grew large enough to benefit from the judgment of outside directors on our Boards, we have sought and retained on our Boards a banker we had come to know at the Bank of America, Mr. Fred Ferroggiaro, after retiring as Chairman of the Bank, served for twelve years on Kaiser Industries' Board while continuing as a Director of the Bank of America. Mr. Lloyd Mazzera, the retired Executive Vice President of Bank America, served for five years on the Board of Kaiser Cement & Gypsum Corporation. Today, Mr. Rudolph Peterson, former President of the Bank and now the Chairman of its Executive Committee, serves on several of our Boards.

Each of these outside Directors has been of great help to us, not only in keeping our companies on a sound financial basis, but also in assuring that our management makes prudent financial decisions.

Always, without exception, our outside Directors associated with the Bank have conducted themselves with the highest integrity and utmost propriety whenever potential conflicts arose. On such occasions, they have voluntarily disqualified themselves from the Board's deliberations and decision making. We, of course, have our own long established policies to require disqualification in such cases, but because outside Directors voluntarily step aside, it is never necessary to invoke them. I, of course, follow the same standards as a Director of BankAmerica Corp.

Among my own outside assignments in recent years, I served as an Incorporator of the Communications Satellite Corporation and as Chairman of the Incorporators of the National Corporation for Housing Partnerships. Both of these congressionally chartered corporations must necessarily do business with some of their shareholders and with other corporations and businesses represented on their own Boards of Directors. Both of these organizations also adopted strict policies of disqualification and rules of conduct for dealing with entities in which their officers or Directors may have an interest. I believe such standards are highly desirable, and that in a well managed company, they work effectively.

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For our own companies, when it comes to inviting outside individuals to serve on our Boards of Directors, I want to know the man well and on a personal basis. There must be a mutual bond of confidence, trust and respect. As my father used to say, I want to "summer and winter" with him first. This kind of personal knowledge develops through years of close business association, such as ours with the Bank of America and its management.

In my opinion, Mr. Chairman, it would be a great loss to the Kaiser Companies, and undoubtedly to other leading industrial firms, if Sections 7, 8 and 9 of your bill were to be enacted in their present form. Not only would we be cut off from choosing Directors from among the bankers we know well who are also on the Board of the Bank of America, we would be barred from replacing them with men we know well who are Directors or officers of many of the other leading banks in the country. As our economy has grown and the financial needs of individual companies have increased, most large business loans today are divided among a substantial number of banks, either under separate loan agreements or, more commonly, under a single agreement.

This practice has two great benefits—it diversifies the risks of any individual bank and it also gives business firms competitive access to a large number of banks instead of having to rely on a single traditional banker. An incidental result, however, is that companies like ours have substantial ongoing borrowing relationships with many of the leading commercial banks in the country, and that no officer or Director of any of these banks could, under the provisions of the bill, be invited to serve on our Boards.

For these reasons, Mr. Chairman, I respectfully urge that the provisions which would flatly prohibit bank Directors and officers from serving on the Boards of companies which are also their banking customers, or vice versa, be eliminated from the bill. It is impossible to legislate integrity, faith and confidence. In our own business experiences over more than fifty years, we are convinced that the great majority of business leaders live according to the highest principles of integrity and respect for the public interest.

Thank you, Mr. Chairman and members of your committee, for the opportunity to express my personal viewpoints on this subject.

The CHAIRMAN. During the past several years this committee has been presented with many examples of conflict of interest or situations which typically lead to conflict of interest between financial institutions.

Bank failures resulting from insider transactions and brokered accounts; the exhaustive study conducted for the Federal Home Loan Bank Board, detailing massive conflict-of-interest situations between savings and loan associations, other financial institutions and affiliated businesses and industries; the committee's own extensive studies on the intrusion of banks into non-banking enterprises and the voluminous interlocking relationships in terms of directorates and trust department holdings existing between the Nation's largest commercial banks and the largest industries and business; as well as information developed by the House Judiciary Committee regarding the instrumental role played by large banks in the conglomerate movement of the last decade, are but a few examples of the problem.

The most far reaching and dramatic example, however, is the collapse of the Penn Central Transportation Co.—the Nation's largest railroad and its seventh largest corporation. Sixteen of the Penn Central's 23 directors were either officers or directors of large commercial banks.

Questions concerning the role played by banks in the events that led to the Penn Central bankruptcy prompted a long range investigation of the company and its nonrailroad subsidiaries by the staff of the Banking and Currency Committee. The staff report and the recommendations which accompany it are the final events which lead to the introduction of H.R. 5700, the Banking Reform Act of 1971.

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Part V of the staff report, "Trading in Penn Central Stock; Financial Institutions and Privileged Information," detailed the massive sale of Penn Central common stock by certain key institutional investors in the weeks preceding the collapse of the railroad. The pattern of their stock sales leads inescapably to one of two conclusions: they were acting either on insider information or on clairvoyance.

As indicated earlier in this statement, Penn Central's 23-member board had 16 individual interlocks in 25 instances with 17 banks. One of these was with Chase in the person of Stuart Saunders, chairman of Penn Central's Board and a director of the Chase Manhattan Bank and its parent holding company, Chase Manhattan Corp. It should also be noted that Mr. Saunders was director of the board of the First Pennsylvania Bank and Trust Company of Philadelphia. The chairman of the board of that bank, William Day, sat on the Penn Central's board.

Chase's heavy interlocks with other financial institutions is indicated by the Banking and Currency Committee 1968 staff report, "Commercial Banks and Their Trust Activities." This study showed that Chase had 28 interlocks with 21 competing financial institutions, including 16 interlocking directorates with 9 major insurance companies, 5 with mutual savings banks and 8 with 7 other commercial banks. This last includes interlocking directorates with the First National Bank of Chicago and, as I said, with First Pennsylvania Bank and Trust, both major competitors of Chase.

The staff investigation of the Penn Central stock sales by institutional investors just prior to the railroad's collapse disclosed that between April 1 and June 19, the last business day before the collapse, Chase sold a total of 436,000 shares of Penn Central common stock out of its trust accounts. Significantly, 66 percent of that total was sold in a single 5-day period beginning May 22 and ending May 28. These sales were in close correlation with a highly important nonpublic event.

The volume of Chase's sale of Penn Central stock during the 5-day period was so large that it constituted 22 percent of the total shares of Penn Central sold on all exchanges during that time. Why did Chase choose to concentrate the bulk of its Penn Central stock sales in these 5 days?

In seeking the answer, the following incident must be recognized. On May 21, 1 day before the selloff began, David Bevan, chief financial officer of the Penn Central, met privately with representatives of the First National City Bank and Chemical Bank New York Trust. First National City and Chemical were lead banks for loans to the Penn Central. Of the $50 million owed Chase by Penn Central, $22 million was part of those lines of credit.

At that meeting Mr. Bevan announced that, because of Penn Central's deteriorating financial condition, it would be forced to withdraw a proposed $100 million debenture offering and, as the sole alternative, seek a $225 million Government loan guarantee. In effect, Mr. Bevan was saying that complete collapse was rapidly approaching and would occur barring a Government loan guarantee of which there was no real assurance at the time.

The following day Chase began its 5-day selloff pattern with the sale of 134,300 shares of Penn Central common, the largest single

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day's sale by Chase at any time. During the remaining 4 days, Chase sales of Penn Central stock ranged between 31,700 and 53,200 shares for a total of 286,000 by May 28, the day Penn Central announced to the public that it was withdrawing the $100 million debenture offering.

The same day the staff report on Penn Central stock trading was issued, March 29, Chase Manhattan, through its Board Chairman David Rockefeller, denied the sales were linked to insider information. The denial included the assertion by Mr. Rockefeller that Chase, in an effort to police itself, had undertaken the examination of its Penn Central stock sales and found nothing to indicate illegal activity.

Mr. Rockefeller said then that the May 21–28 sales were based on a series of public events which occurred from one to more than three weeks before Chase began its heavy 5-day selloff.

Why did Chase wait 24 days from the beginning of these events before it initiated its heavy trading pattern? On the other hand, why did Chase begin its heavy selloff 1 day after the chief financial officer of the Penn Central announced to representatives of banks with which Chase had close ties that the railroad was about to collapse?

These questions, and Chase Manhattan's involvement in the financial affairs of the Penn Central in general and the relationship of these activities to H.R. 5700, were one of the major reasons Mr. Rockefeller was invited to testify to the committee during this hearing.

Mr. Rockefeller, on behalf of the committee, I wish to compliment you for accepting the invitation to testify. Your presence here sets a fine example for the banking industry, one which I hope all of its representatives will closely emulate in the future. Invitations to testify were made to a number of financial leaders. To your everlasting credit, Mr. Rockefeller, you are one of the few to come before the committee during this hearing. I congratulate you, sir.

I must add, however, that I am keenly disappointed to find not even a single reference to Chase's sales of Penn Central stock in your prepared statement. The fact that your statement contains no discussion of Penn Central trading cannot be due to ignorance on your part that at least some members of this committee wished to discuss these transactions with you.

On March 10, I wrote informing you that H.R. 5700 had been introduced. The purpose of the bill was set down in general terms and you were invited to testify at this hearing. On March 31, 2 days after the staff report on Penn Central stock trading was issued, I again wrote to you drawing your attention to that fact. That letter said in part, "* * * It would be helpful to consideration of this legislation for the committee to have the benefit of your bank's testimony, especially since the recent staff report of the House Banking and Currency Committee raised certain questions as to the trading activity in Penn Central stock carried on by the trust department of your bank during the spring of 1970." On April 2, Mr. Rockefeller, you replied to these letters, accepting the invitation to testify on the bill.

Mr. Rockefeller, I would like to know whether you are prepared to discuss in some detail Chase's trading in Penn Central stock. I have many questions—important questions with important answers—which I feel cannot and must not remain unanswered.

We are glad to have you, Mr. Rockefeller, and I believe you have prepared a statement, and you may proceed in your own way, sir.

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STATEMENT OF DAVID ROCKEFELLER, CHAIRMAN OF THE BOARD, CHASE MANHATTAN BANK; ACCOMPANIED BY HERBERT P. PATTERSON, PRESIDENT, CHASE MANHATTAN; AND ROY C. HABERKERN, COUNSEL

Mr. ROCKEFELLER. Mr. Chairman and members of the committee, my name is David Rockefeller and I am chairman of the Chase Manhattan Corporation and its wholly owned subsidiary, the Chase Manhattan Bank, National Association.

I have with me two of my associates—Herbert P. Patterson, president of Chase Manhattan, and our counsel, Roy C. Haberkern.

Since you brought up at some length the question of the Penn Central, Mr. Chairman, I would like to make a few remarks before I start my prepared statement.

The CHAIRMAN. Certainly. You are permitted to do so.

Mr. ROCKEFELLER. I have in fact prepared and will ask to have distributed an appendix to my principal statement on the subject of Penn Central's dealings. I thought that perhaps the subject would come up, although it seems to me not to be specifically related to the bill. So it is prepared as an appendix and this will be distributed immediately.

I believe that those reading the material in the appendix in a fair-minded and objective way will come to the conclusion that neither inside information nor clairvoyance was either necessary or in fact the reason for our sales of the stock. As a matter of fact, we have documented in rather specific detail all of the information that was used by our securities analysts and the dates on which it was made available to us and all the rest.

So I hope this will be helpful to you.

I should point out that so far as the meeting you referred to with Mr. Bevan on May 21 is concerned, that was a meeting to which no one from Chase Manhattan Bank was present. Our trust officers, security analysts and those handling the sale of the stock were not not even aware that the meeting took place until sometime early in January of 1971. So that I think it would be inaccurate and misleading to insist that there was any connection between that particular meeting and our action.

This material is now being distributed, and I will be delighted to discuss it further.

The CHAIRMAN. The only suggestion is, Mr. Rockefeller, that we have a certain time designated in the committee's rules requiring prior submission of the witnesses' testimony so as to give the statements to the members of the committee to permit them to develop questions, so that the members will be in position to interrogate you. Of course, this is the first time we have seen this statement. This is not a criticism, it is a suggestion that it should come at the right time.

Mr. ROCKEFELLER. Thank you. May I proceed with my principal statement?

The CHAIRMAN. Yes, sir, you may insert the appendix to your statement in the record.

Mr. ROCKEFELLER. I appreciate the opportunity to insert it. Thank you. (See p. 752.)

In inviting me to appear today, the chairman referred to my service as a member of the Commission on Money and Credit. In its final

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report a decade ago, that Commission noted that its recommendations attempted to reconcile partially conflicting objectives. On the one hand, there was the desire to preserve and enhance the safety of our financial system; on the other, to provide greater flexibility as a means of stimulating economic growth.

As I have gone over the proposed legislation now before the committee and followed the statements of previous witnesses, I have been struck by the fact that the same conflicting objectives are inherent in this situation as well.

The Commission on Money and Credit came to realize that in dealing with issues of such enormous complexity, there are inevitably trade-offs that must be taken into account. One must consider whether the potential for abuse is sufficiently grave as to outweigh the benefits to the community, and then to come up with the most practical proposals consistent with the public interest. It is my hope that this committee will consider these factors in examining the provisions of H.R. 5700.

Chairman Patman has pointed out that the bill covers five basic areas. On some of these, we at Chase Manhattan are in accord with the objectives, even though we have reservations about the approach adopted, or, in some cases, about whether additional legislation is necessary.

For example, we are unenthusiastic about the widespread practices of offering gifts to attract new depositors. But we believe that any abuses can and should be handled on the State level. We also believe that any regulation of the practice should not deter banks from competing vigorously for new accounts. A clear-cut distinction should be made between free checkbooks or free checking accounts on the one hand on items such as toasters or radios on the other.

We see considerable merit in the proposal that systematic reporting of significant aggregate security holdings by institutions be required. As you know, the Securities and Exchange Commission has recently made recommendations in this respect. We urge that the SEC be given an opportunity to draft appropriate amendments to one of the Securities Acts to carry out this suggestion for disclosure of meaningful information by all institutional investors.

There are other aspects of the legislation now before you which would, in my judgment, do a grave disservice to the public interest. These are covered in detail in a comprehensive memorandum submitted last week by the New York Clearinghouse Association. I should like to associate myself and endorse that memorandum, and would respectively urge that you give it your careful consideration. Rather than repeat the details set out there, I would like to confine my remarks to two key areas: interlocking directorates and stock holdings of bank trust departments.

The proposals to forbid interlocking directorates in varying situations seem to be based on the questionable assumption that interlocks are inherently evil, that they are always and under every circumstance contrary to the best interests of the public.

If the mere fact of interlocking directorates automatically meant the illegal passing of inside information to the detriment of the investing public, or illegal competition or conspiracy in restraint of

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trade, then I, too, would be heartily opposed to all forms of interlocking directorates.

However, I would take strong issue with such assumptions, and I know the record would bear me out. The fact is that there has been no demonstration of evils to be corrected, other than the occasional "bad apple" that no amount of legislation will eliminate. Yet, in the name of reform, the bill would preclude many individuals, whose services have been highly beneficial to the public interest, from serving as directors of either banking or nonbanking institutions.

For instance, one section, dealing with substantial and continuing relationships, would make it virtually impossible for commercial banks to attract outside businessmen with wide-ranging experience to serve on their boards.

It is interesting to note that, in contrast, New York State requires that at least two-thirds of a bank's board be made up of outside directors. At Chase Manhattan, we have 20 outsiders and 4 who are officers of the corporation. We feel that outside directors are vital to commercial banks. They add important dimensions of experience, candor, and objectivity to our deliberations. They keep an inquiring eye on senior management and have the capability of asking the right questions at the right time.

Our outside directors from an examining committee of the board whose function it is to consider the reports on our bank by the regulatory authorities and by our independent certified public accountants. They review all audit and control procedures and banking practices in the light of these reports.

Frankly, it is hard for me to imagine any one of our directors—who also happens to be a director of an outside corporation—controlling or dominating a board of 24 strong-willed and very knowledgeable individuals, all legally liable to act in the best interests of the bank's shareholders.

Under the proposed legislation, we would lose the fertile mind and insights of a man like Ralph Lazarus who probably knows as much about retailing as anyone in the country. We would lose Charles Myers who is one of the Nation's foremost textile manufacturers. We would lose Douglas Dillon and John Connor who, in addition to a thorough familiarity with specific business fields, bring to the board room an impressive background in Government service. And I could make the same point with each of our other outside directors.

What we would have left to choose from would be a board restricted largely to retired individuals and inside directors, Mr. Chairman, which would not be consistent with the public interest. In the organizational structure of Chase Manhattan, these inside directors would be my corporate subordinates. This would be a highly unsatisfactory situation because there would be no real accountability for the chairman.

If there were a pattern of abuses as a result of corporate interlocks, then perhaps there might be reason for additional legislation. But there is no evidence whatever that this is the case. And I am sure it is not the intent of this bill to try to assign guilt by association.

Consider another type of interlock—that between large regional banks and smaller banks situated outside their branching areas.

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The board background of an officer or director of a large metropolitan bank can be of great assistance to the smaller out-of-town bank. Even within metropolitan centers, banks formed by minority groups may well require the guidance and assistance of experienced personnel which they can obtain from the larger banks. Access to such personnel should not be barred as it would be under the proposed legislation.

Chairman Burns, of Federal Reserve, has wisely cautioned against inhibiting corporations—particularly the newer and smaller ones—in their search for directors of highest caliber. It is becoming increasingly difficult for banks and industrial corporations to attract able directors. I'm very much afraid that the proposals contained in this legislation would make it even harder to get the kind of conscientious and resourceful individuals who are so badly needed today.

In the final analysis, major reliance must be placed on the uncompromising integrity and good sense of corporate officers and directors. Rather than taking it for granted that eveybody is dishonest, I believe a more tenable assumption would be that individuals will act with integrity. To the extent that they do not, there are adequate remedies for their removal.

Chairman Burns has said that the Federal Reserve is "not persuaded that a case has been made for further broadening of the restrictions in section 8"—of the Clayton Act—"on interlocks with banks." Clearly, there should be no overlap or conflict between any new legislation and the Clayton Act. If it is shown that section 8 is demonstrably deficient in some respects, it would seem to me more sensible to make whatever adjustments are deemed necessary through amendments to that act.

In the Financial Institutions Supervisory Act of 1966, Congress has already given broad powers to the regulatory authorities to control and bring about the removal of directors who engage in unsound practices or evidence personal dishonesty or unfitness to continue. The stimulus to enact further legislation can only be viewed as a desire to prevent imaginary evils. I would suggest that the risk of occasional abuse is far outweighed by the advantages obtained through competent directors, experienced in financial and monetary affairs and independent of the managements they supervise.

May I turn next to the issue of how much stock a bank's trust department should hold in another corporation.

Because there has been so much confusion about this matter, I should emphasize that the commercial banks themselves do not own this stock. They simply oversee the investments that are held for others in personal pensions trust and investment management accounts.

Where the banks do not have voting responsibility, they send along to their customers all blank proxies and other material relative to the voting of these shares. The customers return the proxies directly to the company without the banks' knowing how they actually voted. This is the practice that Chase Manhattan has followed for many years.

Where the banks do have full discretionary voting responsibility, they vote the proxies in compliance with strict legal requirements and in accordance with their determination of the best interests of the particular acounts involved. In its study of institutional investors, the Securities and Exchange Commission concluded that "the existence of

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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."

Against this background, let's assess the legislation now before the committee. One section would prohibit a bank director, officer, or employee from serving as an officer or director of any other corporation where the bank holds—with power to vote—more than 5 percent of the stock.

This section would prevent bank trust departments from fulfilling their fiduciary role in many close corporation situations represented in estates and trusts under our administration. I would estimate that in perhaps two-thirds of these cases, in our own trust department, we hold over 5 percent of the stock, most of them involving small or family-type enterprises.

There are many situations, particularly in the personal trust area, where a bank may hold a substantial stock position as executor or trustee. The trustee's direct representation on the board is in accordance with the desires of those who want someone with broad experience to protect their interests.

The proposal under consideration would appear to limit a bank's outside directorships to the very largest corporations where it would be improbable that anything approaching 5 percent of the stock would be attained. At times, such a prohibition could be highly prejudicial to the best investment interests of beneficiaries of pension and retirement funds under bank administration. Moreover, other types of institutional managers of such funds would be free from this restriction, thus raising the question of why banks should be singled out for unfair treatment.

Another section of the bill would forbid a bank to retain, in a fiduciary capacity, more than 10 percent of any one publicly held stock. Under this provision, no distinction is made between the case where the bank has discretionary investment authority or no investment authority; whether the bank has the right to vote the stock or no right to vote; whether the stock was purchased by the bank for a customer or came to it in an estate. This provision would be disruptive and unfair, and would put banks at a serious, competive disadvantage in attracting fiduciary accounts.

Such a stipulation would lead to all kinds of complications. Suppose a bank becomes executor of the will of a person whose estate boosts the total fiduciary holdings over the 10-percent limit. Which shares are to be sold to bring the figure below 10 percent? The last shares received? The shares with no tax impact? The shares where no customer or cotrustee or outside investment committee has to be consulted? What is the bank to do in the situation where the trust instrument requires retention of the shares?

Beyond these considerations, can a bank, as fiduciary, make sales if the market in general or the particular stock price appears seriously depressed? If no single holding in any trust account represents as much as 10 percent, can the bank properly sell off the holdings, without risk of surcharge, because the aggregate represents 10 percent or more?

This proposal would artificially restrict investment of funds in securities that the investment manager may believe to be of superior quality. In the case of a smaller company, the 10-percent limit may represent a relatively small aggregate investment. Surely, beneficiaries

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of trusts and pension and retirement funds are entitled to the best possible utilization of the trust assets.

I have already mentioned that section of the bill which would require banks to report on securities held in a fiduciary capacity and the voting activities involved. A disclosure requirement, applicable to all types of institutional investors, should dispel the aura of myth, mystery, and misinterpretation that has pervaded this field. It is also a far preferable remedy to imposing artificial barriers and restrictions applicable only to a limited group of institutional investors and having no reasonable relation to the sound investment of trust assets.

In introducing H.R. 5700, Chairman Patman said that one of the basic goals it seeks to achieve is "the elimination of certain serious conflict-of-interest situations which have been allowed to continue because of existing practices of various financial institutions."

Let me tell you briefly about Chase Manhattan's policy regarding conflicts of interest and so-called inside information.

The trust and fiduciary investment functions of our bank are performed by departments that are wholly separate and distinct from our commercial lending activities. To assure the proper use and control of information received by the bank in its several capacities, there is no flow, or incidental communication of inside information, from the commercial departments or divisions of the bank to the fiduciary investment department or to the pension or personal trust divisions of the trust department.

Similarly, there is no flow, or incidental communication of inside information from the fiduciary investment department or the pension or personal trust divisions of the trust department to other departments and divisions. Our fiduciary investment personnel, when interviewing corporate officers or representatives of brokerage houses, make it abundantly clear that they are not seeking inside information.

Decisions on what securities to buy and sell, and when to do so, are made by our trust investment committees and portfolio managers acting under the committees' instructions. These committees do not consult me as chairman of the board on investment decisions, nor do they consult any other member of the board of directors. They are guided solely by their professional judgment as to what is in the best interests of the accounts they are responsible for managing.

This very strict policy against the use of inside information has been in effect in our bank for years. From time to time as developments warranted, we have reviewed the policy to make sure that it covers every contingency. I am personally not aware of a single instance where it has been violated.

I am fully in sympathy with the objective of eliminating conflicts of interest, but I am not persuaded that this case can be accomplished by reliance on legislation. It is my feeling that many of the alleged abuses which H.R. 5700 seeks to correct by legislation do not exist to the extent that has been claimed. I do not believe, for instance, that all corporate interlocks are inherently wrong. On the contrary, I feel that many interlocks are beneficial to the companies and institutions involved as well as to the public interest.

As for ceilings on trust holidays, I would emphasize that bank trust departments are obligated to manage trust holdings in the best interests of their customers—not to use the stock held in a fiduciary capacity to wrest control of corporations. To mandate overall ceilings

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for securities held in trust would place severe limitations on the exercise of investment judgment. The ones to suffer would be trust beneficiaries—probably the very individuals who depend most heavily on earnings from trust holdings.

The primary need, as I see it, is not so much for more government laws and regulations as for more reliance upon character and integrity in all our dealings, whether in business, finance, or government.

The regulatory authorities have already been given an imposing arsenal of weapons to police banking and financial activities. I think it would be wise to review the controls that already exist and determine whether they need further implementation by amendment, regulation, or supervision. There is a real question in my mind as to the wisdom of imposing stll another layer of sweeping legislation on top of the existing complex of acts, regulations, interpretations, and decisional law at both Federal and State levels.

Such an approach, in my view, would not be consistent with the public interest.

Thank you, sir.

(The appendix to Mr. Rockefeller's statement follows:)

APPENDIX TO STATEMENT OF DAVID ROCKEFELLER, CHAIRMAN OF THE BOARD, CHASE MANHATTAN BANK

INFORMATION CONCERNING SALES OF PENN CENTRAL STOCK BY THE CHASE MANHATTAN BANK DURING MAY AND JUNE OF 1970

Introduction

Numerous questions have arisen relating to the significant increase in sales of shares of stock of the Penn Central Company ("Penn Central") during May and June of 1970. The answers to certain of these questions, e.g., whether any financial institutions made sales of Penn Central stock on the basis of inside information, are extremely important and are likely to affect the confidence of hundreds of thousands of individual investors throughout the country. The gravity of the situation demands careful scrutiny of all the factors which may have influenced the actions of any given institution.

Sales by Chase Manhattan

Analysis of all the pertinent events which resulted in substantial sales of Penn Central from accounts at Chase Manhattan clearly demonstrates that its sales were based solely on an evaluation of Penn Central's financial condition by the Bank's Fiduciary Investment Department.

Management of Fiduciary Accounts by Chase Manhattan

The investment functions of the Bank are performed by the Fiduciary Investment Department ("Investment Department") under the administration of an Executive Officer and separate from all commercial banking activities. The Board of Directors of the Bank has delegated to trust investment committees, composed solely of officers of the Investment Department and of the Trust Department, the authority to manage assets which the Bank holds as trustee or as to which the Bank performs investment management or investment advisory services. These committees have the benefit of investment policies and recommendations and analyses with respect to specific securities provided by the Investment Policy Committee composed solely of officers of the Investment Department.

The research activities in connection with investments are carried on by a research division in the Investment Department. No person from the commercial departments and divisions of the Bank is a member of any of these committees or of the research division of the Investment Department. The files of the Investment Department are completely segregated from the files of the commercial departments and divisions of the Bank and no member of the Investment Department has direct access to any files of the commercial departments and divisions of the Bank.

By Executive Letter, last revised under date of November 4, 1968, which was issued by the Chairman of the Board and the President of the Bank, all personnel were instructed that there is to be no flow or incidental communication of inside information from the commercial departments or divisions of the Bank to the

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Investment Department or to the Pension or Personal Trust Divisions of the Trust Department. This policy has been strictly enforced by the principal executive officers of the Bank and the Heads of Departments.

The following description of the considerations that resulted in Chase Manhattan's negative evaluation of Penn Central's stock indicates that the "striking coincidences" alleged in the Staff Report[1] resulted solely because of the Report's heavy reliance on incorrect and unjustifiable assumptions.

Significant Public Announcements and Chase Manhattan's Response

The Staff Report pointed out that there were many public announcements, press releases and newspaper articles published between April 1, 1970, and June 19, 1970 relating to the deteriorating financial condition of Penn Central which primarily resulted from huge operating losses being incurred by its principal subsidiary the Penn Central Transportation Company ("Railroad"). The public announcements occurring prior to the Government's June 19 withdrawal of its proposed loan guarantee which the Staff Report emphasized are reproduced in Table I below which also contains two additional events—Nos. 3 and 5—which influenced the sale of Penn Central stock by the Investment Department. These additional items are included because they were indications of how other investment analysts reacted to the public announcements contained in Table I which in turn influenced the timing of the Investment Department's decision to make an additional in-depth analysis of Penn Central.

There is one type of very important public announcement which is not contained in Table 1 and which occurred weekly throughout the relevant period. The Association of American Railroads publishes weekly carloading figures for the principal railroads which detail each railroad's volume of various major commodities. Since the transport of some commodities is highly profitable and the transport of others is significantly less profitable, shifts in the composition of carloadings as well as the over-all level of carloadings are very helpful in making current projections concerning a railroad's expected revenues. This information is continually being made available for public review.

TABLE I.—SIGNIFICANT PUBLIC ANNOUNCEMENTS

Number and date:	
1. Apr. 22	Penn Central reports a consolidated loss of over $17,000,000 for 1st quarter of 1970. The reported loss for the railroad for the 1st quarter of 1970 is $62,709,000.
2. Apr. 28	The Pennsylvania Co. (the railroad's wholly-owned subsidiary) announces a proposed offering in mid-May of $100,000,000 of debentures due in 1995. It will use the proceeds from the debentures to purchase certain securities from the railroad.
3. May 13	A leading brokerage firm which 6 months previously had strongly recommended purchase of Penn Central stock stated that it had changed its recommendation on Penn Central stock from a "buy" to a "switch" after analyzing Penn Central's 1st quarter report in light of the general slowing of the economy.
4. May 15	Representatives of the underwriting group state that the Pennsylvania Co.'s $100,000,000 debenture offering, scheduled for June 2, 1970, is expected to have an interest rate of 10½ percent.
5. May 15	Standard & Poor's announces a "BB" rating (speculative) for the Pennsylvania Co.'s proposed $100,000,000 debenture offering.
6. May 28	Penn Central announces inability to make Pennsylvania Co.'s $100,000,000 debenture offering and indicates that alternative methods of financing are being considered. (Announcement came across the Dow-Jones business wire in New York at 1:20 p.m.)

[1] See *The Penn Central Failure and the Role of Financial Institutions, Part V, a Staff Report of the House Committee on Banking and Currency*, 92nd Cong., 1st Sess. (1971) (the "Staff Report").

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7. June 2	Public announcement that First National City Bank of New York heads a group of 73 banks applying for a Government guarantee of a $225,000,000 loan for Penn Central.
8. June 10	Public announcement that Department of Defense will issue guarantee of a $200,000,000 loan for Penn Central.

Response of Chase Manhattan's Investment Department

Since early 1970 the Investment Department had rated Penn Central stock a "D3" which means that it was rated a cyclical stock with no better than average market attractiveness and a permissible "sell." The loss publicly reported in Penn Central's April 22 earnings statement and the general worsening of the economy were of course widely known and various portfolio managers at Chase Manhattan made sales of Penn Central stock during this period pursuant to the permissible "sell" rating.

On May 13, a leading brokerage firm changed its recommendation from a "buy" to a "switch"—the third item listed in Table I above. At that time the transportation analyst had before him the annual report, first quarter interim statements, preliminary prospectus and other information relating to Penn Central. His review of that information indicated that the Penn Central situation required analysis in detail and should be called promptly to the attention of the Investment Department.

He issued a "Flash Report" which (i) briefly reviewed Penn Central's large first quarter loss and stated that a substantial deficit should be anticipated for the year, (ii) noted that a respected brokerage firm which had followed Penn Central's operations closely had changed its recommendation after analyzing the first quarter results, (iii) revised downward the price to which Penn Central shares would have to fall before they might be considered for purchase and (iv) stated that a review of Penn Central's condition was being undertaken at once.

On Friday, May 15, both the proposed 10½% interest rate and Standard and Poor's BB rating announcement indicated that the debentures were being viewed as a speculative, low quality issue. Thus each announcement constituted an additional independent judgment that Penn Central's financial condition was deteriorating significantly.

By Wednesday, May 20, the following sources of information, all of which are publicly available, had been reviewed by the transportation analyst:

(1) Penn Central's 1969 Annual Report;

(2) The Statistical Supplement to the 1969 Annual Report;

(3) Penn Central's First Quarter Interim Report as generally distributed and all related information filed with the Interstate Commerce Commission;

(4) The Preliminary Prospectus dated April 27, 1970, for the $100 million debenture offering by the Pennsylvania Company;

(5) Moody's Transportation Manual;

(6) Statistics published by the American Association of Railroads, including particularly those relating to carloadings of different profitabilities broken down on a weekly basis;

(7) Projections for the United States economy in general for 1970 made by Chase Manhattan's economic staff; and

(8) News articles and forecasts contained in general sources such as magazines and newspapers.

Throughout the trading week beginning Monday, May 18, and ending Friday, May 22, the analyst made various projections on the basis of the above information and discussed the situation with portfolio managers in the Investment Department.

By Thursday afternoon, May 21, the analyst had completed his study and had detailed projections which indicated that Penn Central's 1970 deficit would greatly exceed $100 million and was likely to be as high as $150 million or $200 million. Thus the dimensions of the "substantial deficit" which had been mentioned as a possibility in the analyst's Flash Report of May 13 had been clarified to mean deficit of well over a hundred million dollars!

On Friday morning, May 22, the analyst's study was reflected in a proposed change of rating memorandum which was submitted to the Investment Department's top policy making committee for review at its next meeting on May 26. This memorandum proposed that the Department's rating of Penn Central stock be changed from a "D3" to a "D4" which would downgrade the stock from a cyclical, permissible sale status to a more definite sale status.

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Sales of Penn Central shares

The analyst's various projections and the unfavorable conclusions to which they pointed were widely discussed among the Investment Department's portfolio managers and by early Friday morning, May 22nd, a number of managers had decided to reduce their Penn Central holdings. One portfolio manager held approximately 300,000 shares of Penn Central in various accounts. Records of the Investment Department indicate that on that Friday morning this manager told the Investment Department's trading desk to begin selling 200,000 shares of Penn Central stock. The trading desk, which has the responsibility of executing transactions in the most advantageous manner, tested the market and discovered that there was a ready market for Penn Central stock. As a result 125,400 shares, which is nearly one-quarter of all the Penn Central shares sold by Chase Manhattan during the months of May and June and which is more than twice the number of shares sold by Chase on any other day, were sold that Friday.

During the next week two more significant events occurred. On Tuesday, May 26, the Investment Department's change of Penn Central's rating was officially adopted. On Thursday, May 28, the Penn Central publicly announced that it had been forced to abandon its $100 million debenture offering. Chase Manhattan sold a total of 231,150 shares of Penn Central during the week consisting of five business days from Monday, May 25, through Friday, May 29. The largest aggregate sales occurred on Friday, May 29, when 63,700 shares were sold.

The substantial sales by Chase Manhattan continued throughout the next four business days from Monday, June 1, through Thursday, June 4, during which an aggregate of 153,300 shares were sold.

The sale of these 509,850 shares of Penn Central during the ten business days from May 22 through June 4 was directly triggered by the conclusions which resulted from the detailed analysis conducted by the Investment Department's railroad analyst on the basis of public information. These 509,850 shares are approximately 94 per cent of the total shares of Penn Central stock sold by Chase Manhattan during the months of May and June.

Table II below lists the dates of all the significant sales of Penn Central stock by Chase Manhattan during May and June. The relationship of these sales to the analyst's study (as confirmed by the public announcement of the abandonment of the $100 million offering) is clear.

TABLE II.—DATES OF SIGNIFICANT CHASE MANHATTAN SALES DURING MAY AND JUNE OF 1970[1]

Date	Number of shares	
May 6	9,900	
May 15	1,000	Analyst discusses with portfolio managers his tentative views as to the unfavorable prospects of Penn Central.
May 19	8,000	
May 20	7,000	
May 22	125,400	Analyst definitely concludes Penn Central will have 1970 loss greatly exceeding $100,000,000 and recommends change in rating.
May 25	57,100	
May 26	31,850	Investment department officially changes Penn Central rating.
May 27	39,700	
May 28	38,800	Public announcement of Pennsylvania Co.'s inability to make expected $100,000,000 offering.
May 29	63,700	
June 1	27,000	
June 2	50,000	
June 3	45,700	
June 4	30,600	
June 10	7,800	

[1] The sales referred to in this memorandum are all the sales from pension trust accounts and do not include personal trust, investment advisory or custody accounts. Chase portfolio managers generally do not have sole authority over the excluded accounts and very few sales were made from these accounts during the subject period. The dates listed above of sales of 1,000 shares or greater are based on the actual sell tickets prepared regularly on a daily basis by portfolio managers for their pension accounts. These figures are believed to be accurate. The Staff Report's figures were based on a sampling of brokerage houses and could have included sales for custody accounts and excluded third-market transactions. Even the Staff Report's figures (pp. 10–11) indicate that the vast bulk of sales occurred during late May and early June during and after the time the analyst was completing his analysis.

Table II clearly indicates that Chase Manhattan's sales of Penn Central stock during the questioned period were based on careful analysis of publicly available information on Penn Central's operating and financial condition.

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Staff report assumptions concerning "significant nonpublic events"

The Staff Report lists six events between April 1 and May 28 which are described as "Significant Nonpublic Events Affecting Trading in Penn Central Common Stock." [2] The Staff Report does not explain how each of these events affected the stock trading, but apparently the fact that the substanial sales of stock by Chase Manhattan during late May and early June occurred after one of these events (a meeting to which Chase Manhattan was not privy) is portrayed as an event that caused sales.

This one event was a confidential meeting which is reported as having occurred on May 22 and which was not known to any officer of Chase Manhattan—whether in the Investment Department, the Trust Department, the commercial banking department or any other department. The first occasion on which it appears that any officer of Chase Manhattan heard of the meeting was on May 28, which was after the great bulk of Chase Manhattan's sales orders had been placed. This officer was a commercial lending officer who was appropriately informed of the meeting in connection with his lending responsibilities. No officer of the Investment Department learned of this meeting until early 1971.

After searching examination, Chase Manhattan is convinced that none of the "nonpublic events" listed in the Staff Report were in any way communicated to its portfolio managers who sold Penn Central shares during the period in question or to the stock analyst who advised them.

In addition to the unjustifiable assumptions relating to the conduct of the representatives of the other banks and the conduct of Chase officers, the Staff Report places heavy reliance on the period of "market reaction" in attempting to show time correlations between its list of nonpublic events and the sales of stock by the largest sellers during the period. The Report claims that the "consensus of the experts is that the market usually reacts immediately to any significant public event." [3] It further states that in the case of complex events which require analysis market reaction would be complete in two or three days.

These assumptions are believed to be inaccurate. The two principal reasons that these assumptions are totally inapplicable to the Penn Central situation are contained in the two major studies of the securities markets recently made by the Securities and Exchange Commission ("SEC").

The first reason is that detailed research takes a substantial amount of time. The SEC concluded that it takes a research analyst two weeks on the average to prepare a sound research study.[4] Thus the seven days used by the bank's analyst is clearly understandable and appropriate.

The second reason is that once the research has been concluded and the decision to sell has been reached it may be impossible to dispose of large blocks of a stock as quickly as may be desired. The SEC study of institutional investors indicated the substantial delays which are encountered in attempting to trade large amounts of a stock. Referring to the large positions of block traders, the study pointed out that ". . . the disposition of these positions can take more than a month." [5] It also stated that the big block trade which initiates the attempt to eliminate a substantial holding averages only one-eighth of the total holding, that less than one-half of the holding is eliminated during the first week and that 7 per cent of the holding remains at the end of a month.

Given the SEC's clear conclusions based on lengthy studies, it is clear that Chase Manhattan proceeded promptly and effectively to respond to the indications in public information of the deterioration of Penn Central's financial condition. The unsupported assumptions and conclusions of the Staff Report should be a matter of concern.

Conclusion

Chase Manhattan Bank has a well established policy and practice against the communication or use of inside information in the purchase or sale of securities under its administration. Every effort to discover if this policy might have been breached in any way in the Penn Central situation indicates that this policy was, in fact, strictly observed. Indeed, prior to the time when the vast bulk of Chase's sales orders had been placed no officer even had an opportunity to obtain any such information which might later be improperly used.

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[2] Staff Report, pp. 5–6.
[3] Staff Report, p. 5.
[4] SEC, *Report of Special Study of Securities Markets, Part I*, 88th Cong. (1963) p. 353.
[5] SEC, *Institutional Investor Study Report, Summary Volume*, p. 89.

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Chase Manhattan's respect for the integrity of its officers in this matter is equalled only by its respect for their analytical abilities and sound judgment during a time of great economic difficulties.

In this light, it can be only concluded that the Staff Report was based on incomplete, incompetent and unfounded analysis.

The CHAIRMAN. Mr. Rockefeller, I was unaware——

Mr. WILLIAMS. Mr. Chairman, may I be recognized?

The CHAIRMAN. I don't want to recognize you.

Mr. WILLIAMS. Mr. Chairman, I believe in your opening statement you made some serious allegations, and I would like to say we have now received a statement from Mr. Rockefeller on Chase Manhattan's sale of Penn Central stock.

The CHAIRMAN. You are not recognized now, Mr. Williams.

Mr. WILLIAMS. I would like to suggest he gave a summary of his statement.

The CHAIRMAN. You will be given time.

But this statement here, the appendix, now we told you in our letter that we would ask you about that and you said nothing about it in your original statement. I thought when you said appendix to your original statement, you were bringing in corroborating information for your original statement. But I find it entirely different. It is all on Penn Central, but you didn't mention that in your original statement. Here is where there is unfairness—not to accuse you of being unfair—but we have rules to cover just such situations. We must give the members of the committee copies of testimony of the witnesses in advance, and you gave us yours within the time, 48 hours. That is wonderful. But you said nothing about any appendix. We only received that at 10:05 this morning. So it is unfair to the members of the committee to only receive this at that time, and be in a position to interrogate you about all of these things when the time comes to interrogate you.

To that extent I don't think that you should have been allowed to file this, because it was not according to the rules. But anyway, it is in the record and we will handle it the best we can.

But I feel like if the rules had been complied with according to what the rules say, it should have been filed 48 hours in advance so we can interrogate you about it.

Mr. ROCKEFELLER. May I say a word about that?

The CHAIRMAN. Yes, sir.

Mr. ROCKEFELLER. I am sorry if I didn't abide by the rules. If I did not, it was because I was not familiar with them.

The reason we didn't submit it was twofold: one, it has taken quite a little time and investigation to go back over the records and dig out all of these detailed statements and therefore, we didn't have the information ready when the report as a whole was prepared.

Also, and in all honesty, it seemed to me that the details were not directly relevant to the general broad subject on which you have asked me to testify. Therefore, it didn't seem to me that it was appropriate that they should be part of the body of the testimony.

The CHAIRMAN. Well, the strongest case we have is Penn Central interlocking directorates and things like that. I don't see any escape at all. We asked you to comment on Penn Central and you did not comment in the original statement but bring in something entirely different, which shows that it was prepared long before 48 hours before your appearance here, since it is a rather comprehensive statement—but let that be as it may.

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We will go ahead and proceed from there.

Now, suppose we were to change the interlocking directorate provision so it would—I am not saying we are going to, it depends upon the full committee—leave out nonfinancial institutions, and just make it apply to strictly competing banks, where they have interlocking directorates. We are trying to outlaw that because it would not be fair competition. Would you be inclined to favor it then? In other words, make it apply only to competing corporations and banks?

Mr. ROCKEFELLER. I felt that Arthur Burns' testimony along these lines was rather sensible that—yes, the geographic area should be taken into account. He did suggest that there should be certain cases of very large banks outside the immediate geographic area which are competing. I am not sure that I would accept the particular size test that he suggested. I think that this is something to be explored.

But in any case, I think there is a good deal of logic to his general argument there and I would be disposed to agree with his general proposal.

The CHAIRMAN. I see.

You indicated in your statement that you deny Chase Manhattan sold Penn Central common stock on the basis of inside information.

Mr. ROCKEFELLER. Yes, sir.

The CHAIRMAN. You say you have recently undertaken a search of our activities in connection with the sale of Penn Central stock and have found absolutely no indication that the status of the bank as stated above has been breached in any respect whatsoever.

In connection with the internal investigation made by your bank, I have been following three areas of questions. Since your denial was issued the same day as the committee's staff report was issued, your internal investigation obviously occurred sometime prior to our report. I would like to know exactly when your internal investigation took place.

Now, if you will answer these questions briefly, Mr. Rockefeller, because I only have 5 minutes in this first series of questions, I would appreciate it.

Mr. ROCKEFELLER. Right.

A detailed analysis which led to the appendix which we handled to you a few moments ago was started following the accusations that you made. The denial we made when we first heard what you said, was based on a series of telephone calls. Even from this preliminary and cursory type of investigation we were convinced and have subsequently verified in detail that our initial findings were true.

The CHAIRMAN. I believe you said you commenced your study before our report?

Mr. ROCKEFELLER. No, sir, we did not. We started our study after you made the charge that we had used insider information. We learned of your statement because it was, as I recall it, given out to the press sometime in advance of its actually appearing in the press, and we heard about it. Therefore, we did make very casual inquiries at that time which led us to the conviction that there was no impropriety involved. That was subsequently dealt with in much greater detail through a detailed investigation.

The CHAIRMAN. I hope to discuss that further.

Mr. ROCKEFELLER. I will be happy to.

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The CHAIRMAN. Is it not true that the Securities and Exchange Commission is currently investigating charges dealing with Penn Central's transactions?

Mr. ROCKEFELLER. I am not sure they are continuing. We have already testified before them rather extensively, yes.

The CHAIRMAN. Has your bank been previously subjected to similar investigations by the SEC with respect to your dealings in securities with other companies or is this the first such investigation of this type?

Mr. ROCKEFELLER. I will ask counsel to answer that.

Mr. HABERKERN. It is not the first, sir. We have from time to time over the years received subpenas requiring information concerning various transacttions. We have supplied the information. There has been nothing further.

The CHAIRMAN. Fine.

Is it not true there have been several law suits filed against Chase alleging insider trading in Penn Central's securities by the bank's trust department?

Mr. HABERKERN. Mr. Chairman, several suits have been filed naming a number of banks, investment bankers, institutions, and Chase.

The CHAIRMAN. I am talking about Chase.

Mr. HABERKERN. Yes, sir. Quite a——

The CHAIRMAN. I would like to know the exact nature of the internal investigation of your bank now being conducted. I will ask you to supply that for the record.

Mr. ROCKEFELLER. I will be glad to do that.

(The information requested follows:)

At the time of the large sales of Penn Central stock from accounts managed by Chase Manhattan, the Bank's policy against the communication of information from the commercial departments of the Bank to the fiduciary investment department of the Bank and vice versa was in effect and was well-known to Bank personnel. In response to the Staff Report in late March of 1971, senior management of the Bank took appropriate steps to make certain that this policy had been followed in the case of the Penn Central sales. Senior management and counsel to the Bank interviewed the commercial lending officers who would have been in a position to receive any information which might be imparted to banks which participated in the loan arrangements between numerous banks and Penn Central and its affiliates. Officers in the Fiduciary Investment Department of the Bank who were responsible for the downgrading of the rating of Penn Central stock in May of 1970, portfolio managers who sold large amounts of Penn Central stock during May and June of 1970, and the research analyst whose study and recommendations immediately preceded the portfolio managers' sales of Penn Central stock were also queried. In no case was there any indication that any improper information was received by any of these persons in the Fiduciary Investment Department.

As a result of the investigation, it was determined that Chase lending officers who handled the Bank's commercial banking relationships with Penn Central had in fact no knowledge of any May 21, 1970 meeting [the meeting may have been held on May 22, 1970 since we have received conflicting information as to the date of such meeting] reported to have occurred between Penn Central officials and representatives of Chemical and First National City Bank until May 28, 1970 at the earliest. On May 28 there occurred the first meeting during May of 1970 between the two principal banks and the approximately fifty (50) other banks including Chase who were participants in the two outstanding loans. The May 28 meeting—which occurred after Chase portfolio managers had initiated sales of the vast bulk of the Penn Central shares sold during the period under study—was the first occasion on which the responsible lending officers may have heard references to the earlier meeting at which Chase was not represented.

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A summary of the results of the Bank's investigation is, as Mr. Rockefeller stated on May 3, contained in the Appendix to his prepared statement which was distributed to all the members of the Committee. One of the principal divergencies between the facts contained in the Staff Report and the facts discovered in the Bank's internal investigation pertains to the trade dates on which Penn Central sales were made. The information contained in the Appendix submitted by Mr. Rockefeller was derived from the actual order tickets prepared by portfolio managers for sales of Penn Central stock from their accounts and the related confirmation slips prepared by the Bank's trading desk.

The CHAIRMAN. Were all aspects of the internal investigation documented, were all pertinent individuals questioned? What was the end product of your internal investigation? Is there a report or other document summarizing the results of the investigation? Would you submit it for the record? Are you willing to make all materials and documents relating to this internal investigation available to this committee for review?

Sir, if you will answer these questions for the record, Mr. Rockefeller, we will appreciate it when you examine your transcript for approval or correction.

Mr. ROCKEFELLER. I will be glad to do that, Mr. Chairman.

Of course, the summary of the investigation is what we just have completed and gave to you this morning.

The CHAIRMAN. You mean the——

Mr. ROCKEFELLER. Yes, sir. The appendix to my statement.

The CHAIRMAN. That is the one you didn't file up here this morning?

Mr. ROCKEFELLER. That is correct.

The CHAIRMAN. You have had quite a while.

Mr. ROCKEFELLER. No, sir. It was in its final form only last Friday.

The CHAIRMAN. All right. Fine. Mr. Widnall.

Mr. WIDNALL. Thank you, Mr. Chairman.

I certainly want to join in welcoming you before the committee today and making the full statement which you have. This is an extremely important piece of legislation and it can have a very grave effect not only on the financial community, but on the economy as a whole. There are some rather drastic changes that will be required on the present procedures. I think it is very, very important that we get as much information on the record as possible.

You pointed out some of the difficulties of limiting the amount of a corporation's stock which may be held in one way or another by a bank's trust department. Isn't it true that there are some essential differences between large or controlling blocks of a corporation stock held in a trust under the terms of the trust agreement, large holdings of sound stocks held for investment purposes, and the theoretical problem of undue concentration of wealth?

Mr. ROCKEFELLER. Yes; there certainly is a difference. I tried to point out that particularly in connection with personal trusts, we frequently serve as trustee for a substantial block of stock for a relatively small corporation that has been developed by a family. They have decided for whatever reasons that they prefer to have that stock placed in a trust and managed by us as a banker. Clearly, in that case, our position with respect to the company is very different from our holding large blocks of publicly held stock where the percentage, of course, is much smaller, in most instances.

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Mr. WIDNALL. I might use as an example, giving you control of my corporation for a period of time, because I have got confidence in your ability to manage it until the beneficiaries have reached majority or gained sufficient experience to run it. If enough people have confidence in you, you may end up controlling a number of companies under this type of trust, but I cannot see that this represents any sinister conspiracy to develop any concentration of wealth. Practically speaking, do you think any one bank or group of banks could deliberately or accidentally acquire control over a really significant portion of this Nation's wealth?

Mr. ROCKEFELLER. I do not, sir. As I said at one point in my testimony, even if it were possible, which I don't believe it is, it is completely contrary to the purpose for which we hold the stock. We hold it for the benefit of the beneficiaries—whether personal trust or pensions or whatnot—and we vote it and we buy it or sell it, trying to do a good job in managing the personal affairs of that individual. We are not interested in trying to run the affairs of the corporation. This is a matter of basic policy with us, and I am sure with all other banks.

Mr. WIDNALL. I note that many individuals who are in the communities that I represent—and I would say certainly throughout the United States—are anxious to have an institution such as Chase acting as the trustee of their estate because of corporate continuity, because of departments we have that have extra fees in the area and they know the average individual cannot serve the same capacity and have these things available to them. Also, I have seen many horrible incidents where individuals have been given the role of trustee and that has been the end of the estate. Now, as I understand your testimony, you think that the bill as written would just about destroy the ability of the trust departments to continue their present functioning, isn't that so?

Mr. ROCKEFELLER. I feel it would have a seriously detrimental effect to the smooth functioning of trust departments if the bill were passed, yes.

Mr. WIDNALL. I seem to recall reading somewhere recently the Chase Manhattan Bank acted with a certain number of SBIC's. Would you give comment on this, the effect this legislation would have in your activity in this area?

Mr. ROCKEFELLER. Yes. We do have one small business corporation of our own, Chase Manhattan Capital Corp., and then we have joined with other clearing house banks recently in the formation of a MESBIC in New York. There is no doubt on several fronts the legislation in its present form would be harmful to that.

One aspect would be the inability to take stock warrants as part of the compensation for making a loan in the small investment corporation. This can be a very necessary feature in order to do the financing.

Mr. WIDNALL. For the record, will you develop that further?

Mr. ROCKEFELLER. Yes, I will be happy to.

Mr. WIDNALL. Particularly with respect to activities to assist minority businessmen.

Mr. ROCKEFELLER. I will be very happy to give a fuller statement on the whole thing.

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Mr. WIDNALL. Thank you very much.

My time is up, Mr. Chairman.

(The information requested follows:)

In stating his opposition to Section 14 of the proposed Bill, Mr. Rockefeller emphasized that a complete prohibition of equity participations by lenders, as defined in the Bill, would have adverse public policy consequences in a number of areas.

We endorse in full the statement of the New York Clearing House on equity participations. However, we would like to offer the following additional information. In the industrial and commercial real estate mortgage area, fixed interest rate mortgages have not provided sufficiently attractive yields in comparison with other types of investments. Erosion of the dollar's value through constant inflation poses a great problem for a prospective long-term mortgage investor if he can receive only a fixed rate of return. Equity particiyation is the logical step to counteract the erosion of mortgage portfolio values which results from the repayment of mortgage loans with progressively cheaper dollars. In our judgment, it is clear that if long-term lenders are precluded from taking equity participations the availability of funds for long-term financing of commercial and industrial real estate developments will be dramatically reduced.

A second area where the proposed Bill would prohibit mutually beneficial transactions having no unduly risky aspects is commercial lending to companies of first quality from a credit standpoint which are having temporary cash flow problems. For example, a sound corporation which is incurring large production costs in anticipation of future sales may be unable to pay the market rate of interest in the early years of the financing. In such a situation it may be advisable for the borrower initially to pay interest rates under the market in return for some type of equity participation such as stock rights or warrants. These stock rights or warrants, of course, cannot be exercised by the bank, but they can be sold at a later time in order to bring the bank's return up to that commensurate with the interest rates that would be payable by a borrower of equal financial standing but not having the current cash flow problem.

A similar situation occurs from time to time in connection with so-called "trouble loans". After a loan has been made, a borrower may come to a period when it would not be in either its or the bank's best interest to continue debt service in accordance with the repayment schedule. The lending bank may be requested to stretch out the amortization and to reduce or even waive interest payments. In such an instance some type of participation in future earnings provides a flexible approach to a rearrangement of the terms of the loan.

A fourth problem with the proposed legislation is that it may be construed to apply to loans and other extensions of credit made by banks as trustees. Clearly, banks as fiduciaries of trust assets should not be limited in their investment activities by rules applicable to bank lending activities. If enacted, the prohibition would place bank trustees at a serious competitive disadvantage with individual trustees who might otherwise not be as desirable as trustees because of lack of experience in the investment field or insufficient financial responsibility.

Finally, the effects of Section 14 on bank holding company-affiliated Small Business Investment Companies ("S.B.I.C.s"), such as Chase Manhattan's wholly-owned subsidiary, Chase Manhattan Capital Corporation, would be disastrous for the particular S.B.I.C.s involved and for the nation's effort to increase financing for small businesses.

S.B.I.C.s have provided a great deal of assistance to small business generally throughout the country and have not resulted in any substantial net cost to the government.

This would not have been achieved were it not for the fact that S.B.I.C.s can and do take equity participations in the small businesses they finance. S.B.I.C.s must make capital gains. No venture capital business, and S.B.I.C.s are in the venture capital business, can make profits without capital gains.

Thus, in our view, if the present proposal is adopted each and every bank holding company-affiliated S.B.I.C., such as our own, would immediately begin to shrink its operation and would make no forward investments.

If any members of the committee are concerned lest bank-affiliated S.B.I.C.s abuse their privileges under the Small Business Investment Act of 1958 with respect to taking options or warrants, two observations should be made:

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1. SBA regulations prohibit any S.B.I.C. from taking a control position in its small business clients. Under special circumstances, it is possible for an S.B.I.C. to apply to SBA and get prior approval for taking a control position, but such prior approval is granted only if the S.B.I.C. enters a binding agreement for subsequent divestiture of the control position on terms and conditions approved by SBA. The only reason for this special provision is that occasionally, when an investment is in difficulty, an S.B.I.C. may be required to make available additional funds and to take control of the company temporarily in an effort to solve its financial problems. However, the SBA polices these situations very thoroughly and in accordance with the intent of the legislation.

2. SBA regulations also effectively control the financing of a small business in which a large corporation or bank is a stockholder. In each case where a corporation is an affiliate of a small business concern to be financed, it is necessary for the S.B.I.C. to consolidate certain financial information concerning the corporate stockholder with that pertaining to the small business concern for the purpose of determining whether the company to be financed is the intended type of small business. Thus, the possibility of an S.B.I.C. directing its funds into a concern which is not truly a small business is effectively prohibited.

The CHAIRMAN. Mrs. Sullivan.

Mrs. SULLIVAN. Thank you, Mr. Chairman.

Mr. Rockefeller, the material your bank has submitted to this committee regarding your trust department's dealing in Penn Central common stock, classified as the trust accounts in the two categories, one, maximum discretionary, and two, minimum nondiscretionary. Will you please explain what these two terms mean and how the two types of accounts differ?

Mr. ROCKEFELLER. I will be happy to, Mrs. Sullivan.

The maximum discretionary means that we are given by the beneficiary of the trust or the group that gave us the trust full discretion to determine how the securities that we buy or sell for them are voted, and so in that case, we have full authority to fill out the proxy statements and send them in.

There are actually two other categories of less than full discretionary. In some cases, operate trusts where we have a cotrustee, and in that case, the cotrustee has the right with us to determine how these stocks should be voted, and they also do frequently comment on what stocks should be bought and sold. So that there we have a limited authority. We can make suggestions, but with limited authority.

On the other hand, there are other types of accounts, particularly our fiduciary advisory accounts where we simply give investment advice to customers for which they pay us a fee. There we give them the advice but they have full discretion in the end as to whether they take the advice or not, and also as to how the proxy statements are filled out. In those cases we send them the statements and they fill them out and we don't even know how they are filled out. So that clearly there is an important distinction between these three types of securities.

It would, I think, be a great mistake to lump them together as has been done at times in the past and suggest that a bank has full discretionary authority over all securities held by it, when some of them are held only on a custodial basis.

Mrs. SULLIVAN. Well, what investment fiduciary responsibility does your trust department have with respect to nondiscretionary trust accounts?

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Mr. ROCKEFELLER. Well, we have a whole department that is called an investment advisory department, and we solicit business from customers who have estates of their own that they wish to have advice in managing. We submit to them periodically suggestions as to how we feel it would be to their advantage to invest their funds.

Mrs. SULLIVAN. Does your trust department make recommendations to the beneficiary or cotrustee of a nondiscretionary trust account?

Mr. ROCKEFELLER. Yes, they do. But you are mixing the two, if you will forgive me. As I say, in the investment advisory accounts they make the recommendation and then the individual owning securities makes his own determination independently as to whether he will accept it or not. In the case of the cotrustee, it is a joint decision, and in that case if there is a difference between us that has to be resolved.

Mrs. SULLIVAN. The cotrustees make the decision?

Mr. ROCKEFELLER. Yes, it has to be a joint decision.

Mrs. SULLIVAN. Could you explain why there is such a tremendous decrease in the discretionary trust accounts while the holdings in the nondiscretionary trust accounts remained almost static?

Mr. ROCKEFELLER. Yes, I would be happy to, because this has led to a good deal of misunderstanding and misinterpretation.

Once we decided that it would be to the advantage of our customers to start disposing of Penn Central—and this happened to be back in early May, May 15—we started selling the stock, and we also began to recommend to those others whom we were advising either on a cotrustee basis or as merely investment advisers of our recommendations on Penn Central. It happened that some of the accounts in which we had only cotrustee relationships, the cotrustee disagreed with our judgment. In addition a very large number of shares were held in custody and safekeeping accounts over which Chase has neither investment nor voting responsibility. This accounts for the fact that more was sold in the full discretionary than in the nondiscretionary accounts.

Mrs. SULLIVAN. Well, is it a fact that most all of them disagree?

Mr. ROCKEFELLER. No, but it is a fact that several in whose accounts it happened there were fairly large blocks of Penn Central stock disagreed in this case.

Mrs. SULLIVAN. Is there any documentation showing that the nondiscretionary accounts were contracted and if there was could you submit such documentation for the record?

Mr. ROCKEFELLER. Yes, I think the problem here is that we are getting into the question of disclosing confidential relationships between an individual client and the bank, and therefore while we can give you the facts in a general sense, we feel it would be harmful to our clients to give you their name or specific details.

Mrs. SULLIVAN. If you could give us details omitting the name, but give us some details so that——

Mr. ROCKEFELLER. We will be happy to give you as much as we feel we can without violating our confidential relationship with the customers.

Mrs. SULLIVAN. Thank you.

Mr. ROCKEFELLER. I will be happy to do so.

(The information requested follows:)

The following information set forth in this reply includes all shares of Penn Central stock held in accounts where Chase Manhattan did not have the sole authority to sell such shares. These accounts are in the two areas of investment

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advisory services and personal trusts and estates where there was a cofiduciary. The statistics on initial holdings are compiled as of the dates in the last week of April and the statistics on subsequent holdings are compiled as of dates in mid-June prior to June 21 for which figures are available.

As of late April approximately 71,448 Penn Central shares were held in accounts in the investment advisory area. Since contacts between Bank investment officers and customers frequently take place by telephone, it is difficult to determine precisely the number of customers who were contacted. However, on the basis of written correspondence and recollections with respect to oral contacts of those officers who handled accounts which held Penn Central shares and who remain with the Bank, it appears that accounts holding approximately 56,130 shares were contacted prior to late June and informed that a switch out of Penn Central was recommended but failed to follow the recommendation. Three of fourteen officers who handled accounts which held Penn Central shares are no longer with the Bank and no inquiry has been made of them concerning their oral communications with customers. It, of course, is not unusual to expect that sale recommendations would not have been accepted in a number of cases since the customers involved retained all investment responsibility. An additional 4,195 shares were held in custody accounts where the Bank merely held shares deposited with it and had no responsibility to furnish sale or purchase recommendations. There were sales of approximately 3,712 shares from the accounts prior to June 21, 1970.

On April 27, 1970, 25,296 shares were held in personal trust accounts where there were co-fiduciaries and on June 19, 1970, 20,720 shares were held in such accounts. Investment decisions with respect to such accounts require consultation with the co-fiduciaries involving not only the investment recommendation but also the wishes of the testator, the powers of the fiduciaries, the tax considerations involved and the investment objectives of the trust. Investment decisions in such cases cannot, therefore, be achieved with the same dispatch to be expected with other types of management accounts.

We would like to point out that the figure of 275,997 shares of Penn Central stock described in the Staff Report as non-discretionary holdings included more than 200,000 Penn Central shares held in custody and bank safekeeping accounts. These, of course, were purely custodial accounts and Chase Manhattan had neither investment nor voting responsibility over these shares.

The CHAIRMAN. Mrs. Dwyer.

Mrs. DWYER. No questions, Mr. Chairman.

The CHAIRMAN. All right. Mr. Stephens.

Mr. STEPHENS. Thank you, Mr. Chairman.

I appreciate hearing your testimony, Mr. Rockefeller. You cover about four points in H.R. 5700 upon which you have given an opinion. That doesn't mean that you necessarily agree with everything else that is in H.R. 5700. You just haven't got an opinion one way or the other?

Mr. ROCKEFELLER. No, sir. As I said in the beginning of my statement, I associate myself with the statement that was made last week by the New York clearing house banks.

Mr. STEPHENS. On parts that you did not——

Mr. ROCKEFELLER. That is right, sir. Rather than repeat all those—it would take too long—I simply said I would agree with the New York clearinghouse statement on the other points.

Mr. STEPHENS. Right.

I would like to ask you this: On the question of disclosure, you have indicated that you felt that section would require banks to report on securities has a lot of merit in it, but you prefer for it to be applied to all financial institutions.

Mr. Burns, in his testimony, said that he disagreed with the fact that even in aggregate it would not be possible to keep from violating the idea of the confidence of people that you represented, especially

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in a small bank if you had this in it. You have made no differentiation between a small entity and a large entity in respect to that in your testimony. Do you feel that it is a point that should be taken into consideration?

Mr. ROCKEFELLER. I do think it should be taken into consideration. I think it is very important to preserve that anonymity and therefore any legislation that were adopted it seems to me, should be very careful to take that point into account.

I am glad you brought it up, sir.

Mr. STEPHENS. As I recall, Mr. Burns said that in a small community where you have a small bank, if you have a revelation of everything, it would be impossible for everybody not to know who was meant when that was made as a statement of revelation.

Mr. ROCKEFELLER. It is quite true and would be very dangerous. So I agree completely.

Mr. STEPHENS. I have read the statement that you have here in a hurried fashion. I have read statements you have made before. Am I correct in my assumption that so far as the Penn Central sale of stock is concerned that you are making a point that if you had an intelligent, capable, up-to-the-moment trust department they are going to be aware of every public information and that if they had not done what they did, that they would have been derelict in their duty in advising people of what is good in investments.

Mr. ROCKEFELLER. Quite so, sir, yes.

Mr. STEPHENS. That is the purpose of your trust department?

Mr. ROCKEFELLER. Precisely. Actually, that word in our bank happens to be "fiduciary investment department" which is separate from trust department, but the point is quite correct.

Mr. STEPHENS. I have no other questions, but I would like to say this: that I have had an opportunity to look into the efforts that your bank has been making in respect to housing. I am on the Housing Subcommittee—and the interest that has been taken by your bank in providing guidance and seeking to bring about some of these solutions for the housing problems for low income and moderate income people.

I am of the opinion that regardless of how much money we can afford to spend on every kind of Federal subsidy, that the housing problems of America are not going to be solved until we get private enterprise more fully involved in investing money in housing. In order to do that I think we have got to let private enterprise know they can make some money.

Mr. ROCKEFELLER. Thank you, sir. I appreciate your comments about the bank.

Mr. STEPHENS. Another point I would like to make. When you mentioned the development in responding to Mr. Widnall about SBIC affiliation, does your bank actually own more than 5 percent of the stock or is it a stock company?

Mr. ROCKEFELLER. It is a corporation and the Chase Manhattan Capital Corp. is 100-percent owned by us.

Mr. STEPHENS. In other words, under this you would have to divest yourself of that?

Mr. ROCKEFELLER. I am not sure we would have to divest ourselves of it.

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Mr. HABERKERN. No, sir. I think Mr. Rockefeller's point is that some of the new companies being formed under the aegis of the SBIC's may not be capable at the outset of bearing the ordinary interest costs and therefore a very flexible technique that can be used is to permit SBIC to have some participation in the later equity earnings of new corporations being financed.

Mr. STEPHENS. That would be dealing not with stock but equity?

Mr. HABERKERN. Well, sir, the way the bill is written it applies to any kind of an interest in the corporation of any kind, whether it be stock or participation or dissipation in earnings or a proprietary interest of any kind.

Mr. STEPHENS. You would obtain from equity position where you get more than just plain interest on your money?

Mr. ROCKEFELLER. That is right. This is why I feel the bill as written would hurt us in a number of objectives that I think all of us would agree are important.

Mr. STEPHENS. Your statement doesn't say anything specifically about the participation in an equity situation, but under the New York Clearing House statement——

Mr. ROCKEFELLER. The New York Clearing House statement does go into that in some extent.

Mr. STEPHENS. You agree with what they say?

Mr. ROCKEFELLER. Yes, and Mr. Widnall has asked that I will submit a further statement which I will be very happy to do.

Mr. STEPHENS. Thank you very much. I am very grateful.

(The information requested follows:)

See Mr. Rockefeller's reply on p. 762.

The CHAIRMAN. Mr. Williams.

Mr. WILLIAMS. Mr. Rockefeller, I would like to call your attention to the fact that you were asked to appear before this committee today to testify on H.R. 5700. You did comply with all of the rules of this committee in submitting your testimony on H.R. 5700 more than 48 hours in advance. It was not until the chairman made his prepared statement this morning that the subject of Penn Central was injected into this hearing.

I resent any inference that you have not complied with the rules of this committee. I attempted to get recognition when you finished your prepared statement on H.R. 5700 to call the chairman's attention to the fact that he had made some very serious inferences in his prepared statement. For instance, on page 2, in talking about part five of our staff report, financial institutions have privileged information, he makes the statement "The pattern of their stock sales leads inescapably to one of two conclusions: They were acting either on insider information or on clairvoyance."

At page 5 of the chairman's prepared statement he says "I must add, however, that I am disappointed to find not even a single reference to sales of Penn Central stock in your prepared statement. The fact that your statement contains no discussion of Penn Central cannot be due to anything but ignorance on your part that at least some members of this committee wish to discuss these transactions with you."

I have only had a chance to very rapidly skim over the appendix that you offered us, but I found it to be very interesting, especially on pages 5, 7, and 8 where you list the public announcements and infor-

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mation available to the public. These announcements and information could lead only to one conclusion, and that is that the Penn Central was in dire financial difficulty.

I do want to comment on what I really wanted the chairman to do, and that is to have you give a summary of your appendix so that we could all understand things a little bit better, including the people at this public hearing this morning. I am interested in your final sentence of your appendix, "In this light it can only be concluded that the staff report was based on incomplete, incompetent, and unfounded analysis."

I would like the record to show that we do require witnesses to submit their statements 48 hours in advance.

I have sat here at innumerable meetings and heard the chairman read prepared statements in opening a hearing. Almost without exception, I have not had a copy of the chairman's prepared statement. I received a copy of this statement this morning when he was reading page 4. I would like to suggest that the chairman submit a copy of his prepared statement to committee members at least 24 hours in advance of the hearing. With the size of our staff this should not be too difficult to do.

In commenting on Penn Central, I do know of one officer of one financial institution who was a director of Penn Central. This institution held millions of dollars in Penn Central stock when Penn Central went into bankruptcy. They had a chance to avoid that bankruptcy through a guaranteed Federal loan. That loan would have been justified if we could have gotten all the assets of the Penn Central Holding Co. pledged to secure any Federal loan. This discussion of a federally guaranteed loan took place while we were in recess. I read it in the newspapers that we were going to have public hearings as soon as we were reconvened, but those public hearings were never held. The Penn Central will come out of this bankruptcy all right, but it is the colleges, the universities, the financial institutions, and the people who own Penn Central stock, who will be paying the bill and taking their losses for Penn Central, and this could have been avoided.

I do want to say that I found your testimony here this morning, Mr. Rockefeller, to be very interesting and wholly consistent with the majority of witnesses who have expressed themselves on this bill. I am inclined to agree with you that a review of existing legislation would be more appropriate than the passage of H.R. 5700. Unfortunately, as you probably realize, rules of the Congress are such that our crusades must be carried on within the limits of a committee's jurisdiction, and neither the Securities and Exchange Act nor the Clayton Act are in the jurisdiction of this committee.

I think the record should show the unfair impact of this committee on banks is not the result of widespread abuses in the banking industry, but rather because it is the only way this committee can deal with imaginary abuses or conflicts, by a tangential route of banks which come within our jurisdiction.

That is all I have, Mr. Chairman.

Mr. ROCKEFELLER. May I make one comment, sir?

Chairman PATMAN. Go ahead.

Mr. ROCKEFELLER. I would just like to express my appreciation for what Mr. Williams said, and particularly for the fact that he indicated that he is not aware that by my submitting the appendix sep-

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arately at the hearing this morning it was in conflict to the rule. I was surprised, Mr. Chairman, when you said earlier that you had specifically asked me to speak about Penn Central. May I just say I had been going through—there are three letters, March 10, March 15, and April 8, and I couldn't find——

Chairman PATMAN. What date did you say?

Mr. ROCKEFELLER. The 10th was the first letter asking me to appear, to which I replied I would be happy to testify. Then on the 15th you gave some further details and then a final letter on the 8th of April.

Chairman PATMAN. No, you are mistaken, March the 31st. Let me read the letter.

Mr. ROCKEFELLER. March the 31st.

Chairman PATMAN (reading):

MARCH 31, 1971.

Mr. DAVID ROCKEFELLER,
Chairman, Chase Manhattan Bank,
New York, N.Y.

DEAR MR. ROCKEFELLER: As you are probably aware, the House Banking and Currency Committee will begin hearings on H.R. 5700 on April 20, 1971. These hearings will last approximately two weeks.

Certain provisions of this bill deal with problems of trust department investments and interlocking relationships between banks and other corporations. In this connection, it would be helpful to consideration of this legislation for the Committee to have the benefit of your bank's testimony, especially since the recent staff report of the House Banking and Currency Committee raised certain questions as to the trading activity in Penn Central stock carried on by the trust department of your bank during the Spring of 1970.

Please inform me at your earliest convenience whether you will be able to appear before the Committee during hearings on H.R. 5700.

Sincerely yours,

WRIGHT PATMAN, *Chairman.*

Mr. WILLIAMS. Mr. Chairman, I would like to call your attention to the fact that we authorized subpenaing the records of Chase Manhattan quite some time ago. We have either subpoenaed their records or had our staff members up there talking to them, and Chase Manhattan has been most cooperative. I don't see how we can have too many questions at this time after they have made their records available to us and answered all the questions.

Chairman PATMAN. We assumed, of course, that you would bring out the Penn Central matter. I do think that you were presuming a lot in filing your entire appendix on the Penn Central today and not giving us the benefit of it before you became aware of the rules of the committee.

Mr. Hanna, you are recognized.

Mr. HANNA. Thank you, Mr. Chairman.

I just have one basic observation for the witness.

I have been privileged to sit on this committee for 8 years now, and I have noted that we are one of the real dramatic centers in this Congress. Drama is made in situations which have had antagonists and protagonists, and drama is made when you bring morality into this kind of confrontation. I note that today is no exception. By selecting who is the protagonists and antagonists various people can associate themselves with either side, which I have seen take place very often and you have probably noticed that yourself.

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In the morality of the thing, it seems to determine as it always does in human action what are the intentions and what are the acts. I noticed those who are able to describe what they are doing by their intentions, as long as their intentions are good, focus on their intentions. Those who are the actors focus on the legality or what they presume to be the goodness of their acts.

Now, I have also noticed that the opportunity as provided by society—and the capabilities held by man are very limited—there are few instances when people do good with good intent. I have also noticed that men, being the creatures that they are and wanting the love and affection of their fellow man as they do, that there are very few instances in which you will find men doing evil with evil intent.

So this leaves us in a situation in which we either have men of good intention doing evil or men of evil intention doing good. It seems to me that I am not in a position either by temperament or by wisdom to question the chairman's good intentions. In fact, I subscribe to most of them and I would to all except humility prevents me from this extreme.

I am persuaded that I can't accept all the purifications that you have poured upon the bank's division and its personnel, Mr. Rockefeller. I simply don't want to be pulled into the maelstrom of the drama and I don't want to associate myself either as a protagonist or as an antagonist. But I am going to continue to carry a rather heavy concern about what is being done. In my definition of good it would be the public good, and there are some serious questions as to whether the decisions being made in your bank—many times I am sure the intentions are unquestionable. But the results raise the question as to whether or not in the long run and in the full scope of what your decisions affect, whether it is entirely good in the sense of public good. I think that—and you were saying that you had examined some incompatability, so perhaps you have given some thought to this yourself. So I think if these hearings are going to make a contribution, they may make a contribution and widen the vision of the bank in making their decisions as to what really ends up as the public good, and forget a little bit about the fact that what you are doing is legal and that your intentions are good and if we don't find that you are doing that, we are going to have to change what you are doing so it isn't legal. That is what our job is all about.

Mr. Chairman, I appreciate having the opportunity to sit again at one of the great dramatic presentations and hope we move from the drama to some practical application of the law.

Mr. ROCKEFELLER. May I respond to Mr. Hanna?

I would like to say that I certainly agree that our actions should be consistent with the public good, and if they are not we would like to know it and correct it. What we are trying to do here is to be responsive to the chairman's and your questions and give you the facts as we see them. If, after you examine the facts you find they are not to your satisfaction we will be happy to know about it and try to correct them.

I am bound to say at least in this particular instance I am not aware of any case where our good intentions, as you describe them, are inconsistent with the public good in terms of our actions, but I will be happy to hear further from you, sir, if you find that not to be the case.

Chairman PATMAN. Mr. Lent.

Mr. LENT. Thank you, Mr. Chairman.

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I don't want to break the train of our thought, but I do have a question on the bill itself.

I am wondering, in the unlikely event this bill were to become law, and Chase had to relinquish its outside directors, first of all how would a bank like Chase go about replacing them; and, second, assuming you were to replace these outside directors, with more inside directors, such as officers on the board, wouldn't they create an incestuous situation whereby the performance of the chief officers of the bank would be evaluated by their subordinates?

Mr. ROCKEFELLER. I believe it would, sir, and I believe it would be a very unfortunate situation. I suppose there are three possibilities.

On the one hand, one could increase the number of inside directors, as you suggested, and I think that probably would have to be done. I suppose one could also go to people who are retired from active business so that there wouldn't be the conflict or possibly to the people who have no connection whatsoever with business where, frankly, I don't think it would be very helpful.

Mr. LENT. Since we are really interested here in seeking the public good, do you think that forcing Chase to divest itself of directors of the caliber of Messrs. Dillion and Lazarus would bring about greater public confidence in the bank or hurt it?

Mr. ROCKEFELLER. I am convinced it would hurt it. It would not only hurt the public image, but I think it would hurt the functioning of the bank. I wonder whether the chairman here and others realize the degree to which these very distinguished gentlemen really devote their time and energy and attention to the bank's affairs, and how often their suggestions are of enormous benefit to the bank and hence to its customers and the public.

Mr. LENT. Would your answer, as given to this question, be applicable only to the Chase Bank or would you say that similar effects would be brought about with respect to the other large banking institutions in the metropolitan area?

Mr. ROCKEFELLER. I am sure it would be the same for the other large banks in the metropolitan area. But I think it would be true, also, of small banks, because they, too, need the advantage of businessmen and people who have financial know-how and experience, and they, too, would run into the same kind of trouble, if anything more so.

Mr. LENT. Thank you.

I yield back the balance of my time.

Chairman PATMAN. Yes, Mr. Gettys.

Mr. GETTYS. Thank you, Mr. Chairman. Mr. Rockefeller, the old story down home about the monkey making love to the skunk and he didn't get all the loving he wanted but he got all he could stand. I am just wondering if the private enterprise system of the United States, including the regulated agencies like banks if we are not about to get all of the rules and laws that they can stand and still remain a free enterprise system. I just wonder if your testimony indicates that you believe there are no additional laws needed in the area which is discussed by H.R. 5700, but the regulatory agencies have all the necessary power under statute to oppose such regulations it may be necessary to correct the evils that do exist; is that a fair statement?

Mr. ROCKEFELLER. It is indeed, sir. I think the analogy that you drew is a very vivid one, and I think you are quite right, that the banking

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industry is subject already to a great deal of regulation. I personally question whether it needs the additional regulations that are being proposed in many parts of this particular bill.

Mr. GETTYS. You dealt mainly with interlocking directorates and the handling of fiduciary accounts. You incorporated a separate report of last week. But have you any comment on the equity participation feature of this bill, and I understand your bank, of course, does not participate in that kind of practice—a piece of the action? Banks cannot, can they, participate in the practice known as a piece of the action?

Mr. ROCKEFELLER. We, of course, are not allowed to own stocks. I believe you are referring to the so-called kickbacks.

Mr. GETTYS. Yes, and the equity participation.

Mr. ROCKEFELLER. Kickers.

Mr. GETTYS. That which is a little different.

A consideration of a loan is maybe a certain ownership interest in the property. I don't believe it is a kickback.

Mr. ROCKEFELLER. I apologize. I used the wrong expression. Kickers.

No, there are, I think, certain instances where kickers are justified, and I think it would be a mistake to eliminate them completely. One is the case of mortgage loans which, generally speaking, are of a much longer duration. In this inflationary economy that we are in, it frequently is insufficient to rely exclusively upon the interest rate if one wishes to get a consistent return over a long period of time. Therefore frequently in connection with motgage loans there is some kind of a so-called equity kicker—and this seems to me to be perfectly natural. There are other instances—where corporations are expanding rapidly with a heavy drain on their cash flow and where they can't afford to pay very heavy interest charges in a given period—here there may be some justification for a stock warrant.

Mr. GETTYS. In that area would not the public interest be best served by a close scrutiny by a regulatory agency.

Mr. ROCKEFELLER. This is what seems appropriate to me rather than an absolute prohibition against it, because I think there are instances where this is desirable.

There is one other that I should point to. That is the case of a loan which is made to a company which is in sound condition when the loan is made, and then the company gets into trouble and is losing money. In those cases on an emergency basis it may be necessary to have some kind of adjustment where the bank gets the prospect of future earnings rather than draining what remaining cash they may have. So I feel that it would be far preferable, as you suggest, to have the regulatory agencies indicate in what cases it is justified and what cases it isn't.

Mr. GETTYS. Thank you, sir.

Chairman PATMAN. Mr. Archer, you are recognized.

Mr. ARCHER. Mr. Rockefeller, to continue on the question of so-called equity kickers, do you see this bill as now drawn having a serious deleterious effect on SBIC's?

Mr. ROCKEFELLER. I do very much. I think it really would be deleterious I can only wonder whether this wasn't an oversight in drawing up the bill.

Mr. ARCHER. Wasn't this the very purpose, according to your understanding, of the legislation permitting SBIC's—to let them take equity participations?

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Mr. ROCKEFELLER. Precisely. It is true this means that the SBIC's are able to help small businesses that are just getting underway. They couldn't do it otherwise. That is the reason for it.

Mr. ARCHER. Does your bank have a participation in the Columbia venture between here and Baltimore?

Mr. ROCKEFELLER. We do indeed. We are the bank that has put up all the construction loans for that venture.

Mr. ARCHER. Did you have any equity participation in that?

Mr. ROCKEFELLER. No; we do not.

Mr. ARCHER. It is just strictly a straight loan situation?

Mr. ROCKEFELLER. As a matter of fact, I believe—in fact, I know—the long-term lenders—namely, Continental Life and TIAA—do have an equity participation agreement.

Mr. ARCHER. May I get your comment on another part of the bill; that is, the question of brokered deposits. Do you feel there is no need for any additional regulation or additional legislation with respect to brokered deposits? Do you feel there are some abuses there that need to be touched on by Congress?

Mr. ROCKEFELLER. I do not feel there is the need for additional legislation. There may conceivably be abuses, I couldn't see why they couldn't be eliminated by the governing bodies, such as the Federal Reserve. I feel that there are a number of instances where so-called brokered deposits are perfectly reasonable and where they certainly are used to a considerable extent.

Mr. ARCHER. Thank you very much.

I yield back the remaining portion of my time.

Chairman PATMAN. Mr. Hanley.

Mr. HANLEY. Thank you, Mr. Chairman.

Reference has been made to some lawsuits pending against Chase Manhattan related to its internal activity and the Penn Central matter. Could you tell us how many lawsuits are pending?

Mr. ROCKEFELLER. Again I will refer this to counsel. He is better informed.

Mr. HABERKERN. I believe three have been filed, sir.

Mr. HANLEY. Is the basis for each somewhat similar?

Mr. HABERKERN. Yes, sir.

Mr. HANLEY. Would it be accurate to say that the basis of complaints by claimants results from their dissatisfaction with the determinations made by your fiduciary investment department; would that be an accurate statement?

Mr. HABERKERN. Well, sir, this litigation of course is in court now, and I don't think it would be appropriate to comment upon it.

Mr. HANLEY. All right.

Then, Mr. Rockefeller, in your statement denying insider trading you have cited as one of the reasons for sales of Penn Central stock "A change in the market recommendation by a brokerage firm which had previously strongly recommended the purchases of Penn Central stock." The press reports have suggested that that firm was Butcher and Sherrerd of Philadelphia. Would this be correct?

Mr. ROCKEFELLER. It is correct; yes, sir.

Mr. HANLEY. Could you tell us when that firm changed its recommendation?

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Mr. ROCKEFELLER. I think that is in the—it was May 13. It is in the supplementary testimony.

Mr. HABERKERN. Page 5, sir.

Mr. HANLEY. How did your trust department become aware—how does it become aware of the change in that firm's recommendation?

Mr. ROCKEFELLER. Again I should say it is the fiduciary investment department that has corporate analysts, security analysts who devote their time to getting from public sources all the information they can about companies that could be of interest from an investment point of view and these analysts in a large bank such as ours are broken down so that you have specialists in different fields. We have specialists who devote a good part of their time to studying railroads and other transportation companies. They go to investment houses and brokers and to any other sources that would be able to shed light on the situation. So that it would be a natural kind of contact that they have with them.

Mr. HANLEY. I see. So as opposed to a purely in house operation, fiduciary investment would then rely upon the expertise of firms such as the one that we had mentioned. Is this it?

Mr. ROCKEFELLER. This would be one item of information that they would take into account and digest. They might or might not accept its view. It was merely one of a whole series of facts that came to light over a period of time that caused us to feel that the situation was different. This is on page 5 of the appendix. There are listed a number of different items of information that were brought to the attention of our fiduciary investment department over a period of 3 or 4 months.

Mr. HANLEY. I haven't had the opportunity to thoroughly review the appendix because of the time factor. But in addition to this firm I assume that you rely heavily upon other firms that also have a special expertise in that particular field?

Mr. ROCKEFELLER. We do indeed. We get information I would think from the dozens and maybe even hundreds of sources.

Mr. HANLEY. I assume they are all connected on the basis of their expertise in that particular field?

Mr. ROCKEFELLER. Yes.

Mr. HANLEY. Example, firms such as Sheron Hammel & Co., Black & Co., Inc., Model Roland & Co., would they all at some point be——

Mr. ROCKEFELLER. They are all firms with whom we are in touch in one way or another, and I don't specifically know whether they are ones from whom we got information in this particular case, but they are the type of firm that we use.

Mr. HANLEY. Well, for instance, the three firms that you just mentioned, they all recommended selling or gave you unfavorable analyses of the Penn Central situation during the period of October 1, 1969, through April 27, 1970. We assume that you were aware of this position?

Mr. ROCKEFELLER. It seems probable, although I would have to inquire. I don't know offhand.

Mr. HANLEY. Since your denial statement stated either that your bank relied on this outside information, and specifically the change in recommendation by Buther & Sherrerd, then why didn't the trust department rely on the advice of the other firms that I have related to you? Why were they——

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Mr. ROCKEFELLER. I couldn't answer that question without going back to the people who made the decisions. But they are independent analysist and apparently they interpreted the facts differently than those firms.

Mr. HANLEY. For the purpose of the committee, perhaps the reason for this might be provided. It could be helpful.

Mr. ROCKEFELLER. I would be glad to find out and give you the information, sir.

Mr. HANLEY. For example, now, Equity Research Associates which is, as you know, quite well known for its expertise with respect to Penn Central securities, made a rather dramatic change in its attitude toward the stock back in January of 1969. ERA came out very strongly for Penn Central. At that time they issued a 21-page analysis of the stock. They continued their buy recommendations through September of 1969. However, in October of 1969 they changed their recommendation to sell. They reaffirmed that sell recommendation again in April of 1970. It seems that perhaps your trust department might have relied on ERA's sale recommendation of 1967 to the end of April of 1970.

Mr. ROCKEFELLER. Well, it's conceivable, sir, in retrospect that we should have acted sooner. All I can say is that our security analysts who relied on their own analysis, as well as what they get from a great variety of sources, as I have already indicated, did not feel that the time was right to sell until the moment that is indicated here.

Was it?

Mr. HABERKERN. May 15.

Mr. ROCKEFELLER. May 15.

When you come right down to it, you always have someone on the buy side as well as someone on the sell side. In other words, this is what makes up competition in the securities market, that some people interpret facts one way or some another. For whatever reasons, our own analysis did not come to the conclusion until the 15th of May it was time to switch.

Mr. HANLEY. Thank you very much, Mr. Rockefeller.

I believe my time has expired.

(In response to Mr. Hanley's request the following information was received from Mr. Rockefeller:)

REPLY RECEIVED FROM MR. ROCKEFELLER

An analyst in Chases's Fiduciary Investment Department receives an almost constant flow of industry studies, individual company appraisals, reports to governmental bodies or issued pursuant to governmental regulation and verbal recommendations pertaining to securities within the analyst's assigned responsibility. A number of these reports and recommendations originate in the research departments of the major brokerage firms and investment advisory services. Outside research reports, however, constitute only one of many sources of information which the analyst has at his disposal, and which he reviews in the course of reaching an investment proposal. After the integration, interpretation and analysis of information contained in all available material, the analyst prepares his analytical report and makes an investment recommendation which is submitted to the Bank's Investment Policy Committee for review and final action.

Because of varying investment and legal considerations and different personal needs and opinions of beneficiaries, it is not unlikely that a particular security may be an appropriate investment for one account, while at the same time it may have become a less attractive investment for another account. Also, be-

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cause of the numerous sources of investment ideas normally available to the institutional investor, it is conceivable that one institution may recommend the purchase of a particular security at approximately the same time and price level that an equally well respected institution recommends sale of the same security. In fact, it goes almost without saying that without such opposing views it would be unlikely that a competitive securities market could function with the necessary degree of liquidity. It should be pointed out that the rating system for securities by the Bank's Investment Policy Committee is not designed to result in total sales or total purchases but rather to give guidance to portfolio managers as to the investment characteristics of a particular security at different price ranges in relation to other investment opportunities.

On May 26, 1970 the Investment Policy Committee of Chase Manhattan's Fiduciary Investment Department lowered the investment rating of the Penn Central stock from a "permissive sell" to a more definitive sale status. This decision reflected the culmination of an intensive analysis of Penn Central stock conducted by the Department's railroad analyst on the basis of published information. The Appendix to Mr. Rockefeller's statement set forth some of the significant factors which led to the analyst's recommendation.

Other factors which were taken into consideration by the analyst included the state of the economy and the anticipated rate of recovery, the stringent condition of the money and capital markets and the probable magnitude and timing of the proposed industry freight rate increase. Prior to the preparation of the official rating change dated May 26, 1970, a copy of the Revised Preliminary Circular dated May 12, 1970 relating to the $100 million Pennsylvania Company offering was received.

In summary, the decision to lower the rating of the Penn Central stock on May 26, 1970 was based on the belief of the Bank's Fiduciary Investment Department that the financial and operating condition and outlook for the company had deteriorated materially from earlier appraisals, and that, in view of alternative investments available with reduced degrees of risk, continued commitment of funds was not warranted.

The witness was asked about the sell recommendations and/or unfavorable analyses distributed by Shearson Hammill and Company. Model Roland and Company, Equity Research Associates and Black and Company (Transcript at p. 923). We are not in a position to comment specifically on the reports of any but the latter company, since a review of the material contained in the Bank's investment files contains only the three reports prepared by Black & Company during the period October 21, 1969 through June 16, 1970. Copies of Black and Company's research reports dated October 21, 1969, January 27, 1970 and June 16, 1970 are attached. While the exact wording differed in each instance. Black and Company generally concluded each memo by stating that while they did not recommend that an initial investment position be taken in Penn Central, they did believe that for those accounts which already held Penn Central, retention was justified based on an improved earnings outlook in the intermediate future.

BLACK & CO., INC.,
October 21, 1969.

COMMENTS BY ALEXANDER D. KERR

Penn Central (34⅝). Stock was recommended for purchase (beginning March 1969) as a highly speculative situation on the assumption that, through acquisitions or otherwise, its astute financial management could produce favorable earnings. (See report of March 1969.) Improved rail operations were also looked for. Railroad deficits thus far in 1969 have been much larger than anticipated and there appears little reason to expect any significant improvement in the near future. Based on preliminary reports, the railroad had a $19.2 million loss in the third quarter of 1969 compared with a $10 million loss in the like period of 1968 adjusted to include New York, New Haven & Hartford for comparison. (Penn Central began operating New Haven on January 1, 1969.) Third quarter operations reflect loss of coal traffic from the miners' holidays, all of which occurred in July this year, instead of being divided between June and July. They also reflect heavy flood damage in July and a refund to Southern Railroad in the north-south freight rate divisions case. Additional wage increases became effective

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July 1, 1969, fixed charges rose as a result of financing a heavy capitalization program and the large passenger deficits are continuing. Even though better traffic volume is anticipated for the fourth quarter, a deficit of over $55 million is estimated for the year.

Overall system operations in the third quarter of 1969 resulted in a net loss of $8.9 million which reduced earnings per share for the 9 months to $.73. The fourth quarter is tentatively estimated at a range of from 85¢ to about $1.50 per share, producing 1969 system earnings of $1.60 to $2.20. It is always possible that large real estate operations, security or other transactions in the fourth quarter could increase 1969 earnings. However, the above estimate falls far short of the earlier estimate of $2.35 to $3.40 per share.

Ultimately, Penn Central may accomplish our previous expectations. However, near term problems including rehabilitation of the New Haven, continuing administrative changes, and deferred maintenance, make this potential increasingly difficult to attain. Accordingly, Penn Central stock is no longer regarded as attractive for purchase.

BLACK & CO., INC.,
New York, N.Y., January 27, 1970.

COMMENTS BY ALEXANDER D. KERR

Penn Central Company (28 ⅞). While Penn Central is an increasingly diversified company, it is well to remember that the major source of its gross revenues continues to flow from its transportation operations—rail, pipeline, trucking and warehousing with the railroad producing by far the largest portion. Next in revenue importance are real estate and related operations—Great Southwest Corp., Arvida Corp., hotels, apartments, rents, royalties, etc. Lastly, are those revenues from financial operations, consisting of dividends, interest and gain from the sale of securities.

The costs and expenses related to each of these three divisions varies greatly as to profitability. It is clear from the attached table that the company's poor 1969 performance is due primarily to unprofitable rail operations. Furthermore, until effective cost control of rail operations is accomplished, overall earnings can not be expected to improve materially. Were it not for the profitability of the company's non-rail subsidiaries, 1969 EPS would have been a negative figure rather than the $1.80 which we estimate.

While PC's rail operations are beginning to show some signs of improvement and the worst is probably behind them, the twin problems of management integration (following merger of the NYC-PRR-New Haven, and improving its rail operating performance will continue to plague the company throughout 1970. Added to these internal problems is the uncertain business outlook for 1970. Bearing in mind the rather highly cyclical characteristic of Penn Central's traffic mix, we see little prospect of sufficiently improved operating performance to significantly reduce the rail operating deficit over the next year.

Also, we see no material relief over the next year or two—perhaps longer—from the very large passenger train deficit. We look for eventual take-over of all suburban operations—except for the New York-Washington corridor—by local public authorities. In time, too, most if not all intermediate and long haul passenger trains are likely to cease their runs unless some type of government subsidy is provided. For 1969, the passenger train deficit is estimated at $93 million on the basis of fully allocated costs ($60 million on the basis of direct costs).

Over the longer term—perhaps beginning as early as 1972 and progressively thereafter—we believe rail operations can be improved to the point where they can contribute substantially to total system earnings.

For 1970 the non-rail operations, especially the real estate development group, i.e., Great Southwest Corp. and Arvida Corp., are expected to contribute substantial earnings. In addition, non-rail revenues will be increased over 1969 through the recent acquisition of Southwest Oil & Refining Company, Royal Petroleum Corp., and Richardson Homes Corp. of Indiana. Dividend, interest and gain on security transactions could, likewise, produce better earnings this year over last.

We do not currently recommend an initial investment position in this company. However, for those who now hold the common stock, we recommend retention in view of the improved earnings prospect in the intermediate future.

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PENN CENTRAL COMPANY AND CONSOLIDATED SUBSIDARIES ESTIMATED INCOME STATEMENT

[In millions]

	Revenues		Costs and expenses		Income before fixed and other charges	
	1969	1970	1969	1970	1969	1970
Transportation Operations:						
Railroad	$1,791.8	$1,870.0	$1,822.6	$1,884.0	($30.8)	($14.0)
Pipeline	36.6	38.5	21.4	22.7	15.2	15.8
Trucking and warehousing	98.1	112.8	82.0	96.0	16.1	16.8
Real estate and related	283.8	285.0	161.4	165.0	122.4	120.0
		[1] 100.0		[1] 75.0		[1] 25.0
Financial	74.1	78.0			74.1	78.0
Total	2,284.4	2,484.3	2,087.4	2,242.7	197.0	241.6
Interest on debt					135.9	150.0
Federal income taxes					2.2	3.0
Income to minority					16.6	24.0
Equity in income from subsidairies sold					(1.0)	
Net income					43.3	64.6
Div. on $3.00 preference stock [2]						1.2
Available Common					43.3	63.4
EPS					1.80	2.65

[1] Reflect acquisition of Southwest Oil & Refining Co. Royal Petroleum Corp. and Richardson Homes Corp.
[2] Issued to acquire the two above listed oil companies.

BLACK & CO., INC.,
New York, N.Y., June 16, 1970.

COMMENTS BY ALEXANDER D. KERR

Penn Central Co. (11). The merger on February 1, 1968 of the Pennsylvania Railroad and the New York Central Railroad to form the Penn Central Co. was heralded as the final step necessary to create an efficient, profitable transportation system. Serving one of the most dense industrial areas of the country, the new company forms a vital keystone in the movement of freight traffic in which all railroads have an interest. For example, efficient, prompt and dependable service of a western or southern railroad is of little benefit to a shipper if, when freight reaches the Penn Central, records are lost and delays to equipment are beyond all reason. Proponents of the merger forecasted annual savings in excess of $100 million annually, and expected that passenger and freight service would be vastly improved, and looked to non-rail investment to provide a cushion against historical railroad cyclicality. Now, nearly two and one-half years later, this sprawling conglomerate is nearly bankrupt—indeed it would be confronted with this very situation were it not for Government aid.

What went wrong? Does the Penn Central's near-financial catastrophe imply that no rail merger can be successful? And, longer term, is Federal control the ultimate answer?

On the surface, the abrupt dismissal of Stuart T. Saunders, Chairman, David C. Bevan, Chief financial officer and Alfred E. Perlman, Vice-Chairman by the Board of Directors was precipitated by withdrawal of a $100 million debenture issue of a wholly owned subsidiary, the Pennsylvania Company. Actually, inability to generate adequate interest in this issue was symptomatic of deeper troubles recognized by major lending institutions and which were spelled out for the first time in the preliminary prospectus for the $100 million debenture issue.

It is clear that what went wrong stemmed in part from a credibility gap between the senior officers and Penn Central's Board of Directors on the one hand and the financial community on the other. Until the failure to place the $100 million Pennsylvania Co. debenture issue was known, the financial crisis of Penn Central Co. had not been made clear to many of the Directors.

The inability of the new management to bring together the best of the two former company's operating and financial philosophies resulted in an almost total breakdown in service during the first year of the merger. Service today is better, but far from what it should and could be. With the merger, former Pennsylvania Railroad officers generally assumed the superior positions.

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The excellent and outstanding cost and marketing analysis department of the former New York Central was submerged into the far less capable Pennsylvania Railroad group. Many of the capable officers of the New York Central departed for other companies. As the merger progressed, antagonism between former Pennsylvania and New York Central personnel increased rather than lessened. The computer systems were not compatible, car control was lost and freight schedules were, at best, on a hit-or-miss basis. Deferred maintenance with respect to both right of way and equipment has been allowed to increase.

As earnings fell over the last 2½ years, passenger service was increasingly blamed for the road's troubles. While losses from providing this service were and are substantial, passenger service is not responsible for the breakdown in operating performance. Losses from this service are shown below on a fully-allocated I.C.C. basis and on an estimated out-of-pocket basis.

	1967 [1]	1968 [1]	1969
Passenger revenues	$282,910	$249,919	$230,766
Passenger expenses	337,167	318,795	291,846
Ratio (percent)	119.2	127.6	126.5
Net Passenger revenues	$(54,257)	$(68,876)	$(61,080)
Tax Accruals	31,302	30,957	28,702
Net Rents	10,079	12,988	14,982
Net passenger operating revenues	(95,638)	(112,821)	(104,764)

[1] Includes New York Central and New Haven.

The longer term outlook for passenger service is, from a company and industry standpoint, encouraging. The Senate has approved the creation of a "for profit" National Railroad Passenger Corporation. The Act is before the House and approval is expected shortly. The Act provides that all intermediate and long-haul passenger service can be turned over to the corporation on or before March 1, 1971. The Act provides as follows:

"Upon its entering into a valid contract (including protective arrangements for employees), the railroad shall be relieved of all its responsibilities as a common carrier of passengers by rail in intercity rail passenger service under part I of the Interstate Commerce Act or any other law relating to the provision of intercity service: Provided, that any railroad discontinuing a train hereunder must give notice in accordance with the notice procedures contained in section 13a (1) of the Interstate Commerce Act. (2) In consideration of being relieved of this responsibility by the corporation, the railroad shall agree to pay to the corporation each year for three years an amount equal to one-third of 50 per centum of the fully distributed passenger service deficit of the railroad as reported to the Commission for the year ending December 31, 1969. The payment to the corporation may be made in cash or, at the option of the corporation, by the transfer of rail passenger equipment or the provision of future service as requested by the corporation. The railroad shall receive common stock from the corporation in an amount equivalent in par value to its payment."

We believe that within three years all suburban and other similar local passenger service will be operated under various community, city or state public authorities. So, for the Penn Central, the financial responsibility of providing passenger service of all kinds will cease within a relatively short time. Next year could witness significantly reduced passenger service losses.

Penn Central management from the first day of merger embarked on an ambitious program of non-rail acquisitions, all of which have turned out to be profitable ventures. The emphasis, however, in non-rail activity only served to hide the progressive breakdown in overall operations, and of equal and perhaps greater severity, the short-term financing for long-term debt. While exact figures are not available, the following table shows the approximate debt due on a consolidated basis for the next five years, including this year:

	Millions
1970	$228
1971	160
1972	180
1973	271
1974	165

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In order to meet short-term loans and other obligations, the Department of Transportation, calling on the Defense Department, will arrange to guarantee loans from various banks aggregating $200 million until Oct. 31, 1970. After that date it is assumed longer-term financing will be arranged with suitable Government guarantees. The near-term financing should give the company breathing time to restructure its management team (we are reasonably certain additional management changes are contemplated—and needed), plan for improved operating performance, and hopefully, arrange for much needed additional motive power and freight equipment.

It would seem logical to assume that as more permanent financial arrangements are made, the company may be required to dispose of some nonrail assets. The realization of cash from the sale of any one of these holdings may be in serious doubt because of the lack of buyers able to pay a "fair value". Also, a number of subsidiaries and investments are not freely available for sale since they have been pledged as collateral for bank loans, mortgages, etc., such as Arvida, Manor Real Estate Co., Dispatch shops, Great Southwest Corp. and other, smaller land operations. Other assets include a 25 percent ownership in Madison Square Garden Corp., wholly-owned Buckeye Pipe Line, Southwestern Oil and Refining Co., and various trucking and terminal companies.

It is difficult at this time to make any forecast of conditions which may be imposed under long-term Government-guaranteed financing. From all reports it seems evident that the House Banking Committee's influential chairman, Rep. Wright Patnam, and others may spearhead an opposition movement which could impair or delay the long-term guarantee proposal. The near-term Government guarantee of $200 million is not in question.

For 1970, the earings outlook is clouded, to say the least. While we believe the transportation division will operate at a sizeable deficit, we do not have any evidence of the conditions which will be imposed as long-term Government guaranteed financing is arranged. Once conditions are known, a detailed estimate will be prepared. In the meantime, our current forecast indicates a deficit for Penn Central Co. of at least $2.00 per share. This contrasts with earnings per share of $0.18 for 1969 (before extraordinary charges).

On a more hopeful note, we believe, Penn Central can survive as a profitable company. To reach this goal, it is obvious that adequate long-term financing must be arranged, management changes be effected, operating performance be sharply improved, and financial relief from passenger service be forthcoming. The appointment of Edward G. Kreyling as executive vice-president of traffic is a step in the right direction. He is not a former NYC or PRR man, but is well-versed in modern traffic concepts. This is the type of appointment needed for other departments.

Penn Central's catastrophe does not imply that no rail merger can be a successful venture. Both the Seaboard Coast Line and the Norfolk Western-Nickel Plate mergers have been successful. And the most recent merger, the Burlington Northern Inc. appears to be well on its way to a very profitable operation.

We do not believe that nationalization of the rail industry is inevitable simply because of the example to date of the troubled Penn Central. On the contrary, many railroad companies are very successful operations with quite favorable prospects. Accordingly one should not allow the Penn Central debacle to cloud "The RR Outlook" which will discuss the longer-term outlook for the industry.

At the current market price, an initial investment position in Penn Central is not recommended. However, retention can be justified on the basis that a satisfactory solution to meet intermediate to long term financing should be reached eventually.

Chairman PATMAN. Mr. Frenzel.

Mr. FRENZEL. Mr. Rockefeller, I would like to pursue a question Mr. Archer imposed with respect to the development of new towns.

My first question relates to the development of new towns. You indicated here that one of the operations in which you had been involved in—a construction loan circumstance—actually did have an equity partcipation in the long-term financing. I happen to have one of these new towns on the edge of my district in which I am extremely interested.

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So my question would be to push you a little bit farther.

Would the passage of section 14, which would forbid equity participation, have a dampening effect on any financial institution's participation in the development of new towns?

Mr. ROCKEFELLER. To be honest with you, I have forgotten whether that applies to insurance companies—counsel tells me it does, therefore, it would have, I think, a very severe impact on long-term funds that might be available from insurance companies and pension funds, because they have increasingly found it attractive and desirable, even necessary to have some inducement beyond just an interest rate for investments of this kind, which, to some extent, have a greater risk involved and also the risk of changes in the value of the dollar than in other types of loans.

Mr. FRENZEL. Thank you. As long as you are the Nation's ranking expert in financing of this kind of development, I think that is very important testimony.

I would like to ask Mr. Haberkern if the language of section 22 actually would prohibit free checking accounts?

Mr. HABERKERN. I am afraid that would be the way it would be construed, sir.

Mr. FRENZEL. Would it also prohibit free parking?

Mr. HABERKERN. It could, sir.

Mr. FRENZEL. Thank you very much. That is a very unusual section as it is finally interpreted to us.

I would also like to comment a little on the Penn Central business. We do have this wonderful staff report. I notice that it shows the names of the members of the committee, but it isn't until page VII where it says, and I quote, "reviews and conclusions found in this staff report do not necessarily express the view of the committee or any of its individual members."

I think it is important that we know something about that.

I personally have no association with that staff report, even though my name appears on the back of the front cover. I am sure there are many other members who feel the same way. I think your testimony, Mr. Rockefeller, was important in that you point out the real complaint here, the whole basis of sections 2 through 9 of this bill is that there is something wrong with interlocking directors and somewhere along the line we have to deal with them. Yet, there is no showing anywhere, and I submit not in here, either, that interlocking directorates have been the particular cause of any failings in our system. I think your testimony related very strongly to that particular point.

It was only last week that we had a banker from a small town tell us what it would do to his board of directors. You have been very graphic and very vivid, I think, in telling us the kinds of experiences and expertise which would be denied to your board were those provisions actually made into law.

I appreciate having the benefit of your testimony this morning.

Mr. ROCKEFELLER. Thank you, sir.

Mr. FRENZEL. Mr. Chairman, I yield the balance of my time.

Chairman PATMAN. Mr. Chappell.

Mr. CHAPPELL. Mr. Rockefeller, let me pursue the Penn Central a bit, too. I believe in your press release of March 29 you made the denial that your trust department acted on inside information, and in doing

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so you cited various public events as the basis for your sales of the Penn Central stock. Among those was, first, the Penn Central's first quarter of 1970 losses. Second, the April 28, 1970, search for—one hundred million debenture offering which reviewed the need for substantial additional financing. No. 3, the trading in Penn Central stock during May 1970. Four, an item which Mr. Hanley mentioned, a change in the market recommendation by a brokerage firm which had previously strongly recommended purchases of Penn Central stock. Number 5, a Standard and Poor's changing of Penn Central's obligations from BBB to BB on May 15. And six, revised a circular for the proposed debenture offering which disclosed Penn Central was having substantial difficulty in rolling over its commercial paper. Now, in connection with those cited public events, I would like to ask you two or three questions. First of all your list of public events does not include the October 26, 1969, announcement by Penn Central that it would not pay a dividend for the fourth quarter of 1969 for the first time in 123 years. Then, secondly, that Penn Central's announcement on February 4, 1970, that the railroad's losses for 1969 were 10 times greater than its losses for 1968. I think these would appear to me to be rather significant events as regards Penn Central's stock.

Is there any particular reason why your trust department didn't react to these events and begin——

Mr. ROCKEFELLER. I am sure they were aware of them and obviously they were not happy about them, but Penn Central stock derived the income from other sources beside the railroad. As you know, the Pennsylvania Co. has many important and productive enterprises, and at that point at least its earnings were more than sufficient to take care of the needs of the overall corporation. I don't pretend to be personally an expert in this field. I am merely surmising really when I make that statement. I am sure these facts must be taken into account.

Mr. CHAPPELL. Do you feel that interlocking directorates had anything to do with it?

Mr. ROCKEFELLER. Nothing whatsoever.

Mr. CHAPPELL. Now, the first event which you cited, the announcement of Penn Central's first-quarter losses occurred on April 22, 1970, yet your trust department didn't begin selling the stocks until May 22. That is a full month later. Any particular reason why it took so long to react to that event? Did interlocking directorates have anything to do with it?

Mr. ROCKEFELLER. I honestly don't have here the full record. Some of it is given in this appendix, but I could provide you with a more detailed report on that and would be happy to do so.

Mr. CHAPPELL. I personally would appreciate it.

Now, the second event you cited which is the one on April 28, the April 28 circular came out about 25 days before your trust department started selling. Does it normally take your trust department that long to analyze or react on a circular day?

Mr. ROCKEFELLER. Again, I would rather fill that in, if I may, sir. I just don't know the reasons.

Mr. CHAPPELL. Would you do so on that one too, sir?

Mr. ROCKEFELLER. I would be very glad to.

Mr. CHAPPELL. Now, the third event which you have mentioned is the one, the heavy trading of Penn Central stock in May which took place

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starting, I believe, on May 12 and apparently immediate reaction to the May 12 revised circular. These heavy sales continued through the rest of May and June. There again why did it take your trust department 10 days from May 12 to 22 to realize the sales of Penn Central stock had increased and therefore reacted on them?

Mr. ROCKEFELLER. Well, there I think the explanation is fairly apparent. We had blocks of the stock, some of them were large ones in a number of accounts. It clearly would have had an adverse effect on the market if all of the stock had been dumped in a single day. We are dealing in very large numbers of shares. Therefore, as is the custom in such things, our trust department handled the sales in a way so as to minimize the impact on the market. I would assume that was an important consideration.

Mr. CHAPPELL. I wonder if it isn't fair to state here, to note here, starting on May 22 your bank, Morgan Guaranty, Continental Illinois, and Allegheny Corp., and its subsidaries were mostly responsible for the increase of Penn Central stock; is that not a proper notation?

Mr. ROCKEFELLER. Those very likely are the facts. I don't know myself. I don't think that is particularly surprising in that the three banks have large trust departments with large security holdings. The information by that time was sufficiently clear to most people who were mostly selling rather than buying.

Mr. CHAPPELL. Yet, though, you held through those periods and still your interlocking directorates had nothing to do with it?

Mr. ROCKEFELLER. I have absolutely no doubt about that.

Mr. CHAPPELL. You said the change in recommendation by brokerage firm occurred between May 12 and May 15. It took your trust department more than a week to react on this. Is that an unusual time?

Mr. ROCKEFELLER. Again let me give you the full fill-in. I just don't know the details and I would have to give you the information.

Mr. CHAPPELL. All right, sir. I would appreciate it if you will do that.

(The information requested follows:)

See Mr. Rockefeller's reply on p. 775.

Mr. CHAPPELL. Mr. Patterson.

Mr. PATTERSON. The SEC's study indicated that it is not unusual for a good analyst to take as long as a month to make a study of the stock, of the specific stock.

Mr. CHAPPELL. Of course, my question related specifically to your own trust department, why it took so long to react.

Mr. PATTERSON. Our analyst, as it says in this appendix, took some 7 days to complete his study, which is one of the reasons that the sales did not begin immediately on a particular announcement day.

Mr. CHAPPELL. All right, sir.

Now, Mr. Rockefeller, as your fifth event you cited Standard & Poor's May 15 change in ratings on the BBB. Again, Mr. Rockefeller, this was a week before your trust department started selling. Even more important is that the fact on April 13, 1970, Standard & Poor's gave a very unfavorable analysis of Penn Central stock. Again, why is it that your trust department reacted in this manner to this analysis?

Mr. ROCKEFELLER. I believe the decision to sell was made by the investment committee on May 26. Again, I will fill in the facts for you. I am not able to answer the details of how the decision was arrived at and what the progress of steps were.

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Mr. CHAPPELL. All right, sir.

My time has expired.

Mr. ROCKEFELLER. Much of it, I might say, I think is in here, but if any of it is not, we will go over it again and try to add to what we have done.

Mr. CHAPPELL. Will you do so?

Mr. ROCKEFELLER. I hope you have a chance to read this as well.

Mr. CHAPPELL. My time has expired.

Chairman PATMAN. Mr. Koch.

Mr. KOCH. Thank you, Mr. Chairman.

Mr. Rockefeller, it is a special pleasure to welcome you to this committee. I am a new member, but we are old acquaintances and you are a distinguished member of the New York City community and my district particularly.

I would like to ask you a question concerning your testimony and that is this: On page 8 of your testimony in connection with your comments on investments exceeding 5 percent, you said that most of your trust department's holdings that totaled over 5 percent are family type enterprises. My question is do you regard Chase's holdings, United Aircraft Corp., in which your holding is 6.2 percent: Boeing Aircraft Co., there you have 8.7 percent; Safeway Stores, there 6.7 percent: Trans World Airlines, 7.3 percent; Pan American World Airways, 6.7 percent: and Eastern Airlines, 6.4 percent. Do those form the categories of family type enterprises?

Mr. ROCKEFELLER. They do not, I am very glad you raised the question, because it gives me an opportunity to point out the misleading nature of the figures which you are using and others, not because you intend to, I realize, but because the figures are given in a global sense. The figures do not differentiate among securities over which we have full investment authority, joint control, or no control whatsoever. The percentage holdings of the stocks you listed would in most cases, if not in all, but under 5 percent, if you took into account only those over which we have full discretion. I believe that this is the only part that is really relevant to this discussion.

Mr. KOCH. When you complete your testimony would you give us the actual breakdown with respect to these particular corporations that you have named?

Mr. HABERKERN. Sir, it is very difficult to go back to a particular date. We can give it as of a current date.

Mr. KOCH. Current date will be satisfactory.

(In response to Mr. Koch's request the following information was submitted by Mr. Rockefeller:)

Company	Number of shares held with sole investment discretion	Percent of outstanding shares [1]	Number of shares held with sole voting discretion	Percent of outstanding shares [1]
United Aircraft	113,310	0.9	130,615	1.0
Boeing	16,204	0.07	21,161	0.09
Safeway Stores	14,200	0.05	112,464	0.4
Trans World Airlines	861,045	8.2	858,050	8.2
Pan American World Airways	356,900	0.9	357,740	0.9
Eastern Airlines	711,169	5.9	692,369	5.8

[1] Outstanding share figures are based on Standard and Poor's Stock Guide, May 1971.

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Mr. KOCH. When pursuing your testimony on page 8, you state that Chase's representation on the board of another corporation is due to the desire of the creator or beneficiary of a trust to have the trustee represent their particular interest on a board. I wonder, are there people on Chase's board that have such a mission?

Mr. ROCKEFELLER. No.

Mr. KOCH. Would you approve of that kind of a mission?

Mr. ROCKEFELLER. If there were very large blocks of Chase stock held by a particular group it would seem to me that that would be a logical thing. But the fact is that the largest holding of Chase stock is in the neighborhood of 1 percent and this is so small a percentage that I didn't——

Mr. KOCH. Well, maybe my question isn't sufficiently zeroed in.

I assume in the sense of the interlocking arrangement your comment was that the desire oftentimes is, for the creator or beneficiary of a trust, to have the trustee represent their interest on such a board. Now, would you tolerate that on Chase's own board?

Mr. ROCKEFELLER. I don't see that the question is applicable, Congressman. Perhaps I misunderstand the question. But it is the other way around, that Chase through the trust holds the stock and represents the beneficiaries in other companies.

Mr. KOCH. I understand that. What I am saying is that, reversing the situation, would you tolerate someone on your board, on Chase's board having such a mission representing such an interest. That is my question, on your board, not you on someone else's board, but someone on yours.

Mr. ROCKEFELLER. I understand. As I indicated, if as would be the case in many small banks, a family owned a very large percentage of the stock of the bank, it would seem to me quite natural that someone representing that stock should serve on the board and in that case I would see nothing wrong with it. We don't happen to have that situation in Chase and therefore there seems to be no——

Chairman PATMAN. All right, Mr. Rockefeller.

I have a statement here that I would like to file with the record at this point. Without objection, so ordered.

I will quote just a small part of it.

"1. During the period April 1, 1970 to June 19, 1970, Chase sold a total of 436,300 shares of Penn Central common stock: 17,400 shares in April; 309,200 shares in May; and 109,700 shares in the first 19 days of June.

"2. For the first 37 trading days of the subject time period—April 1, 1970, through May 21, 1970—Chase sold only 40,000 shares. The total sales of 40,000 shares represented only about 9 percent of Chase's total sales of 436,300 shares for the period April 1, 1970 to June 19, 1970.

"3. On May 22, 1970, Chase sold a total 134,300 shares of Penn Central common stock—more than three times the total amount of stock Chase had sold in the previous 37 trading days combined. The 134,300 shares sold on May 22, 1970, represented almost 31 percent of Chase's total sales for the period April 1, 1970 to June 19, 1970.

"12. Stuart Saunders, chairman of the board of Penn Central, was a director of Chase Manhattan Corporation and Chase Manhattan Bank.

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"13. Chase Manhattan was a major creditor of Penn Central—as of July 1970, Chase held about $50 million of the outstanding debt of the Penn Central and various of the subsidiaries.

"14. Included in the above debt holdings was a $12 million participation in the $300 million revolving credit loan given the railroad by a group of 53 banks. First National City Bank of New York (FNCB) was the lead bank in this credit arrangement.

"Also included in Chase's debt holdings was a $10 million participation in the $50 million loan given to the Pennsylvania Company—the railroad's wholly owned subsidiary—by Chemical Bank New York Trust Co.

"On May 21, 1971—the day before Chase began its massive sales of Penn Central common stock—David Bevan, chief financial officer of the Penn Central, met with representatives of FNCB and Chemical Bank. The meeting included discussion of (1) Penn Central's deteriorating financial condition, (2) the necessity for postponement of the Pennsylvania Company's proposed $100 million debenture offering, and (3) Penn Central's intent to seek a $225 million government guaranteed loan.

"15. June 1970, Penn Central and various subsidiaries had about $5 million on deposit in various accounts at Chase Manhattan Bank.

"16. Chase was a member of the 10-member bank steering committee that represented the banks participating in the proposed government guaranteed loan in May and June of 1970."

To sum it up, there was a close relationship between Chase, Penn Central, First National Citizens Bank, and Chemical Bank. Did Chase have any contact with anyone connected with the May 21 meeting between officials of Penn Central and those two New York banks, Mr. Rockefeller?

Mr. ROCKEFELLER. I did refer to this earlier in the testimony. I am happy to do so again, Mr. Chairman, that we did not participate in that meeting and we did not know about the meeting until some time later.

Chairman PATMAN. All right, sir. When later?

Mr. ROCKEFELLER. Our investment people didn't learn about it for several months later. In fact, it was early this year that they first heard about that meeting. Whether any other lending officers heard about it sooner I don't know. But they certainly did not know of it at the time and didn't hear of it for some several days or weeks—May 28, I understand from Mr. Patterson, was the first date lending officers, as opposed to the fudiciary officers, heard of it.

Chairman PATMAN. Would you document that when you take your transcript for correction or approval?

Mr. ROCKEFELLER. I would be very happy to.

(The information requested follows:)

It is not possible to document such testimony. A search of the Bank's files revealed no information concerning the meeting on May 21 or May 22, 1970. Questioning of Chase lending officers who attended the meeting of representatives of approximately fifty (50) banks with Penn Central officers on May 28, 1970 indicated that at the May 28th meeting mention was made of a prior meeting at which representatives of the lead banks, Chemical and First National City Bank, were present. Questioning of personnel from the Fiduciary Investment Department in early 1971 indicated that they had not theretofore heard of the May 21 or May 22, 1970 meeting.

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Chairman PATMAN. Now, then, you in one year, I believe in 1968, your bank bought a considerable amount of Resorts International stock in the Bahamas. I believe that is true; isn't it?

Mr. ROCKEFELLER. No, sir; we did not buy Resorts International.

Chairman PATMAN. Your trust accounts didn't?

Mr. ROCKEFELLER. I would like to make it quite precisely clear what happened to me here, sir.

Chairman PATMAN. Yes.

Mr. ROCKEFELLER. One of our investment officers came to the conclusion—and this was concurred in by our investment committee—that we should reduce the very large holdings that we have had in Pan American Airways. It was brought to their attention that an issue of securities was being offered by Resorts International. Our investment people went down to Nassau to look at the operations of Resorts International, came to the conclusion that they offered attractive investment opportunities, and as a result exchanged stock of Pan American Airways in several accounts for stock—for notes and warrants, not stock, for notes and warrants of Resorts International. So that the bank itself did not purchase stock, nor did the trust department purchase stock. It exchanged the Pan American stock for notes and warrants of Resorts International on behalf of our trust customers.

Chairman PATMAN. Those are the ones that you had charge of?

Mr. ROCKEFELLER. These are the ones we had charge of.

Chairman PATMAN. That was 150 accounts; wasn't it?

Mr. ROCKEFELLER. Approximately that, sir.

Chairman PATMAN. And you traded the amount of over $1,000,000 shares; wasn't it?

Mr. ROCKEFELLER. Something of that order. There were no dollars because it was an exchange of securities.

Chairman PATMAN. Value was over several million dollars; wasn't it?

Mr. ROCKEFELLER. I don't recall.

Chairman PATMAN. Will you document that in your reply?

Mr. ROCKEFELLER. I would be glad to document that in the reply.

(The information requested follows:)

The dollar value of the Pan American stock which was exchanged for securities of Resorts International in the trust department accounts of customers of the bank was approximately $20,437,500. This is determined by multiplying the 750,000 shares of Pan American common stock which were exchanged by $27.25, which was the price of each share at the time the terms of exchange were determined.

Chairman PATMAN. Wasn't it very unusual, that is the International Resorts Gambling Casino, isn't it?

Mr. ROCKEFELLER. Resorts International had a large——

Chairman PATMAN. Gambling casino.

Mr. ROCKEFELLER. Had a large resort development, which included condominiums and hotels and various other things.

Chairman PATMAN. Gambling casino.

Mr. ROCKEFELLER. In connection with the hotel there was a gambling casino. I should point out in connection with a large number of resort hotels in that part of the world——

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Federal Reserve Bank of St. Louis

Chairman PATMAN. It is rather unusual because at that very time we were pressing the banks to put more money into housing, we were in a desperate situation, that was in 1968, wasn't it?

Mr. ROCKEFELLER. It was in 1968, sir.

Chairman PATMAN. And we were pressuring the banks, and I remember that we did get in contact with somebody at Chase Manhattan and they were unable to make any money available for housing, although we were in desperate need, and I was very much disappointed when I learned later that you had used a lot of your funds for gambling casinos.

Mr. ROCKEFELLER. Sir, we did not use our funds.

Chairman PATMAN. Well, exchange is the same thing.

Mr. ROCKEFELLER. We exchanged securities in trust accounts.

Chairman PATMAN. Well, you use other people's money, you have charge of other people's money. It was worth several million dollars and you exchanged them for gambling casino stock. That was rather unusual at a time when the country——

Mr. ROCKEFELLER. The exchange of stock for Resort's notes is quite different from gambling casino stock. I think, Mr. Chairman, you are not being quite fair in the implications of what you are saying.

Chairman PATMAN. Let me put it a little bit fairer, Mr. Rockefeller, did you try to exchange it for housing stock of some kind that would tend to——

Mr. ROCKEFELLER. I did not have anything to do with the decision of the investment officer. As a matter of fact, in this particular case, it is a rather good example of the fact that the "Chinese wall" works extremely well, because the action of our trust department and our fiduciary investment department was not known to our lending officers. In point of fact, when the information came out, the account officers handling Pan American Airways were considerably embarrassed because Pan American was not very pleased with the exchange. So I think this is a rather good and tangible indication that the two are completely separated. Neither Mr. Patterson nor I nor anyone in the lending department had any idea this was taking place and this is not surprising. This is why we do it this way, so that the investment officers handle these accounts themselves and do not get inside information and do not get in touch with the lending officer.

Chairman PATMAN. Well, they are obviously trust accounts. This committee in 1967–68 studied trust departments. We found that there were 3,000 banks with trust departments out of the 14,000 banks and the total value of these trust accounts amounted to $253 billion. It surprised us that it amounted to that much. But they did. Then 49 banks held more than half of it. Then recently we have had that list brought up to date, and now there are about $290 billion in trust accounts and 19 banks have half of those trust accounts by amount.

We think it is something that we should look into when so few people are handling so much of the money in this country and not putting any of it into housing, which is what I have been able to discover. It all goes to speculation and high-interest loan charges and gambling casinos and things like that where we can't get any hardly for housing.

This is a brochure of your Resort International here. Here is a picture of one of the wheels that is turning. They lost $4 million last year.

Mr. ROCKEFELLER. Yes, it didn't do very well; so I understand.

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Chairman PATMAN. You would have done better if you had put it in housing.

Mr. ROCKEFELLER. I could not tell you. It depends on what particular housing project. But I would doubt whether there are low-cost housing projects that from an investment point of view would be an appropriate investment for our trust accounts. Indeed, probably the best way for us to reduce the size of our trust holdings would be to put most of the funds into low-cost housing because we wouldn't have the trust funds for very long.

However, Mr. Chairman, I agree with you that it is very important to find some means whereby it could be made compatible with the interest of trust funds to do something in the field of housing. Not long ago, after considerable research and thought, I made a proposal, a copy of which I would like to send you, sir, recommending a means whereby I believe private funds can be put into development, not just of housing, but into the development of satellite communities and the development of new communities within existing cities. I think there is quite a little that needs to be done in this regard, and my suggestion was that there be two new agencies created. One would be a Federal agency which would either be new or the development of an existing one, which would acquire sites for new cities either outside or within old cities, and the other would be a development bank——

Chairman PATMAN. That is what I was going to ask you about next.

Mr. ROCKEFELLER. Good. May I anticipate your inquiry.

Chairman PATMAN. One other thing about that, about the SBIC's that was mentioned a while ago.

Mr. ROCKEFELLER. Could I just finish this thought.

Chairman PATMAN. Yes, go ahead and send me a copy of that. We would like to have that.

Mr. ROCKEFELLER. I would be very happy to.

But the idea would be to create an urban development bank, the securities for which would be bought by the commerical banks and the bonds would be bought by the insurance companies and pension funds. We are getting down to the point that you raised. I believe that this bank would provide the funds for the predevelopment costs of these new communities. I believe when this gets going and if it is as successful as I believe it will be, then it will be possible for our pension funds to start investing. We are spending quite a lot of time in developing this idea, and I think that you—I believe it is entirely consistent with your own philosophy and belief.

Chairman PATMAN. I am glad to know that. There is a question about the National Development Bank. But this setup would not make it illegal for you to transfer trust accounts to the stock in a development corporation that you contemplate? In other words, just like a——

Mr. ROCKEFELLER. If my National Urban Development Bank grows and develops as I hope it will, I believe that it would be an eligible security for trust accounts.

Chairman PATMAN. If you had that before, you could have invested all those 150 accounts, several million dollars, for something in housing rather than——

Mr. ROCKEFELLER. This is perhaps the case. Unfortunately, we didn't in 1968, Mr. Chairman.

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Chairman. PATMAN. On the SBIC's.

Mr. ROCKEFELLER. What the people did was to do the best they thought they could at the time.

Chairman PATMAN. Fine. Now the only reason for the existence of the Small Business Investment Corporation is because banks were not willing to make loans that will take care of small business. First, we passed a bill here in the House that put up $120 million capital, $10 million from each of the 12 Federal Reserve Banks and capital to start off a small business around the idea of a small business investment company. It went to the Senate and they changed it entirely, and the session was near the end, and we had accepted it substantially like they passed it. But the reason we had to do that was because the banks were not getting into this business, not helping us at all. We had to do something. Then before we knew it, the banks were beginning to form these SBIC's and have their own SBIC's. I believe you said you had your own SBIC?

Mr. ROCKEFELLER. We have one, sir. We think it has been very successful.

Chairman PATMAN. But the law was changed, the bank can't own the majority of stock in an SBIC. You know that, don't you?

Mr. ROCKEFELLER. There is a grandfather clause—we still do own 100 percent of ours.

Chairman PATMAN. I know, but you are going to carry out the spirit of the law, I know?

Mr. ROCKEFELLER. We think we are in accordance by the grandfather clause.

Chairman PATMAN. I know it was the intention to get the banks to reduce their holdings below 50 percent. Now, as to how the law was written, I don't remember the language exactly. But we don't want SBIC's to be owned by banks and let them carry around a Government guarantee in their hip pocket and then instead of making the Government liable you get the Government's guarantee. This is not looked upon with favor. Too many of the proposals to change FDIC contemplate that it will be in that direction of taking off the restrictions on banks and making it so that we can use the hip pocket guarantee of the Government. Guarantee of loans and not let the banks——

Mr. ROCKEFELLER. All I can say is that in our own particular case we have something like 160 loans totaling something in the neighborhood of $7 million at the present time. These have been extended to a whole variety of enterprises, including the very interesting black-owned company in Watts where we feel we played a very constructive role in enabling a group of very able black entrepreneurs who had not been able to find funding to go ahead in a very interesting business which I recently visited.

There are a great many of these. There is a very able man who is head of this corporation. We expect to expand it as rapidly as we can and we believe it is very much in the spirit of what the Congress intended when it created the SBIC.

Chairman PATMAN. Now, about the National Development Bank, I was out there the next day or two in Los Angeles after the trouble in Watts. I got a taxicab driver to take me through Watts. I was amazed at the disruption there, but one thing that attracted my attention and really attributed to the culture of life and a lot of those people, in this

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destroying of the buildings there in the center, they destroyed the high interest loan sharks first, the saloons next and then the secondhand furniture store which was a front for the high interest loan charge. They destroyed those first which I felt indicated something else entered into it besides what was pictured in the paper, and you couldn't hardly blame the folks under the circumstances. But I am glad it has been getting along so well after that.

Mr. ROCKEFELLER. You apparently visited the part I didn't see, but I hope you will visit the Watts Manufacturing Co., and give them a very warm welcome.

The CHAIRMAN. Yes, sir; I remember you did find some money for housing out there on the west coast where we have lots of money.

Mr. ROCKEFELER. We have done it in a number of the parts of this country, including New York City.

The CHAIRMAN. Now on the National Development Bank, Senator Sparkman introduced the bill in the Senate; I introduced it in the House. It has been in here with this committee. It could be compared with the old Reconstruction Finance Corporation, although they are not exactly alike.

In 1932, there was a bill introduced on the floor one day. It had never been printed, never been referred to the committee. It was an emergency measure, had to do something right quick. So the banks, railroads, and insurance companies—and we would put up $500 million and it could be expanded 7½ to 1 to help these organizations. Now, I was for it because in helping the banks you help all the people because you can unfreeze your frozen funds and you can take care of a lot of things you couldn't take care of otherwise. It was very necessary, the same way with insurance companies, same way with railroads. We gladly voted for it, the Democrats. Of course, that is when Mr. Hoover was in power. Mr. Hoover was in power, himself, 4 years, but he only had charge of Congress the first 2 years.

The last 2 years, when this bill came there, there were more Democrats than Republicans so the bill was voted out favorably. It made lots of money for the Government and never lost any money. It saved the schools because I can name you States where they had to close their school doors and they couldn't pay their teachers, but the RFC could make loans, they could readvertise their debts, make the payments smaller and maturities longer and they opened up those schoolhouses in these different States on that one thing.

Now, right now, the banks have lots of municipal bonds. At one time, I looked into them. About how much is it. Mr. Rockefeller, they have now?

Mr. ROCKEFELLER. Altogether? I would have to guess. I know it is a large sum.

The CHAIRMAN. It is tremendous. At one time I know they had a 30-percent loss, and I am sure they have got a big loss right now. If they had a National Development Bank they could handle those frozen assets in a way that they could become liquid and get back into the channel of trade and distribution and help the country tremendously.

Now, RFC did so much with it, if we had another bank like that now, the National Development Bank with $1 billion capital instead of $500 million and could expand 20 to 1, instead of 7½ to 1, which would be orthodox, nothing wrong with 20 to 1; the bad thing is 22

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to 1—there is nothing wrong with banks creating money—but since banks have $1 to every $22 created, why it is certainly not wrong for the National Development Bank to have 20 to 1 expansion. Personally, I think it would take care of our credit needs for the future. What do you think about it.

Mr. ROCKEFELLER. Mr. Chairman, I think that the RFC in the days when it was created and very ably run by Mr. Jesse Jones, as you indicate, served a very useful purpose. This was in the depths of the depression. I think probably it was a necessary instrument.

I am not equally convinced we need that particular form of instrument today, and I should say that the National Urban Development Bank, which I was referring to, is quite different in concept than the one that you have just outlined. I would like to persuade you maybe mine is better.

The CHAIRMAN. I would be glad to see your plan. If it is better, I will accept it. But, you see, mine is overall and yours is restricted.

Mr. ROCKEFELLER. It is designed to take care of the requirements of the 75 million new people that we will have in the country in the next 30 years. So it may be restricted but it covers a pretty broad field.

The CHAIRMAN. Well, we have got to have more money and credit some way and I think you recognize that especially on account of the expanding population. We must have it. We must not be restricted by a few banks that have certain restrictions and limitations that they cannot supply the needed funds, although in the Federal Reserve you create money, too, just like these commercial banks. They are the only two institutions that can create money on Government credit. That is quite a lucrative franchise.

Take for instance the banks, some of these become what we call "squeaky wheels," complain about not making much money and restricted and limited. But I think the banks made more last year than they have ever made in history, didn't they?

Mr. ROCKEFELLER. Some did and some didn't.

The CHAIRMAN. I had the staff get up for me the amount of free money that the banks had this last fiscal year. I was really amazed to find out how much it was. Take for instance, business and personal deposits, $175.7 billion; Government deposits, $25.3 billion including the States $17.2 billion; $23.8 billion, in interbank deposits; foreign government and bank deposits, $3.6; a total of $228.4 billion that you didn't pay anything for. That is demand deposits. You don't pay for that.

Mr. ROCKEFELLER. We don't pay, except for the services, of course, that we provide for the customers. We don't——

The CHAIRMAN. Of course, you don't charge the small ones for that? It has to be a pretty low account if you charge.

Mr. ROCKEFELLER. Well, yes, that is true for small accounts which are so expensive to handle that we couldn't——

The CHAIRMAN. That is right.

But, of course, that is comparatively small.

Now, you have created in that year $25 billion, which is all right, too, if you do it in the public interest—I am not objecting to it; I am not objecting to any of these privileges banks have. I am not suggesting that since they do have the most lucrative franchise on earth, creating money on the credit of the Government of the United States, paying

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nothing for it, that they ought to be very careful to engage in some social responsibilities, as other central banks do and help out people on transactions and not overcharge them, charge them a reasonable rate.

Mexico requires 30 percent of the loans be made for housing. Now, of course, over here they think it wouldn't pay, but it is paying in Mexico. They have lots of homes down there.

You take all the central banks, except our own, they use their resources to help out on projects dealing with social problems I think the time has come when we have to call on the Federal Reserve.

Mr. ROCKEFELLER. Mr. Chairman, you said several times the banks have the privilege of creating new funds. I am sure you understand, but just for the record, I think it should be pointed out that individual banks do not have that capability. The banking system, as a whole, does.

The CHAIRMAN. That is a fractional reserve.

Mr. ROCKEFELLER. This is a rather important distinction, and of course their ability to do it is subject to control.

The CHAIRMAN. But the money is manufactured, nevertheless, and on demand deposits it is less than 10 to 1. When the goldsmith started that, $100 in gold was placed with the goldsmith, he gave a receipt for the $100. Now, the person who has the gold didn't want to keep it; didn't want to protect it, and that cost him money and he would rather have the goldsmith receipt, as you know, rather than gold, and he could use that to pay debts just like today. The goldsmith found out that he could issue 10 receipts for one, and he could still be in business and wouldn't be hurt and he did that. That is where the idea came from as to that 10 to 1.

Of course, time deposits came and we never did recognize them until recent years, I believe it was. Take, again, the issue of money, you might say, and equate it on the basis of 3 percent reserve, that is $33⅓ a month. In the last fiscal year the record shows that the banks created $25 billion on a reserve of $1 to every $22 that was created. They comingled the reserve and arrived on the basis of $22 created for every $1 they had. This is pretty good for your franchise, and I am not objecting to it if you will use it in the public interest.

Mr. ROCKEFELLER. We are getting now into something which is interesting to me as an ex-economist, a discussion of very broad issues of international and national finance, which I hope we can pursue. On the question of the banks' sense of social responsibility, though, I don't think they have a different feeling than you do. I think they do feel that they have a responsibility to their depositors and their shareholders as well as to the community.

The CHAIRMAN. Oh, certainly, that is number one to the people who put the money in.

Mr. ROCKEFELLER. We are increasingly seeking opportunities in which we can consistently contribute more to the economy as a whole, and to housing, more than we have in the past. We are making considerable headway in that regard.

The CHAIRMAN. I am disappointed in the banks' not protecting more venturesome loans. I feel in a free enterprise system that ventures are part of it, that sometimes they win, sometimes they lose.

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Mr. ROCKEFELLER. That is fine with equity funds, sir, but I think when you are dealing with your depositors' money, again, they wouldn't leave it with you very long if they thought you were dealing in venture-type of loans where there was a good chance they wouldn't be paid.

The CHAIRMAN. The banks have now a 2.4-percent deduction on loans, don't they, that is, for losses?

Mr. ROCKEFELLER. It was 5-year——

The CHAIRMAN. Seven years from now it is going to be a little lower?

Mr. WIDNALL. Could I draw your attention to the fact that that is the second set of bells for a quorum call for us.

The CHAIRMAN. I will be through in just a minute.

Mr. WIDNALL. I would just like to know what your intent is. Another witness was called. We will be back.

The CHAIRMAN. I think we had better make it 2:30. Will that be all right? Who is our witness? Mr. Meyer; is he here? Would 2 or 2:30 suit you better?

Mr. MEYER. Any time that will suit you, sir.

The CHAIRMAN. Thank you, sir. You are very cooperative.

Mr. WIDNALL. Mr. Chairman, I believe Mr. Rockefeller has a plane that he has to get.

The CHAIRMAN. One or two questions here.

Now, I have got Lockheed and Penn Central. I didn't look very favorably on Penn Central for obvious reasons, and a lot of other people didn't. Now, we find out what caused them to go bankrupt; it wasn't only high interest, it was incompetency and mismanagement and many other things. I think we are right in turning it down. Then Lockheed comes up.

If we began to make loans of the taxpayers' money by a vote of Congress or members of the legislature, I don't think it is a very sound way. I think we ought to have some system to pass on it and get security and then, certainly, it should be provided if we let Lockheed have $300, $200 million; don't you think the taxpayers that furnish that money should be paid first?

Mr. ROCKEFELLER. You mean the funds the people put up should be paid first?

The CHAIRMAN. Yes. Now, they want the Government to save them. The Government puts up its taxpayers' money and puts it up to save a company. Don't you think they ought to be paid back, first?

Mr. ROCKEFELLER. Certainly they should be given adequate recognition and perhaps a preferred position.

The CHAIRMAN. I am glad to hear you say that. I am glad to think surely the taxpayers should come first, and be preferred.

Mr. ROCKEFELLER. I think, however, this is a complicated thing and what Congress has to take into account is the total picture and what is, in fact, the public interest. It seems to me quite conceivable that in this particular situation the failure of Lockheed could do an incalculable amount of damage, not only to the shareholders of Lockheed but to many other companies as well and, therefore, it could well be that the public interest would be served by a special loan guaranteed in some way by the Government.

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The CHAIRMAN. Do you think, generally, the taxpayers should be preferred?

Mr. ROCKEFELLER. I think that they have to be given adequate recognition. Just exactly how they should be handled, I wouldn't care to try to suggest at this point. I haven't followed the details of it very closely.

The CHAIRMAN. I don't want to take more of your time.

I will close this part of it and we can meet after lunch at 2 or 2:30, whichever suits you best.

Thank you very much Mr. Rockefeller. We have enjoyed hearing your testimony. We appreciate the suggestions you made and every one of them will be considered by us. We appreciate your views.

Mr. ROCKEFELLER. It is a pleasure to be with you.

The CHAIRMAN. The committee stands in recess until 2:30 this afternoon.

(Whereupon, the committee recessed at 12:45, to reconvene at 2:30 this afternoon.)

AFTERNOON SESSION

The CHAIRMAN. The committee will please come to order.

This morning I announced that I was placing in the record testimony by Edgar Kaiser, head of Kaiser Industries.

Edgar Kaiser is one of the most successful industrialists the world has ever known. Not only has he continued to make a great success of Kaiser Industries, following the footsteps of his most illustrious father, Henry Kaiser, but he has found the time and the financial and other resources to make a great contribution in helping to solve many of our country's and the world's social and economic problems.

Edgar Kaiser, as we know, was chairman of the committee appointed by President Johnson to study housing problems in the United States and it was, as a result of the kindness of the Kaiser Commission investigation, that led to the creation of the National Housing Partnership which has the potential to make severe inroads in solving our housing needs in this country.

I am sure all members, when they receive their transcripts, will want to take the opportunity to read Mr. Kaiser's statement.

Our next witness is John M. Meyer, Jr., chairman of the board of Morgan Guaranty Trust Co.

Unlike the previous witness, Mr. Meyer, I note with satisfaction that you have described Morgan's Penn Central common stock trading in some detail in a four and a half page appendix to your statement of H.R. 5700 which you submitted to the committee 4 days ago in compliance with the rules. Your efforts are all the more laudable in view of the fact that the Banking and Currency Committee report on Penn Central trading was far more critical of Chase Manhattan's trading than that of Morgan. However, the degree to which the committee accepts your explanation of these transactions remains to be seen.

Mr. Meyer, you may begin by reading or summarizing your statement and the appendix and then the committee will have some questions to ask you.

You may proceed in your own way, sir, and we shall be very glad to hear you and give consideration to your views.

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STATEMENT OF JOHN M. MEYER, JR., CHAIRMAN OF THE BOARD, MORGAN GUARANTY TRUST CO. OF NEW YORK

Mr. MEYER. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, I am John M. Meyer, Jr., chairman of the board of Morgan Guaranty Trust Co. of New York. I thank you for your invitation to appear before the committee in connection with its consideration of H.R. 5700. "The Banking Reform Act of 1971."

On my right is my friend and counsel, Mr. Lloyd Cutler.

The CHAIRMAN. Good afternoon, sir.

Mr. MEYER. The Chairman's letter of invitation to appear referred to the report of the committee's staff in which Morgan Guaranty's sales of Penn Central Co. stock on behalf of clients are discussed. Accordingly, there is attached to my statement an appendix which makes clear that those sales were based entirely on public information.

The New York Clearing House Association, of which Morgan Guaranty is a member, has submitted a statement of its position on H.R. 5700. We subscribe generally to the Clearing House statement, which deals with the bill section by section in its attached Memorandum of Comments. To save time and avoid duplication, I shall forego a section-by-section discussion and focus on what seems to me to be certain of the most critical issues.

There will always be room for reform in banking, as in any other field of human endeavor. To me, banking reform means improvement in banking standards, procedures, and practices—for the benefit of the economy and society at large, and thereby also for the benefit of bank customers, stockholders, and employees.

Banking reform, whether initiated from within or from without, must be undertaken with great care. If there are abuses not subject to remedy under existing law, let us cure them. Let us not, however, in the absence of persuasive evidence, impose rigid new prohibitions on top of the existing system of regulations and laws—which have, I believe, served the Nation well. Rigid new prohibitions can be counterproductive and can reduce the capacity of the banking industry to fulfill its responsibilities.

Improvements in banking have our support. So we agree with the concept of annual disclosure of the securities holdings of bank trust departments and of the voting of these securities. We think it would be wise to place reasonable bounds on the reporting required, to avoid piling up meaningless mounds of papers. It also seems to us that there is good reason to apply similar requirements to all who manage funds for others.

We agree with the principle of full protection for the deposits of public bodies. We believe that a combination of coverage by the Federal Deposit Insurance Corporation with a pledge of securities by the depositary banks where public deposits exceed a specified level in relation to that bank's total capital is far preferable to straight 100 percent coverage by the FDIC.

We would support legislation designed to give the supervisory authorities additional power to deal with abuses which flow from imprudent loans linked to brokered deposits. We would also support

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giving such authorities power, if they do not now have it, to regulate giveaways by banks.

We further consider it appropriate to broaden the existing restrictions on interlocking relationships between competing depositary institutions: commercial banks, savings banks, and savings and loan associations. We respectfully suggest that it would be logical for such legislation to come as an amendment to section 8 of the Clayton Act, as part of the body of antitrust law to which the subject of anticompetitive interlocks thus far has belonged. We therefore support the proposals regarding interlocks between depositary institutions which were offered by the Chairman of the Federal Reserve Board in his statement to this committee of April 26, 1971.

Notwithstanding our basic agreement on the foregoing points, we must join issue with some of the other major features of the bill. As I read the bill, certain directorships and certain holdings of investments by bank trust departments for their customers are considered bad per se. The bill gives no weight to the many benefits that accrue to the public from the service of outside directors on the boards of banks and business firms and unnecessarily interferes with the important fiduciary services banks perform. In the judgment which it appears to render by its restrictions on certain kinds of directorships and certain investment holdings, the bill is not supported by any empirical evidence which would indicate that significant anticompetitive effect or other public injury is connected with such directorships or holdings. The bill would ban all such directorships and arbitrarily limit such holdings, merely because a few scattered cases of abuse may occasionally occur—cases for which existing law provides effective remedies.

I entered the banking business 1 year before the 1929 crash flattened the financial community. One of the things the Nation learned in that disaster was that the laws and internal standards then governing the financial community were not strong enough. With the help of the Congress and some of the new agencies it created, the financial community has made significant progress toward correcting this deficiency.

I mention these events of four decades ago because they made an indelible impression on the generation of bankers of which I am one.

The banking industry has just come through, in the sixties, a longer sustained boom than that of the twenties, and we have come through it with a high sense of responsibility. Even the shock of last year's liquidity crisis, following the Penn Central collapse, was safely absorbed without significant damage to the banking system or to the industrial economy.

This record can be attributed in part to new laws resulting from congressional alterness—and to judicial decisions that deal rigorously with the fiduciary duties of directors and the use or transmission of "inside" information. But I believe the main reason is the lesson we learned and the rigid internal standards the banking industry has zealously enforced.

Banks bear a great burden of public responsibility. Society relies on them to safeguard and invest its savings, to provide funds to businesses, consumers, and governments, and to finance stable, steady economic growth. While performing these continuing roles, banks must

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also develop sound responses to the financial problems of a complex, mobile and rapidly changing society.

To discharge these obligations, banks need access to the best advice and the wisest judgment available. They should not be fettered by sweeping new prohibitions that would isolate them from such advice and judgment. They need more contacts with other segments of the economy, not fewer.

Turning to the specific provisions of the bill, let me identify those which cause our bank particular concern. Sections 2, 7, 8, and 9 would place arbitrary restrictions on the composition of boards of directors. Section 13 would arbitrarily restrict a bank's aggregate holdings for its many fiduciary accounts of stock in any one company, and would prevent a bank from holding as fiduciary its own stock or the stock of its parent. These restrictions would be counterproductive.

First, I would like to discuss the subject of corporate officer or director interrelationships, commonly referred to as "interlocks." With regard to such interrelationships among financial institutions (covered by section 2 of the bill), I have already indicated our agreement with the broadening of restrictions against interlocks between commercial banks, savings banks and savings and loan associations along the lines suggested by Chairman Burns. We do not believe that experience indicates any need or justification for further prohibitions in this area.

Sections 7 and 9 would introduce absolute prohibition against interlocks between a bank and any company with which it has a continuing lending relationship, or for which it manages a pension fund. Section 8 would also ban interlocks between a bank and a company where the bank holds in all of its fiduciary accounts combined more than 5 percent of any class of the company's voting stock.

Those with whom I have consulted advise me that such a ban would have to rest on a different regulatory theory from that underlying existing antitrust laws. These laws impose stringent restrictions on horizontal relationships between competitors. Congress has to date been unwilling to impose any flat ban on vertical relationships in competitive areas of the economy such as banking. Economists recognize that such relationships may sometimes have procompetitive effects and often involve such small shares of any relevant market as to cause little concern about significant antitrust competitive consequences. For these reasons, a blanket rule against all interlocks between customers and suppliers makes little, if any, regulatory sense.

These sweeping and unnecessary prohibitions against interlocks would cause significant harm to banks and their customers. They would substantially interfere with the ability of banks to receive the broadest spectrum of advice on their boards. Equally important, they would deprive any company of the benefit of a banker's broad-gage experience and judgment on its own board, except at the price of preventing the company from obtaining material banking services from the director's bank. The relationships we are discussing do not involve any conflict of interest or potential abuse as to the overwhelming majority of issues coming before each board. In the occasional instance that might arise, existing law as to disqualification, nondisclosure of inside information, and the fiduciary responsibility of directors is wholly adequate to deter and provide a remedy for violations.

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At Morgan Guaranty, for instance, it is only in extremely rare cases that our board of directors has to consider a matter relating to a company with which one of our own outside directors is associated. In those rare instances, that director disqualifies himself and takes no part in the decision. Similarly, in the rare case when a matter involving Morgan Guaranty comes before the board of a company of which I am an outside director, I take no part in the decision. I believe that the same rules of abstention are followed as a general practice on most boards.

Banks in the major financial centers, and also in smaller cities and towns, now serve a wide range of business firms, and many business firms now deal with a large number of banks. Broad, multibank participation in substantial loans to a single company has become commonplace, as the size of an individual company's borrowing needs has grown to exceed the prudent loan size or the legal lending limit of even the largest banks. Such participation enhances competition by increasing the number of banks available to a corporate borrower while allowing each participating bank to hold a well-balanced range of risks in its loan portfolio. The same trend is apparent in other banking services, including the investment management of employee benefit funds where corporations increasingly spread their business among competing banks.

These developments have occurred for sound economic reasons, and the resulting diversity among the customers of banks, and among the sources of banking services available to companies, is an important element in the financial strength of the Nation's economy. Such diversity should not be unnecessarily restricted, as it would be by the interlock provisions of H.R. 5700. Under the bill, the larger the number of business firms that each bank serves, the narrower would be the range of sources from which both banks and business firms could obtain outside directors.

The proposed interlock restrictions would have a drastic impact on Morgan Guaranty. To illustrate this, I will describe briefly some of the functions our board performs, and some that it does not perform.

Our board does not act on the bank's day-to-day operations. It does not act on individual loans. It does not act on the purchases and sales of securities by the bank's trust and investment division. Rather, the board is concerned with matters of major bank policy, such as entry into new financial markets (for example, oversea expansion), anticipation and responding to social, economic, and financial trends, dividend policy, internal controls, capital requirements. Above all, it has responsibility for the choice of the bank's top management and for reviewing that management's performance.

The effective discharge of these duties by the board of a bank requires the participation of men from outside the banking field, men of stature, competence, and objectivity, with a wide scope of business experience. New York State banking law specifies that at least two-thirds of the directors of a bank chartered by that State must be outside directors. We believe that requirement is a sound one. We try to obtain the wisest and most experienced outside directors we can. We believe the executives and directors of major business firms are among those best qualified for this service. Their experience qualifies them to

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deal with the widest range of complex business problems. They bring a broad range of judgment and skills to the bank.

Morgan Guaranty is a wholesale bank emphasizing service to corporate clients. It has continuing lending relationships with many of these corporations or invests their employee benefit funds. The bank also holds for clients, with power to vote, more than 5 percent of a class of stock of a number of corporations. Any one of these relationships would invoke the restrictions of the bill, and thus would bar us from obtaining the best qualified outside directors.

Morgan Guaranty's board of directors consists of 24 directors, of whom 16 are "outsiders." H.R. 5700 would disqualify all but one of these valuable outside directors and would for all practical purposes preclude obtaining for our board the kind of business experience and judgment they now bring. I am not suggesting that qualifications of the kind they possess are the only ones that can be valuable to a board. Other kinds of background, training, and experience also have their contributions to make, and I think there will be an increasing tendency to enlist for boards individuals who can bring valuable insights besides those of the businessman. But the need for the kind of contribution the business leader can make as an outside director of a bank will continue, and H.R. 5700 would come very close to making it impossible to fulfill this need. In smaller communities served by only one or two or three banks, the effects would be particularly serious.

Before turning to section 13 of the bill, dealing with stock ownership. I would like to discuss Morgan Guaranty's trust and investment business with you. Our business in that area is handled in our trust and investment division, which has a staff of 525, including 143 officers.

We are proud of the reliance placed on us in the management of fiduciary assets. We are fully aware of the responsibilities we bear as one of the leading fiduciary institutions in the Nation.

Our most substantial area of fiduciary business is in the field of employee benefit funds, where we act as trustee for funds established by more than 400 corporations and institutions. Other fiduciary assets come to us under the provisions of wills or living trusts. Others are in investment advisory accounts maintained by individuals and institutions, such as colleges, hospitals, and charitable foundations.

The accounts we supervise are subject to their own individual investment objectives, which vary widely. In order to attract and hold business, we must first be certain that we discharge our full legal fiduciary obligations. We must also be alert to the test of investment performance, which is constantly applied to us.

Competition in the fiduciary and investment management field is intense. By far the greater part of the assets entrusted to our care are withdrawable at the option of the client. Last year, business which moved to us from other fiduciaries totaled several hundreds of millions of dollars in asset value, and accounts that left us to go to other fiduciaries, I am sorry to say, also ran into the hundreds of millions. To remain competitive, and to give the best possible service to those who place their confidence in us, we must have the flexibility to make those investments we deem most advantageous for any particular account at any particular time.

Section 13 of H.R. 5700 would make it unlawful for a bank such as Morgan Guaranty Trust Co. to hold, in any fiduciary capacity, more

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than 10 percent of any class of securities for which a registration statement has been filed under the Federal securities laws. This provision would impede the performance by banks of the investment functions entrusted to them.

The stated purpose of the provision is, by restricting bank fiduciary holdings, to eliminate the possibility that insured banking institutions could exercise "undue influence or control" over nonbanking businesses.

There are, of course, special situations such as family owned companies or intermediate investment-vehicle companies where our trust and investment division holds a controlling interest. As we understand the purpose of the provision, it is aimed not at these incidental cases but at the aggregation of substantial holdings in major, widely held business firms. Morgan Guaranty Trust Co. neither seeks nor exercises "influence" or "control" in any sense over such companies.

The bank does not decide that it wants to hold any specified percentage of a particular stock. The trust and investment division invests in what it deems to be attractive securities for a wide range of fiduciary account needs; if the overall holdings aggregate any particular percentage, it is not because of an intent to gain influence or control over a company.

In many cases, the trust and investment division decides to reduce or not to increase the holdings in a given company, even though it continues to regard the company as an attractive investment. Such decisions are made with reference to individual accounts, either to increase diversification in the portfolio or to enhance liquidity. Because of the diversity of investment objectives and other considerations among the many accounts it manages, the division during any given period can well be both buying and selling the same company's stock—buying for some accounts, selling for others.

We see no public need for the restriction that would be imposed by section 13. It is wholly arbitrary and would, in many cases, hamper insured banks in achieving the best investment results for the beneficiaries of fiduciary accounts. It would complicate the discharge of fiduciary obligations, both in investment selection and with respect to the tax and other considerations relevant to a particular fiduciary account. Since the provision restricts only insured banks, other financial institutions and advisers would be free of such restrictions. Insured banks would be at a serious competitive disadvantage in the area of investment management.

In this regard I would refer the committee to the thoughtful remarks on this subject by other witnesses, particularly Commissioner Smith of the Securities and Exchange Commission in his statement to this committee (pp. 19–21).

We are also concerned about the provisions of section 13 that would flatly prohibit the holding by any bank in a fiduciary capacity of any shares of its own stock or of the stock of its parent holding company, including shares held in bank profit-sharing plans. If this proposal is aimed at preventing self-perpetuation by bank managements, prohibition against voting such stock is all that is required. I understand that existing laws already prohibit such voting in many cases. In any event, we agree that it is sound policy to provide against such voting. In our bank we have a firm policy to this effect, and we do not vote any of the stock of our parent holding company which is held in fiduciary ac-

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counts, including the stock held in Morgan Guaranty's profit-sharing trust. Where we have a cofiduciary, the stock is voted by the cofiduciary without any participation on our part.

If the proposed restriction is also aimed at preventing the possible conflict of interest which may arise between a bank which holds its own stock in trust and the beneficiaries of the trust, the proposal appears to be unnecessary. I am advised that, under general principles of fiduciary law, a bank may not purchase or retain its own shares in a fiduciary capacity unless expressly authorized to do so by the underlying instrument.

It should be clear by now that we oppose sweeping prohibitions which would interfere with the ability of banks to discharge their fiduciary obligations and to obtain the best judgment and advice at the board-of-directors level. The main basis for our objection is that there is no proven need for such proscriptions and that we believe existing law is adequate to remedy the occasional wrongs which may occur. We do, as I stated earlier, favor legislation that would require all who manage funds for others to make appropriate disclosure of investment holdings and of fiduciary voting.

You have been very courteous to me, and I thank you for this opportunity to express our views on H.R. 5700.

The CHAIRMAN. We will also insert in connection with your remarks your appendix if you desire that.

Mr. MEYER. I would appreciate that if you would, Mr. Chairman.

The CHAIRMAN. Without objection, so ordered.

(The appendix to Mr. Meyer's statement follows:)

APPENDIX TO STATEMENT BY JOHN M. MEYER, JR., CHAIRMAN OF THE BOARD, MORGAN GUARANTY TRUST COMPANY OF NEW YORK

The invitation to appear before this Committee in connection with H.R. 5700 referred to the Report of the Committee staff issued on March 29 and entitled "The Penn Central Failure and the Role of Financial Institutions—Part V." Since Morgan Guaranty Trust Company is one of the nine financial institutions whose sales of Penn Central common stock during the period April 1–June 19, 1970, are discussed in that Staff Report, I am adding this appendix to my statement before the Committee in order to deal specifically with the content of the Report insofar as it relates to Morgan Guaranty.

The Staff Report makes sweeping suggestions that sales of Penn Central stock by some of the nine institutions mentioned in the Report, including Morgan Guaranty, may well have been made on the basis of information not available to the public. I therefore am taking this occasion to state categorically to the Committee that the sales of Penn Central sock by Morgan Guaranty were not made on the basis of such information.

At Morgan Guaranty all decisions to buy or sell stock for accounts over which we have sole investment discretion, or to recommend purchase or sale where we have only partial discretion or act in a purely advisory capacity, are made in the Trust and Investment Division. All decisions to sell or recommend sale of Penn Central stock were made in that Division. The Division did not have confidential information about Penn Central. It did not obtain confidential information—as the Staff Report might seem to suggest—from the two members of Morgan Guaranty's Board of Directors who were also directors of Penn Central. It did not obtain confidential information from any officer or employee of the bank who was concerned with Morgan Guaranty's commercial banking position vis-a-vis Penn Central. The bank has strict rules, in writing, forbidding any flow to the Trust and Investment Division of such information from any other part of the bank.

Now let us review the events. At the beginning of April 1970, Morgan Guaranty's Trust and Investment Division held in trust and investment advisory accounts an aggregate of 1,001,275 shares of Penn Central common stock. By

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that time there had been wide public notice of Penn Central's financial difficulties. The Staff Report (p. 3) notes: "Prior to April 1, 1970, it was general knowledge within the financial community that the Penn Central Transportation Company was having financial difficulties, particularly after the discontinuance of the normal quarterly dividend for the last quarter of 1969."

During the month of April the Trust and Investment Division, acting for its trust and investment advisory accounts, sold a total of 45,375 shares of Penn Central common stock, which was less than 5% of its total holdings.[1] Surely this is not the conduct of a seller acting on the basis of confidential information. And indeed the Trust and Investment Division was not so acting.

Total sales by the Division during the period from May 1 through May 28, 1970 were 21,542 shares—even less than during the month of April. Again, the very limited amount of selling in relation to total holdings refutes any inference that the selling was based on confidential information.

All the rest of the sales referred to in the Staff Report were made after the public announcement on May 28 of Penn Central's decision not to proceed with the proposed Pennsylvania Company $100,000,000 debenture financing, which the Staff Report (p. 4) aptly characterizes as a significant public event. On May 29, after learning of that significant and widely publicized event, Morgan Guaranty's Trust and Investment Division decided to sell all Penn Central common stock held in pension and other employee benefit accounts where it had sole investment discretion, and to sell it as rapidly as possible without unduly affecting the price of the stock. The Division's Securities Trading Department was instructed to carry out this selling program. At the time of that decision, on May 29, the number of shares of Penn Central in sole-discretion pension and other employee benefit accounts was 838,200. A total of 369,700 shares were sold from those accounts by June 19.

From accounts other than pension and employee benefit, an additional 33,762 shares were sold between May 29 and June 19. All told, 403,462 shares were sold during the period. This very large volume of sales in the aftermath of the May 28 announcement, compared with the relatively small volume of sales before, makes it immediately apparent that the sales were made, not on the basis of any confidential information, but in response to significant public events, the latest of which was the cancellation of the Pennsylvania Company financing.

The program of selling all Penn Central shares held in sole-discretion pension and other employee benefit accounts, initiated on May 29, was not completed until June 30. More shares were sold after June 21, the date Penn Central Transportation Company filed for reorganization, than were sold before that date.

The Staff Report (p. 22) notes that Morgan Guaranty's sales were particularly heavy during the period May 29 through June 10, the period immediately following the public announcement of the collapse of the proposed financing. The Staff Report then goes on to state that the "material submitted by Morgan Guaranty does not explain the basis" for those sales. This, it seems to me, is a surprising statement, for two reasons. First, the Staff Report's own timetable (p. 4) of "significant public events affecting trading in Penn Central stock" makes the basis for the sales abundantly clear. The basis was the May 28 announcement. Second, Morgan Guaranty was not asked by the Committee staff to "explain the basis" for its sales during any period.[2]

The Staff Report (p. 23) notes that most of the sales of Penn Central stock by Morgan Guaranty during the May 29–June 10 period were ratified by the bank's Committee on Trust Matters after the sales occurred. It says: "This was quite different from the Committee's prior practice of approving the sales before they were made."

This apparently reflects a misunderstanding. In the practice of Morgan Guaranty's Trust and Investment Division, specific purchases and sales of stocks for pension and employee benefit accounts always are ratified after the transactions have been carried out. In the May 29–June 10 period, 90% of the sales made were for such accounts.

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[1] This figure, and those hereafter given for sales by the Trust and Investment Division, are somewhat larger than those contained in the Staff Report, principally because the Report derived its figures from a survey of only some of the broker-dealers through which Morgan Guaranty effected its sales.

[2] The Staff Report (p. 22) also comments that the material submitted by Morgan Guaranty does not "show whether these sales were made from discretionary or non-discretionary trust accounts." The original written request for such a breakdown was withdrawn by the Committee staff to make possible earlier submission of the data. It was not renewed in the more than six months which intervened between Morgan Guaranty's submission of material and the publication of the Staff Report.

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Those preparing the Staff Report may have assumed, because certain sales made for accounts other than pension and employee benefit funds were approved in advance by the Committee on Trust Matters while others were ratified after the transactions had been carried out, that a change in practice occurred. In fact, specific purchases and sales for such accounts in many cases are ratified after the transactions have been carried out.

All the facts as to Morgan Guaranty's activity in Penn Central stock point to one conclusion: that Morgan Guaranty in no way traded on the basis of confidential information.

The CHAIRMAN. Now, in examination of this sale of Penn Central stock by Morgan, Chase Manhattan and Continental, a very interesting pattern develops. This pattern can be seen quite clearly on the chart that has been given to you. As can be seen from the chart, Chase Manhattan began heavy sales on May 22, completing such sales on May 28. On May 29, the very next trading day, your bank began heavy sales. Your bank completed heavy sales on June 11 and the very next trading date, June 12, Continental Illinois began its heavy sales. Continental sales continued through the last trading day prior to the filing for bankruptcy on June 19. The pattern of these sales of Penn Central stock raise the following questions concerning the possibility of a coordinated sell-off effort by the three banks involved.

Can you explain the sales pattern as shown on the chart, Mr. Meyer? Is this pure coincidence?

(The chart refered to faces this page.)

Mr. MEYER. I do not believe I can, sir. I would like to comment on one comment you made, if I may.

The CHAIRMAN. Yes, sir, you may.

Mr. MEYER. If I understood the words correctly, something to the effect that perhaps this established a pattern of cooperation or coordination. I just want to tell you, sir, and this committee, that our securities trading department, which is a part of the trust and investment division, keeps its own counsel and does not discuss its purchase or sales with anyone outside the bank. We had no knowledge of what these other banks were doing.

The CHAIRMAN. Now, you quote again the phrase that you attribute to me if you please about the pattern.

Mr. MEYER. I thought you said something to the effect that this schedule showed a pattern.

The CHAIRMAN. Well, I said a very interesting pattern develops.

Mr. MEYER. Right.

The CHAIRMAN. All right. Have you finished, sir?

Mr. MEYER. I have.

The CHAIRMAN. Now, then, is this a pure coincidence? See, the chart shows itself you did not trade at the same time. When one traded the other two did not. When the second one traded the first and third did not. When the third traded the first two did not. I just do not understand how that could happen unless there was some understanding or some unconversational understanding.

Mr. MEYER. Well, I would like to repeat what I said a moment ago, Mr. Patman. Certainly to my knowledge there were no conversations between our securities trading department and the departments of the other banks.

The CHAIRMAN. Yes, sir. Did your bank meet with Chase or Continental during the period of May 22 to June 19 to discuss Penn Central or any other matter?

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DAILY SALES[1] OF PENN CENTRAL COMMON STOCK BY THREE BANKING INSTITUTIONS DURING PERIOD MAY 15, 1970 TO JUNE 19, 1970

Date	Chase Manhattan Bank	Morgan Guaranty Trust Co.	Continental Illinois National B&T Co.
May:			
15	0	0	0
16 (2)			
17 (3)			
18	0	0	0
19	0	7,600	0
20	9,000	3,775	0
21	2,000	200	0
22	134,300	0	0
23 (2)			
24 (3)			
25	53,200	0	500
26	32,100	0	0
27	31,700	0	9,500
28	35,300	0	10,000
29	0	44,900	0
30 (2)			
31 (3)			
June:			
1	12,100	28,500	0
2	0	25,900	0
3	0	24,200	0
4	3,000	40,600	0
5	100	31,000	0
6 (2)			
7 (3)			
8	0	0	0
9	0	96,500	0
10	0	44,100	500
11	0	8,400	0
12	90,700	0	108,950
13 (2)			
14 (3)			
15	0	0	56,100
16	0	0	37,700
17	500	0	44,200
18	1,500	11,600	24,600
19	1,800	1,100	19,400

[1] Because the dates were taken from the brokers' responses to the SEC questionnaires, the dates may not agree exactly with the records of the institutions.
[2] Saturday.
[3] Sunday.

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Mr. MEYER. Would you state the dates again, please?

The CHAIRMAN. Did your bank meet with Chase Manhattan or Continental during the period May 22 to June 19 to discuss Penn Central or any other matter?

Mr. MEYER. Representatives of our commercial banking department attended a meeting where there were I believe representatives of 53 other banks present. I do not recall the precise——

The CHAIRMAN. You mean of 53 other banks?

Mr. MEYER. Yes, 53 banks. I believe that was on May 27.

The CHAIRMAN. That is the only time that you have recollection of or knowledge of?

Mr. MEYER. Right.

(The following supplemental information was received from Mr. Meyer for inclusion in the record:)

Mr. Myer understood this question to refer to meetings of the entire 53-bank group. Subsequent to May 28, 1970, which was the actual date of the 53-bank meeting, there were a number of meetings attended by officers of Morgan Guaranty and other banks, including Chase Manhattan and Continental, for the purpose of working out the details of a possible government-guaranteed bank loan to Penn Central Transportation Company. At none of these meetings did the Morgan Guaranty officers in attendance ever discuss sales of Penn Central stock by Morgan Guaranty's trust department or the trust department of any other bank, and such officers had no knowledge as to any such sales.

The CHAIRMAN. Now, when I was talking to a group of Penn Central directors on one Saturday—we spent most of Saturday—it seemed to me that they were insisting that they were not in any danger of really just causing a total loss or anything like that. At the same time they were not insisting that they could not avoid bankruptcy. In fact, they told me that if I did not agree with them and support the loan that they would go into bankruptcy by 12:01 the next night. Approximately 77 banks held the obligations loan of the Penn Central—and they would not agree to put up any more money, although they are the ones that had to be bailed out, they would not agree to put up a penny. It occurred to me that $225 million would have just been chicken feed or practically nothing in comparison to what the 77 banks had invested in Penn Central and would be bailed out if the 225 million were granted as a loan by the Government. But don't you think that when the Government by political vote, which is not a very good way to make a loan, as you know, if they commit the taxpayers' money, $200 or $300 or $400 or $500 million, whatever it is, to bail out a concern, we will say Lockheed that is up now, that the other debentures and obligations and bonds and notes should be subordinated to this claim which should be the first claim if the taxpayers are going to put up the money to save them. Shouldn't that money be paid back first if they are saved?

Mr. MEYER. Mr. Chairman, if you will permit me, it seems to me there are two questions there. One, any discussions which I heard which concerned a possible Government guarantee of loans to the Penn Central, at no time as far as I am aware concerned a guarantee of loans which a bank presently had outstanding. Guarantees of future loans pertain solely to new money and not to the existing loans which

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a bank had on its books. In my language, sir, that was not a bailout of the bank.

The CHAIRMAN. I know, but the banks would get the benefit out of it?

Mr. MEYER. That is quite true.

The CHAIRMAN. Well, if they get the benefit of it why should not they have enough interest in it that they could make sure that the taxpayers, if they are——

Mr. MEYER. I think there should be proper provision made for the taxpayers in the event there is a Government guarantee.

The CHAIRMAN. In the event it recovers and is saved, why the first money should go to paying the taxpayers back?

Mr. MEYER. Sure. I think there ought to be adequate protection.

The CHAIRMAN. Whether to pay the bank $250 million, whatever it is, or whether it is the creation of new money, it is all the same from one standpoint, that the taxpayers are furnishing the money and if that saves the company the taxpayers should be paid back first?

Mr. MEYER. I think the taxpayers should have adequate protection, yes, sir.

The CHAIRMAN. Well, that is the proposition I put to the group of Penn Central directors and government official that met with me. But since the banks would not subordinate their obligations and they would not agree to pay the taxpayers first, of course I told them I could not be for it. I was against it. They did go into bankruptcy the next day just like they said they would do. I think the disclosures since that time have justified the opposition of those of us who opposed it for that reason, because certainly if there ever was a case of insiders taking advantage of a situation this Penn Central is the outstanding example of the century, a $7 billion concern, much over a hundred years old.

My time has expired.

Mr. Widnall.

Mr. WIDNALL. Thank you, Mr. Chairman.

We appreciate your coming before the committee, Mr. Meyer and giving your testimony.

Mr. MEYER. Yes, sir.

Mr. WIDNALL. On July 8 of 1968 our committee issued a report entitled "Commercial Banks and Trust Activities, the Emerging Importance on the American Economy." An underlying thesis of the report was that 5 percent or more holding of stock was actual or potential control of a company. The chapter heading of that report reads "The airlines and the banks who is in control?"

Morgan Guaranty was listed as holding in its trust department as of July 21, 1967, 7.5 percent of American Airlines, 7.4 percent of TWA, 8.2 percent of United Airlines. By implication, the bank trust department controlled three airlines, since in each case stock held exceeded 5 percent.

I am interested in what has happened to your implied sinister position in controlling these airlines. What was your trust department's percentage holdings in these three airlines at subsequent periods, such as No. 1, June 30, 1968, about a year after the initial reporting and only a few days prior to publication of that report. Do. you have the figure with you?

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Mr. MEYER. I do not, sir. I can say this, I can get the figure on the date you request. Those shares were originally purchased by our trust and investment division for investment purposes, not for purpose of control. Subsequent to the dates mentioned in the 1968 report, the holdings of shares in those companies were substantially reduced or eliminated. I do not know the figures as of the present time or as of the dates you mentioned. I would be glad to get them for you if you wish me to.

Mr. WIDNALL. Well, supplementing the question I just asked, would you give me the figures for December 31, 1968—or give the committee, I mean to say, the December 31, 1969, and December 31, 1970?

Mr. MEYER. Yes, we will.

(In response to the information requested by Mr. Widnall, the following information was received from Mr. Meyer:)

APPROXIMATE PERCENTAGES OF OUTSTANDING COMMON STOCK OF 3 AIRLINES HELD BY MORGAN GUARANTY IN TRUST AND INVESTMENT DIVISION ACCOUNTS

[In percent]

	July 21, 1967	Dec 29, 1967	June 28, 1968	Dec 31, 1968	Dec 31, 1969	Dec 31, 1970	May 7, 1971
American Airlines, Inc	7.5	7.2	0.4	0.3	0.3	0.3	1.4
Trans World Airlines, Inc	7.4	6.0	.5	.6	.4	.3	.1
United Air Lines, Inc (now UAL, Inc)	8.2	9.2	.7	.5	.3	.1	1.0

The CHAIRMAN. Mr. Widnall, would you yield for me to read exactly the language in the subcommittee report?

Mr. WIDNALL. Yes, I will yield.

The CHAIRMAN. It says:

> The subcommittee in carrying out this survey determined that in general, a stockholding of 5 percent or more of any class of stock in a single corporation was a significant factor in judging the extent to which a bank might have substantial influence or control over a corporation.

Mr. WIDNALL. Well, I tried to get at that, Mr. Chairman.

The CHAIRMAN. Thank you very much for yielding.

Mr. WIDNALL. I certainly hope if the regular trust reporting dates are different than the dates that I have quoted, that you can so note and use the regular reporting dates.

Now, I would also like your comment on stocks being sold or holdings reduced during those periods followed by this question: Did the trust department sell these airline holdings to give up control or was the action taken because of investment considerations? I understand there has been some sale.

Mr. MEYER. Then investment in the first instance was made for investment purposes and not for control, and the sales were made for investment purposes and not to divest control because control was never there.

Mr. WIDNALL. You want to emphasize that first of all you never had control of any of those corporations, even though you had 7.5 percent of American Airlines, 7.4 of TWA and 8.2 of United Airlines?

Mr. MEYER. That is correct, sir. I do want to emphasize that we purchase for investment. Our success, whatever success we have had in the investment field and managing other people's money, is entirely

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premised on the fact that we invest for their benefit and if we had not been reasonably successful they would have long ago left us.

Mr. WIDNALL. Do you think there is any point percentage-wise where in the first place a small corporation as against a large corporation, control would be established by having a certain percentage, 10 percent, 15, 25, 50? Could we have the benefit of your views on that?

Mr. MEYER. I do not think there is any percentage, Mr. Widnall. The SEC commented on that in their long study, 3,400 pages. In my mind control is a matter of fact rather than a matter of supposition. I think one could argue with considerable intellectual honesty that control is established when a person has over 50 percent. There you have a majority of votes and can control and vote the board out or in. To my mind that is not so with anything less. Any specific holding of any one investor or trust department is not by itself the sole determining factor.

Mr. WIDNALL. Where you are holding stock in these trusts the stock is held under different terms in most every stock; is that not so?

Mr. MEYER. That is correct, sir.

Mr. WIDNALL. So that in many instances you would have the absolute right to vote the stock?

Mr. MEYER. That is right.

Mr. WIDNALL. In possibly other instances there would be modified parts of that agreement where there would be consultation with the stockholder or something like that; is that not so?

Mr. MEYER. That is correct, sir.

Mr. WIDNALL. What would you say was the average in connection with that? First do you have the right and do you vote down the line or what is the usual arrangement?

Mr. MEYER. Our investment accounts of that nature fall into three general categories. I think category 1 is best described as accounts where we have sole authority as to purchase or sale and the right to vote.

Category 2 is where we do not have such sole authority but where there is one or more cofiduciaries. The third category is where we have an investment advisory account, where we advise the owner as to what we think is an appropriate sale or purchase, and he decides whether to accept or to reject our suggestions. In those cases the right to vote is lodged entirely in the hands of the owner and not in ours.

Mr. WIDNALL. I would like to continue further, but my time is up. Thank you.

(The following supplemental information to the question above of Mr. Widnall was received from Mr. Meyer:)

Morgan Guaranty's Trust and Investment Division has sole voting authority with respect to common stocks held in approximately one-half of its trust and investment advisory accounts, shares voting atuhority with co-fiduciaries or others with respect to approximately one-third of such accounts, and has no voting authority with respect to the balance. In terms of total market value of common stock held in such accounts it is estimated that the Trust and Investment Division has sole voting authority with respect to approximately 62%, partial voting authority with respect to 15% and no voting authority with respect to 23%.

The CHAIRMAN. Mr. Gonzalez.

Mr. GONZALEZ. Thank you, Mr. Chairman. Thank you. Mr. Meyer, for taking your time.

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Following along the line of questioning by the distinguished minority leader, and you repeated in your verbal testimony which I see in your written testimony on page 12, and I quote, "Morgan Guaranty Trust Co. neither seeks nor exercises influence or control in any sense over such companies."

Going back to the same committee report that Mr. Widnall referred to, on pages 307 through 314 the report states that the Morgan Guaranty Trust Co. did have an unusual number of relationships with 11 of the largest corporations in this one special category. He mentioned the airlines. This one mentions the smelting and refining of nonferrous metals. Morgan's Trust Department held between 5.1 percent and 17½ percent of the common stock in seven of these companies, including Kaiser Aluminum and Chemical Corp., Kennecott Copper, American Smelting and Refining, American Metal Climax, Phelps Dodge, Revere Copper and Brass, Scovill Manufacturing Co., Saint Joseph Lead Co., and Alcan Aluminum Ltd. In addition, Morgan had seven interlocking directorships with six of these 11 companies. Morgan also managed nine pension or profitsharing plans for four of the 11 companies. We do not have information on other important relationships that perhaps Morgan would have with these 11 companies, such as loans and deposits and the like.

The point is that when Morgan Guaranty has such a heavy involvement through stockholdings, interlocking relationships, pension plans with 11 major companies in the same field, that is to say in the same field where these companies would or should be competing against each other, it is very hard to believe that such a relationship could not lead to substantially adverse anticompetitive effects.

In your statement you mention conflict of interest, and in this other one that I read, you talked about no intent to try to influence or control. Well, now, don't you think that it is reasonable to believe that you would influence and that it would be along the lines of anticompetitive trends?

Mr. MEYER. No, sir; I would not subscribe to either of those conceptions. Where we have voting power we feel we should vote, just as we think the citizens should vote in an election. That does not mean we try to influence or control. We do not participate in the day-to-day business practices of these companies or even suggest to whom they sell or what they sell. So we are not engaged in the slightest sense of the word in anything which could be construed as having an effect on competition. Our role is that of an investment manager of funds for other people. That does not carry with it the slightest implication that we try to manage the business of these firms, because we do not, sir.

Mr. GONZALEZ. You would not believe, then, that there is even the slightest scintilla of influence through the fact that you do invest from a purely investment standpoint in an area where, with the best of intentions to help the companies, you could produce from a national interest policy standpoint anticompetitive equations or forces, even with the best intention of helping through investments the individual companies affected?

Mr. MEYER. Well, the SEC just completed a big study. We spent 12,000 man-hours in helping them prepare it and we would like to think we were constructive and frank in our replies. The SEC report—I have not read it all—it is 3,400 pages, as you know. I have read parts

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of it and the parts I have read lead me to believe, and in fact they say so, that they have found no such influence. So I subscribe to their statement. Sure, it is in accord with our practice.

Mr. GONZALEZ. We can disagree on the net or relative influence of percentage interests, in other words, apparently from what you say 5 1/10 percent may or may not have any substantial effect as far as control is concerned. However, I believe you will agree that the general theory or feeling among antitrust lawyers and authorities is that it does not take necessarily 50 percent to have substantial or controlling interest. In many cases it could be considerably less. As the report says, a criteria of 5-plus percent. But it is your opinion that the Morgan Guaranty Trust Co., through its management and its investments and its judgment in handling the trust funds, even though involved in the same field of competition such as in this case, the nonferrous metals, does not have that kind of an influence or control or at least it does not intend to?

Mr. MEYER. That is what I believe.

Mr. GONZALEZ. Thank you very much.

The CHAIRMAN. Mr. Stanton?

Mr. STANTON. I have no questions at this time.

The CHAIRMAN. Mr. Williams?

Mr. WILLIAMS. Thank you, Mr. Chairman.

Mr. Meyer, I want to compliment you on your testimony on H.R. 5700. Actually you are only emphasizing in a very clear, concise manner that which has been emphasized to the committee before about the dangers of H.R. 5700.

Mr. Meyer, did you ever see this chart before, which was distributed here at this meeting here today?

Mr. MEYER. No, this is the first time I have seen it, sir.

Mr. WILLIAMS. Well, I know in your statement, on page 2 in the appendix to your statement, that you say at the beginning of April 1970, Morgan Guaranty Trust and Investment Division held an aggregate of 1,001,275 shares of Penn Central common stock. Then you go on to say that the—the committee staff states that prior to April 1, 1970, it was general knowledge within the financial community that the Penn Central Transportation Co. was having financial difficulties, particularly after the discontinuance of the normal quarterly dividend for the last quarter of 1969.

When was the discontinuance of that dividend announced?

Mr. MEYER. Sometime during the fourth quarter of 1969, sir, I believe.

Mr. WILLIAMS. So, in other words, even prior to 1970, there was every evidence that the Penn Central was in difficulty?

Mr. MEYER. Yes, there was evidence.

Mr. WILLIAMS. Now, the statement has been made that this chart indicates some kind of a pattern. The only thing that I can say about this chart is that it proves that no pattern actually developed, because on May 28, 1970, Penn Central announced her decision not to proceed with the proposed Pennsylvania Co. $100 million debenture financing. That was on May 28.

Now, in the period shown on this chart up to and including May 28, Chase Manhattan sold 297,600 shares of Penn Central stock, whereas you sold only 11,675 shares. Are those figures basically correct?

Mr. MEYER. If I understand correctly, the figures on this chart——

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Mr. WILLIAMS. Up to and through May 28, the date of the announcement by Penn Central of their decision.

Mr. MEYER. These figures were based, I believe, on information which the staff received from brokerage houses. Our figures, I believe, again are not identical with this. In fact, they are somewhat larger than this.

Mr. WILLIAMS. Well, still in all, these figures are even close. You sold—Morgan Guaranty Trust Co. sold under 12,000 shares of common stock at the same time that Chase Manhattan was selling 297,600 shares of Penn Central common stock?

Mr. MEYER. That is approximately right. [The exact figure is 17,522 shares.]

Mr. WILLIAMS. Are you familiar with the appendix presented to this committee this morning by Mr. Rockefeller of Chase Manhattan?

Mr. MEYER. I am not, sir.

Mr. WILLIAMS. Well, I think we can have a copy made available to you. But on page 5 and on pages 7 and 8 Mr. Rockefeller lists the various public announcements and the various information available to the public concerning the financial condition of the Penn Central Railroad, and actually my own reaction is that having had the information which was available even as early as January or February when the annual 1969 annual report of the Penn Central Railroad was issued, I think that I would have realized that this stock was backing a poor financial risk; would you agree with that conclusion?

Mr. MEYER. I agree there were straws in the wind, some of which were very strong, sir.

Mr. WILLIAMS. Now, apparently, according to this chart, right before the the Penn Central filed for reorganization and went into bankruptcy you had sold only a little over 468,000 shares of your over 1,001,000 shares, and you also state here that you sold more shares after the bankruptcy than you sold before. I agree with you that it is a very surprising statement when our staff report then goes on to say that your sales were particularly heavy during the period May the 29th through June the 10th, May 29th being our own staff's indication of a significant event and then the staff reports that material submitted by Morgan Guaranty does not explain the basis for those sales. I would like to say that anybody who was in the trust department and did not recognize this sort of thing does not deserve to be in anybody's trust department.

Now, this morning for the first time I have heard some comments at this meeting and they were made by the chairman about what happened on this Saturday meeting which the rest of the committee members read about in the newspapers. The statement was made this morning that at a meeting on a Saturday which Mr. Patman had with Penn Central directors and representatives from over 70 banks that these $225 million Government-guaranteed loans were discussed.

I would like to ask Mr. Patman if at any time during this meeting the banks that made the loans to Penn Central offered to subordinate their loans to the Penn Central in favor of a Federal Government guaranteed loan?

The CHAIRMAN. The banks were not there. They had somebody representing them.

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Mr. WILLIAMS. I said when you met with representatives of over 70 banks.

The CHAIRMAN. They would not put up a dime or permit their obligation to be subordinated or to pay back the Government first.

Mr. WILLIAMS. I did not ask you if they offered to put up a dime. I am asking you if at any time the representatives of these banks offer to subordinate the loans of these banks to the Penn Central in favor of a Federal Government guaranteed loan?

The CHAIRMAN. No; they said they would not do it.

Mr. WILLIAMS. Is there any type of record of this meeting? Were any notes taken?

The CHAIRMAN. Not to my knowledge. Now the interviews you talk about in the newspaper, they came from me, not from the people there.

Mr. WILLIAMS. In other words, there is no type of record of any kind of this meeting?

The CHAIRMAN. Not to my knowledge. Now, it is possible some of these people there made notes. I am sure they did. But there is no accurate record made of it, no reporter.

Mr. WILLIAMS. Was this any kind of a secret meeting? Were members of the public invited?

The CHAIRMAN. They asked me to meet with them. That is all. They determined who would be there. I did not.

All right, Mr. Wylie.

Mr. WYLIE. Thank you, Mr. Chairman.

Thank you, Mr. Meyer, for a very significant contribution.

Purchasing stock for investment purposes implies that you have confidence in the existing management of that company. I suppose, and therefore it follows that you would have no incentive to exercise control over that company; is that a fair statement?

Mr. MEYER. That is a fair statement; yes, sir.

Mr. WYLIE. However, suppose you acquire 5 to 10 percent of the stock of a corporation and after a year or two the corporation starts downhill. It is obvious by anybody's standards. Would you at that point be more inclined to divest the stock you have in that company or utilize whatever resources you have to exercise more control over the company?

Mr. MEYER. Our first inclination would be to dispose of the shares.

Mr. WYLIE. You would not attempt to protect the investment you have. You think the best way to protect the investment you have would be to divest yourself—why would that be, sir? Would it depend on the size of the corporation or what kind of corporation it is, or——

Mr. MEYER. You are quite right in your initial statement that one of the considerations and perhaps the most important consideration in making an investment in the first instance is the management, its ability, its integrity and its character. It is also tied up with the nature of the industry and that company's performance in the industry. If two or three things happen simultaneously, whether the industry is facing heavy going or whether the industry is doing well and that particular company is doing poorly, then you do have to decide whether you want to dispose of the stock and find another investment which seems relatively more attractive. These things over a period of time all come down to one's judgment and opinion, and fortunately

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most of the time the judgment proves to be right. There are occasions when it is not.

Mr. WYLIE. Yes, sir.

I think what I am saying, in the case of the Penn Central Corp., you did have a considerable amount of stock. Then as you indicated in questioning from Mr. Williams, you say that the corporation was going downhill and so at that point you attempted to divest. If it had been possible to acquire enough shares to control ownership of the corporation then there might have been other considerations?

Mr. MEYER. Well, that is right, sir. Percentages are very difficult, they are elusive—control would carry with it the implication that we could force an election of a new board of directors, but that was not the case.

Mr. WYLIE. All right. Now, in your testimony you indicated that you would not favor this prohibition against interlocks, I believe, is that correct? You did say that you would support the statement of the New York Clearing House Association. I am not sure as to what their position was on interlocks, but I think the American Bankers Association took the position that they would not object to some revision on interlocks if it were limited to a geographical area between competing depositary institutions. Would you favor a provision such as that?

Mr. MEYER. Our position, sir, as to a ban on interlocks which would apply to competing depositary institutions would include the concept of an area. For example, I can imagine an officer of our bank who is a trustee of a suburban savings bank in his own town and they are in no way competitive with Morgan Guaranty or any other New York commercial bank. It is a suburban savings bank, active in real estate lending.

Mr. WYLIE. So the geographical area concept might not necessarily be the whole test; is that what you are saying?

Mr. MEYER. No, not the whole test, but it could be one's test. I would think there are so many variables, and things to be weighed, that it is best left to regulation rather than try to draft a law which would cover all conceivable points and consequences.

Mr. WYLIE. Thank you.

The other area—well, I think the American Bankers Association thought there might be some area for improvement in the case of equity participation. Do you see possible mischief here that could be corrected?

Mr. MEYER. Well, equity participation, sir, you have to break down in two fields, one by the commercial part of a bank and another by the trust department. In our own case we seldom take, on the commercial side, an equity either in terms of warrants or a share of gross revenue side, an equity participation either in terms of warrants or a share of gross revenue or shares of stock. When we have made a loan which turned out to be bad and the company is reorganized or its debts restructured in due course, then we may take an equity participation. I believe that would be ruled out as I read this bill. I think the bill would also rule out the use of equity participations by SBICs. It would rule out the taking of equities in various real estate mortgage loan transactions, both commercial—well, primarily commercial, because they

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have a corporate form. I think myself that equity participations have added to the flow of funds available to the building industry rather than detracted from it.

Mr. WYLIE. Thank you very much, sir.

The CHAIRMAN. Mr. McKinney?

Mr. MCKINNEY. Thank you, Mr. Chairman.

Mr. Meyer, nice to have you.

Mr. MEYER. Thank you, sir.

Mr. MCKINNEY. I am sorry that there are not more members here to hear you, but I am sure we will all read your testimony as I found it very valuable.

Just as a passing comment, I think that bankers, while they may be running terrified before this bill, as I would if I were a banker, should feel complimented because I have heard since these hearings began that not only do you run some of those most complicated banking systems in the world but you seem to be implicated in running the railroads, airlines, nonferrous metal business, the shipping business, and many others, and I guess I would feel fairly proud if I thought one of my directors could wield this massive influence on the world, and I have heard it intimated that you run certain parts of Congress, but I do not believe it.

I would like to emphasize a point that I think Mr. Widnall brought out and I think you were quite clear on it, but it seems to pass by the notice of a great many of the members of this committee, and that is as a trust department—and I believe at least as I used to know the old Guaranty Trust Co., you were famous as the widows protector, I think. You had many kinds of trust funds; isn't that correct?

Mr. MEYER. That is correct, sir.

Mr. MCKINNEY. Would you say or could you give us in the individual trust fund, let us say, separate from the corporate pension fund, and so forth, what percentage of the individual trust funds that you probably wield the voting power in to sort of a broad general picture?

Mr. MEYER. I do not know the answer to that. I do not have the figure.

I believe it is a reasonably educated guess, but not much more than that, that in the personal trust area where control of properties come to us through a will or through a living trust, those cases are very few in number, and relatively small in size and for the most part represent inheritance of family firms.

Mr. MCKINNEY. Isn't it more correct, though, the cofiduciary trust or broad pension fund where you have to meet with other advisers and responsible individuals as well as the agency account are probably your largest——.

Mr. MEYER. Numerically as we said, sir, we have pension trusts for about 400 companies and institutions and you said that was in a field by itself, which it is. That is the largest part of our business in dollars. Next would come investment advisory accounts, where in a broad sense we have a fiduciary responsibility, but in the legal sense we have no right to vote. I would think that the investment advisory accounts as to dollar amount would rank second: and third would be the personal trust accounts—wills, estates, and living trusts.

(The following supplemental information was submitted by Mr. Meyer for inclusion in the record:)

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MORGAN GUARANTY TRUST CO. OF NEW YORK TRUST AND INVESTMENT DIVISION, SUMMARY OF ACCOUNTS AND ASSETS DERIVED FROM REPORT TO THE FEDERAL RESERVE BANK OF NEW YORK AS OF DECEMBER 1970

[Dollars in thousands]

Type of account	Number of accounts	Market value of common stocks	Market value of other assets	Total market value
Pension and other employee benefit funds	774	$8,036,788	$3,826,466	$11,863,254
Personal trusts	5,221	2,357,972	1,021,489	3,379,461
Investment advisory	1,141	2,619,131	1,171,886	3,791,017
Total	7,136	13,013,891	6,019,841	19,033,732

Mr. McKinney. I think you have again proven the point that I have tried to bring out time after time at these hearings, that you cannot just simply lump all the stock that is held in a trust department of a bank and say that this is stock that is run by the bank. It is in effect in all different types of trusts and under all sorts of different situations.

Mr. Meyer. That certainly is correct. It is 100 percent correct.

Mr. McKinney. Now, I would like to ask you a question which I think is a moral question and it is a very—there has been the definite implication, and I think there is in H.R. 5700, that there is something morally wrong with trust departments holding a great deal of stock in one corporation. I have made the claim, and I would just like your comment on it, that it would be a great deal morally—more dangerous, for instance, if your bank were to sit there and suddenly decide whose stock it was going to sell if it were to live up to this bill?

Mr. Meyer. That would present us or any other trust company with problems which we shudder to think about. Whom do you deprive of an asset which you think is a good investment? Do you sell it across the board? No; you cannot because there are all kinds of tax consequences as well as the terms of the instrument themselves. And to dispose of an amount of shares on the basis of an arbitrary figure is really going to mean the most unfair arrangement that one can imagine as far as the implication and the burden on some individual accounts is concerned.

Mr. McKinney. This bill would also stop you from taking on a large trust that might be left to you in death, either to run for a hospital or for an individual or university if it were composed mainly of a stock in which you already had heavy holdings?

Mr. Meyer. Yes; that is correct, sir, and as far as a man's estate is concerned, his assets are not known to the executor or say a trust company until after his death. So you have no way of knowing what you are going to get.

Mr. McKinney. I have briefly, because my time is running out—I have been looking at this chart, and, of course, I have never understood how any bank, as I commute to New York on a railcar—never understand how it continues to hold Penn Central as it did, although I realize it had an attractive profit.

Would not one of the explanations very simply for the sales pattern or suggested pattern be that you were dealing with what amounts to a pretty lethal stock during this period, stock in a corporation about which everybody, including the housewife, is having some serious

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questioning and most of your trust departments, I believe, check the market for sales so as not to overload; is that correct?

Mr. MEYER. That is correct.

Mr. MCKINNEY. In other words, most of the—and I am not a broker or banker—but most of the stock of the Penn Central sales have got to be handled through one floor agent usually in the New York Exchange, and you would not on the day that some other bank had dumped 53,000 shares really want to sell that day or that week, really, if possible, would you?

Mr. MEYER. Well, we would not know what they are doing. We have a securities trading department which is a part of our trust and investment division, and in that department they are charged with executing the orders that come from the trust and investment division. A part of their job is to know the market to the best of their ability and to handle purchases or sales so that there is as small a disturbance as to price as possible.

Mr. MCKINNEY. Right. Now, my time is up, but I am just saying to myself that I do not think the securities department would sell a stock if they noticed huge sales on that particular day.

Mr. MEYER. They would certainly check the bid and ask very carefully, not only as to price but amounts, sir.

The CHAIRMAN. I want to ask some questions. Then we will go around again if you would like to.

The chart shows conclusively, I think, but whether it is by coincidence or regardless of how it was, these three banks, Chase Manhattan, Morgan Guaranty, and Continental Illinois, that there was considerable cooperation between them—I do not know how it could be by accident—I am not saying how. But when one, like Chase Manhattan was in the market, one of the others was not in the market at all and the other one was in just very little. So then when the Morgan Guaranty was in the market Chase Manhattan was practically out of the market, most of the days not a sale and the others just very little. The Continental Illinois, every day is zero, zero, zero, except one, 500 shares. Then when the other one was in the market like Continental Illinois, why outside of one day there is practically no sales by the other two.

Now, one time when I was district attorney in Texas and the service station raised the price of their gasoline about 5 cents a gallon we had a grand jury investigation, and we kept trying to find out how that all happened. They would just go up and down, the same amount every day and that 5 cents is a whole lot. Then finally one witness said, well, I will tell you how. He said we didn't have any talk, we didn't have any letter writing, we just had an unconversational understanding. I don't say that you had an unconversational understanding, but the figures demonstrate that if you were not trying to work together you did work together anyway without knowing it just by coincidence.

Now, there were almost no sales from Chase nondiscretionary trust accounts. I am asking you this about Chase to ask you if your pattern is similar to that. There were almost no sales from Chase nondiscretionary trust accounts. Between April and June 30, 1970, Chase reduced its holdings of Penn Central common stock in its discretionary trust accounts by almost 570,000 shares, from 638,686 shares to 70,663. For its nondiscretionary trust accounts Chase holdings of Penn Central

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common stock for the same period remained about the same, 275,997 shares in April as compared to 276,000—actually increased by June 30, 1970. Was your portfolio reduced in proportion to that, Mr. Meyer, or in what proportion did yours——

Mr. MEYER. I do not know the proportion, Mr. Chairman, but——

The CHAIRMAN. In Penn Central stock?

Mr. MEYER. I think one answer to your question is that most of the Penn Central shares that we purchased were purchased for accounts where we had sole discretion—primarily pension and other employee benefit funds.

The CHAIRMAN. When you look over your transcript for approval or correction would you bring us up to date on that to see about the proportion of yours that is reduced, discretionary, or nondiscretionary?

Mr. MEYER. Yes, we will do the best we can.

But before leaving that I would like to go back again, if I may, to state again that I deny just as emphatically as I can that there was any understanding between us or any other bank, not just these banks, or any other participant——

(In response to the request of Chairman Patman, the following information was submitted for the record by Mr. Meyer:)

Of the 1,001,275 shares of Penn Central held in trust and investment advisory accounts on April 1, 1970, 893,254 shares were held in accounts where Morgan Guaranty had sole investment responsibility and 100,341 shares were held in accounts where co-fiduciaries or other parties had to be consulted. A total of 7,680 shares was held in accounts where Morgan Guaranty had no investment responsibility.

Of the 893,254 shares held in sole responsibility accounts (primarily pension and employee benefit funds), 47.5% were sold or delivered out by June 19, 1970.

Of the 100,341 shares held in accounts where Morgan Guaranty had to consult with co-fiduciaries or others, 76% were sold or delivered out by June 19, 1970. With respect to the unsold shares for this category, the largest portion was held in accounts where the co-fiduciaries or other parties had indicated that they did not wish to sell the stock.

The CHAIRMAN. I am not disputing you. I am in no position to dispute you. That is the reason I said it looks like it could have been a coincidence, just an accident. But there is a close relationship. I mean, that is demonstrated here in these sales, the way I see it. Of course, other people can see it a different way.

Now, was there any pattern as to the type of sales for the type of customers that you were selling? Were you selling for the big customers or selling for the little ones or middle sized?

Mr. MEYER. We were trying to sell for all and to prorate as equitably as we could, depending on the volume of the sales. There was no pattern of choosing one above the other.

The CHAIRMAN. If you did like Chase did, you did a good job for the discretionary accounts, but no job at all for the nondiscretionary accounts. Of course, they were handicapped.

Mr. MEYER. For nondiscretionary accounts, sir, you would have to go either to a cotrustee or the actual owner to get their consent and sometimes that takes a little longer.

The CHAIRMAN. Well, you had a month or longer to do that. Don't you think that you should have kind of gotten hold of these nondiscretionary people and say, look here, we want to sell a lot of your stock but we are not permitted to sell yours unless you tell us so, but we just

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want to tell you the facts so you can take advantage of the same thing if you want to.

Mr. MEYER. We have cleared out the so-called nondiscretionary accounts.

The CHAIRMAN. You did do that?

Mr. MEYER. Yes.

The CHAIRMAN. But none of them sold, some of them bought. That is Chase. Of course, I don't know what——

Mr. MEYER. That isn't us. I don't know what they did.

The CHAIRMAN. I am asking you now to put it in the record, bring it up to date.

Mr. WILLIAMS. Mr. Chairman, I would like to ask one question.

The CHAIRMAN. Well, of course, logically——

Mr. WILLIAMS. I mean, I would like to ask one question of you.

The CHAIRMAN. All right, I yield to you.

Mr. WILLIAMS. On this chart we have before us it shows that between the period from May 15 until June 11 Continental Illinois sold only 20,500 shares of Penn Central common stock. At the same time Chase Manhattan and Morgan Guaranty were selling hundreds of thousands of shares of Penn Central common stock, how do you account for this difference? Do you think that in some way Chase Manhattan and Morgan Guaranty managed to convince Continental to hold on to a stock whose value was dropping rapidly?

The CHAIRMAN. I ask you what do you think about it? I do not know. I do not have any opinion of it. But I do say that when Chase Manhattan was selling from May 22 to May 28, and of course that is the weekend, too. Saturday and Sunday did not count, is 5 days, while the others, Morgan Guaranty sold practically none. In fact, Morgan Guaranty sold not a share.

Mr. WILLIAMS. Let us talk about what I want to talk about for a moment. You are supposedly answering a question for me.

The CHAIRMAN. Continental-Illinois sold very little, less than 20,000 shares.

Mr. WILLIAMS. Continental-Illinois in the period May 15 to June 11 sold 20,500 shares. You have indicated in some way there is collusion between these banks. I will say to you in answer to my own question there is no possible way Chase Manhattan and Morgan Guaranty could have convinced Continental-Illinois to sell only that small amount of stock in light of the public knowledge that was available concerning the Penn Central's financial condition.

The CHAIRMAN. I will ask the gentleman to take his chart and look at it. It is obvious that Chase Manhattan sold their stock from May 22 to May 28, really 5 days. And the other——

Mr. WILLIAMS. Wait a minute. While you are inquiring about May 22——

The CHAIRMAN. That is what you said.

Mr. WILLIAMS. May 22 to May 28.

The CHAIRMAN. Yes; that is 5 days. You see, Chase Manhattan sold a lot of shares.

Mr. WILLIAMS. If you look at the chart you will see on June 12 Chase Manhattan sold 90,700 shares.

The CHAIRMAN. Don't try to jump the gun. Let's trace this down first. Now, that was Chase Manhattan's week. Chase Manhattan's week they sold about 400,000 shares, I guess.

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Mr. WILLIAMS. One week, they had 2 weeks, 134,000 shares the previous Friday.

The CHAIRMAN. I am trying to answer you, and the Morgan Guaranty did not sell any, not a share during any of those days. Continental-Illinois only sold 19,500 shares, and that was just 5 days of trading. The rest of the days they did not trade at all.

Mr. WILLIAMS. If you are talking about a 5-day week figure, your figures are wrong.

The CHAIRMAN. Going on down to May 29–June 11, it is an entirely different picture. That period was Morgan Guaranty's period.

Mr. MEYER. That is correct.

The CHAIRMAN. Morgan Guaranty really sold it.

Mr. MEYER. We started on the 29th following the public announcement of the 28th.

The CHAIRMAN. Chase Manhattan did not sell any for several days, but sold 12,100 shares one day and 3,000 another in all that period of time, and all that period of time Continental-Illinois sold only 500 shares 1 day. The pattern is that when one went in the market the other two stayed out, the way I see it. Now if that is not correct you just explain it, Mr. Meyer, I am not attacking you.

Mr. MEYER. I appreciate that, and I think I can explain——

The CHAIRMAN. I am not impugning your motives. It could be by coincidence. It could be just by accident. I do not know what happened. But the chart is there.

Mr. MEYER. That is correct, sir.

The CHAIRMAN. Yes.

Mr. MEYER. I see the chart and I see on May 29 for Morgan Guaranty 44,000-odd shares. That demonstrates to me very clearly what we have said in our appendix, that we started selling Penn Central shares the day following the public announcement that the $100 millon bond issue, of the Pennsylvania Co. was called off.

The CHAIRMAN. But, you just sold a couple of days then stopped?

Mr. MEYER. No, sir; we started from May 29——

The CHAIRMAN. Well, the 29th on you were a big seller, then, and the others did not sell much, but from June 22 to June 19, that was Continental-Illinois period of time.

Mr. WILLIAMS. Where do you see June 22 on this chart, Mr. Chairman?

The CHAIRMAN. I mean June 12.

You see, that was Continental-Illinois' period of time and they sold a lot of stock, and Morgan Guaranty sold practically none and Chase Manhattan sold a substantial number but nothing in comparison to what the other did.

Mr. WYLIE. Will the Chairman yield just a minute so that I may get it in perspective.

How many shares of stock were outstanding in Penn Central on say May 15?

The CHAIRMAN. You mean 24 million shares?

Mr. WYLIE. 24 million shares. How many did these three companies own on that day?

The CHAIRMAN. I have not considered it.

Mr. WYLIE. Pardon me?

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The CHAIRMAN. I have not added it up.

Mr. WYLIE. Was it a substantial percentage?

The CHAIRMAN. I do not know. I do not think it makes any difference. I think the difference is what each company had at the time.

Mr. WYLIE. It makes a difference on how much impact it might have had.

The CHAIRMAN. We are not talking about the impact on Penn Central. They are talking about the trading desk, the trading. Chase sold 22 percent of all the shares that were traded of Penn Central on one day, for example. That is a substantial amount.

Mr. WYLIE. Of all the shares traded, but that is not all the shares they owned.

The CHAIRMAN. That is right, Penn Central common.

All right, Mr. Gonzalez.

Mr. GONZALEZ. Just two things I did not have a chance at, Mr. Meyer.

You stated in answer to a question I believe by Mr. McKinney that the biggest activity was with respect to your pension funds. Would that be as much as two-thirds of your trust assets?

Mr. MEYER. Our trust assets are approximately $19 billion. Of that amount approximately $10 billion is represented by the pension trust and profit sharing accounts of the 400 companies which I mentioned.

Mr. GONZALEZ. I see. The SEC institutional investor study shows banks have sole voting power over equity investment of 75 percent of employee benefit accounts. Would this be the pattern here?

Mr. MEYER. I cannot answer that. I do not know, Mr. Gonzalez.

Mr. GONZALEZ. The other question was with reference to your statement on page 2, and it is something that I have been interested in with respect to the overall bill, H.R. 5700. You agree on page 2 that it would be desirable to have annual disclosures of security holdings of the bank trust departments within reasonable bounds. And I think I understand the usual problem with reporting, and that is a lot of documentation and sometimes a complaint of businessmen that a lot of it is unnecessary or supreflous or redundant. But could you elaborate on what you mean as reasonable, since this is another bill which we may obtain action on.

Mr. MEYER. That is a very fair question, sir, and we have been scratching our heads to try to define what is reasonable. We think it should be periodical. We think there should be a lag in time between the "as of" reporting date and the date the report is made available. We have not come to rest in our own minds as to what we think is reasonable. We are still working on it. It could be a number of issues. It could be the 50 largest holdings of any bank or trust department. It could be all those holdings of voting shares which may have a market value of x up. We are not prepared to say at this time what we think is sensible. We think that there is a different problem with small banks in smaller communities than with banks in larger cities where they do business with residents not only in their own areas but other places. We are trying to evolve what would be reasonable on that score and we have not arrived at it yet, I am sorry to say.

Mr. GONZALEZ. That is a tough one. Thank you very much.

The CHAIRMAN. I apologize for overlooking another witness that we have here immediately after Mr. Meyer.

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Mr. Groos, who is waiting has a prepared statement, about three or four pages. I wonder if there are any other questions the members would like to ask of the present witness, Mr. Meyer?

If not, we will dismiss Mr. Meyer with the thanks of the committee.

Your testimony will certainly be given consideration. And you are a most sincere witness. Thank you very much for your attendance.

Now, Mr. Groos. Your name is Ernest Groos, Jr.?

Mr. GROOS. Yes, sir.

The CHAIRMAN. All right, take a seat. Mr. Gonzalez, I will ask you to present him to the committee.

Mr. GONZALEZ. I appreciate this deeply, Mr. Chairman. It is an honor and a privilege. He has two fellow San Antonians with him. He may wish to have his attorney——

The CHAIRMAN. They may join him, and he can call on them at any time.

Mr. GONZALEZ. Let me take this opportunity to say that Mr. Groos represents one of the most famous pioneer names of the San Antonio and southwest Texas area. He is a descendant of a family that is not only distinguished historically but has made its mark in economic, banking, and social circles of San Antonio which as you know is a very historic city. It is the queen city of the Southwest.

Mr. Groos, reflecting this tradition, is here on my suggestion; and I first wish to express our thanks for his willingness to travel all the way from San Antonio and come up here and take his time and invest his money in doing so. I think what he has to say has a very definite relevance to what this committee is discussing now. It also gives us a chance to show what is the impact of some of the practices and some of the forces that this committee is attempting to evaluate and appraise.

It is a deep satisfaction to be able to have a gentleman who reflects a very stable, a very noble background, not only as to family but as to a banking institution.

The Groos National Bank was first chartered or started as a private bank in 1854. It has resisted Indian raids, survived panics and depressions that our history shows us we have had at periodic intervals.

So it is a real pleasure, Mr. Chairman, to present to you Mr. Ernest Groos from San Antonio, Tex.

The CHAIRMAN. We are very glad to have you, sir.

STATEMENT OF ERNEST GROOS, JR., PRESIDENT, GROOS NATIONAL BANK, SAN ANTONIO, TEX.

Mr. GROOS. My name is Ernest Groos, Jr. I am the president of the Groos National Bank, San Antonio, Tex. I am here on the invitation of Congressman Henry B. Gonzalez.

I am appearing before this committee to give you a very brief statement of the history of the Groos National Bank, to talk with you about the policies of the Groos, to make a few observations and suggestions as to what the ownership of bank stock means, and, of course, to answer any questions which the committee members may wish to pose. Probably most of you know that our bank is one of the two oldest in Texas.

We were organized in 1854; and like most banks organized that long ago, we started out as a private banking institution. As in the case of

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most other banks of that day and time, we commenced in the banking industry as an ancillary activity to another business.

As time passed and the chartering of banks by the Government became more prevalent, the Groos obtained a national bank charter in 1912. Quite naturally, with the granting of the charter, there results the accompanying supervision and control and accountability to the supervising authorities. Our predecessors in the bank recognized the desirability of these controls and their exercise in the public interest.

When the Federal Deposit Insurance Corporation was organized in 1933, along with the vast majority of bankers over the country, the management at the Groos recognized that this was a desirable and a much-needed addition to our banking system. Historically, all of us know that faith and confidence in banks individually and, indeed, in our entire banking system had been very badly shaken by the depression and—most of all—by its impact on individual banks.

We have always felt that close and careful supervision over banks was a necessary and desirable thing if public confidence is to be maintained.

Early in January of this year word came to us at the Groos National Bank that a rather large block of stock had been purchased from our largest single shareholder, and that shareholder had been assured that the purchase was being made by Mr. Clinton Manges as an investment only, and that he entertained no idea of attempting to take over the operation and management of the bank. At that time we had no knowledge or hint that Mr. Manges is a convicted felon.

It is worthy of consideration by this committee to take a look at the possibility of requiring that all bank stock in all federally chartered banks be automatically included as registered securities, in which event a tender offer would be required in order to purchase stock control.

Prior to our annual shareholders meeting, which was held on January 18, 1971, and some time thereafter, the stock acquisition activities of Mr. Manges proceeded at a stepped-up pace.

I wish to observe that the job which is done by the Comptroller of the Currency and the Federal Deposit Insurance Corporation, as well as by banking authorities in most States, in reviewing and passing upon applications for new bank charters, is a most thorough one which insures many things in the public interest.

It not only insures the fact that the need exists for the banking institution, but that the stock will be held by responsible people of character and integrity, and that the officer personnel will be competent, qualified, and honest. Supervisory officials assure themselves of the fact that irreparable harm and injury to existing banks in the area will not occur as a result of the granting of a charter.

Let us now compare this with the total lack of supervision and control over the acquisition of large blocks of stock in existing banks—indeed, as in the instance of the Groos Bank, the majority ownership. Consider by contrast the recent situation at the Groos Bank where a raid on stock ownership control, financed by another bank, enabled a convicted felon to acquire stock ownership control. It certainly seems incongruous that the banking regulatory authorities have and use the means to meticulously examine and to grant or refuse to grant a charter for a new bank based upon their examination while at the same time control of an existing bank can be financed and purchased

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without any examination or prior approval by regulatory authorities whatsoever. Yet there is in reality no difference as far as the public is concerned.

The protection of depositors, shareholders, employees, and the public at large is the very same in both instances. It is a matter which should give serious concern to people like you gentlemen who are involved in fixing the rules, not only for the granting of charters, but for the operation and the continuing fidelity of those who have the privilege, granted by the Government, to operate these organizations which, in our opinion, must remain synonymous with integrity and fair dealing.

I realize the primary purpose of this inquiry is to attempt to ascertain the need for appropriate legislation. My great concern is that the reporting requirement on the part of lending banks who are making loans for the purchase or acquisition of bank stock, and the reporting requirement for the purchaser, is an after-the-fact type provision.

In other words, the landing bank and the purchaser are not required to obtain approval of the regulatory authorities prior to purchase and acquisition. My own suggestion is that whatever notice is to be given should be given before the loan is made, and perhaps there should be a provision for FDIC and/or Comptroller of the Currency approval, with such approval required in advance of making any loan involving the purchase or acquisition of bank stock involving 20 percent or more of the capital—or any stock acquisition which results in control. This would prevent the takeover of banks by persons, firms, or corporations who would not be acceptable to the regulatory authorities were they applying for a new bank charter. The acquisition of control by unacceptable purchasers circumvent the bank charter requirements.

(The following statement of Clinton Manges, stockholder, Groos National Bank, San Antonio, Tex., was received by the committee for inclusion in the record at this point:)

STATEMENT ON H.R. 5700 BY CLINTON MANGES, STOCKHOLDER OF GROOS NATIONAL BANK OF SAN ANTONIO, TEX.

The Chairman and members of the committee, I am Clinton Manges. I live in San Antonio, Texas, and am one of the principal stockholders of the Groos National Bank of San Antonio and also of the First State Bank & Trust Company of Rio Grande City, Texas. Congressman Henry Gonzalez of San Antonio was kind enough to invite me to appear before the Committee in connection with its consideration of HR 5700, "The Banking Reform Act of 1971."

Congressman Gonzalez' invitation was originally delivered to me through my attorney, Mr. Jack Skaggs of Harlingen, Texas. At that time it did not appear to us that we had any expertise which would be of assistance to the Committee, and we did not have any real interest in the provisions of HR 5700, since I was in the position of being a stockholder only, in one national and one state bank. As a private citizen, I recognize that the laws regarding banking are always under review, but I felt that the Committee, its staff, and other persons more actively engaged in banking would be far better qualified to pass on the provisions of the proposed Banking Reform Act.

On Monday, May 3rd, however, my attorney Mr. Skaggs was present during the testimony of Mr. Ernest Groos, President of the Groos National Bank. This testimony, and various questions and comments made by members of the Committee, received wide publicity through the news media in San Antonio, Houston, and in other parts of the United States. I therefore feel that it is necessary for me to set the record straight in regard to my acquisition of more than 50 percent of the common capital stock of the Groos National Bank. I would first

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like to discuss the $2500 fine that I paid in a federal criminal proceeding in 1965. The major attack which has been made on me by Mr. Groos revolves around the statement that I have a "criminal record," that I am a "convicted felon" and other statements of a like nature.

In 1959 I was a small businessman operating in the Rio Grande Valley of Texas. Some cotton gins in Raymondville, Texas came on the market as a result of the death of their owner. I was very anxious to purchase and operate these cotton gins, but simply did not have the funds and could not obtain the funds through conventional financing to pay the price requested by the Estate. I therefore applied for a Small Business Administration loan. My loan application was prepared by a certified public accountant and was approved, in advance, by an attorney (not Mr. Skaggs). I might add, in this regard, that my education is limited. I do not have the advantage of a high school education and I rely to a large degree on the advice and counsel of persons whose education is superior to mine.

The S.B.A. and I got along fine, until we had a very bad cotton season and my loan payments went into default in 1961. My cotton gins were foreclosed on by the S.B.A. At the trustee's sale the S.B.A.'s trustee offered the real estate on which the gins were located for sale at a different time and place than the gin stands and other equipment. This resulted in the properties bringing less to apply against my debt, since the people who had bought the real estate had an advantage in bidding on the equipment, because anyone else who bid on the equipment would have to move it away. I had a civil lawsuit with the S.B.A. over the manner in which this sale was conducted and the case went clear to the United States Supreme Court, but I lost and ended up with a judgment against me in the amount of $101,488.20. Incidentally, I paid this judgment in full, with interest, about four years in advance of the date agreed on with the government and have letters from the S.B.A. congratulating me on the manner in which I discharged this debt to them.

While I was litigating with the S.B.A. in the civil courts, they took my 1959 loan application apart with a "fine tooth comb", and in 1963, I was indicted by a grand jury in Lubbock, Texas, 600 miles from my home, on two counts, claiming that I made fraudulent statments in connection with my 1959 loan application. I went to Lubbock, voluntarily appeared before the grand jury, and told my story in detail.

My case remained pending in Federal Court until 1965, and at that time the government dismissed one of the counts against me and I entered a plea of guilty to the other count. I was fined $2500. I paid my fine the same week in cash and set out to pay my debts and rebuild my estate.

I refused to take bankruptcy. Every personal debt that I owed was paid. All judgments against me or my corporations were paid or settled, and, as previously stated, the government was paid in full.

I would like to add that the count to which I entered the plea of guilty was based on poor phrasing in my loan application. My accountant had stated in filling out the application that the down payment on the gins would be made with $116,000 which was "deposited to the bank." There was in fact $130,000 deposited in a bank in Raymondville which I had made arrangements to borrow to make the down payment, but these funds had not been transferred to my name at the time the application was filed. By 1965, however, I had become weary of fighting with the S.B.A. I had exhausted myself financially in paying attorney's fees and traveling expenses in going back and forth from my home in the Rio Grande Valley to the Northern District of Texas where my case was pending, and I was willing to pay a fine to buy peace with the government and have the opportunity for a fresh start.

Federal Judge Davidson stated at the time he imposed the fine that he considered the prosecution to be technical in nature and that he regretted having to fine me on my plea of guilty. The Judge did not assess any other penalty, suspended or otherwise, and I deeply resent the implication made during the Committee Hearing to the effect that I should be regarded as a "criminal" or a "convict." Many, many businessmen, bankers, farmers and other respectable American citizens have, at one time or another in their lives, been required to pay a fine in connection with some government infraction. I think it is extremely unfair that the management of the Groos National Bank, having lost a fair contest over ownership of a majority of stock in this banking association, should continue to "hit below the belt" by suggesting that I am unfit to buy and own their stock and that Congress should pass some kind of a special law to give them a "rematch" in a contest which they lost months ago.

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I would now like to turn to my relationship with the Bank of the Southwest at Houston. I want to make it clear that I am not a "front man" for the Bank of the Southwest, I am not their trustee, and I owe them nothing, except money. I borrowed money from the Bank of the Southwest, part of which was used to purchase my stock in the Groos National Bank. My debt to the Bank of the Southwest is presently secured by over 56,000 shares of stock in the Groos National Bank, approximately 75 percent of the stock in the First State Bank & Trust Company of Rio Grande City, Texas, and over 25,000 acres of Texas ranch land. I have reduced my indebtedness to the Bank of the Southwest by two million dollars this year, through the sale of other ranch land belonging to me.

A question was raised during the Committee Hearings about the interest on my loan, and how it would be paid. My loan bears interest at eight percent per annum, and such interest will be paid by me out of money and properties belonging to me. I am not relying on dividends that might come from the Groos National Bank. I am confident that I can make both principal and interest payments on my loan as they fall due out of my own assets. If I was not confident of this, I would not have borrowed the money in the first place.

I am not taking instructions from the Bank of the Southwest and have no intention of doing so. I did suggest that one officer of that bank be invited to serve on the Groos Board because I thought this would be healthy for the Groos Bank. Congressman Williams commented during the Hearing I would be an unlikely person for the Bank of the Southwest to choose as a "dummy" or "front man," and the fact is that I am neither.

Next, let me comment on the tactics of the present management of the bank since January of this year. Immediately prior to the Annual Stockholders Meeting on January 19, 1971, the present management of the bank requested that I not appear at the Stockholders Meeting, though I then had acquired over 55,000 shares of stock in the bank. They offered to leave four vacancies on the Board of Directors and to put four other persons to be designated by me on the Board. This would have given me representation of four out of fifteen directors, certainly far short of control. To this date I do not have a single director on the Board or a single representative in the bank.

On January 27, 1971, I presented 56,018 shares of endorsed common capital stock to the Groos National Bank and requested transfer. They delayed transferring the stock for a week. On the same day that I requested the transfer, the management of the bank, without my knowledge or approval, attempted to "register" the bank stock with the Comptroller of the Currency. This registration could have been voluntarily accomplished years before, but presumably the bank management did not want additional federal supervision or control of their securities, until it became obvious that I had succeeded in acquiring more than 50 percent of the bank's common capital stock, then they were all in favor of as much control as possible.

At about this time a voting trust began to circulate to the stockholders who had not sold to me, though this could have been done years before. In short, the bank management attempted to shut the barn door long after the horse had gone. They will not give me a copy of this voting trust, though the law requires it to be deposited at the bank.

During the course of the Committee Hearings some unfair comments were made regarding the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation. On several occasions it was suggested that Mr. Camp and Mr. Wille should be invited before the Committee to be asked why they hadn't done something about the Groos Bank situation. It was strongly implied that neither agency had taken any steps to investigate my acquisition of the Groos Bank stock and to find out the connection of the Bank of the Southwest with such transaction. I find myself in the peculiar position of having to defend these two agencies since the management of the bank failed to do so.

I simply do not understand why Mr. Groos did not advise the Committee that by letter dated March 4, 1971, Mr. Camp prohibited me from "participation in any manner in the conduct of the affairs of the Groos National Bank," and stated that this "prohibition shall remain in effect until modified or terminated by the Comptroller's Office." Mr. Groos was aware of this order, for a copy was served upon the Groos National Bank. Mr. Groos is also aware that the Regional Administrator of National Banks at Dallas requested me to file detailed financial reports and biographical reports, and that these reports were filed on March 25, 1971, and informational copies were supplied to the Federal Deposit Insurance Corporation. These very detailed forms contained a com-

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plete disclosure regarding the $2500 fine which I paid in connection with the 1959 S.B.A. loan application, letters of recommendation and reference from various Texas businessmen who will attest to my character and honesty, and a complete report of my borrowing relationship with the Bank of the Southwest and other banks.

As Mr. Groos knows, I have been personally interviewed by the Regional Administrator of National Banks, and I followed various instructions and suggestions made by both the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation. I have meticulously observed every order or suggestion of either agency. I have not attempted to assume control of the Groos National Bank or to make any change in its policies or personnel.

I am now waiting for the regulatory agencies to process the information that I supplied to them, and at the appropriate time I will request that the order of the Comptroller of the Currency be withdrawn or modified.

In the meantime, as Mr. Groos knows, though I own more than 50 percent of the stock in the Groos National Bank, I have no representative on the Board or in the bank's employ. I have heard that though the bank's deposits are up, the bank's 1971 earnings are down. I cannot verify this because I have no access to internal bank information. I have no way to protect my investment. The bank's lawyers will not reply to simple requests directed by my lawyer for information which should be available to any stockholder.

Under the circumstances, it seems to me inaccurate to suggest that the Comptroller of the Currency and the Federal Deposit Insurance Corporation have in any way neglected their duty to study major acquisitions of national bank stock.

Now I would like to make a simple appeal for fair play. From the time I acquired my stock ownership in the Groos Bank, I was advised by the management of the bank, the officers of other banks with which I did business, and the personnel of the federal regulatory agencies, that undue newspaper publicity regarding a change in ownership of a majority of the bank stock could only damage the bank and impair its public image. For this reason, except for one public statement which was cleared in advance with the bank's attorney, I have refused to make any public comment.

For over four months, however, the bank management has continued to promote newspaper and television publicity, culminating with Mr. Groos' testimony before this Committee. I cannot relate his testimony as having any bearing on any proposed provision or section of HR 5700. I can therefore only conclude that the testimony was given for the sole purpose of obtaining additional publicity for a cause that is already lost. Surely, this Committee would not consider some amendment to HR 5700, which would have the effect of depriving me of the property rights which I have purchased in the stock of the Groos National Bank. Certainly this Committee would have neither the power nor inclination to attempt to interpose itself into a private transaction that is now a matter of history.

I am frankly a little tired of hearing how the Groos National Bank fought off Indian raids in 1854, and how all the "best" people in San Antonio, Texas have been associated with this bank, and what fine social credentials are enjoyed by its officers. Four of the members of the Board of Directors of this bank, who are also very socially acceptable, saw fit to sell their stock to me. The owners of more than 50 percent of the stock saw fit to accept my money, and presumably found my money more attractive than a piece of paper that was paying a quarterly dividend of only forty cents a share.

I do not claim to be very well educated. I have not had the time during my life to spend making social contacts. As a child I picked cotton with my family from Oklahoma to Texas. I did not graduate from high school. I was not an officer during the second World War, but served in the Coast Guard as a Seaman Third Class. All of my four children are adopted, and I only hope that I will be able to give them more education than my parents could give me.

Though I am not a banker, I think I know what a bank should do for people, and if I ever have any influence on the management of the Groos National Bank in San Antonio, I promise this Committee that influence will not be exerted for my own benefit or for the benefit of any Houston bank. It will be used for the benefit of the people of the City of San Antonio and South Texas.

Mr. Chairman, I greatly appreciate the courtesy of the Committee and of Congressman Henry B. Gonzalez, who was instrumental in advising me how to make this testimony a part of the record of this Committee's hearings on H.R.

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5700. Please see letters attached from Lloyd M. Bentsen, Sr. and Mr. Tim Timmins.

MARCH 24, 1971.

Mr. WM. B. CAMP,
Comptroller of the Currency, U.S. Treasury Building,
Washington, D.C.

DEAR MR. CAMP: It has come to my attention that there is quite a severe attack in banking circles against Mr. Clinton Manges of San Antonio, formerly of Raymondville, Texas, and the understanding I have is that, this originates from an indictment against Mr. Manges about ten years ago.

For your personal information I want to state that, I am familiar with this entire transaction and I personally feel this indictment should never have been brought and was only sustained on a technicality.

I further want to state that, I have known Mr. Manges for more than a quarter of a century and during that time have transacted many, many various deals with him which involved in some cases several hundred thousand dollars in a single transaction. Many of these transactions were based on word of mouth and not even in writing, and in every single case, over this quarter of a century or more, Mr. Manges has respected his word in every detail and all of these transactions have been handled on the very highest plain.

In consider Mr. Manges not only absolutely honest, but a man of high integrity and extreme ability. I would certainly personally appreciate any consideration you can give Mr. Manges in connection with his acquisition of controlling interest in a couple of banks in this area.

Mr. Manges does not have a lot of banking experience and acknowledges this fact, and for this reason, told me that he had in each case selected experienced bankers to serve on the boards so that he could also profit and learn by their guidance.

As stated, I would sincerely appreciate any consideration you see fit to give Mr. Manges.

Sincerely,

LLOYD M. BENTSEN.

DALLAS, TEX., *January 21, 1971.*

Re Clinton Manges.

THE BOARD OF DIRECTORS,
The Groos National Bank,
San Antonio, Tex.

GENTLEMEN: I have been requested to give you some information in regard to Mr. Clinton Manges, and I am happy to comply. I was Assistant United States Attorney for the Northern District of Texas from 1961 to 1970. From 1961 to 1965, Mr. Barefoot Sanders of Dallas was United States Attorney for this District. From 1965 to 1970 I served as Chief of the Criminal Division of the United States Attorney's Office in Dallas and was responsible for all criminal matters in Federal District Courts for the Northern District of Texas.

I represented the United States in a case called United States of America vs. Clinton Manges which was No. 3-63-80 in the Northern District, and I had primary responsibility for this file in October 1965, when a judgment of conviction was entered against Mr. Manges in Judge Davidson's Court in Dallas.

Mr. Manges had been charged on two counts with violation of 15 USC 645, which is a special statute covering false statements alleged to have been made to the Small Business Administration for the purpose of procuring a loan. The permissible penalty under this statute is $5,000.00 and, or two years, or both, on each count for which a defendant might be convicted.

I made an extensive pre-trial investigation of this matter which involved two statements alleged by the Government to have been made in a Small Business Administration application signed by Mr. Manges on March 24, 1959, to procure an SBA loan in the amount of $295,000.00.

During the course of the Government's investigation, our office had very open and candid cooperation from both Mr. Manges and his then attorney, Mr. Jack Skaggs of Harlingen, Texas. Mr. Manges voluntarily appeared before a Federal Grand Jury in Lubbock, Texas, in May of 1963. Subsequently, Mr. Skaggs made Mr. Manges available for extensive interviews and interrogations by me and members of my staff.

It was Mr. Manges' position that the statements made in his SBA application were literally true, but that the application which had been prepared in his behalf

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by a Certified Public Accountant and approved by an attorney (not a member of Mr. Skaggs' firm) contained poor phrasing, and Mr. Manges conceded that one of the statements contained in the application might well have been misconstrued by the loan examiners approving the $295,000.00 loan.

Accordingly, on motion of the Government, one of the counts against Mr. Manges was dismissed; and in October of 1965, Mr. Manges entered a plea of guilty to the other count and was fined $2,500.00 in Judge Davidson's Court. At the time the fine was imposed, I was present in the courtroom and remember that Judge Davidson, from the bench, in open court, expressed his opinion that the charge was technical in nature and his regret, on Mr. Manges' plea, at being required to assess a fine. He did not assess any term of imprisonment, suspended or otherwise. Mr. Manges paid his fine in cash on the day of the hearing or within a few days thereafter.

In the foreclosure proceedings instituted by the SBA, the gin properties pledged as collateral were sold and the Government obtained a civil judgment against Mr. Manges in the amount of $101,488.20.

I have been told, though I cannot verify from my own knowledge, that this judgment was subsequently paid in full with interest by Mr. Manges to the United States of America.

From my own personal recollection and my investigation and contact with Mr. Manges, I feel that an analysis of his character, morals and capability should be based on his full lifetime performance to date, and not on the isolated instance described above.

Sincerely yours,

TIM TIMMINS.

The CHAIRMAN. Mr. Groos, your statement is sworn to, I notice, by a notary.

Mr. GROOS. Yes, sir.

The CHAIRMAN. I think you have an excellent statement there, and you have pointed out some weaknesses that should be corrected and what can be done now.

The person who purchases that stock from this felon, is he trying to get control of your bank?

Mr. GROOS. Well, I would suggest that possibly I am not qualified to testify as to just exactly what the intent is. We do not know.

The CHAIRMAN. Any moves in that direction?

Mr. GROOS. There are no moves being made at this time.

The CHAIRMAN. You go ahead, Mr. Gonzalez, and ask any question you want to.

Mr. GONZALEZ. Well, Mr. Chairman, I do have some questions I would like to ask at this time, because I might fill in the committee by saying that this has agitated the community now for several months. It was a matter of newspaper reporting and speculation before the Congress convened in January, and at the time I brought it to the attention of this committee even at its formative stages because it does have an implication, and since the bank is situated right in the middle of the district I represent I felt that I had more than a casual interest and responsibility since I am a member of this committee, and it bore right into the point of the statistics and the findings that this committee and its staff has been giving us since 1964.

In connection with this, I might fill in the fact—and I could ask it by way of a question—that the Bank of the Southwest and Houston, Tex.—this has been verified—has been the principal source of the loan of near $6 or $7 million with which the controlling ownership or controlling shares of Groos National Bank stock has been purchased; is this true, sir?

Mr. GROOS. Yes, sir; this is correct.

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Mr. GONZALEZ. The Bank of the Southwest is a considerably sized bank in the neighboring city of Houston which is the biggest city in Texas.

Now, Mr. Groos, after the loan was made for this purpose and the officials of the Bank of the Southwest have admitted that they extend this line of credit in that amount, which is substantial, for this purpose, the purpose of "taking over the Groos National Bank," which is not a small bank, which in terms of history, intergrity, and service is a big bank.

Now, inasmuch as at this time there is no current pressure being exercised for a change in management or the board of directors, what would be satisfying the interchanges which I figure would be at least $1,500 a day, for the near $6 million loan that the Bank of the Southwest has extended for this purpose?

Mr. GROOS. I do not feel I would be qualified to answer that question. I simply do not know.

The CHAIRMAN. Well, what size was the loan, Mr. Gonzalez?

Mr. GONZALEZ. My information is that it is in excess of $5 million, and I as a personal belief, I am sure that it has reached the amount of $6 million.

Now, as you know, Mr. Chairman, banks do not lend $6 million that is outstanding because it is being used. The money has been extended in the purchase of this stock.

Now, what is being used for interest payments? Generally the bank is going to have to charge interest for that loan, and the people who borrowed it are going to have to be paying it, and the pattern in other acquisitions of a similar nature, some of which are currently underway, as I pointed out last week in the case of the Public National Bank here in the District of Columbia has been, for these larger takeover firms or individuals to milk the bank they are taking over in order to pay for the interest charges that they have to pay for the loans that are made to take the bank over with——

The CHAIRMAN. That happened in Texas, too?

Mr. GONZALEZ. And also the unloading of "bad paper" on the puppet bank.

Now, in this case I am trying to find out who and in what manner is paying for the interest on $6 million, which I figure is not less than $1,500 a day. I was going to ask one other question.

At any time has the individual or group of individuals who have purchased these shares of Groos Bank stock, have they at any time approached the bank board in order to request a change in management or directorship?

Mr. GROOS. They had approached us in connection with a naming of additional persons to the board.

Mr. GONZALEZ. But since that demand you have heard nothing further?

Mr. GROOS. I believe that is correct, to the best of my recollection.

The CHAIRMAN. May I suggest, Mr. Gonzalez, that since the Groos Bank, which has such a wonderful reputation over a period of 126 years, had no knowledge of this, they were not properly protected by the regulatory agencies which had the power to go into it anyway, whether there is any law requiring it or not? It occurs to me that certainly their examinations should go into questions like that and protect the public as well as the bank that is——

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Mr. GONZALEZ. Precisely, Mr. Chairman, and you will recall I brought some of these issues up when we had Mr. Willie here because we had raised quite a bit of commentary, and I made a specific request that we bring him.

This is what I want to ask next. In acquiring the shares of stock that these people did they made different offers to different owners. In other words, in some cases they paid as much as three and a half times the normal worth of the share. In other cases they paid the normal worth of the share, in other cases $10 or $20 more; is that true?

Mr. GROOS. The offers made did vary considerably. The stock had been trading at approximately $60 a share in the regular over-the-counter local market. I understand that offers for that amount or close thereto were made to some shareholders, and as time went on the price very rapidly increased. I understand that one shareholder was offered $160 a share. I understand that there was some stock that—or we have been told that some of it traded in the vicinity of $150 a share. But the offers that were made varied considerably, and this of course confused some of the shareholders immensely. They did not know what was going on, and some of them that reported to us that they were frightened by the activity and simply did not know what to make of it.

Mr. GONZALEZ. Mr. Chairman, I have been informed, and I have been studying the regulatory agency's regulations, and their own regulations spell out that this is contrary to their rules, regulations, and procedures of operation. This is the reason that I had wanted to question both Mr. Willie as well as Mr. Groos. What has been the role that both of these regulatory agencies have played in your experience, that is both FDIC as well as the Comptroller of the Currency?

Mr. GROOS. We think that these people have endeavored to keep themselves informed as to precisely what our situation is. They have remained in contact with us. We understand that they will have been in contact with the other people. We feel that to the extent that they are able under existing regulations and laws that they have been helpful and quite concerned with the public interest.

My concern is simply that it appears to us that under present regulatory legislation there simply seems to be no legal means to prevent this from happening before it happens. There is some after the fact provisions. But the pure fact of the matter is as far as we are able to determine, that there is nothing that the Comptroller's Office or the FDIC could legally do prior to this happening to prevent it.

Mr. GONZALEZ. Since I last corresponded with you and the other parties involved I have done further checking and I find that the offer of unequal tender is a violation of the present regulations, that the regulatory authorities themselves have set up. I also find that in the past other Comptrollers have issued cease-and-desist orders and have compelled the people attempting to do this to stop and refrain right then and there because of these tactics of moving in in a disproportionate manner and offering in one case three times the value, in others three times the normal value. Apparently in this case neither the Comptroller nor the FDIC has said so precisely in writing. That is what I am looking for.

The CHAIRMAN. An injunction would apply there, I am sure. Here is what I base this on. This is a terrible thing. You know, here is a

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wrong in equity and law. I feel like that you can get relief on this, I believe you can. You have good lawyers in San Antonio, some of the best lawyers in the United States are in San Antonio. They are good ones. I believe you could go into a court of equity and get relief. This is just a horseback opinion. I have not looked into it. But if you do not, if you will keep Mr. Gonzalez acquainted with the facts so he can tell our committee, if you cannot get relief that way there is one government in the United States and the only government that can nullify contracts, that is the Federal Government, this Government. No other government can. And I think in a case like this that we should consider nullifying any contract of sale of stock under those circumstances. So I am ready to go into that because that is very much in the public interest.

How do you feel about it, Mr. Widnall?

Mr. WIDNALL. Mr. Chairman, I would wholeheartedly support you on that.

I would like to know if the gentleman would yield to me?

Mr. GONZALEZ. Certainly. I will be glad to yield to the distinguished minority leader.

Mr. WIDNALL. I think the committee is grateful to you for bringing this to our attention, and it is a matter that requires some real honest-to-goodness research and I would say assistance from what you have told us.

I would like to just ask this one question. When you are offered $160 a share is that in cash or convertible debentures or debentures or what?

Mr. GROOS. This offer I was told by the person who received it was a cash offer.

Mr. WIDNALL. I think the committee should have as much documentation as possible in connection with it. That would be very helpful.

Mr. GROOS. I would like to repeat what I said a few moments ago concerning some of the offers that were made, that these offers were varied very substantially from $60-some odd a share and some were negotiations, complete at that price up to and including $150 a share. I understand these were all cash offers.

The CHAIRMAN. This bears out what has been happening. Now, about 7 years ago this committee went to the question of a bank down in Virginia, near Norfolk, Crown Savings Bank, and it was shown that one of the city slickers made a deposit of money, called it brokered funds. Unlike the revenue sharing, it had strings attached. And the string was that the bank, in order to get this brokered fund, would have to make a loan of an equal amount to somebody that was suggested by this person. That finally broke the bank. That was disclosed right here in this committee room. All the regulatory agencies I guess know it. But now, then, of the last 19 banks in liquidation, over half of them have been in liquidation because of brokered funds, and the credit unions have lost millions of dollars in this Sharpstown bank, and they have lost in other banks. Savings and loans, pension funds, and all other kinds of funds have lost because of these brokered funds breaking the bank. I have yet to see a regulation put out by any regulatory agency warning the people of brokered funds or warning institutions that had funds to invest about the dangers of brokered funds. I think you might inquire into that, too, Mr. Gonzalez, at the same time. I will help you on that.

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I wanted to bring one or two additional points out and they will emphasize what Mr. Groos has testified to here. That is that we have this vacuum, this gap in the law. If his bank were to be acquired by a holding company it would have to go to the regulatory authority, disclose a fact and get permission. If on the other hand somebody wanted to start a bank he would have to go and get a charter and get a set of questions to answer, if they do not have to answer if it is approached this way.

The CHAIRMAN. That is the main point. That is an evasion of the law.

Mr. GONZALEZ. Exactly. This is the reason I thought I would at least introduce a flat prohibition in order to focus attention on the need for reform in this respect of the law.

The CHAIRMAN. And I would consider a cancellation of any contract like you have represented here.

Mr. GONZALEZ. Which is I think the very thing to consider.

The CHAIRMAN. And the Federal Government has a right to nullify contracts.

Mr. WILLIAMS. Could the rest of the members of the committee have an opportunity for questioning, please?

The CHAIRMAN. Certainly, are you through Mr. Gonzalez?

Mr. GONZALEZ. Yes.

The CHAIRMAN. I will yield to you, Mr. Williams.

Mr. WILLIAMS. Thank you.

I would like to say that it has been my pleasure to be in San Antonio on many occasions. I do not think the people in San Antonio are such that can be taken by city slickers. I think the queen city of Texas ranks as a city in its own right.

Mr. GROOS. Thank you.

Mr. WILLIAMS. I am very much interested in your testimony. Is this Mr. Manges a local citizen?

Mr. GROOS. Yes, he maintains a residence in the city of San Antonio and possibly other places, too.

Mr. WILLIAMS. Wouldn't the San Antonio police department have a record of a convicted felon?

Mr. GROOS. No, sir. I guess I just cannot answer that. I do not know what the police department would have a record of, but——

Mr. WILLIAMS. Well, you say on page 2 that Mr. Manges is a convicted felon.

Mr. GROOS. Yes, sir.

Mr. WILLIAMS. Did the bank in Houston that was financing his stock purchasing know that he was a convicted felon?

Mr. GROOS. We are advised by one of their officers that they did know this.

Mr. WILLIAMS. And yet they chose to use him as a front man?

You do say here that Mr. Manges has now achieved majority control of your bank?

Mr. GROOS. Yes, sir.

Mr. WILLIAMS. But I also gather from your statement that he has not made any effort to use this majority control?

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Mr. GROOS. That is not entirely correct. Shortly after control was acquired there were certain requests made of us pertaining to board meetings and matters to be taken under consideration at board meetings.

Mr. WILLIAMS. Well, do you get the impression that Mr. Manges is determining how to vote this stock and what request to make or do you get the idea that the Houston bank is making the decisions?

Mr. GROOS. Again, sir, I did not understand the question.

Mr. WILLIAMS. I say do you get the impression that Mr. Manges is making the decision on how to vote this stock or to make the request that he has made or do you get the impression that this is coming from the Houston bank?

Mr. GROOS. I am not qualified to answer that question. I really do not know. This is Ralph Langley, counsel for the Groos Bank.

Mr. LANGLEY. Mr. Williams, we have been advised by both Mr. Manges and the Bank of South West officials that he is the owner of the stock and that their capacity is only that of a lending agency.

Mr. WILLIAMS. Well, I would not expect you to say anything else really, but I was really asking for your impression.

Now, Mr. Gonzalez has made the very important point. Here is a man indebted in this bank in Houston to the tune of somewhere in the neighborhood of $6 million and where is the money coming from to make the interest payments on this $6 million?

What type of dividends do you pay? How much stock does he hold for this $6 million and what would he be getting from your bank in the way of dividends on his bank stock?

Mr. GROOS. He would be getting only the regular current dividend which was 40 cents a share, last quarterly dividend which was payable to shareholders as of the report of March 15.

Mr. WILLIAMS. That would be $2.40 a year on a $60 share?

Mr. GROOS. Yes, and thus far that is all that has come from his investment in this bank stock.

Mr. WILLIAMS. I agree with you, Mr. Gonzalez, there is a very real question where the balance of the money is coming from because $2.40 a share on a $60 share is less than 5 percent interest. We know he cannot borrow it for that.

The CHAIRMAN. Mr. McKinney, would you like to ask some questions?

Mr. MCKINNEY. Just very briefly, Mr. Chairman.

I think I am in agreement with most members of the committee and Mr. Gonzalez, it seems to me, when we were discussing your bill at another meeting the flat prohibition you suggested I considered as far too severe. It would seem to me that one of the areas we could work in, Mr. Chairman, would be the necessity of a review and possibly cancellation of sale in shares of stock, of a bank of any percentage of shares over a certain point which would be dangerous to any financial institution putting the same prerequisites on the people owning the shares or controlling them than we do on people who start a bank. But the problem here is that for some reason or other, and the more you hear about it the worst it gets, because I cannot quite frankly believe the Houston Bank would want you that badly to have to absorb the interest unless they were going to use you pretty fast and the thing that disturbs me most that I see going on in certain areas of our finan-

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cial community is why people are willing to pay exorbitant prices for businesses and/or institutions which involve the passage of large amounts of money and therefore I question the fact of—whenever they are looking for a front.

It would seem to me if there is any danger, and I have often thought that there is, that any bank or particularly bank which deals with the public could be used as a front for the disposition of cash and large funds and the transfer of funds which a bank can freely do without charters which we should require—in the State of Connecticut we require a pretty stringent investigation of a man who buys shares in a bar and grill if he is going to have a liquor license. It seems to me we should establish the character of a man who buys a large share of bank stock.

Mr. GONZALEZ. That is right, Mr. McKinney. I think we appreciate your expressions. I agree with them. I incidentally sent the same notice to all the people that had expressed an interest in this Groos Bank situation, including some who had written, apparently interested in behalf of the individual interested in take-over of the bank, and invited them to participate if they so wanted to. I did want to point that out, because the position I have taken, inasmuch as at this time there is nothing in the law that prevents anybody from purchasing bank stock, he does not have to go to the FDIC, he does not have to go to the Comptroller to get permission.

The only requirement under present law or statute is that once there is a change, once a board of directors has met and passed a resolution, that resolution is sent to the FDIC for information only, not for permission, but just for information and you are very right when you say that you can get a pool hall license, you can get a liquor store license with a lot more difficulty than what it takes to take over a bank. This is the reason why criminal syndicates have moved into the banking industry. They are there now. They just remain to be exposed. Now and then we get information in connection with something else, as I did last week about the pitiful situation with the Public National Bank right here in the District. It is tottering. It is just a shell because that has been milked. That has had bad people unloaded on it and it is going to collapse. Everybody says we better not say anything and the regulatory agencies take the position that well, let's not say anything until it does go under. Then we will have insurance money that will take up of up to $20,000 a depositor. But it does not take care. I know what this has done to the city of San Antonio, because their fine points are intangibles. You have a lot more association with this bank than just business. Remember that San Antonio, as historical a city as it is, has people who are decent citizens from some of the original German Palatinations.

I would say that 90 percent of those families believe in the Groos National Bank next to their church, and when they think that the Groos National Bank is going to be lost to some stranger and there is some doubt and question, their first reaction is to say well, I don't know that I want to continue to do business, if it is not going to be the Groos, if it is not going to be the Groos family that we have trusted for a hundred and some years, and there is all of these insidious rumors and of course newspaper speculation has been great. I can imagine

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what would happen in these other communities such as in Michigan, such as in this area where the same things are happening.

I think we have a clear appraisal and an immediate question, Mr. Chairman, that we have got to act upon because I don't think we can depend on the regulatory agencies. I have read the regulations, and according to their regulations a Comptroller, or really in pursuance of them, should have issued a cease-and-desist order the moment it was made to pay a disproportionate share to one shareholder as compared to another. It is not a law, no.

The CHAIRMAN. There is another thing. In order to get a charter this ex-convict could never have qualified, but he can qualify to borrow the money to buy the stock to own the bank without going through any regulatory agency and the State, of course, cannot nullify the contract.

Mr. MCKINNEY. Would the gentleman yield for a moment?

Mr. GONZALEZ. One thing further.

I think we ought to have clear the nature——

The CHAIRMAN. It has been suggested that they are bandits, not Indians.

Mr. GONZALEZ. The sequence of events is that in January this was a hot matter in the public mind in San Antonio. It was brought to my capacity as a Congressman generally, but also specifically as a member of this committee of which membership I am extremely proud.

Now, at that time, and right in the middle of the request I made to you as chairman when we were forming the committee for this new Congress, the demand was made for a change in ownership or at least in the directorship with Mr. Manges suggesting himself as one of those to be appointed and it was subsequent to that time that somehow or other the information was brought forth showing that he indeed had been charged and found guilty and convicted and sentenced to a felony charge of deception of fraud in the process of seeking an SBA loan in the northern district of the Federal court in Dallas, Tex. When this documentation was presented I did not go at any time to the regulatory authorities to say I want this or I want the other. I think these people should or should not. I merely raised a question about the public interest because if the Groos National Bank had been issued a charter the charter had to be issued on the basis of public necessity and convenience.

The CHAIRMAN. Did you do that before this transpired?

Mr. GONZALEZ. Well, at the time that I first made an inquiry of the regulatory agencies it was not clear if enough stock had been bought to control or whether it was just a substantial portion. We did not know. Later I was informed.

The CHAIRMAN. Well, I would pursue it. I think you have a real case in the public interest that all States would be interested in.

Mr. GONZALEZ. Well, from the standpoint of San Antonio, here is a bank chartered for a specific purpose. Now if another bank wishes to move in and offer the money in order to gain control——

The CHAIRMAN. This cannot be disputed. That is the reason there is a hiatus in the proof. In one case the proof is necessary and in the other case it is just as bad. It looks to me like the regulatory authorities have some responsibility of rising to the occasion and making sure that does not happen, whether there is any law or not.

Mr. GONZALEZ. I am sure that they have the power inherently to seek——

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The CHAIRMAN. Do you have any suggestions as to any future hearings on this, Mr. Gonzalez?

Mr. GONZALEZ. Well, sir, I would like to keep the matter open.

The CHAIRMAN. That will be fine. I will keep you advised and I will keep the committee advised.

Mr. GONZALEZ. Also there may be others present here who may have some wish to be heard on the other side or the collateral side, I do not know for sure.

The CHAIRMAN. It is possible we could submit a question to the regulatory authorities along this line to see if they have any suggestion to make about the recourse.

Mr. GONZALEZ. Mr. Chairman, I will be very grateful for the benefit of your sound judgment and long experience.

The CHAIRMAN. I am not sure as to how sound it will be, but I will be very glad to cooperate with you because it looks to me like this is a real swindle. I mean, the public would be swindled, our public.

All right. Well, if there is nothing else before the committee we will meet tomorrow morning and we will hear the Assistant Attorney General, the Honorable Richard W. McLaren, and that will close the testimony on this bill, H.R. 5700.

Mr. GONZALEZ. Mr. Chairman, one further thing before we close.

Would it be possible to ask both Mr. Camp and Mr. Wille to come back and answer briefly the questions about what inherent authority they do have with respect to cease and desist?

The CHAIRMAN. May I suggest, Mr. Gonzalez, I think we could direct a letter to each one of them and put the facts in there and let them make a suggestion, but if that fails to work we will have them before the committee.

Mr. GONZALEZ. All right.

The CHAIRMAN. Without objection, we stand in recess until 10 o'clock tomorrow morning.

(Whereupon, at 5 p.m., the committee recessed, to reconvene at 10 a.m., Tuesday, May 4, 1971.)

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THE BANKING REFORM ACT OF 1971

TUESDAY, MAY 4, 1971

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND CURRENCY,
Washington, D.C.

The committee met, pursuant to recess, at 10:05 a.m. in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman, Barrett, Sullivan, Ashley, Gonzalez, Minish, Hanna, Annunzio, Brasco, Chappell, Mitchell, Johnson, Brown, Williams, and McKinney.

The CHAIRMAN. The committee will please come to order.

We have this morning as our last, but certainly not least, witness on H.R. 5700 and related bills, the Honorable Richard W. McLaren, Assistant Attorney General for Antitrust.

As all of us realize, a major and perhaps most important part of this legislation deals with the anticompetitive effects of various relationships among competing financial institutions and between them and other corporate entities.

Mr. McLaren is not only officially the leading Government expert on antitrust matters, but he is also one of the outstanding authorities on antitrust in or out of Government. Therefore, it is my feeling that his testimony here today probably is as important to the deliberations of this committee as any testimony we have received during the 2½ weeks of extensive hearings on this legislation.

On many occasions in the past, this committee has benefited greatly from the testimony of the Justice Department on legislation it has considered involving antitrust matters relating to banking. As many of you will recall, the Justice Department has actively assisted this committee in drafting such legislation involving antitrust matters in relation to banking as the Bank Merger Act of 1969, the Bank Merger Act of 1966 and the Bank Holding Company Act of 1970.

We are sure that Mr. McLaren, as he and his predecessors in the past have, will contribute substantially to the consideration of this legislation by this committee concerning antitrust legislation relating to the banking community.

Mr. McLaren, we will be very glad to hear from you.

And you may proceed as you desire, sir.

Mr. ANNUNZIO. Mr. Chairman——

The CHAIRMAN. Mr. Annunzio.

Mr. ANNUNZIO. I would like to make a unanimous request at this time that following Mr. McLaren's testimony and the interrogation by the committee members I may insert into the record a letter from Mr.

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Donald M. Graham, chairman of the board of the Continental National Bank in Chicago, and a statement prepared by Mr. Graham for this committee hearing on H.R. 5700.

The CHAIRMAN. Without objection it is so ordered.

All right, Mr. McLaren, you may proceed.

STATEMENT OF HON. RICHARD W. McLAREN, ASSISTANT ATTORNEY GENERAL FOR ANTITRUST, DEPARTMENT OF JUSTICE; ACCOMPANIED BY DONALD I. BAKER, CHIEF, OFFICE OF POLICY PLANNING

Mr. McLAREN. Thank you very much, Mr. Chairman.

Mr. Chairman and members of the committee, I appreciate very much your kindness over the last 2 weeks in accommodating my schedule so that I could come to cover with you some of the important issues which are raised by H.R. 5700.

With me this morning is Mr. Donald I. Baker, Chief of our Office of Policy Planning.

As you probably know, the administration is presently preparing legislation which would provide broad regulatory controls aimed at eliminating the types of abuses to which H.R. 5700 is addressed.

Pending the introduction of that legislation, and I am very sorry that we do not have it ready now, we have been a little busy up at the Justice Department in the last couple of weeks. I would like to limit my remarks to those provisions of H.R. 5700, which most directly involve competitive issues. I am speaking primarily of those provisions dealing with interlocks between financial institutions including insurance companies and the provisions involving mutual savings bank ownership of stock in other financial instructions. With regard to the other sections of the bill, especially those concerning conflicts of interest and banking practices, I defer to my colleagues in the regulatory agencies, who have already appeared before this committee.

First, as to existing law, as this committee knows the economic and political effects of interlocks between various types of financial institutions has been a subject of congressional as well as public concern in the past. In the first part of section 8 of the Clayton Act, enacted in 1914, Congress prohibited certain types of interlocks between banks. I think that we would all agree that the passage of time has demonstrated the inadequacy of section 8's bank interlock prohibitions to deal with many of the competitive issues that have arisen in our increasingly complex economy.

The principal limitations of section 8's bank interlock prohibitions are clear. Those prohibitions apply only to banks which are members of the Federal Reserve System. They do not reach interlocks between member banks on the one hand and a number of potentially competitive institutions such as mutual savings banks, savings and loan associations, and insurance companies on the other hand. Moreover, the prohibitions apply only to interlocks between institutions located in the same local market.

Some of the omissions of the bank interlock prohibitions of section 8 may be reached under the second part of section 8 which prohibits certain interlocks between corporations engaged in commerce. We

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believe that the latter portion of section 8 may be reasonably construed to prohibit certain bank-nonbank interlocks where the corporations are competitors. However, the manner in which section 8 was drafted has created certain ambiguities as to the relationship between the two parts of the section and the possibility of lengthy litigation over the issue of statutory construction has impaired the effectiveness of section 8 in this area. In any event, the fact that the second or general part of section 8 only prohibits director interlocks between competitors has reduced its effectiveness as an enforcement tool.

In view of the inadequacies of section 8 of the Clayton Act and the serious issues raised by interlocks among powerful financal institutions, the Department of Justice supports the general purpose of H.R. 5700—to make the law more responsive to the public interest needs of today. The bill, however, is quite broad in scope and would cover many types of commercial relationships. Thus, before discussing the specific situations dealt with in H.R. 5700, I think that a few remarks on the general policy considerations relating to financial interlocks would be appropriate.

Any determination to prohibit personnel interlocks between independent financial institutions must in our view be based upon a balancing of potential adverse effects and benefits which might result from such relationships. This is a difficult matter. We in the administration are carefully considering how to achieve this balance in an economically realistic manner, and we plan to deal with personnel interlocks in our proposed legislation.

Where the interlock is between competing firms, the potential adverse competitive effects are relatively clear. Personnel interlocks may foster, and make it harder to detect, anticompetitive information exchanges and concerted management decisions of the type that the antitrust laws are designed to prohibit.

Moreover, extensive interlocks between the major sources of credit may result in the emergence of common commercial policies inimical to the development of the type of innovative and diversified economy which competition is designed to effect. Conversely, any general benefits which can only be achieved through personnel interlocks between direct competitors are difficult to perceive.

The potential anticompetitive effects of personnel interlocks, of course, are not limited to situations involving direct competitors. Such interlocks between firms in a supplier-customer or other nondirect competitor relationship can foster practices which result in competitive foreclosure and favoritism that distort the competitive process. Such problems are particularly significant in the financial area during periods of credit rationing. However, while the anticompetitive potential of personnel interlocks between firms which are not direct competitors is real, the likelihood of the interlock resulting in significant anticompetitive effects depends heavily upon the facts of a given case.

On the potential benefit side, there is more to be said in favor of interlocks between firms which are not direct competitors than is the case where the firms are direct competitors. For example, a bank providing specialized financing to a particular industry might benefit from having a member of that industry on its board of directors and vice versa.

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Thus, determining whether personnel interlocks between firms which are not direct competitors results in net social benefit or harm may not be subject to a categorical answer; instead, it may very well require a careful analysis of the facts in individual cases.

Dealing more specifically now with interlocks between financial institutions, let us first consider commercial banks with commercial banks.

That commercial banks are competitors in particular markets is well established both in law and economics. The Supreme Court has stressed this point in a whole series of bank merger decisions, beginning with *Philadelphia National Bank* (374 U.S. 321, 356–57) in 1963. At the ame time, it is equally clear that this competition does not depend upon the distinction contained in section 8; that is, between member and nonmember banks.

The more difficult question is determining the exact geographic area in which particular commercial banks are likely to compete. As has been frequently noted most banking is local in character, and for the vast number of banks the local area surrounding particular offices is the appropriate market for analysis. This is essentially the geographic rule adopted by section 8.

There are, however, two important exceptions to this general rule. First, the operations of the very largest banks are clearly national in scope. For instance, almost all of the term lending to very large corporations is made by banks having a billion dollars worth of assets or more. These are the only institutions capable of satisfying the credit needs of these customers, and their operations in this regard are essentially unrestricted by geographic boundaries.

The second exception concerns banks which are important regionally but whose size does not make them national competitors. These banks either directly or through holding companies are capable of operating throughout a particular State, and they must be considered potential entrants into local markets other than those in which they currently maintain offices. This is, of course, the theory behind a number of our current section 7 suits in the banking field (for example, *United States* v. *First Nat'l Bancorp.*, Civil No. 2413 (D. Colo., filed July 8, 1970)). Interlocks between such banks and local banks may well act to discourage entry and thus can have an even more anticompetitive impact than interlocks between actual competitors by barring completely the entry of a competing bank. Consequently, any prohibition on horizontal interlocks should take into account the geographical area of both actual and potential competition.

I would like to make one final comment concerning the geographical area of markets. Some have suggested that interlocks between financial institutions in small communities should be exempted. Our feeling is quite the opposite. The alternative sources of financial services available to persons in small towns are already quite limited, and in such cases any further coordination of banking policies and management would be very undesirable. This is a point the Supreme Court stressed in its decision last term in the *Phillipsburg* case.

Although horizontal interlocks between commercial banks present the clearest competitive dangers, vertical interlocks could also be a source of difficulty. Interlocks between correspondent banks might, for instance, tend to foreclose the market for correspondent services. On the

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other hand, such interlocks could possibly contribute to the effectiveness of the correspondent relationships, and without more evidence, we are not prepared to recommend general rules in these areas.

Now, what about interlocks between commercial banks with thrift institutions?

Although the Department in its antitrust enforcement efforts against bank mergers has frequently used commercial banking as a market standing alone, we recognize that in a number of important submarkets commercial banks compete with other institutions. The Supreme Court stressed the same point in its *Phillipsburg* decision which I mentioned earlier. Commercial banks, savings and loan associations, and mutual savings banks are all important sources for real estate loans. Similarly, commercial banks, credit unions, and in some areas mutual savings banks, are important sources of consumer credit. On the savings side, all of these institutions may compete for funds in local or occasionally more extensive markets. Interlocks between commercial banks and thrift institutions competing in these submarkets can, of course, have the same anticompetitive consequences as interlocks between commercial banks.

These interlocks can also cause the interlocked institutions to specialize their functions so as to avoid competitive overlaps, thus effectively reducing the consumers alternatives in these submarkets. For instance, a commercial bank may concentrate in short term business lending—in which it would not compete with an interlocked thrift institution—and avoid mortgage lending—leaving that to the interlocked partner. This is a problem which has occurred in areas where mutual savings banks have substantial interests in commercial banks, about which I shall have more to say later, and it may be enhanced by personnel interlocks.

Next, interlocks of thrift institutions with thrift institutions.

Interlocks between thrift institutions in geographical areas in which both compete are obviously subject to the same criticisms as those between commercial banks and between commercial banks and thrift institutions. An example is the Chelsea Savings Bank case (*United States* v. *Chelsea Savings Bank*, 300 F. Supp. 721 (D. Conn 1969)), filed in 1968, the Justice Department opposed a merger between the savings institutions because it would eliminate direct competition for savings deposits and mortgage loans in the local area involved.

Now, interlocks between depository institutions with insurance companies.

The competitive overlap of depository institutions is fairly self-evident. What is sometimes less well recognized, however, is the overlap between banks and life insurance companies, particularly in providing real estate financing. During the course of a relatively recent antitrust trial, the *Crocker Anglo National Bank* case in California in 1967, evidence showed that insurance companies held almost as much mortgage debt on nonfarm real estate in California as did commercial banks and contributed a significant share of all such funds. A similar pattern exists nationally. Thus, even from the limited view of horizontal competition, insurance company interlocks with other financial institutions pose problems.

Insurance company interlocks with financial institutions may also create competitive dangers in markets other than those in which

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the two institutions compete directly. This may be particularly true of casualty insurance companies. For instance, in 1969 the Department indicated that it would oppose the pending acquisition by First National City Corp. of Chubb & Sons, a large casualty insurance firm; we expressed concern that the acquisition involving the very large enterprises would create opportunities for tying insurance to loans and vice versa. That transaction was abandoned incidentally without a complaint ever being filed.

At a more local level, a savings and loan association or other lender could require the use of an interlocked insurance company as a precondition to a mortgage loan. Such abuses have been frequently alleged in the past. However, section 106 of the Bank Holding Company Act of 1970 now prevents commercial banks from conditioning loans on such purchases from the bank, and the Federal Home Loan Bank Board, as you undoubtedly know, has recently proposed regulations in this area. Whether these remedies will be adequate remains to be seen.

But even without formal tying, there may be a significant tying effect. A customer might be encouraged to voluntarily use an interlocked insurance company in order to promote favorable action on his loan application. This could happen if the interlock is well known or if because of the interlock the insurance company is given some preference, such as an office in the savings and loan association.

Such tying effects may not be reached directly by the tying prohibitions in the antitrust laws, yet in some circumstances they could be serious impediments to competition. Similar trying effects can, of course, exist with any of the peripheral services accompanying real estate lending—for instance the use of title, closing, and appraisal services. So banks and insurance company interlocks are another area which we are considering.

Next I would like to consider briefly interlocks between depository institutions, primarily banks, and securities brokers and dealers. Such interlocks with member banks are already subject to Federal Reserve Board regulation. H.R. 5700 would extend this prohibition to all depository institutions. Security dealers compete directly with banks in several markets. Commercial banks through their trust departments compete with security dealers in providing investment services, and both compete in providing credit for the purchase of securities.

Of perhaps even more importance than these horizontal relationships, however, has been the evidently widespread existence of reciprocity between banks and security dealers. In these cases the bank purchases brokerage services from a broker for its trust and investment activities, and in return the broker maintains deposits at the bank or uses other bank services. This problem was particularly severe before the introduction of negotiated commission rates when artificially high rates gave bankers considerable incentive to tie their use of a broker to the broker's deposits in the bank or its use of bank services. Hopefully, the advent of negotiated commissions will reduce considerably this pressure for systematic reciprocity.

Brokers are, of course, large bank customers, and even in the absence of reciprocity, personnel interlocks could lead a bank to favor one broker over its competitors. More fundamentally such interlocks would also violate our continuing national policy of separating se-

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curities dealing from banking—a policy reiterated just a few weeks ago by the Supreme Court in *Investment Enterprises Inc.* v. *Camp.*

Finally, I would like to comment briefly on banking interlocks with customers. This is a troublesome area, and we have one current case. *United States* v. *Cleveland Trust Co.* (Civil No. C–70–301 (N.D. Ohio, filed March 26, 1970)) in which we charge that bank representation on the boards of directors of competing customers violates section 8.

Nevertheless, we can imagine situations in which bank-customer interlocks would be appropriate. New institutions particularly may need to bring important customers onto their board in order to attract their patronage. Bank representation on the customer's board may be necessary protection when lending to a closely held corporation, or representation may be appropriate when the bank is making a particularly risky loan. Also, it would seem anomalous to require any important stockholder or director of a bank to take his business elsewhere.

Given the variety of cases which may exist, this would appear to be another area in which a flexible regulatory approach rather than a legislative rule should be adopted.

Sections 2 through 6 of H.R. 5700 would eliminate personnel interlocks in all of the situations I have described. But H.R. 5700 goes far beyond that by adopting absolute prohibitions which take no account of geographical markets, size or competitive factors.

We are working with others in the administration to develop a narrower bill, or perhaps more flexible is a better term, which would reach those interlocks with harmful potential but which would not automatically circumscribe their use when competitive problems are not raised. These discussions are not complete and investigation is ongoing, and I hope we will have something very definite soon.

Let me turn now from interlock questions to the other provision I propose to discuss. This is section 10 of the bill. It prohibits mutual savings banks from owning stock in any other financial institution. Specifically, it prohibits a mutual savings bank from owning any stock in any federally insured bank or savings and loan association, or in any bank or savings and loan holding company, or in any insurance company, or in any broker or dealer registered under the Securities and Exchange Act of 1934.

For reasons I shall explain, we believe that this provision is much too broad, but that a narrower version would have merit.

The ownership by mutual savings banks of commercial banks is quite extensive in New England. This committee has itself documented this overlap. For instance, in Manchester, N.H., the committee's study found that the three largest mutual savings banks in the community were the largest shareholders of Manchester's three largest commercial banks. This pattern is repeated throughout New England, especially in smaller communities.

A variant of this ownership pattern exists in Boston, New England's leading financial center. There, a number of large mutual savings banks own shares in the city's leading commercial banks. Although each individual savings bank's stockholding is relatively small in proportion to the total shares outstanding, their cumulative totals are significant.

This savings bank ownership of commercial banks in the same geographic area poses a number of possible competitive problems. It can

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inhibit vigorous competition between the two types of banks in the fields where they do (or could) both operate. It gives the mutual savings bank a substantial interest in the profitability of its nominal competitor, as well as potential influence over the management of the latter. It encourages formal or informal understandings designed to protect the profitability of both, understandings by which mutual savings bank and the commercial bank may attempt to divide the market by service categories.

Thus, for example, it appears that commercial banks in New England may not choose to compete vigorously with mutual savings banks for personal savings or in providing mortgage money. Any such loss of competition is, of course, particularly important in the smaller banking markets where the two institutions may be the only significant alternatives available to local residents.

To some extent, these situations may be covered by existing law. The Department has successfully maintained that section 7 of the Clayton Act applies to mergers and acquisitions involving mutual savings banks. (And here I refer to the *Chelsea Savings Bank* case up in Connecticut.)

Section 7 reaches a minority stock holding which falls short of full control where it causes the requisite anticompetitive effect; this was specifically held by the Supreme Court in the *DuPont-GM* case decided in 1957. On the other hand, where two or more mutual savings banks jointly influence or control a commercial bank, the litigation problem under section 7 would be more complex; and this, as I have noted, seems to be the very type of situation which exists in Boston. In these circumstances, it would seem desirable to eliminate the doubts and obscurity which may result from litigation, and we shall look into this problem area carefully in developing the administration's bill.

We believe, however, that section 10 of H.R. 5700 is too broad. It would seem possible to deal with New England type problems by simply prohibiting a savings bank from owning stock in a commercial bank operating in the same community or adjacent communities. This would leave mutual savings banks free to invest in stocks of banks operating in other communities, or elsewhere in the country, while eliminating the principal competitive dangers noted above.

Section 10 of the bill would also apply flat prohibitions to savings bank shareholding in other types of financial institutions. We do not have any present basis for believing that a flat prohibition is required. It is quite possible that substantial cross ownership between very large savings banks and very large life insurance companies might conceivably have some impact on the secondary mortgage market or the large project mortgage market. It is also possible that cross ownership between a mutual savings bank and a casualty insurer might encourage the type of tying or tying effect I have described above. However, we have no information that such risks are actually present and therefore we would not recommend enactment of legislation to prohibit any mutual savings bank from owning any of these other financial institutions. We would, of course, keep a careful eye on substantial stock acquisitions by mutual savings banks under the Clayton Act, section 7. This is because such acquisition of, say, insurers, could

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raise some of the types of problems we have seen in our proposed case against the First National City-Chubb & Son in 1969.

In sum, the Department of Justice is not aware of significant problems arising out of mutual savings bank ownership of financial institutions other than commercial banks. Therefore, we see no need for legislation concerning ownership of these other entities by mutual savings banks.

In conclusion, I would like to say that we are very sympathetic with this committee's efforts to deal with some very difficult competitive problems. The need is for pragmatic solutions which deal with the problem in flexible meaningful ways, ways that eliminate the competitive risks without unnecessarily fettering the financial industries involved.

The CHAIRMAN. Thank you very much, Mr. McLaren. Your statement is one of the most helpful and well-documented pieces of testimony that we have had. And I congratulate you on it.

Mr. MCLAREN. Thank you very much, sir.

The CHAIRMAN. I am a little bit disappointed, however—I realize that it is through no fault of yours—that the administration has been unable, after almost 2 months, to come up with a clear position on this legislation. You state that the administration is presently preparing legislation, which, of course, is encouraging to us, we appreciate that. My own feeling is that the committee should take up this bill in executive session not later than the early part of next month, the early part of June.

As I said, the administration has had plenty of time to study this legislation. Can you give us any idea as to when the administration is likely to give us its position on this important legislation, Mr. McLaren?

Mr. MCLAREN. As I indicated earlier, Mr. Chairman, we will make this the first order of business. And I would hope very much that we could come up with definitive and specific language, within 2 or 3 weeks.

The CHAIRMAN. That will be fine. That will about coincide with the time when we will take it up.

Mr. MCLAREN. I hope so. We will make every effort to do it.

The CHAIRMAN. You are familiar, Mr. McLaren, with the Bank Merger Act of 1960 and the Bank Merger Act of 1966, are you not?

Mr. MCLAREN. Yes, sir.

The CHAIRMAN. And you are also familiar with the Bank Holding Company Act of 1970?

Mr. MCLAREN. Yes, indeed.

The CHAIRMAN. Would you characterize these pieces of important legislation as part of the body of antitrust laws particularly pertaining to banking institutions?

Mr. MCLAREN. Yes; I think that is certainly a fair statement.

The CHAIRMAN. Thank you, sir.

In your long experience as an antitrust lawyer do you feel that there are any substantial problems created in terms of administration of antitrust laws due to the fact that these laws were passed as separate pieces of legislation rather than as part of the Sherman Act or the Clayton Act?

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Mr. McLaren. No, Mr. Chairman, I do not think that separation of acts has had an adverse effect on our enforcement work. I take it that is the question.

The Chairman. You refer on page 13 of your testimony to the laws regulating interlocking relationships between member banks of the Federal Reserve System and security brokers and dealers. Would you regard this prohibition in 12 U.S.C. paragraph 78, as a part of the general body of law pertaining to prohibitions against interlocking directorates?

Mr. McLaren. Broadly speaking I think so, yes.

The Chairman. Is it not correct that this prohibition is part of the Banking Act of 1933, legislation originally passed by this committee?

Mr. McLaren. I am sorry, I did not get it, Mr. Chairman.

The Chairman. Is it not correct that this prohibition is part of the Banking Act of 1933, legislation originally pased by this committee?

Mr. McLaren. That is my understanding, yes, Mr. Chairman. I do not know whether there have been amendments or not. But certainly the original.

The Chairman. And is it not also correct that part of section 8 of the Clayton Act dealing with interlocking relationships among banks is administered by the Federal Reserve Board over which this committee has jurisdiction?

Mr. McLaren. Yes, that is correct.

The Chairman. Thank you very much, sir. If you care to elaborate on any part of your testimony when you get your transcript, you may have the privilege of doing so.

Mr. McLaren. Thank you very much, Mr. Chairman.

The Chairman. Mr. Brown.

Mr. Brown. Mr. Chairman, if I may, I will defer to Mr. Williams. He was here earlier.

The Chairman. I know. But you either take it or pass it up.

Mr. Brown. Could we take Mr. Williams and come back to me in the regular order?

The Chairman. If you will let me handle it, I think everyone will receive equal treatment.

Mr. Barrett.

Mr. Barrett. Mr. McLaren, I understand that your further statement on H.R. 5700 which you will submit in a few weeks' time will give clarification on the ambiguities in this bill?

Mr. McLaren. Yes, specific suggestions.

Mr. Barrett. There is little question but that this committee has for years dealt with the antitrust matters involving banking. Do you see any objection from the administrative point of view to the committee's dealing in this legislation with interlocking relationships as they relate to competing financial institutions?

Mr. McLaren. I think not, Congressman Barrett. I suppose there is a question of symmetry between the treatment of banks and industry in general, but I do not regard that as anything of great significance. In other words, if a definite scheme for the regulation of interlocking directorates between financial institutions should be adopted through legislation originating in this committee, this would to a degree make

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section 8 of the Clayton Act a dead letter. But I do not regard that as any particularly serious proposition.

Mr. BARRETT. I have two other questions I would like to ask you. I find your analysis of the problem of the area of competition to be very interesting. As I understand it, you take the position that there are really two areas, geographically speaking. One is the nationwide market for the largest banking institutions, another is a regional area for minimum-sized banking institutions and holding companies, and the last is the local metropolitan area for small banking institutions. Is this a generally accurate breakdown of your analysis?

Mr. MCLAREN. I think that we have to say also that there are very definite overlaps between markets. For example, the national firm also competes in regional and in local markets.

Mr. BARRETT. You seem to feel that there is evidence that the billion-dollar-figure banks competing nationally mentioned by Dr. Burns is not as arbitrary as it may seem. You cited an article, I think you said, in the April 1956 issue of the Federal Reserve Bulletin. And I was wondering if you could elaborate a little on the findings of that article to be submitted for the record.

Mr. MCLAREN. I am sure we could do that, Congressman. I do not believe that we have it with us. You are referring to the article referred in footnote of page 7 of my statement?

Mr. BARRETT. Yes.

Mr. MCLAREN. We will be glad to do that, Congressman.

Mr. BARRETT. Thank you.

That is all, Mr. Chairman.

(In response to the information requested by Mr. Barrett, the following reply was received from Mr. McLaren:)

REPLY RECEIVED FROM MR. MCLAREN

Our prepared statement indicated that banks with a billion dollars worth of assets or more are responsible for most of the term lending to major corporations. This information was based upon a comprehensive study conducted by the Federal Reserve Board in 1955 and 1957 which related the size of business borrowers to the size of the lending banks.[1] These surveys showed that banks whose deposits were a billion dollars or more provided 85.5 per cent of all term loans to the largest borrowers (those with assets of $100 million or more). These same banks were also responsible for 80 per cent of term loans to the next largest group of borrowers (those with assets between $25 and $100 million).[2]

Looked at from the point of view of the banks involved, lending to the largest borrowers in 1955 constituted 30.4 per cent of all business loans made by banks having more than $2.5 billion worth of deposits and 31.6 per cent of all business loans made by banks whose deposits were between $1 and $2.5 billion.[3] The proportion of such loans in the portfolios of the next largest group of banks (those with deposits between $500 million and $1 billion) falls off sharply, constituting only 17.4 per cent of their business loans. Within the limits of the statistical categories available, this does suggest that the billion dollar figure tends to separate off those banks which do a very substantial business with the largest national corporations.

These figures are, of course, now somewhat dated, but they are the latest publicly available. We understand that the Federal Reserve Board is beginning a new business loan survey which should shed additional light on the importance of billion dollar banks as national lenders.

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[1] See "Member Bank Term Lending to Business, 1955–57," Federal Reserve Bull. 353 (April 1959).
[2] Id. Table 9 at 363.
[3] *Business Loans of Member Banks*, Federal Reserve Bull. 327, Table 4 at 332 (April 1956).

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The CHAIRMAN. Mr. Williams.

Mr. WILLIAMS. Thank you, Mr. Chairman.

Mr. McLAREN. I appreciate the fact that you have come here this morning to give us your views on H.R. 5700. This bill was introduced on March 8, and to the best of my judgment, this is the first time anyone from your Department has been up to see us either formally or informally to discuss this proposal which has such a direct bearing on your areas of interest.

I am also pleased to know that the administration is preparing a bill. Obviously you have done a great deal of research in this area which qualifies you to comment on this subject. It must be a very complex matter, as I gather that despite the fact that the Office of Management and Budgets clearing Mr. Camp's testimony 2 weeks ago, it was not possible to get yours cleared in time for you to get your statement to us until 5 p.m. yesterday. I think your statement and your assistance have really contributed a lot to our efforts to develop sound legislation.

In discussing antitrust competitive results of interlocks between thrift institutions and commercial banks, you know that in some areas the thrift institutions do most of the mortgage lending while commercial banks serve other lending needs. Isn't it reasonable to assume that this alleged division of the market is as much the result of the structure of the institutions and the market as any collusion? For example, a savings and loan is restricted by law to mortgage loans, and it can be expected to compete vigorously for this business and the savings to support it. A commercial bank, on the other hand, will compete more effectively for savings which it lends on short-term loans which customarily carry a higher interest rate. My point is that in determining whether interlocks are anticompetitive, we must look at more than a list of directors and a loan portfolio. Do you agree?

Mr. McLAREN. Yes, sir; I agree entirely.

I think that there is no question that the different institutions do tend naturally to specialize. On the other hand, sometimes you find through statistical analysis that, for example, commercial banks are more specialized in one area of the country than in another, and this we found to be true, or rather the committee found to be true, in New England where mutual savings banks have significant interests in commercial banks.

Mr. WILLIAMS. If I interpret you correctly, you are saying that while anticompetitive actions may result from interlocks in corporate stockholdings, that by and large you think the absolute provisions of H.R. 5700 are too broad and too absolute. For example, I note your statement on page 5 that: "The likelihood of the interlock resulting in anticompetitive effects depends heavily upon the facts of a given case."

I understand that you are going to recommend modifications of section 8 of the Clayton Act to include officers, trustees, directors, and employees, and to modify the definition of a geographic area; is my understanding correct?

Mr. McLAREN. Well, this is certainly one of the areas we are concerned about. Personally it seems to me that where you have a prohibition against interlocks of directors, but do not cover executives. you may be locking just one end of the barn.

Mr. WILLIAMS. I think you sum up things very nicely in your conclusion of your statement when you said:

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The need is for pragmatic solutions which deal with the problems in flexible, meaningful ways, ways that eliminate the competitive risks without unnecessarily fettering the financial industries involved.

I think when you make that statement you are expressing the sentiment of many people who have appeared before us in these public hearings. I would like to request you to make certain that all members of this committee get your proposed legislation when it is finalized.

Mr. McLaren. Yes, sir.

Mr. Williams. Thank you.

The Chairman. Mrs. Sullivan.

Mrs. Sullivan. Thank you, Mr. Chairman.

Mr. McLaren, you emphasized very strongly that the anticompetitive problems are at least as great in smalltown areas as they are in larger communities, and therefore you urge the committee not to exempt the smalltown areas from any interlocking prohibition we might adopt. But could you elaborate a little on the problem in the small towns. If it is too difficult to do this now, would you elaborate on this subject when you go through your transcript?

Mr. McLaren. Just very briefly, our concern is that in the small community, we may have only two or three or a handful of banks, and if they are interlocked, then when a man goes up to get the loan and gets the answer "No," from one bank, it is probably going to be "No" in all.

In other words, there is on effective competition which would promote the best kind of service to the consumer.

Mrs. Sullivan. But wouldn't the small communities have a more difficult time trying to find the people to serve?

Mr. McLaren. I cannot help but feel that with the breadth of our educational programs and the basic good sense of our American businessmen, that we do not have to have the same people on bank boards.

Mrs. Sullivan. This is one of the reasons that they have given for being exempt.

I gather that you strongly agree with the sponsors of H.R. 5700, that any interlocking personnel prohibitions adopted by this committee should include at least life insurance companies and probably insurance companies generally; is that correct?

Mr. McLaren. Well, this is an aspect of the thing that we are working on, Mrs. Sullivan. I cannot say that we have really come to a workable conclusion that covers all the different kinds of problems that are presented. And as I said earlier, I am very regretful that we have not come up with definitive answers. But this is something we are still studying, and I do not have an answer for it.

Mrs. Sullivan. I think that this is maybe one of the areas that you could cover when you further elaborate in your statement.

Mr. McLaren. Well, our experiences are indicated in the *Crocker Anglo* case. Our evidence very clearly showed that big banks and big insurance companies out there were in competition in real estate lending. We do not have a great broad sample of the data. But this certainly has led us to make additional inquiries and to consider the matter with Commerce and others. It is something for which we are hunting final answers.

Mrs. Sullivan. Is there any question in your mind that life insurance companies do compete substantially with commercial savings banks and savings and loans?

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Mr. McLaren. Certainly there is some competition, but at what level and what size and what area? These are all problems that we have to work on.

Mrs. Sullivan. Another reason for your urging us to include insurance companies in these prohibitions is the substantial potential for tie-in arrangements between lenders and insurance companies to the detriment of customers of banks, is that correct?

Mr. McLaren. Certainly for the larger institutions. As I indicated this was a matter of serious concern to us in the *First National City Bank-Chubb* case. We threatened suit on that basis. And they abandoned their merger plan.

Now, whether the same thing applies when you get down to much smaller banks and much smaller insurance companies, and particularly if they are in different areas, these are things we are trying to resolve.

Mrs. Sullivan. Thank you very much. Thank you, Mr. Chairman.

The Chairman. Mr. McKinney?

Mr. McKinney. No questions, Mr. Chairman.

The Chairman. Mr. Gonzalez?

Mr. Gonzalez. Yesterday Mr. Meyer from the Morgan Guaranty & Trust endorsed the idea that there was need for some regulation on this question of interlocking directors, but he was not too sure exactly how and to what extent. And he felt that the big danger was overregulation, and perhaps duplication of paperwork, as some of the bad parts of regulatory aspects.

I asked him if he had any specific ideas as to just what should be included by way of prohibition and he said well, they hadn't really arrived at the answer; it was a difficult and complex question and they were still studying the matter.

In view of the fact that you say you are preparing legislation, do you have any specific ideas as to the limitations, the scope of them, the type of wording that the legislation should include?

Mr. McLaren. Congressman, I very much regret that we do not have specific proposals at this point. I think, as the chairman indicated, that this legislation has been on the table for 2 months. And I wish we had made better progress. We simply do not have the specific language to recommend at this time. But I certainly hope we will within the next 2 or 3 weeks.

Mr. Gonzalez. Also late yesterday afternoon I heard not only from constituent banks, but area representatives. One of the things that agitated the public mind in my district was an apparent takeover of one of the most historic and traditional banks in the area, the Groos National Bank, which has been in existence since 1854, mostly through the funding of about $6 million worth of credit from the Bank of the Southwest in Houston, Tex. And apparently it was going along pretty well until we raised questions at the time we were just forming and organizing the committee and subcommittees. Since then we have had more of a chance to go into some of these patterns.

Here is a bank that has total assets of somewhere between $85 and $90 million. It was chartered for a purpose. It began as a private institution in 1854. As we noted before, it successfully resisted even Indian raids. There is a question that it will survive this raid this time. And the question here is, the bank was chartered for a certain purpose, to serve the community in San Antonio, in 1912. This has been

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serving those purposes very well. Here is a much larger institution in Houston, Tex., enabling an individual group of individuals with a little over $6 million to take over the control of a $90 million institution, for purposes still yet to be revealed.

Now, there has been a pulling back since all of this has hit the newspapers, and it is not too clear at this point exactly what it is the takeover people want to do.

In the meantime the bank naturally is going through a period of turmoil. The way the shares of stock were acquired was through uneven tenders, that is, some of the shareholders that had the bulk of the shares sold out for three and a half times the normal value of the stock on a cash basis, according to the president of the bank, the other day. Others were given the normal worth of the stock. Others were given $10 or $20 more.

Now, since then I have had a chance to look at some of the regulations both by the Comptroller as well as the FDIC. It seems to me that the regulations spell out that this type of acquisition of the stock is contrary to the rules and regulations of the regulating authority. I do not think it is a statutory prohibition or regulations. I have not been able to find any. But apparently there are regulations governing it on the part of the regulatory authorities.

My question to you is this: Is it necessary for us to have to legislate through specific statutory definition what apparently inherently both of these regulatory agencies now have to have authority to control? I know that if this were a merger the people attempting the merger would first have to come and obtain consent from the regulatory authorities. I also know that if this were a bank holding company or a holding company attempting to acquire it, they would have to come and get consent first from the regulatory authorities.

I also know that if the people attempting to take over the bank were attempting to get a charter, they would have to come and apply, and they would be certain to find contest. But apparently there is nothing to inhibit this kind of a takeover, where if you have the cash and you can persuade enough of the shareholders to sell at an inflated price, you cannot prevent the takeover of a bank. It means that nothing is being done.

You have your regulatory agencies. What is the Justice Department doing about seeing to it that the inherently regulatory power is being utilized by the Government regulatory authorities? What is to prevent the criminal end of it coming in, as they well may be through this method?

Mr. McLaren. I am not familiar with the particular situation you describe. If actual control is changed by this kind of offer and the change in stockholders, this is a matter which must be brought to the attention of the appropriate regulatory authorities. If the transaction resulted in an anticompetitive situation, that is to say, if either actual competition between the acquiring group and the acquired bank was lessened, or if the acquiring company was a likely potential entrant such entrant was a significant competitive factor this is something that we in the Antitrust Division would look into. And as a matter of fact, in a situation somewhat like that, we have brought a Sherman Act proceeding down in Kentucky, where certain individuals rather than corporate interests—pooled their funds and moved in to take

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control of a bank. Since they also controlled another bank in the same community, we were able to go in under the antitrust laws. (*United States* v. *Owensboro National Bank*, et al.). But apparently the situation that you pose is not in this category. I am sorry that I am really not prepared to say anything much more on that.

Mr. GONZALEZ. Mr. Chairman, I have been given notice that my time has expired, but could I ask unanimous consent to ask one more question?

The CHAIRMAN. Certainly.

Mr. GONZALEZ. Can I ask this question? Maybe through a search of the statutes and regulations you can help us on this. Of course, I can deal with the Department of Labor. But I want to find out what it would take for these interests in San Antonio to approach the Justice Department and see if there is a possibility of the Sherman——

The CHAIRMAN. You may ask him to answer it when he looks over this transcript. Is that satisfactory, Mr. McLaren?

Mr. MCLAREN. Yes.

And, Congressman Gonzalez, if you would be willing to take a few minutes after the hearing I would be glad to take down the name of the bank and its counsel if you would like us to get in touch with them.

Mr. GONZALEZ. I think they are in the office now, if I could get them to come over here.

The CHAIRMAN. Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman.

Mr. McLaren, is the commodity money and credit so different as to justify specific legislation regarding anticompetitive relationships and practices when such anticompetitive relationships and practices exist in the same way and probably to the same extent in all commercial activity, and the latter are controlled, or can be controlled, by general legislation?

Mr. MCLAREN. I think that is quite a broad question, Congressman Brown.

Mr. BROWN. This committee has jurisdiction only over financial institutions. This committee can legislate only with respect to financial institutions. Probably you are aware of the committee system in Congress and know if we go beyond our area in attempting to legislate against anticompetitive practices or relationships that the jurisdiction of the committee would be questioned.

Mr. MCLAREN. I think that the answer to your question is that Congress has seen fit to deal with money and banking separately from general industry, and in fact I think it is fair to say that you have a very general separation of banking and lending on the one side and industry and borrowing on the other side. To be more specific, section 8 of the Clayton Act, which is a part of general antitrust legislation, deals specifically with banks in a special provision.

Mr. BROWN. I am not sure that I understand your answer to that, because you are saying under the Clayton Act we have in general legislation specifically dealt with particular problems with respect to financial institutions, but we have generally legislated against anticompetitive relationships and practices. What I am saying, which I thought you would agree with, was that probably this could be

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done with general legislation rather than specific legislation such as H.R. 5700.

Mr. McLaren. I was thinking of general legislation in terms of the Sherman Act which prohibits every contract, combination, or conspiracy in restraint of trade. And here I think that the focus is more sharply on the question of the problems of financial institutions, particularly banks, rather than the entire economy. And we have dealt with it that way. Certainly Congress has dealt with it, both ways. Generally, the Sherman Act does cover banks and so on. The Clayton Act, too, covers industry generally, but it also zeroes in and specifically mentions banks.

Mr. Brown. Is it then your testimony that you think it is better to deal with the financial institutions in specific legislation, even though the practices and relationships exist in all commerce?

Mr. McLaren. I think we have pretty much made that decision. We have really a vast system of laws dealing specifically with banking.

Mr. Brown. All the decisions are subject to review and revision and modification; are they not?

Mr. McLaren. There is no question about that. It is entirely possible to amend either the banking laws or the antitrust laws to deal with bank interlock problems.

Mr. Brown. Let me ask you in a different way about existing requirements on disclosure. Wouldn't clear disclosure of interlocks of all kinds to shareholders and other interested parties, when potential anticompetitive situations exist, permit, even provoke a self-policing of such relationships to a greater extent than it does now, sir? And then would you follow it up by telling me what requirements in the way of disclosure are presently in the law?

Mr. McLaren. So far as I know, a disclosure of an interlocking directorship arrangement as such is not required by law. For example, you may have your proxy statement filed for company A, and that shows you a director of company A, and separately you may have a proxy statement on company B. But there isn't any statement formally pointing out the connection.

Mr. Brown. What I am talking about is, What if, in your proxy statement, you had to make a disclosure that Mr. X is a director of these different companies, and even that the law which required the disclosure further required to be set forth the fact that he is a director of bank Y, which deals with the same geographic competitive area?

Mr. McLaren. My feeling is that—and I haven't given this a great deal of thought in this particular way—that if you know that there is a price-fixing conspiracy going on, you are not going to be any happier about it because you know about it if you can't do something about it. In other words, disclosure——

Mr. Brown. Do you think that an industry cannot police itself, that shareholders do not pay attention to who their officers are—their directors? Do you think this would not be a deterrent to interlocking relationships which might be or appear to be anticompetitive? All I am asking, Mr. McLaren, Do we avail ourselves of the tools that are already available without Government regulations? I think we are getting so that we are regulated to death. And I wonder if we have availed ourselves of the tools and the means to possibly cause a

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certain amount of self-policing rather than the Federal Government having to do it.

Mr. McLaren. I don't think that the registration is much of an answer for that. For one thing, you have section 8 problems now which do prohibit interlocking directorates, and we still find they are existing. It is not a question of registering or publicizing the fact that they exist, it is a proposition that the law prohibits it, but we still find it.

Mr. Brown. Have we reached the point where we pass laws and we can't enforce them because we don't have the ability to enforce them, then we pass another law; is that it?

Mr. McLaren. Oh, no. We are enforcing them, and I think the fact that we have relatively very few cases on this subject indicates that the law is effective. Were there simply a law requiring disclosure, I think we would have a very large number of interlocking directorates, which I regard as undesirable.

Mr. Brown. Thank you, Mr. Chairman.

The Chairman. Mr. Minish.

Mr. Minish. Thank you, Mr. Chairman.

Mr. McLaren, as I understand your statement regarding the ownership of commercial bank stock by mutual savings banks, do you believe that potential antitrust effects could be involved by limiting such ownerships in the geographical areas served by the banks?

Mr. McLaren. That is certainly one of the things we are considering very seriously, and that is my present thinking; yes.

Mr. Minish. Would your legislation that you are going to send up here deal with this?

Mr. McLaren. We intend to deal with personnel interlocks between different types of institutions, yes.

Mr. Minish. Let me ask you this. Do you feel that personnel interlock prohibitions against insurance companies and the depository institutions can be drafted which only curtail those interlocks and where actual and potential competition is present.

Mr. McLaren. That is what we are going to find out in the next 2 or 3 weeks. It isn't an easy proposition, Congressman, you are entirely right.

Mr. Minish. Thank you. That is all. Thank you, Mr. Chairman.

The Chairman. Mr. Johnson.

Mr. Johnson. Thank you, Mr. Chairman.

Mr. McLaren, I am delighted to see you here today.

Mr. McLaren. Thank you.

Mr. Johnson. I have had quite a number of conversations with you on the telephone, but I believe this is the first time I ever had a chance of saying hello to you.

I notice in the first part of your statement you say: "As you know the administration is presently preparing legislation which would provide broad regulatory controls aimed at eliminating the types of abuses to which this bill is addressed." When do you figure that bill would be ready and would be sent to the Hill for introduction?

Mr. McLaren. Well, as I stated earlier, we are regretful that it isn't ready now. We are going to try to move promptly. I understand this committee expects to move into its marking up session by early June. And we certainly hope to have something to the committee before that time.

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Mr. JOHNSON. May I direct a question to our chairman?

Would the administration bill be referred to this committee Mr. Chairman, or what committee do you suppose would have jurisdiction over it? Would the Judiciary handle it?

The CHAIRMAN. Of course, the hearings will have been completed. If anyone wanted to offer it as a substitute they would have the privilege of doing so if it is germane, and I assume it will be.

Mr. JOHNSON. Would it be referred to this committee when it is introduced?

The CHAIRMAN. That is a parliamentary question. I assume it will. But we have now concluded hearings on this bill and I don't think the committee would hold hearings on another bill which would be introduced as a substitute or amendments. We spent about 2½ weeks on this bill and I don't think the committee would be prone to go into another bill along the same lines.

Mr. JOHNSON. Mr. Chairman, I don't quite agree with that reasoning. Here is our Justice Department, which has made, let us say, an impartial study of this whole field, and as a result of no doubt a greater research and study, are going to put together a bill which may be much better than this bill, which may reach a situation which needs regulating, and which probably would be more meaningful, and maybe one that some of us could support. So I am hoping that you will defer marking up this bill until we have had a chance to look at the Justice Department bill, and it may be a bill that we can all go for, whereas you might have a lot of trouble on the bill in front of you

The CHAIRMAN. Let me suggest to you that if we had adopted that policy on the holding company bill last year we wouldn't have a holding company bill now, because considerable pressure was brought to bear on us not to have hearings on the holding company bill until the Commission on Bank Structure has finished. There is a commission now, and it may be suggested that we should withhold any action. That comes up on every bill. Now, then, if Mr. McLaren has some good amendments to suggest for this bill, we would be very glad to accept them. I know that this bill will probably be amended in many respects. But we don't have to hold a new hearing on another bill that is similar in order to get around to making the proper amendments to the bill we have.

But we want to do the right thing about it. And certainly we will give consideration to it. If his bill is better than ours, I would be in favor of substituting it.

Mr. JOHNSON. Thank you, Mr. Chairman.

Mr. McLaren, as you probably know, this bill that we have extends its attentions to the banks, the savings and loan associations, and the mutual savings banks, and so forth, and then adds the rather maybe nongeneric term, "and insurance companies." It doesn't define what is an insurance company or what is not an insurance company. It has been running through my mind in listening to the questioning of Mr. Brown, what is the jurisdiction of this committee over the regulation of insurance companies and their activities? For instance, this bill would deny the insurance companies the right to receive equity participations. I realize that the Supreme Court says that insurance is commerce. In your bill you apparently are going to attack insurance companies. Under what legal theory would you attempt to reach an insurance company or insurance companies?

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Mr. McLaren. Congressman Johnson, I don't think that our bill would go to that particular part of H.R. 5700. We certainly defer to the banking people on that. The part that we are particularly concerned about is interlocks. And to the extent that we reach some language covering the insurance-bank interlock, it would be a question of insurance companies in effect having representatives on bank boards. So it would be banking related, but also insurance related.

Mr. Johnson. In other words, I had the idea here that, if we are going to regulate the internal workings of insurance companies, which this bill seems to do, we are, in effect, saying to an insurance company, you can make a mortgage loan but you can't receive an equity participation, it runs in my mind that we would have to allege that it was against the public interest or, let's say, an equity participation is something deleterious as it flows through interstate commerce, in order to reach the internal workings of the insurance company which is not insured under the FDIC and not nationally chartered like the national banks are?

Mr. McLaren. I see your point. I am afraid that I am not able to make any input on that at all. It is just something I haven't really studied, the internal insurance aspects.

Mr. Johnson. Thank you. My time is up.

The Chairman. Mr. Hanna.

Mr. Hanna. Thank you, Mr. Chairman.

I was thinking that one of the problems that is at the base here is that we are in an era of a capital shortage. You don't have to be chairman of this committee to understand that. When you see large commercial enterprises threatened with bankruptcy, such as Penn Central, Lockheed, and LTV, to name a few, and when you see the cities and the districts who are in such dire need of capital, and when you see programs being proposed here in Congress that demand capital input, such as the environmental problem, it seems me that we could come to the conclusion that we are in an era of capital shortage, wouldn't you agree?

Mr. McLaren. Capital shortage in relation to demand, I agree; yes.

Mr. Hanna. Then it seems to me, if that is true, that the flow of capital is then more critical and the quality of that flow is more important as a public policy question, than if that condition did not exist. Therefore I think that we are constrained to look much more critically at the actual flow of capital. If that is dictated by special arrangement, it would have no connection with the public policy, and as a matter of fact, it may be going contrary to the public policy. So wouldn't you say that this heightens our critical attitude in terms of how the capital is flowing under the existing circumstances?

Mr. McLaren. Obstructions to the free flow of funds certainly become more and more important as the funds are in short supply and there is a heavier demand.

Mr. Hanna. This constrains me to move to the opposite end of the table from Mr. Brown. He thinks we are going too far. I don't think we are going far enough. My feeling is that if we are not going to go on the basis of reducing the taxes, or in peaks and valleys, then we have got to do something more constructive about the money policy of this country, how that money has accumulated, and where it has accumulated, and how it is applied. I feel that this is only a picayune

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operation here in terms of affecting the capital flow, and we are kind of Lilliputians trying to tie down Gulliver.

But I would think that it is important that this committee and some of the others look at the alternatives of getting a more effective money control policy, because look at the other side of the coin. How is this administration suggesting that we face these problems? Well, it is a kind of Mickey Mouse operation, if you want my judgment. And I have been part of that Mickey Mouse. We don't want large capital flows in the budget, that is clear. So if we have a housing project and we don't want it in the budget, we start a Fannie Mae operation, and we start a separate corporation for the Federal home loan bank. We don't want to be burdened with the Post Office, so we make it a separate corporation. Where do they get their money? Do they dig it up out of the ground? No, they do not. They go into the money market where the supply is already short. So we are not going to worry about what happens in that market. We have the burden of taxes off our shoulders. We have the burden of responsibility for operation of the Congress. So where is it? It is right out there in that private operation, where now we find we have some concerns about how people are stacking up the cards in terms of getting the most out of the operation for specific and special interests.

So it just seems to me that what this whole question does, it gives us a look at the whole inside operation, and we find that we are really fooling ourselves and fooling the people. If we think we can solve the problems by taking them outside the public arena and putting them in the private arena and then saying, don't worry, the private money market will take care of all of it. Where is the money coming from? If the private money is already short, it is like finding some person who is running a dog kennel and giving him three more big dogs and no more bones. And it just seems to me that that is not going to solve the problem of this country.

So, if Mr. Brown is worrying about us going too far, I can assure you that I am worrying about us not going far enough.

There is one other question I want to ask you. As you study this problem, part of the problem is that the charters for the various institutions were set in 1930. The operating conditions that set forth these charters were one thing in 1930, and something entirely different now. Are not the competitive postures of these institutions like insurance companies, mutual savings banks, savings and loans, commercial banks, obscuring all the lines of distinction that originally existed when we drew the original charters? Don't you find in your operations that this becomes part of the problem?

Mr. McLaren. There have been tremendous changes in the last 40 years, there is no question about that. And I would say it is true that the distinctions have been blurred in many respects. This is part of what the Commission on Financial Structure is studying. I must say, however, that in this whole area I have to defer to the expertise of the Council of Economic Advisers and the Treasury.

Mr. Hanna. I hope that you have a different sort of people that would like to share the concern that you find in the firing line, because whatever they all decide ultimately has to be enforced by people like yourself. And I am sure that you must sometimes be frustrated with the rhetoric that has to refer back to the charter of 1930 and the

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action in the field which has to be predicated on the realities of the competition of 1970 and the rest of this century.

I thank you, Mr. Chairman.

The CHAIRMAN. Mr. Brasco.

Mr. BRASCO. Mr. McLaren, on page 5 of your statement you say:

Thus, determining whether personnel interlocks between firms which are not direct competitors results in the net social benefit or harm will not be subject to a categorical answer; on the contrary, it may very well require a careful analysis of the effects in individual cases.

I think you have hit it on the head when you talk about what social benefit there is in terms of this question of interlocking directorates. And on page 8 you go on to say, and I agree with you, that small cities and towns should not be exempt from any decisions made on limiting interlocking directorates because of lack of adequate talent to serve on these various boards. I think that you agreed with many things that I have said on other occasions, that we do have a wealth of people that are capable of serving, that we do have the educational programs for many to perform these functions. Now, when you put the both of these together, the social benefits and the fact that we do have enough talent to go around, and also the fact that we are discussing this question of interlocking directorates because of the potential harm that having them can do, don't you think that the best approach might be just a flat prohibition, and then giving everybody enough time to have an opportunity to get out of them, so that when these institutions would be dealing with each other, no matter in what area, whether it be in the business world or the financial world, we would have a situation where people would be dealing with each other basically at arms' length. The question specifically, then is, don't you think that we should come up with the ban, but give everybody enough time—and I am not saying what the time should be, I really don't know, I am not an expert on that—but enough time to set the atmosphere so that we can make the transition without doing any harm to the industry as a whole?

Mr. MCLAREN. There should be a phasing out period, whatever rules are ultimately adopted.

I do think, though, that as far as simply outright prohibitions are concerned, there are some areas where we may go too far if we do engage in that. There may be some areas where there should be an outright prohibition. For example, if in fact there are local areas where the talent to run the banks is spread pretty thin, it seems to me that perhaps there should be some discretion in the regulatory authorities to make some exceptions. I think we have to look very closely at these cases and make up our minds on the best evidence we can get. Where the evidence is clear enough of anticompetitive or antisocial results, then we should have a flat prohibition. In other areas there ought to be more of a flexible rule.

Mr. BRASCO. If I am putting words in your mouth, I don't mean to do that. You have mentioned that there should be some kind of a phasing out here. My only thought is—I will say this because I am trying to get a posture on this thing myself—my only thought would be then, if we had a flat prohibition with adequate time for phasing out, might we not then set an exception where institutions which want to do this would have to come before some regulatory agency and

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prove something that I think personally is going to be rather difficult, with the broad talent that we do have in this country, that indeed and in fact there is no talent upon which they can draw, might that then be the answer, the prohibition plus coming in, If that is the case? Because other than saying that there is a shortage of talent—and I don't want to put myself in the position of casting any disparaging intentions on those who are involved in interlocks—but other than the shortage of talent, I see no good reason other than setting up the potentiality for some problems in the future.

Mr. McLAREN. A qualified prohibition.

Mr. BRASCO. Yes.

Mr. McLAREN. Prohibited unless you can establish that it would not be a harmful thing. That is certainly a possibility.

Mr. BRASCO. Not that it couldn't be a harmful thing, but you just have nobody in the area that is considered to be talented enough to serve.

Mr. McLAREN. It is a balancing process, the potential harm against the hardship to the bank.

Mr. BRASCO. That is exactly why I fixed on page 5, I thought that is exactly what you were trying to say, the balance between the two, my own opinion is to have some kind of a phasing out, as you suggested, but do it in a way that we take all contingencies into consideration in terms of not creating havoc in the industry. And I think you would be bet off with the general prohibitions, myself.

Thank you.

The CHAIRMAN. Mr. Chappell.

Mr. CHAPPELL. Mr. McLaren, your statement documents competition between insurance companies and banks in the mortgage lending field. Isn't it true that these entities also compete for pension fund management and mutual funds and savings?

Mr. McLAREN. I have heard that said, yes, Congressman. I don't know to what extent it is true. But I certainly believe that it is true in some respects, to some degree.

Mr. CHAPPELL. The next question I have, Mr. McLaren, really comes from as much ignorance as I can muster in the field. And that has to do with this thought. It seems to me that all of us are saying that any act or device, financial device or otherwise, that is in restraint of trade should be made unlawful. Is that really what you are saying? Or maybe I should say restraint of competition should be made unlawful? Is that a fair statement or not?

Mr. McLAREN. I think we have already really some pretty good general statements to that effect. Legislation now is sort of like the development from the Sherman Act to the Clayton Act. The Sherman Act was very general. Then the Clayton came along and zeroed in on certain specific activities. I think that is like what we are doing here.

Mr. CHAPPELL. My next question is going to be, is there any better way, any better approach than we are making, trying to pull all of these prohibitions together in one place? I know that we have got them all over the law books, if I understand it correctly. Is there a better way to pull them together and make enforcement more effective?

Mr. McLAREN. I hesitate to answer that, because we have really focused on just two or three parts of the bill, and there are a number

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of other things in the bill that are just outside my competence, I feel. I am afraid I can't offer much assistance to the committee on that.

Mr. CHAPPELL. Is it your feeling that the real deficiencies lie in the total law or in your own capacity to cover the ballfield and to do an adequate job of enforcement?

Mr. MCLAREN. I think in part section 8 isn't adequate to do the job that it apparently was intended to do. We are now faced with alternative methods of reform. We can amend section 8 either generally or specifically with respect to banks and financial institutions, or we can adopt special legislation covering the banking and financial area itself.

Mr. CHAPPELL. Which would be your preference or recommendation?

Mr. MCLAREN. I don't think I really have a preference, as long as we do provide the kind of new legislation that I think we need, that is to cure theses shortcomings I feel we now have, as I have outlined in my statement.

Mr. CHAPPELL. Thank you.

The CHAIRMAN. Mr. Mitchell.

Mr. MITCHELL. Thank you, Mr. Chairman.

Mr. McLaren, I hope you will forgive the low man on the totem pole on the Democratic side raising two very naive questions, perhaps.

You allude to the administration's legislation. Am I right that you in your office have made inputs into that legislation?

Mr. MCLAREN. Yes. We are doing this interagency and comparing experiences in trying to devise a language that we think will be acceptable and to do the job.

Mr. MITCHELL. Would those inputs have been based on specific instances of abuses that have been brought to the attention of your office?

Mr. MCLAREN. I think it is a little more general than that. We do have a number of economists on the staff. And we look into a great many matters that come to us and that don't necessarily result in litigation, but do result in education.

Mr. MITCHELL. The potential?

Mr. MCLAREN. Yes.

Mr. MITCHELL. For example, in terms of interlocks between commercial banks and commercial banks, your office would assume that either of these are there or the potential of these are there; is that correct?

Mr. MCLAREN. Yes.

Mr. MITCHELL. Is that equally true under interlocks between depository insurance, depository aggregates, and insurance companies, that you would assume that abuses or potential for abuses exist there?

Mr. MCLAREN. As I stated earlier, our experience with the bank-insurance interlock is relatively limited, although we did get a good hard evidence in a case tried in California on that subject, and we are trying to expand our information in that area.

Mr. MITCHELL. In terms of the interlocks between banks and security brokers and dealers, would your office have any information about abuses or potential for abuses within that category?

Mr. MCLAREN. There, again, I think that we are relatively short of hard information, and we are having to rely on our economists, and also on other parts of the Government.

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Mr. Baker reminds me that we do have reciprocity information that turns up in some investigations.

Mr. MITCHELL. I think it is only fair to lay out to you why I pursued that line of questioning. Sitting here in the hearing I noticed that a number of witnesses have come forward and they have talked very glibly and profoundly on occasion about the absolute absence of any abuse at all in terms of these interlocks. So I am very grateful that because you are making inputs into the administration's legislation you are suggesting that the abuses or the potential for abuses are there, and therefore justifying really the kind of actions we are proposing under H.R. 5700. So that is very helpful.

Thank you, sir.

Mr. McLAREN. Thank you.

The CHAIRMAN. Thank you very much, Mr. McLaren. You have made a great contribution to our progress on this particular legislation. And we look forward to your suggestions. And you may expect the same cooperation from this committee that we have received from you. And we will work together and see if we can't get the public interest served. Thank you again for appearing.

Mr. McLAREN. Thank you very much, Mr. Chairman.

The CHAIRMAN. Mr. Annunzio.

Mr. ANNUNZIO. Mr. Chairman, I ask unanimous consent that at this time I may insert in the official record of the hearings the statement of Donald M. Graham, chairman of the Board of Directors of Continental Illinois National Bank & Trust Co., of Chicago, located in the Seventh Congressional District of Illinois which I have the honor to represent.

Mr. Graham is a distinguished banker in our city and one of its most outstanding civic leaders. He is a trustee of the Better Government Association, on the board of directors of the Chicago Central Area Committee, a trustee of the Chicago Wesley Memorial Hospital, and chairman of the Mayor's Committee for Economic and Cultural Development of Chicago.

He is active in numerous other civic organizations and educational institutions, and serves on the board of many universities. He has been not only a highly respected member of the banking and business community in Chicago, but a leader as well in helping to bring about better understanding among the people of our city.

Mr. Graham's statement and letter addressed to me which follows, I know will make a substantial contribution to the hearings of this committee on the Banking Reform Act of 1971.

(The letter to Mr. Annunzio from Mr. Donald M. Graham, and the statement referred to above, and the response by Chairman Patman to Mr. Graham's statement follow:)

CONTINENTAL BANK.
Chicago, Ill., May 4, 1971.

Hon. FRANK ANNUNZIO,
Longworth Building,
Washington, D.C.

DEAR FRANK: It had been our firm understanding that I was scheduled to appear before the House Banking and Currency Committee on May 5 and I had been planning to do so, in response to Chairman Patman's invitation to me to give the Committee the benefit of our views on H.R. 5700 and on the Committee Staff Report relating to the sale of Penn Central stock made by the Trust Department of the Continental Bank. Hence, we were surprised and disappointed when we

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received a letter from Chairman Patman advising us that the hearings "must end by May 4, 1971" and that the only time available during the hearings was the afternoon of May 3—the one date when long-standing prior commitments precluded my appearing.

We do desire very much to assure that all members of the Committee have the benefit of our views on H.R. 5700 and on the Staff Report document. In particular we believe that document constituted a harsh and unjust attack on the Continental Bank which has resulted in a substantial amount of harmful, adverse publicity. Under the circumstances, we do hope that you will have the time to read the attached statement which I had prepared for delivery before the Committee.

We would, indeed, appreciate any comments you may have on this statement.

Sincerely,

DON.

STATEMENT OF DONALD M. GRAHAM, CHAIRMAN OF THE BOARD OF DIRECTORS, CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST COMPANY, CHICAGO, ILL., RELATING TO H.R. 5700 AND THE COMMITTEE STAFF REPORT ON SALES OF PENN CENTRAL STOCK (PART V)

My name is Donald M. Graham. I am Chairman of the Continental Illinois National Bank and Trust Company of Chicago. I am appearing here in response to Chairman Patman's March 31 letter, which stated that "it would be helpful for the Committee to have the benefit of the Continental Bank's testimony" about H.R. 5700, "especially since the recent [Committee] staff report raised certain questions" about sales of Penn Central stock by the Continental Bank's Trust Department in June, 1970.

Before commenting on H.R. 5700, I would like to make some remarks about the March 29 staff report and the accompanying letter of transmittal. These documents together condemn the Continental Bank harshly and unjustly. The unfounded attack on the Continental Bank has subjected the Bank to considerable harmful adverse publicity.

We suggest for the consideration of this Committee that it would be appropriate in situations of this kind to give individuals and organizations in our position an opportuntiy to comment prior to the publication of serious charges against us. This would not only be a fair course of action, but would help assure that significant public policy decisions are based upon accurate and complete information.

As you know, the Continental Bank's Trust Department sold a substantial volume of Penn Central common stock during the period June 12–June 19, 1970 (See Table 9. at pp. 10–11 of the staff report). All of those sales occurred after the Trust Department's Stock Selection Committee issued a memorandum on June 12, 1970 recommending the sale of Penn Central common stock by all Trust Department accounts; that memorandum is quoted at page 23 of the staff report. Both the staff report and Chairman Patman's letter transmitting that report to the members of this Committee charge, at least implicitly, that our Trust Department's decision to sell its holdings of Penn Central common stock was made on the basis of "inside information" provided by the Bank's Commercial Department.

In fact, however, as I shall demonstrate, that charge is unfounded. On the contrary, we have carefully investigated all aspects of the Bank's relationships with Penn Central and its affiliated companies during the first half of 1970, and that investigation demonstrated without question that there was nothing improper or unethical about any aspect of the Continental Bank's conduct with respect to Penn Central and its financial difficulties. More particularly, that investigation established that:

1. The June 12, 1970 decision of the Continental Bank's Trust Department to sell Penn Central common stock was based entirely on public—not insider—information.

2. The Continental Bank has a firm policy precluding Trust Department personnel from obtaining access to inside information about customers of the Bank's Commercial Department, and the Bank's Trust Department did not obtain any information about Penn Central from the Commercial Department.

I might add that I personally have carefully examined this matter to satisfy myself that there was full compliance with the Bank's clear-cut and enunciated policies.

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For the Committee's convenience, I should like to summarize briefly the principal criticisms of the Continental Bank which appear in Chairman Patman's transmittal letter and in the staff report itself:

1. Chairman Patman's transmittal letter states that the trust departments of the identified banking institutions "conducted their massive sales of Penn Central on the basis of either great clairvoyance or inside information."

2. Chariman Patman's transmittal letter, while conceding that our bank "did not have interlocking directorates with the railroad," nevertheless suggests that our Trust Department's decision to sell Penn Central common stock on June 12, 1970 resulted from what Chairman Patman characterizes as the Continental Bank's "close ties" with Penn Central—that is, because "the Bank had more than $23 million of the outstanding debt of the railroad and was a member of the bank steering committee which participated in critical meetings with Penn Central directors and high officials of the Treasury Department during the period June 10 to June 13", and because, "in the midst of these secret meetings—involving banks, Administration officials, and the hierarchy of Penn Central", our Trust Department "suddenly decided on June 12 to get rid of "a substantial amount of Penn Central stock.

3. Chairman Patman's transmittal letter also states that the persons who purchased the Penn Central stock which our Trust Department sold in June 1970 "can rightfully feel that they were victims of a massive shell-game carried on by financial entities in a position to know the innermost financial secrets of the Penn Central organization."

4. The staff report itself refers (p. 25) to "the probability" that some of the Continental Bank's sales of Penn Central stock during the period from June 12 through June 19, 1970 "were related to certain nonpublic events", and goes on to state that "the trading in stock of a company on the basis of nonpublic events involves very serious legal and ethical questions that must be resolved".

Let me address myself first to the factors which led the Trust Department's Stock Selection Committee to issue the June 12 memorandum recommending the sale of Penn Central common stock by all Trust Department accounts. Even a cursory review of the country's financial press demonstrates that a number of events which occurred, and were announced publicly, between Monday, June 8, 1970 and Friday, June 12, 1970 were "significant public events" which might have induced a prudent investor to sell his holdings of Penn Central common stock. Interestingly enough, however, none of the events to which I am referring are mentioned in Table 4 of the staff report—a table which is entitled "Significant public events affecting trading in Penn Central common stock". Was this omission inadvertent?

For example, on Monday, June 8, 1970 both the chairman and the chief financial officer of Penn Central resigned after a special meeting of the Penn Central directors. Those resignations and the special directors meeting were reported by the Wall Street Journal on Tuesday, June 9, 1970, in a three-column article which carefully detailed the gravity of the Penn Central's financial condition and the causes thereof. Similar articles appeared on that day in the financial pages of the New York Times, the Chicago Tribune, the Chicago Daily News, and many other leading newspapers throughout the country. Indeed, even the opening sentence of Chairman Patman's letter transmitting the March 29, 1971 staff report to the members of this Committee states:

"On the morning of June 9, 1970, millions of Americans picked up their newspapers and discovered that the Nation's largest railroad and seventh largest corporation was in deep financial trouble."

On Wednesday, June 10, 1970, one of the two Wall Street Journal articles discussing Penn Central's problems was headlined "Nixon Plans $200 Million Penn Central Loan Guarantee; Rescue Reflects Fear Of Panic If Firm Collapsed." The opening paragraph of that article referred to "growing evidence that Penn Central Co., owner of the nation's largest railroad, is snarled in a critical financial crisis"; the article went on to discuss in great detail the gravity of Penn Central's financial difficulties. The second June 10 Wall Street Journal article about Penn Central stated that "the Nixon Administration's willingness to rescue the Penn Central Co. in part reflects concern that collapse of such a large corporation could send damaging shockwaves throughout the economy." Similar stories appeared in numerous other papers on June 10, and Penn Central common stock was the most actively traded stock on the New York Stock

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Exchange on that day; it closed at $12.50 per share, down $1.50 from the previous day's closing price.

On Friday morning, June 12, the press reported even more depressing news for Penn Central. In a note on its front page, the Wall Street Journal stated:

"Aid to Penn Central Co. proposed by the Nixon Administration appears headed for trouble on Capitol Hill. Substantial opposition has arisen, and the House Banking Committee is expected to undertaken a thorough investigation of the loan-guarantee plan."

The detailed Wall Street Journal story on that subject, which appeared on page 2 of the June 12 edition, pointed out that some members of this Committee and of the House Commerce Committee apparently opposed the Administration's proposal to use the Defense Production Act to help Penn Central. The concluding paragraph of that article said:

"Mr. Patman said statistics provided by the Administration on the Penn Central's financial situation appeared 'extremely discouraging and did not convey any confidence in the ability of the corporation to successfully handle additional loans.' "

Similar stories regarding the severity of the Penn Central financial crisis appeared that same day in the financial pages of newspapers throughout the country. There was, of course, other disquieting public information prior to these dates and the cumulative effect of all such public information was pertinent to the Bank's ultimate decision to sell.

On the basis of *publicly available information* regarding the gravity of Penn Central's operating and financial problems (which even Chairman Patman commented about to the press on June 11) the Stock Selection Committee of our Bank's Trust Department concluded that prudent investment judgment required liquidation of the Trust Department's holdings of Penn Central common stock and reinvestment of the proceeds of such stock sales in other securities which had more attractive prospects for future growth. Accordingly, the Trust Department Stock Selection Committee decided to recommend the sale of Penn Central common stock from all Trust Department accounts—doing so in the June 12, 1970 memorandum, which refers to "the basic operational problems of the railroad company" and states that "it is doubtful that substantial losses can be avoided for the foreseeable future."

Surely the numerous publicly-announced events and widespread press comment to which I have referred provide more than ample basis for the Trust Department's June 12 decision to sell its Penn Central common stock. Indeed, as I mentioned earlier, Chairman Patman's transmittal letter states that "millions of Americans * * * discovered that [Penn Central] was in deep financial trouble", merely by reading their newspapers on June 9.

Moreover, the staff report itself, after stating that "the stock sales for most of the institutions generally had very little relationship to the significant public events," concedes that:

"The one possible exception to the above observations was the June 12, 1970 stock sales by Chase Manhattan and Continental Illinois." (p. 16)

It necessarily follows that our Bank's sales of Penn Central common stock after June 12 fall within the same exception. As Table 9 of the staff report shows, most of our Trust Department's sales of Penn Central common stock in the second quarter of 1970 occurred on or after June 12. Virtually all of our Trust Department's sales of Penn Central common stock during the period prior to June 12 were made at the direction of persons outside the Bank who made the investment decisions for the accounts involved (except for three transactions, totalling 27,700 shares, which resulted from the special needs of three specific trust accounts).

In this connection, I should also like to comment briefly about the staff report's suggestion that there was something improper about the fact that the word "FLASH" was stamped across the top of the Stock Selection Committee's June 12 memorandum recommending the sale of Penn Central common stock. In fact, the word "FLASH" is stamped across the top of every memorandum whereby the Trust Department Stock Selection Committee changes a prior recommendation, or promulgates a new recommendation, as to a particular security. That word is used to alert each recipient of the memorandum to the fact that the memorandum contains timely information, and therefore should be read promptly. During the year 1970 a total of 167 "FLASH" memoranda were issued by the Trust Department Stock Selection Committee.

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Moreover, despite the contrary impressions conveyed by the staff report and by Chairman Patman's transmittal letter, it is completely clear that there was no leak in the rigid barrier which we maintain between our Trust Department and our Commercial Department, and that the Stock Selection Committee did not receive any "inside information" about Penn Central from the Bank's Commercial Department. Our Bank has for some time had a firm policy precluding Trust Department personnel from obtaining or using confidential information about customers of the Bank's Commercial Department.

That policy most recently was reaffirmed in a March 13, 1970 Operating Department Personnel Bulletin entitled "Standards of Ethical Conduct For Members Of The Bank And Its Subsidiaries And Affiliates". The Bulletin states, in part, that "confidential information about Commercial Banking Department customers cannot be used by the Trust Department in making investments for fiduciary accounts." Indeed, the Bulletin expressly provides that Trust Department personnel (including officers) cannot have access to files which contain confidential Commercial Department information.

Moreover, we have undertaken an educational program in order to make certain that that policy is known to, and understood by, all of our personnel who might be affected by it. For the past several years, we have given a series of lectures to bank personnel regarding the legal principles governing the use of inside information in connection with transactions in securities.

Those lectures, which were given by an experienced senior attorney from the Bank's outside counsel, were attended by Trust Department personnel (including securities analysts and officers in the Trust Investment Division) and by Commercial Department officers. At the conclusion of each lecture our personnel are encouraged to pose questions and to discuss the issues fully, in order to insure that there is complete understanding of the subjects covered in the lecture.

As I stated earlier, I have personally looked into this matter carefully and there is no indication whatsoever that our policy prohibiting Trust Department use of Commercial Department information was violated in connection with the Penn Central situation. On the contrary, it is abundantly clear that there was ample public information supporting the Stock Selection Committee's June 12, 1970 decision to sell Penn Central common stock from all Trust Department accounts.

I will now turn my attention to the proposed legislation which is before this Committee—H.R. 5700.

The Bill is complex and in part very technical. It includes some provisions the objective of which we support wholeheartedly. Other provisions we find troubling. Rather than attempt to deal with all of the provisions of the Bill in my testimony, I would like to concentrate on some of the key features which are applicable to commercial banks.

RESTRICTIONS ON THE COMPOSITION OF BANK BOARDS OF DIRECTORS

The provisions of the Bill which we find most disturbing and unrealistic are those which would establish severe new restrictions on the composition of the boards of directors of banks and other financial institutions—restrictions which we believe would be contrary to the public interest.

Under present law there are certain restrictions on the composition of bank boards of directors. The Glass-Steagall Act prohibits anyone from being a bank director who is also a director of any company engaged to any significant degree in the securities business, and the Clayton Act presently prohibits interlocking directorships between commercial banks operating in the same locality. In 1962 I was a member of the Comptroller of the Currency's Advisory Committee on Banking which recommended that the Clayton Act restrictions be extended to prohibit interlocking relationships among all forms of competing depository institutions. We support the provisions of the Bill insofar as they would accomplish that objective.

The proposed Bill, however, goes far beyond the recommendations of the Advisory Committee on Banking and beyond historical purpose of the Clayton Act which, as Chairman Burns emphasized to the Committee, has been "to prohibit only those interlocks which tend to diminish or eliminate competition." In addition to expanding the restrictions on relationships among financial institutions, the Bill would exclude from a bank board of directors any person who is a director of (1) any insurance company, (2) any corporation for which the bank manages an employee-welfare or pension benefit plan, (3) any corporation with

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respect to which the bank has voting power over more than 5% of any class of stock, and (4) any corporation with which the bank has a substantial and continuing lending relationship. In addition, the Bill's prohibition on any bank director's performing legal services in connection with a loan or other business transaction with the bank would probably have the effect of preventing lawyers with substantial corporate practices from serving as bank directors.

The Bill's proposals are so broad and inclusive as probably to require the resignation of most of the outside directors presently serving on bank boards of directors, including a majority of the members of many major bank boards. As the Comptroller of the Currency has stated to the Committee, there are no "documented examples of practices against the public interest sufficient to justify the sweeping dislocation of accepted business practices" which these provisions would entail.

Under the new restritcions proposed by the Bill, it seems to us very doubtful whether a major bank would be able to find a substantial number of suitable outside directors with the necessary business expertise to serve on its board. If the Bill were passed in its present form, therefore, I believe the likely effect would be that major bank boards of directors would increasingly consist largely of present or retired bank officers and other insiders. This is not the general practice in American business, and it has, in particular, not been the practice among banks.

Outside directors contribute to public trust and confidence in the bank by assuring the public that bank operations are being reviewed by disinterested outsiders of reputation and standing in the community. More importantly, outside directors draw the bank and its officers into close and continuing contact with the attitudes and needs of diverse and important segments of industry and of the community which the bank serves. This kind of involvement, rather than isolation and inbreeding, seems to us to be appropriate and necessary for an institution which plays a central role in economic life.

The most important contribution of outside directors to a bank is the able, experienced and disinterested judgment which they bring to bear on matters of basic policy. The view is sometimes expressed that outside directors play a passive and relatively unimportant role in corporate life. In my experience, both with our own bank and with other corporations which I serve as a director, that view is false. Increasingly in recent years, outside directors play an active and critical role when important decisions must be made on the selection of executive personnel, major changes in financial structure or policies, the expansion of an institution's activities into new fields and other major actions which affect the well-being of the institution, its depositors and other customers, and the public in an important way.

The Comptroller's Advisory Committee on Banking concluded in 1962, after extensive consideration, that it would be undersirable to restrict the composition of bank boards of directors in the way the Bill now proposes. The intervening years have not altered my judgment on this issue. Moreover, developments in the law as to the accountability of directors and the consequences of insider abuse of position have made improper conduct by directors even more unlikely. At the same time, the need emphasized by Chairman Burns to the Committee "for directors of the highest caliber available" to assure that banks will be managed soundly and will be responsive to the needs of the community, has, if anything, increased.

In our judgment, the Bill's proposed restrictions on boards of directors would cause a drastic and undesirable change in the management structure of banks and other corporations which might well have a serious disruptive effect on our economy.

PROVISIONS RELATING TO BANK TRUST DEPARTMENTS

The Bill contains several important provisions relating to the activities of bank trust departments.

Like other banks, we have been disturbed about the concern relating to bank trust departments which has recently been publicly expressed. In large part we believe this concern to be unfounded. As my earlier comments indicate, the staff report and other remarks on Penn Central trading are an example of controversy which has been generated without close attention to the facts of the case. We are disturbed about this kind of controversy, however, even if it is without merit. As major financial institutions, banks are a legitimate subject of public interest and they depend heavily on public trust and confidence. We hope, therefore, that

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one result of these hearings and any legislation which may follow will be to help to put to rest the public concern and controversy which may have developed in this area.

The Bill's most important proposal in this area is that trust department investments be disclosed publicly on an annual basis. We believe that reasonable public disclosure of trust department investments would be desirable and we believe that such disclosure can be worked out in a way which is consistent with our fiduciary duties to our customers. Public disclosure may contribute to eliminating the fears which have been expressed about bank trust department "domination" of many corporations and about other aspects of trust department operations.

Our only qualification with respect to such disclosure is that we are concerned that procedures be devised which will not violate our customers' right to maintain privacy as to the investments of their particular accounts and which also give reasonable recognition to the very real administrative burden which disclosure requirements may impose. The Bill as presently drafted would require annual disclosure of every security investment of a bank trust department, whatever its nature and size. We believe that Chairman Burns is correct in stating that the objectives of the Bill do not require such total disclosure, which may pose a considerable administrative burden in view of the very large number of different accounts which are managed by a major bank trust department. The Securities and Exchange Commission in its proposals arising out of the Institutional Investors Study has very recently suggested that bank trust departments be required to report aggregate holdings in excess of 5% of any class of stock of a corporation registered under the Securities Exchange Act of 1934 or, alternatively, that the SEC be given rule-making power to establish reasonable disclosure requirements. The SEC proposals acknowledge explicitly that some recognition should be given to the administrative burden which disclosure requirements may impose. In addition, we believe that there may be circumstances in which disclosure of investments in privately-held companies is uncalled for and would be inconsistent with our customers' right to privacy.

We suggest that disclosure be made, pursuant to reasonable regulations, to a regulatory agency which would have authority to decide in what form information would be made public. In addition, as a matter of competitive fairness, any disclosure requirements should apply to all persons, individual and corporate, engaged in providing investment management and other fiduciary services to the public.

With the foregoing qualifications, we support reasonable disclosure which is designed to satisfy legitimate public interests.

With respect to any restrictions on the operations of bank trust departments which go beyond the requirement of reasonable disclosure, we believe there are two criteria which should be met.

First, any restrictions should be enacted only if careful review of available factual data indicates the presence of problems. In this connection, as you know, the SEC has very recently submitted to Congress its Institutional Investors Study which includes a great deal of data on bank trust departments, as well as other institutional investors. The study is very complex, is just now being made available to banks and others, and its findings have just begun to be evaluated. It would seem to us to be appropriate for this Committee and Congress now to permit a reasonable time for careful evaluation of the Institutional Investors Study before undertaking major legislation in this area.

Second, any restrictions which prove to be necessary should be carefully drafted to eliminate problems without interfering unnecessarily with a bank trust department's exercise of its fiduciary responsibilities.

The Bill's proposal to outlaw any aggregate bank trust department holding of more than 10% of any class of stock of a company which has filed a Securities Act registration statement fails to meet both of the foregoing criteria. The figures released by the SEC's Institutional Investors Study indicate that the number of large companies in which a single bank trust department holds more than 10% of the stock is very small. Furthermore, as Chairman Burns noted in his statement of the Committee, the Study did not find evidence that banks generally used their stockholdings to try to control management of other corporations. The available data, therefore, does not indicate that a limitation of this kind is called for at the present time.

If the fears supporting such a limitation should prove to be well-grounded at some future time, then any limitation should be drafted to apply only to a bank trust department's holdings which involve discretionary voting power

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and it should apply only to a bank trust department's deliberate aggregation of a large block of stock and not to situations in which existing blocks are placed in the hands of a bank trust department as trustee under a will or *inter vivos* trust. In addition, any restrictions on bank trust departments should apply also to all other persons, individual and corporate, providing investment management and other fiduciary services to the public

DEPARTMENT FROM ESTABLISHED REGULATORY PATTERNS

I would like to deal generally with a number of the more technical provisions of the Bill which outlaw specific practices in which some banks have engaged. Several of these provisions seem to us to represent an unwarranted and undesirable departure from the established pattern of bank regulation by federal and state agencies, and to introduce risk of legislative rigidity where administrative flexibility is needed.

As a general rule, we believe that Congress should legislate when significant problems have developed with which the banking agencies are unable to deal under present law. "Brokered deposits" are an example of such a problem. The regulatory agencies have asked Congress to outlaw such "brokered deposits" and we support that request.

Matters such as "equity participations" in connection with loans or premiums in connection with new deposit accounts, on the other hand, fall into a different category.

Base on a survey done in August, 1970, the Comptroller of the Currency has estimated that only about 3/10 of 1% of national bank loans involve "equity participations". The question is basically one of deciding under what circumstances it is appropriate for a bank loan to be related in some way to the profits of the enterprise to which a loan is being made. Our bank has almost universally refrained from making loans involving such participation. However, there may be circumstances where such terms might be desirable in the future for both borrower and lender and, as Chairman Burns emphasized, they may "facilitate extensions of credit to relatively new firms and real estate developers which typically lack ready access to the public capital markets." We are aware of no abuses which would call for Congress to establish a statutory prohibition as to this matter.

If a prohibition on "equity participations" is to be enacted, we believe that as a matter of competitive fairness it should apply to all commercial lenders.

It seems to us particularly undesirable to provide for private actions as a means of regulation in this area. The Bill would give a borrower the right to recover twice the fair market value of any prohibited "equity participation," together with reasonable attorneys' fees. This provision seems to be a deliberate invitation to private actions, probably on a class action basis. Such actions, which may involve considerable publicity and enormous amounts of alleged damages, are an undesirable method of seeking to regulate technical aspects of the operations of banks, which depend heavily on public trust and confidence. If any action is to be taken in this area, it should take the form of a grant of flexible authority to the bank regulatory agencies.

Similarly, a statutory prohibition against the giving of gifts to new depositors seems to us undesirable. The banking agencies have already issued regulations establishing standards in this area. The giving of nominal gifts for the opening of new deposit accounts seems to us a harmless promotional practice and we cannot see a justification for Congressional action to prohibit it.

Finally, I would like to mention the Bill's proposal to provide for FDIC insurance up to 100% of all public deposits. The effect of this provision would be to allow public agencies to deposit funds in various banks without regard to their financial soundness. Small banks might thus receive large amounts of public deposits, with the allocation likely to be based—once the need for financial soundness has been eliminated—largely on political considerations. We question whether this result would be consistent with a sound overall financial structure and whether it is a result which justifies the exposure of FDIC funds to the additional risks involved. We also share the concern expressed by the Federal Reserve Board about the disruption of the market for Federal and municipal obligations which may result from the repeal of present requirements that securities be pledged to secure public deposits.

In conclusion, I would like to thank the members of the Committee for the chance to present my view on the Bill and to respond to the staff report on the Penn Central situation.

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RESPONSE BY CHAIRMAN PATMAN TO PREPARED STATEMENT SUBMITTED BY DONALD M. GRAHAM, CHAIRMAN, CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST COMPANY

In his prepared statement submitted to this Committee, Mr. Graham emphatically denies that Continental Illinois National Bank and Trust Company sold any shares of Penn Central common stock on the basis of insider information. Mr. Graham maintains that Continental's sales of Penn Central stock during the period June 12–19, 1970, were based strictly on public events, primarily newspaper and magazine articles that appeared during the period June 9–12, 1970.

In denying the allegations that appeared in Part V of the Committee staff report, Mr. Graham fails to address himself to four very important factors, as discussed below.

1. In defending Continental's sales of Penn Central common stock, Mr. Graham states that Continental's decision to begin selling its holdings on June 12 was based primarily on newspaper and magazine articles that appeared during the period June 9–12. As discussed in Part V of the staff report, numerous public events occurred considerably prior to June 12, 1970, that indicated the seriousness of Penn Central's financial problems. Many of these events consisted of public announcements by the company and various Government agencies. In addition, between October 1969 and April 1970, various brokerage houses and investment advisory firms recommended selling Penn Central stock.

It seems unusual that a trust department the size of Continental's would ignore the public pronouncements and sell recommendations by various market experts as noted above, and instead rely on newspaper and magazine articles for its decisions on when to sell its stock holdings. To ignore the events described above, all of which occurred prior to June 12, and then to react so positively to a series of newspaper and magazine articles, raises serious questions regarding the competency of Continental's trust department.

2. Mr. Graham was the third banker to categorically deny the allegations contained in Part V of the staff report. Mr. Rockefeller of Chase Manhattan Bank and Mr. Meyer of Morgan Guaranty Trust Company also maintained that their banks acted strictly on the basis of public events. If we are to accept the statements of all three individuals at face value, then we can only reach one conclusion—the trust departments of both Morgan Guaranty and Continental Illinois are inferior in comparison to the trust department of Chase Manhattan.

All three banks were exposed to the same public events and all three banks maintain that they acted strictly on these public events. Yet Chase Manhattan began its heavy sales on May 22. It took Morgan Guaranty a week longer—its heavy sales began on May 29—to react to the same public information. Continental Illinois did not react until June 12—two weeks after Morgan began selling and three weeks after Chase began selling.

Is there really such a wide variance in the capabilities of the three trust departments?

3. The chart, facing page 804, shows the sales of Penn Central common stock by Chase Manhattan, Morgan Guaranty and Continental Illinois during the period May 15–June 19, 1970. As can readily be seen from the heavy lines, there appears to be a pattern to the stock sales by these three banks.

Chase Manhattan's heavy sales of Penn Central common stock occurred during the period May 22–28. On the very next day, May 29, Morgan Guaranty began its heavy sales of Penn Central common stock. Morgan completed its heavy sales on June 11, and the very next day, June 12, Continental Illinois began its heavy sales of Penn Central common stock. Continental continued its heavy sales through June 19—the last trading day before the Railroad filed for reorganization. In summary, while one of the three banks was in the market selling Penn Central common stock, the other two banks were conspicuous by their virtual absence from the market.

An analysis of the figures on the chart leads inescapably to the need for closer scrutiny of the circumstances surrounding the sales of Penn Central common stock by these three banks. Was there a definite pattern to the sales as a result of collusion by the three banks, or was it strictly coincidence?

4. A close analysis of the sales of Penn Central common stock by Chase Manhattan and Morgan Guaranty disclosed that the primary beneficiaries of both banks' "timely" sales were the large pension funds held in discretionary trust accounts. The smalled discretionary trust accounts and the nondiscretionary trust accounts at both banks apparently did not reap the benefits of the two trust

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departments' "clairvoyance" with respect to the timely sales of Penn Central common stock.

In his statement, Mr. Graham does not describe the types of trust accounts involved in Continental's large sales of Penn Central common stock during the period June 12–19, 1970. Accordingly, we cannot determine whether this was another example where only the large pension funds benefitted from a bank's timely sell-off of stock.

The CHAIRMAN. The committee will stand in recess subject to the call of the Chair.

(Whereupon at 11:47 a.m. the committee adjourned subject to the call of the Chair.)

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APPENDIX

(The following statements on H.R. 5700 were submitted to the committee for inclusion in the record:)

STATEMENT OF HON. CHARLES E. BENNETT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Mr. Chairman, I appreciate this opportunity to appear before the Committee, considering H.R. 5700, the Bank Reform Act of 1971. I congratulate the Chairman and Committee for the fine work they have done in recent Congresses on reform of the banking business. I have been pleased to work with the Committee in the drafting and the passage of some of the landmark laws in this field, particularly in closing the loopholes in the Bank Holding Act of 1956.

It is in further pursuit of closing all the loopholes and removing all the exemptions of the Bank Holding Company Act that I appear before you today. I hope the suggestion I present can become an amendment to any bill reported from the Committee or as a separate bill and that it can be enacted into law in this session of the Congress.

Very simply, my legislation, which is contained in H.R. 583, introduced on January 22, 1971 in the 92nd Congress, would amend the 1956 Act eliminating the only existing exemption that for labor, agricultural, and horticultural organizations. I enclose a copy of my bill with this statement.

This is the only exemption remaining in the 1956 Act—the others having been removed by the Congress over the last several years. In fact, three times, in 1955, 1965, and 1969, the House of Representatives has voted to remove all the exemptions from the Bank Holding Company Act of 1956. All except the labor, agricultural, and horticultural loopholes were closed in 1970.

I believe in the principle established by the Glass-Steagall Act of 1933. That is, it is in the public interest that banks and non-banking businesses should remain separate. I also firmly believe in the purposes of the Bank Holding Company Act of 1956 to prevent concentration of the Nation's financial resources in a small group of organizations.

Therefore, with these objectives as national policy, established by the Congress over four decades, there is no good reason for continuing the existing exemption for labor, agricultural, and horticultural organizations.

I am happy to see that the Federal Deposit Insurance Corporation agrees with my bill and supports removing the last exemption to the Act of 1956.

"Labor unions in particular appear to have considerable resources, represented for the most part by investments and member dues," the FDIC Chairman Frank Willie wrote Chairman Patman on April 14, 1971. "The Corporation is unaware of any abuses arising out the control by labor unions of banks or out of the existing exemption from the divestiture requirements of the Act for such unions. In our view, however, the potential for unhealthy concentration of economic resources and for anticompetitive practices in the allocation of credit and financial services is just as real with these control situations, considering the resources of labor unions, as it is when other companies not now exempt from the Act control one or more banks. It is conceivable, for example, that in some instances the interests of outside depositors or borrowers in union-controlled banks could be subordinated to the interests of the controlling union or its members."

The FDIC chairman wrote his positive report on my bill prior to the judgement in the U.S. District Court in Washington against the United Mine Workers of America and the National Bank of Washington, which the labor union owns 74 percent of the stock in. There were obvious abuses in this labor union owned bank relationship. The judge said there had been a 20-year conspiracy to enrich the union and the bank at the miners' expense. The basic conspiracy which the

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judge found was that the trustees of the UMW's Welfare and Retirement Fund were guilty of "excessive accumulation" over 20 years of large cash deposits, paying no interest from the $160 million annual welfare fund in the union-owned bank to the benefit of the bank and to the union.

The judge held that the effect was operation of the welfare fund by the union and bank officers "so as to give their special interests collateral advantages" while at the same time denying the fund's beneficiaries the millions of dollars in increased payments that could have flowed to them from more profitable investments. Of the National Bank of Washington, the city's third largest bank, the judge said it "knowingly participated in a continuing breach of trust that has rebounded substantially to its own benefit." He ruled complete withdrawal of all mine union and welfare fund deposits from the bank by June 30. In the past, these funds have totaled as much as $75 million, 30 percent of the bank's deposits.

Mr. Chairman, this is evidence enough that this exemption should be removed. The United Mine Workers is perhaps not the only union which owns a bank. I understand there are others.

As to the agricultural and horticultural organizations exemptions, I do not believe there are any such groups now which have an interest in banking. The exemption was written into the law in 1956, and since these organizations do not now exist there is no further reason to have the loophole remain. To retain the exemption might only stimulate the possibility of some new organization being established to escape the purpose of the law.

In its first report after the passage of the 1956 Act, the Federal Reserve Board said: ". . . it if it contrary to the public interest for banking and nonbanking businesses to be under the same control, the principle is applicable whether a company controls one bank or a hundred banks, and the possibility of abuses for such common control is the same. In fact, if a company controls only one from such common control is the same in fact, if a company controls only one large bank that company's interests in extensive non-banking business could lead to abuses even more serious than if the company controlled two or more very small banks . . ."

It is necessary then, I believe, to remove the last exemption from the Bank Holding Company Act of 1956. The Federal Reserve Board has supported this measure to close all the loopholes over the years, and House of Representatives has passed legislation to accomplish this three separate times.

While this exemption for labor, agricultural, and horticultural organizations remains in the law there is a strong opportunity for abuses. "The line between banking and commerce should not be erased," former Federal Reserve Board Chairman Martin has said. I agree, and I hope that Committee will either report out my bill favorably, or amend the legislation under consideration to remove the last remaining loophole in the Bank Holding Company Act of 1956.

Thank you for this opportunity to appear.

H.R. 583

A BILL To amend the Bank Holding Company Act of 1956 to eliminate the existing exemption for labor, agricultural, and horticultural organizations

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That so much of section 4(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(c) as precedes the first numbered paragraph is amended by striking out "(i) a labor, agricultural, or horticultural organization and which is exempt from taxation under section 501 of the Internal Revenue Code of 1954, or (ii)."

Statement of Hon. Robert D. Price, a Representative in Congress From the State of Texas

I greatly appreciate being afforded the opportunity to participate in these hearings being held by the Committee, hearings which are being conducted to seek ways to strengthen our banking system and thereby strengthening our economy. And I commend the members of the Committee on their interest in these vital areas.

The banking system of this nation is a cornerstone of the capitalist system. It is thanks to it that domestic capital can be mobilized and distributed through a

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great variety of financial services at costs that among the lowest, if not in fact the lowest, in the world.

The development of our banking system, like the development of our free enterprise system, has depended greatly upon competition. Bearing this thought in mind, I would point out what we as legislators are often apt to forget; namely, that legislation cannot prevent failures in any competitive system, much less in the banking system. Legislation can only provide a system of commands and prohibitions within which a competitive system can be regulated in accordance with the public interest. In banking this is accomplished through an interrelated system of state and federal laws coupled with federal deposit insurance which ameliorates competitive failures when they do occur.

Under this set of circumstances, new legislation should be confined to areas in which present laws are nonexistent or unenforceable and where demonstrable evidence of unallowable abuse exists.

Mr. Chairman, it is within this context that I would like to share with the members of the Committee my strong opposition to several features of H.R. 5700. the Banking Reform Act of 1971. Specifically, I oppose those provisions pertaining to interlocks among banks, trust departments of insured commercial banks. and equity participation loans. I will discuss each of these areas in turn.

As regards the provision on interlocking relations, I cannot find in published commercial records or in conversations with members of the banking community here on the East Coast and in my home state of Texas sufficient evidence to lead me to conclude that present laws governing interlocks are inadequate for their purpose. Even more fundamentally, I do not find that the occasional and. I might add, well-publicized abuses of interlocking relationships even begin to outweigh their salutary benefits.

Generally speaking, the cross fertilization of talent and commercial acumen which has resulted from individuals holding interlocking directorships has greatly strengthened the free enterprise system and hence the nation. More particularly, in rural areas such as the 18th Congressional District of Texas. and in other relatively sparsely populated regions of the country, the willingness and legal ability of talented individuals to hold interlocking directorships has provided irreplaceable underpinning to our regional economies. In this regard, the opinion of the bankers in my area of the country is that their operations would be quite detrimentally affected if the interlock provisions of H.R. 5700 were enacted. Thus, in addition to the fact that the proposed bill is written in such general language that the sections on interlocking relationships and related matters contain no references to competitors and market areas or to exceptions based on need, the application of the bill as written would not be consistent with the best interests of the banking community and the economy as a whole.

Another section of H.R. 5700 prohibits a bank trust department from holding more than 10 percent of any class of stock registered under federal securities laws. I believe the theory behind this particular section, that restricting bank fiduciary holdings eliminates the possibility that insured banking institutions could exercise "undue influence or control" over non-banking business. is aimed at slaying largely imaginary dragons. By this I mean that in the ordinary course of business a bank does not make a management policy decision on its holding a certain amount of a particular stock; the bank's Trust and Investment Department invests in what its officers think to be attractive securities from a fiduciary point of view. Thus holdings reflect financial judgments rather than management policy influences. Moreover, from a regulatory point of view, the SEC's Institutional Investor Study Report states, "the existence of potential power on the part of institutions to influence corporate decisions by reason of heir substantial shareholdings does not demonstrate that such influence is in fact exercised."

Finally, if this section were enacted, it could well create more problems than it purports to solve. For one thing it would deny individuals holding substantial stock holdings from seeking the services of a bank trust department if they so desired, and in effect would curtail their freedom of choice by forcing them to rely on individual fiduciaries. Secondly, it could create serious and continuing problems for individuals and families who prefer dealing with a bank trust department which has an ongoing existence, rather than with an individual who by the very nature of things offers a much more impermanent relationship. Thirdly, any time a bank's trust department exceeded the magic 10 percent limit, whether by design or as a result of a third party bequest, the trust department would be forced to sell enough of its holdings to regain its 10 percent status, even at the detriment of the beneficiary of the bequeathed estate.

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I am also opposed to the provisions in H.R. 5700 which would prohibit banks, other thrift institutions, and insurance companies from accepting any equity participation in consideration of making a loan. This is a practice that was not commonplace a few years ago; this is a practice that has been a by-product of tight money markets and our highly inflationary economy.

Despite this somewhat inauspicious beginning, however, experience has shown this practice has enabled bankers to make some worthwhile loans they otherwise would have not been able to make. Moreover, when the equity participation is linked to a right to any payment which is derived from income on property or enterprise, the practice constitutes a flexible means of adjusting credit charges to changing economic conditions. This means that relatively new firms and land developers can obtain new lines of credit rather than being forced to rely on the leavings of the so-called "safer accounts" as they have in the past. To the extent this practice is judiciously utilized, the economy in general benefits as well as the parties involved.

Mr. Chairman, the three areas I have discussed; interlocks, trust limitations, and equity participation loans, constitute the main objectionable features I have to H.R. 5700. Other areas of the bill, such as the new disclosure requirements and the prohibitions on banks using giveaways to attract depositors, concern me deeply as well.

In summary, I would say as regards the bill itself, I am strongly opposed to this Congress or any other Congress for that matter enacting sweeping prohibitions that would interfere with the ability of our nation's banking system to conduct its managerial, commercial, and fiduciary affairs. My strong opposition stems from my deep conviction that the need for the changes as proposed in H.R. 5700 are not supported by necessity and that existing state and federal laws are adequate to remedy the occasional wrongs that occur.

As for the field of banking, there always will be need for reform, just as there will always be need for reform in other areas of man's endeavors. But change that creates more problems than it cures is not reform. And change for the sake of change leads not to reform but to ruin.

STATEMENT OF HON. TENO RONCALIO, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WYOMING

DEAR MR. CHAIRMAN: I am particularly disturbed about the provision contained in Sec. 25 of H.R. 5700 which would forbid attorneys at law who serve as a trustee, director, officer, or employee of a bank to perform legal services, in connection with a loan or other business transaction with such insured bank, for or on behalf of any person; and Sec. 6 which forbids a person who is a trustee, director, officer or employee of a mutual savings bank to perform legal services in connection with a loan or other business transaction with such mutual savings bank, for or on behalf of any person.

I feel these are arbitrary and unreasonable restraints on the liberties of our nation's lawyers.

Furthermore, inclusion of these sections in H.R. 5700 would create an unnecessary hardship on small banks such as those found in my State of Wyoming. In the small cities in my state, normally of populations below 10,000 persons, there is a limit to the human resources available to establish and direct a bank. In light of this fact, it would be nearly impossible to have capable bank directors who are not at the same time engaged in the business community in other capacities.

I would like, at this time, to include in the records of this hearing the following letters from three of my Wyoming constituents who voice their doubts as to the justness of precluding attorneys from serving as members of a bank board.

THE WYOMING NATIONAL BANK,
Casper, Wyo., April 6, 1971.

Hon. TENO RONCALIO,
U.S. House of Representatives,
Washington, D.C.

DEAR TENO: I want to take this opportunity to acquaint you with my concern as respects HR 5700, recently introduced by Congressman Patman. As a former banker, and as an attorney, you certainly will be aware of the extreme position Mr. Patman has taken when he would preclude attorneys serving on the board of

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directors of a bank. In addition, the smaller the bank is and the smaller the community in which it is located, the more impossible it becomes, in my opinion, to have capable directors serving on the board, who are not at the same time conducting a business relationship with the bank.

Certain provisions in Mr. Patman's bill might be beneficial, particularly in the area of brokered funds and in the area of give-aways to induce people to establish a relationship with a bank.

There is deep concern on the part of many bankers that a majority of the House of Representatives of the United States is prepared to vote in favor of HR 5700 as it stands. In the long run, this would be most detrimental to the banking industry and the people it serves. I would appreciate your reviewing this bill in depth and am hopeful that you will see the many injustices contained therein, and will vigorously oppose this bill in its present form.

With best personal regards,

Very truly yours,

R. W. MIRACLE, *President.*

SHOSHONE FIRST NATIONAL BANK,
Cody, Wyo., April 1, 1971.

Hon. TENO RONCALIO,
U.S. House of Representatives,
Washington, D.C.

DEAR TENO: I am very much concerned on Bill HR 5700, introduced on March 8, 1971 by Wright Patman. I am sure you are well aware of this bill and, as an ex-Wyoming Banker, realize the problems the bill will create to Wyoming banks. First, it appears we will not be able to have an attorney on our Board. This would be very harmful to small banks. In addition, it would appear that no director of a corporation could serve on our Board as long as there was any business relationship between the corporation and the bank. This will eliminate many directors from being able to serve. This, of course, would be extremely harmful.

Another objection I have is the matter of reporting of amounts of stock held by trust departments. I am sure this is very easy for the large banks, where their trust departments are on computers. This would be a burdensome item for a small bank, and of course the amount of stock owned by trust departments of small banks would be infinitesimal. However, the report would still have to be filed.

I certainly object to the invasion of the confidentiality of the business of a bank and its customers. I certainly have no objections to reporting to supervisory authorities the loans of officers, directors and their corporations, and immediate members of their families. Of course, this is done to the Comptroller of the Currency and he could make the information available to the FDIC. I would have no objection to making a supplemental report to the FDIC if this is necessary, but I do object to having this information furnished the FDIC, then become public knowledge. If the FDIC retains it on a confidential basis, I could see no major objection other than the fact that it is a duplication of effort, since the supervisory authorities get this information at the time of making their examinations.

There are certain provisions that appear to be good, and I certainly am heartily in accord with the idea of making "brokered" deposits illegal, and also would be glad to see the elimination of give-aways for inducement of accounts or increases in accounts.

I personally am opposed to the idea of providing automatic FDIC coverage for public deposits. I feel this is what sets a good bank apart from one with a higher loan ratio. A sound bank will have adequate bonds to pledge to secure these public deposits; the bank that has loaned all of its money, of course, finds itself in difficulty in this regard. However, I think such a bank is not as sound as the bank with the lower ratio, and I do not feel the bank with the high loan ratio should be allowed to increase that ratio even higher, since they would have to hold no bonds to secure their public funds.

I realize the whole bill is a major problem, but I do feel small banks in small communities would be unduly restricted in their ability to serve their communities. since basically we would be deprived of many outstanding men to serve as directors.

When the bill is presented, I hope you will concur in the thoughts herein expressed and work for the defeat of at least the provisions mentioned.

Very truly yours,

R. S. ALLEN, *President.*

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STEADMAN & STEADMAN,
Cody, Wyo., March 31, 1971.

Re H.R. 5700—Banking Bill—Conflict of Interest.

Hon. TENO RONCALIO,
Congressman, House Office Building,
Washington, D.C.

DEAR FRIEND TENO: My attention has recently been directed to a bill known as "H.R. 5700," which is pending in the House of Representatives.

The information that I get with respect to this bill indicates to me that it would if enacted, make it difficult, if not impossible, for an attorney to serve as a director of a bank anywhere in the United States, and any such a result as that seems to me to be most extreme and perhaps improper and irresponsible.

With best personal regards,

Yours very truly,

OLIVER W. STEADMAN.

STATEMENT SUBMITTED BY THE CONFERENCE OF STATE BANK SUPERVISORS ON H.R. 5700, THE BANKING REFORM ACT OF 1971 TO THE HOUSE BANKING AND CURRENCY COMMITTEE—MAY 6, 1971

The Conference of State Bank Supervisors (CSBS) welcomes the opportunity to present its views on H.R. 5700 to the Committee. The problems to which this legislative proposal addresses itself, maintenance of competition and sound banking, are those in which the Conference shares the Committee's concern. The basic issue involved is not, however, whether to promote competition and sound banking which we all endorse, but whether in promoting them, the public interest is best served by sweeping new legislation, or through limited steps in areas of proven need coupled with better utilization of existing statutes and the regulatory-supervisory framework.

In studying the provisions of H.R. 5700, the Conference of State Bank Supervisors proceeded from the belief that the public interest is best served with a system of privately owned financial institutions operating in a highly competitive environment, with maximum flexibility to experiment and innovate consistent with maintaining a sound financial system.

The following analysis also reflects the recognition that a key ingredient in the American banking system is the interrelationship between scope for managerial judgment and discretionary, flexible supervision. Such supervision provides for safeguards for the public by controlling or halting practices in individual instances where depositor safety, or public needs, or bank capital or management do not justify these practices, without prohibiting them in instances where they are justified.

Such a system imposes only general "rules of the game" within which there is wide latitude for individual judgments and decisions. Considerations of bank soundness and competition should recognize that:

(1) sound management cannot be legislated;

(2) creating a fail-proof system risks penalizing the public by reducing bank flexibility and punishing all for the apparent sins of a few; and

(3) restrictive new legislation should be enacted only when there is ample evidence that the abuse from certain practices outweighs benefits, and when existing law is either ineffective or unenforceable.

Our nation has always evidenced a distrust of power concentration, whether it be economic or political. That distrust and a deeply ingrained concept of private property, have led us to favor a system of economic activity carried out by competing private units subject to certain public restraints. Two kinds of limitations of relevance here have been found necessary. First, to assure that the system remains competitive, we have enacted a system of antitrust laws which provide a general framework within which business operates. At the same time, we have recognized that certain classes of business, because of particular public interest factors, should be shielded from competition and granted a regulated monopoly. Such classes, which include utility companies, in the absence of competition are closely regulated as to the service provided, the rates charged, and the return allowed on investment. In addition, such industries receive immunity from the application of antitrust laws in view of control by a regulatory agency.

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This has clearly not been the case in banking. Uniquely imbued with public interest characteristics, banks operate in a system of controlled entry and are subject to a variety of supervisory activities, including periodic examinations. But they are not granted a legal monopoly to provide services in the community nor are they granted immunity from the antitrust laws by virtue of their subjection to a regulatory agency. It has long been recognized that the public good is served by having banks operate in a competitive environment with broad scope for management judgment.

There are, of course, public costs in such a system. Freedom to make judgments in the allocation of bank resources means freedom to make mistakes and opportunity to be dishonest, either of which may result in bank failure. Legislation cannot prevent failures in a competitive system; it can only provide a supervisory framework for minimizing their frequency through periodic examinations and from producing widespread harm when they do occur through deposit insurance.

Such a system is the one the United States has adopted over a period of two hundred years. That this system has met the public's need for a sound banking system is apparent. Even the statistics of failure support that view. Since January 1, 1969, nineteen insured banks have failed, representing 0.00137 of the total number of insured bank and about 0.00041 of their total deposits according to recent testimony by FDIC Chairman Wille. While not unmindful of the inconvenience and hardship caused by even so miniscule a failure rate, this has been outweighed by the benefits to the public of a banking system better able to mobilize capital and deliver financial services at cheaper rates than any other country in the world. Furthermore, deposit insurance has protected those who could have had their financial security destroyed by these bank failures.[1] While it would be possible to prevent bank failures through nationalization, or by reducing the system to a very few banks with hundreds of branches nation-wide backed by government guarantees, or by regulation which would virtually prevent management decisions, the cost to the public would outweight, in our opinion, the benefits.

CSBS believes recent banking history supports the contention that bank soundness can and should be handled under a system which permits banker judgment subjected to competition of the marketplace and supervisory scrutiny. Such a system provides the flexibility needed for the industry to meet public needs and, by virtue of the decentralized nature of the system allows for experimentation and alternative approaches to common problems. Supervisory control allows not only for banker judgment but for supervisory judgment. Supervision is not a cut and dried matter which can proceed simply by applying rigid rules to bank activity. To do so would stifle banking and ill-serve the public. A practice in which one bank may be able to safely engage may, due to differences in personnel, reserves, or asset composition, be quite unsafe for another. Needed financial services in one community or market may be unneeded or undesirable in another.

Each federal statute imposing a restriction or prohibition on all banks reduces both bank and supervisory flexibility and, therefore, should be imposed with the utmost caution. If Congress and the people want a banking industry more responsive to public needs, it is important to rely upon the administrative techniques of supervisory authorities to keep bank activities within proper bounds in terms of soundness, and to resist the temptation to prohibit by statute freedom which can be abused but which in the vast majority of cases is not.

CSBS believes the principles enunciated above have particular applicability to §§ 14 and 19–24 of H.R. 5700. Further detail regarding Conference views on equity participations, premiums, and brokered deposits is contained in the Appendix, as are the Conference's views on loan disclosure and credit extension to agents, trustees or nominees, and 100% insurance of public deposits.

The Conference is also concerned with those aspects of H.R. 5700 which relate to the maintenance of competition and potential conflicts of interest. While implementation of the federal antitrust laws is not the responsibility of state bank supervisors, they are of necessity concerned with anticompetitive practices and inter-corporate relationships that may affect the ability of the banking public to receive financial services at reasonable terms, or that might affect bank judgment and therefore bank soundness.

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[1] Deposit insurance limits are adequate for individual deposit protection but do not preclude community hardship due to loss of public deposits. The CSBS position of the provision of H.R. 5700 dealing with 100% insurance is presented in the Appendix.

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The United States has adopted as a matter of national policy, comprehensive antitrust laws to prevent anti-competitive abuses. In addition, state law and judicial decisions provide a clear framework of fiduciary responsibility covering many aspects of dealings between financial institutions and others. As a general principle, CSBS believes any consideration of new legislation to "prevent conflicts of interest and encourage competition" should be based on a firm conclusion that—

(a) Existing antitrust law does not provide sufficient deterrents to abuse; and/or

(b) Existing antirust law cannot be adequately enforced; and

(c) There is evidence of significant abuse which clearly outweighs the benefits, if any, of any practice to be prohibited.

There are numerous instances involving interlocks where the public interest is well served. In smaller communities *de novo* bank charters which increase competition in local markets may occur only when businessmen decide to participate in the organization of a new bank and support the bank by placing deposits with it and participating in its direction. In such communities, interlocks also may offer the best opportunity for small business firms to obtain directors possessing needed financial sophistication; this may also apply to smaller thrift institutions and credit unions. There are, moreover, numerous cases where a public spirited officer or director of a financial institution, noting a local need, has been the key figure in organizing a new firm to meet that need. Often the new firm borrows from that individual's financial institution and he has often served as a member of the board of the new company, giving it continued useful guidance. Legislation that would prohibit such relationships as these could be counter-productive and should be approached with the utmost care.

CSBS is not aware of any substantial body of data demonstrating widespread anti-competitive abuses and conflicts of interest growing out of inter-corporate relationships involving banks, although a few situations have received wide publicity. We believe that at the present time the extent to which existing antitrust law is applicable to anti-competitive abuses involving banks, and the extent to which existing law provides protection from abuses of fiduciary responsibility growing out of conflicts of interest, have not been fully explored. Further, it should also be recognized that the vast majority of interlocks are informal and that such "social interlocks" can be just as anti-competitive as the formal variety, and even harder to prohibit. This further argues for reliance on the general framework of antitrust laws and their vigorous enforcement, on management integrity, and on active regulatory supervision.

The present provisions of H.R. 5700 dealing with "Interlocking Relationships and Related Matters" contain neither references to competitors and market areas, nor to exceptions in cases of genuine need, and thus appear far too broad. In addition, Section 10 of the bill (and Section 8 in the case of Rhode Island) would prohibit investments by mutual savings banks, (chartered solely under state law) expressly permitted by state law. Such investments do not reflect oversights but rather sober reflection by state legislatures of institutional and public needs and related risks. In the absence of evidence of abuse, CSBS opposes such interference with state policies.

The Conference believes it would be preferable to approach the question of interlocks by broadening the existing prohibition against interlocking directorships in Section 8 of the Clayton Act to cover all competing depository institutions and to cover institutions in different geographic areas but which do nonetheless compete. Any such change should provide for genuine hardship exceptions involving smaller institutions. Such broadening would remove an inequity and be consistent with the general policy of preventing interlocks between direct competitors. CSBS believes, in the interest of consistency and logic, that the administration of this broadened provision should appropriately be placed in the Justice Department, not divided among the banking agencies.

Appendix

RESTRICTIONS AND DISCLOSURE WITH RESPECT TO LOANS FULL DEPOSIT INSURANCE FOR PUBLIC UNITS

1. Equity participation loans

In recent years the practice of equity positions in connection with loans has been engaged in with increasing frequency by commercial banks and other lending institutions. This has been due in large measure to a tight money market

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and a highly inflationary economy that has eroded the actual returns on long-term, fixed interest rate lending commitments.

Indeed, many lenders consider equity participations as purely an inflationary hedge and there is good reason to believe that some worthwhile loans would not have been made without this feature.

While banks have participated in equity participation loans, this practice correctly still plays a rather small role in bank lending policies. In a recent survey conducted by the office of the Comptroller of the Currency, a sampling was conducted of 502 national banks, including all 149 national banks with total deposits of $225 million or more. This survey, according to the Comptroller's office, reflected only 112 equity participation loans. Totalling $159 million as of August 31, 1970. This represented only .27 of one percent of the $58 billion volume of outstanding commercial and industrial loans of the banks sampled. Only 42 of the 502 banks in the survey reported any equity participation loans.

In a recent polling of our own fifty State Bank Supervisors, none felt that these loans were supervisory problems in their state at the present time nor had any found such lending to be a widespread practice among State-chartered banks.

While we do not in fact favor equity participations as an ordinary bank arrangement, and would generally oppose such, there may be circumstances especially during tight money markets when equity participations would be a useful and practical device for channeling funds into socially desirable uses which would not otherwise happen. If equity participation loans constitute problems in given situations, present regulatory provisions can deal with such situations.

From a supervisory standpoint CSBS does not believe it necessary nor desirable to prohibit entirely the use of equity position loans by banks and for that reason we oppose Section 14 of H.R. 5700 that would entirely eliminate such practice.

We desire also to point out that this section as presently drafted does not include mortgage companies, pension funds and other organizations engaging in the business of making or placing construction and commercial loans. The omission of such companies would give those lenders an obvious and unfair advantage over lending institutions already enumerated in Section 14 of this bill. Therefore, this section should be sufficiently broadened to cover such lending institutions in the event it is deemed desirable to restrict or prohibit equity participation loans.

2. Giveaways designed to attract deposits

The banking system of this country is characterized in some functions by strong limitations on competitive practice. Thus there is little scope for banking organizations to compete with each other in prices to gain deposits.

The solicitation of deposits is but one of the areas of bank operation in a competitive market that requires imagination and constant effort on the part of management in order to maximize its effectiveness. Correspondingly this phase of operation must receive careful supervisory attention in order to prevent unsound practices that would threaten deposit stability of financial institutions or invite unfair practices. But the Conference of State Bank Supervisors is not aware that the utilization of gifts or other premiums to attract deposits has had adverse effects along these lines.

A recent survey this year of our fifty State Bank Supervisors failed to indicate that the practice of "giveaways" to induce deposits constituted a supervisory problem of any consequence at this time or had resulted in significant deposit instability.

It is understood there have been isolated instances wherein abuses of "giveaways" have occurred and short periods of strained liquidity when their use was overdone. But it is believed that undesirable practices in the offering of gifts to attract deposits have been rare when viewed in the light of the industry-wide practice in most States of soliciting deposits through this medium. In view of this, in view of consumer benefits from the practice, and since practices in this area can be regulated within the framework of existing authority at both Federal and State bank regulatory levels, the Conference of State Bank Supervisors opposes Federal legislation that would prohibit the limited use of gifts to attract deposits.

3. Brokered funds

The Conference of State Bank Supervisors does not believe there is a compelling need for federal legislation to prohibit brokered funds, the use of which by poorly managed banks has helped create additional problems for them. However, the practice does not appear to be of sufficient value that a prohibition

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would work any hardship on properly-run banks and, therefore, the Conference does not oppose a legislative remedy. At the same time, the Conference urges that care be exercised in discussions of recently failed banks to keep perspective, and to distinguish between unsound practices contributing to failure and the vehicle to fuel such practices.

While according to Chairman Wille of the FDIC, misuse of brokered funds was a major contributing factor in 8 of 19 recent bank closings, to keep perspective, as indicated earlier the 19 closed banks represented only 0.00137 of the total number of insured banks and 0.00041 of their total deposits. Furthermore, according to FDIC data, only 264 insured banks were utilizing brokered funds at the time of a recent survey and the dollar volume totalled only $260 million.

Brokered funds by themselves do not constitute an evil or a problem. Available data indicate that the vast majority of banks have not utilized brokered funds and that most of those that have done so, have not jeopardized thereby the bank or its depositors. Unsound loans or dishonest dealings have been the primary cause of all bank failures and recent history is no exception. It happens that in the recent period, efforts in such cases were facilitated by funds obtained through brokers, but what caused the difficulty was unsound lending or self-dealing. It would therefore seem more logical, if any legislation were to be the result of recent experience, to prohibit only those brokered deposits encompassing a tied loan agreement.

4. Disclosure

Those portions of Sections 15–18 which deal with disclosure regarding loans to directors, trustees, officers or employees or members of their immediate families relate to information useful in bank supervision. Bank supervisory agencies presently have authority to require this data without new legislation. CSBS believes that under whatever conditions such data is collected, it is not necessary for purposes of assuring sound practice to make that information public, and that doing so could, in some instances, have unfair competitive effects. Those portions of Sections 15–18 dealing with extending credit to corporations where stock is owned by the directors, trustees, officers or employees or members of their immediate families of institutions extending such credit are subject to the principles enunciated earlier covering interlocking relationships. In addition, while the opportunity for abuse exists in such relationships, there is no comprehensive data available on such loans, and their outright prohibition could create hardships or economic disruption, especially in smaller communities. Finally, from a sound banking standpoint, it is the financial condition of the borrower that counts, not his relationship to the bank.

As to extending credit to "any agent, trustee, nominee, or other person . . ." without knowledge of the identity of the recipient of the beneficial interest, this is a matter of sound management and supervision which would dictate that the lender be satisfied as to loan soundness. If this does not require identity of the said recipient, there is not grounds for requiring such by legislation.

5. 100% insurance coverage of Federal, State and local Government funds

The Conference of State Bank Supervisors supports the principle of 100% insurance coverage of public deposits, especially those of State and local governments, with the proviso that the insurance agency be given authorization to limit the amount of such funds that can be accepted by an insured bank.

Complete insurance coverage of such monies would not appear to place a substantial burden on or jeopardize the insurance fund. Particularly is this true in view of the authority that would permit a limitation on the amount of public funds that can be accepted by an insured institution, thus preventing these funds from becoming a disproportionate part of the total deposits.

We agree with the remarks of Chairman Wright Patman who commented at the time of introducing H.R. 5700 that when Federal, State and local governmental agencies lose money in a bank failure, it is the taxpayer who suffers. For, while the current $20 000 coverage of Federally-insured deposits is adequate for virtually all individual deposits, the same class of depositor can stand unprotected when large public deposits are involved in a closed bank. Because of this, and because of the regulatory controls provided to the FDIC in this legislative proposal, we endorse the objectives of this section of the bill.

At the same time, CSBS urges careful study before making such a change so as to create no hardship or inequity because of existing arrangements in many states to provide protection of public deposits beyond present FDIC limits.

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STATEMENT OF ASSOCIATION OF AMERICAN RAILROADS

The Association of American Railroads opposes those provisions of H.R. 5700 that would, in the situations specified, prohibit interlocking directorates between business or industrial corporations (including railroads) on the one hand, and financial institutions (banks and, in some contexts, insurance companies) on the other.

Section 9(a) of the bill would prohibit anyone who is a director, trustee, officer or employee of a bank from serving on the board of directors of any corporation with which the bank has "a substantial and continuing relationship with respect to the making of loans, discounts, or extensions of credit."

The enactment of restrictive legislation of this kind would, almost certainly, have a severe and detrimental impact upon the composition of the railroads' boards of directors. We have taken a look at the membership of the boards of a number of major railroads, picked at random. A substantial proportion (well over half) of the directors of those railroads canvassed are also directors or officers of banks.

This is not to say that all or even most railroad directors with banking affiliations would necessarily fall within the prohibition of section 9 of the bill (a "substantial and continuing [credit] relationship" between the railroad and the bank), but the potential for conflict with the statute would be there in a great many instances. The result would be to eliminate from service on railroads' boards of directors many talented and highly-qualified men or, in the alternative, to dry up and foreclose valuable bank-customer relationships wherever an interlock was present.

The railroads can ill afford either result, or any combination of them. The financial requirements of this industry are well-known and need not be elaborated here. Railroads are heavily in the capital and financing market. They have great need, on a continuing basis and at the highest executive level, for the expert advice and counsel of men with first-hand knowledge and understanding of both financial affairs and the railroad industry.

To obtain the services of such directors, a railroad should not have to forgo banking relationships and abandon sources of credit; nor should the banks in question be required to relinquish the railroad as a customer or potential customer.

Government officials with special background and expertise have acknowledged, during this Committee's hearings on H.R. 5700, that the public interest is well-served through having interlocking directorates between business corporations and the banks. Thus, Arthur T. Burns, Chairman of the Board of Governors of the Federal Reserve System, testified on April 26, 1971:

"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." (p. 2)

Similarly, William B. Camp, Comptroller of the Currency, testified on April 21, 1971:

"We have not seen documented examples of practices against the public interest sufficient to justify the sweeping dislocation of accepted business practices which would be caused by the adoption of the . . . prohibitions in Sections 2 through 9. On the contrary, we think it would be most detrimental to the public interest to curtail the use of scarce executive management talent in this way." (p. 2)

Richard W. McLaren, Assistant Attorney General for Antitrust, testified on H.R. 5700 before this Committee on May 4, 1971, as follows:

". . . A bank providing specialized financing to a particular industry might benefit from having a member of that industry on its board of directors and vice versa. Thus determining whether personnel interlocks between firms which are not direct competitors results in net social benefit or harm may not be subject to a categorical answer; on the contrary, it may very well require careful analysis of the facts in individual cases." (p. 5)

And, on April 20, 1971, Frank Wille, Chairman of the Federal Deposit Insurance Corporation, testified:

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"The proposed prohibition . . . appears to be too restrictive in light of what we velieve to be common banking practice. The problems we have encountered in this area stem not from interlocking relationships as such, but from such items as excessive loans, loans to borrowers with poor credit standing, and loans on preferential terms." (p. 7)

Section 9, it should be noted, is not limited to situations where a "banker" serves on the board of a business corporation. The prohibition would also operate in reverse: no nonbanker member of a railroad's board of directors, for example, could sit on the board of a bank with which the railroad had a substantial and continuing credit relationship.

This would not only prevent top railroad executives from serving as directors of the banks with which their companies might otherwise do business; it would also prevent a credit relationship between a bank and a railroad having as a member of both their boards a director otherwise unconnected with either. For example, suppose a situation in which an industrialist (e.g.) the president of a manufacturing concern) is a director of a railroad and also of a bank. The railroad and the bank, by reason of this third-party interlock, would be within the prohibition.

Thus, section 9 would drastically curtail the reciprocal use of directorial talent by the banks and railroads, and would also curtail their common enjoyment of third-party directors. In the alternative, it could force what might be unnatural credit arrangements. Railroads would be deprived of the benefit of bankers' experience and judgment on their boards, except at the price of being forbidden to obtain material banking services from the banks so represented. Credit relationships could also be disrupted in instances where a railroad and a bank shared an outside director not primarily identified with their banking or railroading.

We oppose section 9 of H.R. 5700. There is no record of abuse to justify it. The need for it has not been demonstrated.

We also oppose other provisions of the bill that are, in our judgment, unnecessarily restrictive in their prohibition of interlocking directorates. Among such prohibitions are those contained in section 7, where a bank or insurance company manages the business corporation's employee welfare or pension benefit plan, and in section 8, where a bank or insurance company holds in the aggregate, with power to vote, more than 5 per centum of any class of stock of the corporation. As in the case of section 9, there has been no evidence of abuse or other showing of need for these rigid proscriptions.

STATEMENT OF WILLIAM P. SAWYER, PRESIDENT, MASSACHUSETTS FEDERAL SAVINGS COUNCIL, INC.

Re H.R. 5700.

My name is William P. Sawyer. I am President of the Massachusetts Federal Savings Council, Inc., the membership of which includes the thirty-four Federal Savings and Loan Associations in Massachusetts with total assets of over two billion dollars. I am instructed by the Council to make the following statement concerning H.R. 5700.

RECOMMENDATION

In general, the Council concurs with the statement made before this Committee on April 22, 1971, by Tom B. Scott, Jr. on behalf of the United States Savings and Loan League. The Federal savings and loan associations in Massachusetts are especially glad to see that nearly all of the provisions of H.R. 5700 will apply to non-federally insured mutual savings banks.

I am speaking today to draw the attention of the Committee to the fact that H.R. 5700 does not appear to cover activities by cooperative banks. The term "mutual savings bank" as defined in 12 U.S.C. 1813(f) means "a bank without capital stock." In Massachusetts, Chapter 170 of the General Laws authorizes cooperative banks to sell capital shares.

There are 146 cooperative banks in Massachusetts. Of these 38 come under Federal controls through membership in the Federal Home Loan Bank of Boston. I do not think I can urge too strongly that this Committee consider including cooperative banks within the terms of H.R. 5700. It is particularly important to do this in matters affecting the solicitation of savings accounts, such as the prohibition against "giveaways." With the U.S. League, we endorse

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this prohibition but we can only do so to the extent that it applies equally to all thrift institutions in Massachusetts.

The recent history of unequal application of rate control regulations to thrift institutions in Massachusetts resulted in a devastating loss—as high as 26% of total deposits in one case—to these federally regulated thrift institutions. The tendency of savings deposits to remain where placed, barring the offer of higher rates or other benefit, makes the loss suffered by the federals all the more damaging. Moreover, the harm done during that period extended beyond the federally regulated institutions to the Massachusetts home builder. Before that period, rates for home loans were consistent across the country now Massachusetts home builders are paying the highest rates in the country.

I might also note in passing that the unequal application of federal rate regulations to Massachusetts thrift institutions resulted in a greatly diminished Federal Home Loan Bank membership in this commonwealth. On September 22, 1969, I testified before the Senate Committee on Banking and Currency that, to date in 1969, 47 cooperative banks had withdrawn from the Federal Home Loan Bank System. They did so in order to meet the competition of the unregulated thrift institutions and I predicted that more would follow. You can see from today's testimony that of the 135 banks who were members of the System on January 1, 1969 only 38 now remain. Those cooperative banks remaining in the Federal Home Loan Bank System represent less than 15% of the total assets held by such banks. In Massachusetts at present, cooperative banks which are neither federally insured nor members of the Federal Home Loan Bank control over two and a quarter billion dollars—approximately the same as the Federal savings and loan associations.

I hope, therefore, that this Committee will provide for the uniform application of the provisions of H.R. 5700 to all Massachusetts thrift institutions.

STATEMENT REGARDING H.R. 5700 OF THE CALIFORNIA SAVINGS AND LOAN LEAGUE, PASADENA, CALIF., FRANKLIN HARDINGE, JR., EXECUTIVE VICE-PRESIDENT

The California Savings and Loan League wishes as much as the author of H.R. 5700, Chairman Patman, to have financial institutions operate soundly, ethically, and with equivalent treatment for all customers. The whole system of public examination and supervision and the system of law and regulation affecting financial institutions are for the purpose of seeing that these objectives are carried out. While there are a few exceptions, those who have served as officers and directors of financial institutions in the last generation or two have carried out their responsibilities in running these institutions soundly and without taikng advantage of their position in the inside. Granted there have been some abuses, but the negligible number of such abuses must be kept in mind in framing any additional legislation to close loopholes which still appear to exist. The League is firmly of the opinion that legislative overkill will cause substantial disruptions while at the same time will not completely eliminate some of the abuses which are bound to occur since human beings will be involved.

Section 2 through 8. Interlocking Directorships.—The California Savings and Loan League has in its membership federal savings and loan associations, state-chartered mutual associations, and state-chartered guaranty stock associations, as well as holding companies owning savings and loan associations. These associations are located in all the population centers of the state and they represent associations from the very largest in the United States with $3.5 billion to associations of $2 million. During the last fifty years of the history of the business in California there have been literally millions of transactions which have involved officers, directors and employees of these institutions.

One can almost count on the fingers of two hands the number of instances where officers or directors of associations have taken advantage of their position to abuse their corporate responsibilities. We say this despite the fact that there are officers and directors of these associations who have had the type of affiliations which this bill would outlaw for the future. In other words, we submit as a general proposition that people who have become officers and directors of savings and loan associations have inherent integrity and ability which, except in very rare cases, guide them in corporate conduct which is above reproach. Thus, we view with some alarm the implications of this bill which would upset so drastically the corporate stewardship of savings and loan associations in California and elsewhere.

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It would appear that those who drafted this bill have failed to recognize the current restraints that are already imposed upon officers and directors of savings and loan associations, in particular, and financial institutions, in general. First and foremost of those restraints is the liability which such officers and directors assume in their corporate capacity of being vulnerable to litigation arising from their action or inaction on behalf of the corporation. Furthermore, there are any number of legal limitations on relationships of officers, directors and employees with their respective financial institutions which have been established by state and federal law. In other words, all of the theoretical situations which have motivated this bill have existed for years without causing abuse except in the most isolated situations. Furthermore, we are realistic enough to believe that this bill, if passed in its proposed form, would in no way deter those very few persons from improper corporate actions because such people will always break the law or violate business ethics if it suits their purpose.

This situation can be likened to the drunk driving problem. Theoretically every driver is a potential drunk driver. Laws on the books penalize the drunk driver who kills, maims or damages property, but such acts continue. The problem can be solved if Congress passes a law which prohibits *everyone* from driving. Congress is not going to ground every driver because it knows it would be legislative overkill as only a few drivers will be intoxicated when driving. Likewise, since Congress knows only a few officers and directors will act illegally or unethically, there is no need for the grounding of so many officers and directors from corporate directorships.

All those sections of this bill dealing with interlocking relationships between financial institutions and corporations with which those financial institutions do busness will cause massive resignations of those who now serve on these boards of directors of financial institutions and corporations. There will be need for massive replacement of those board members and officers who would be forced to resign their present positions. We believe that such persons will be replaced in large measure by persons of lesser capabilities. This view does not preclude the fact that there are some capable persons in this world who are not now serving on the boards of financial institutions who might serve as replacements. But, generally speaking, the assumption is that those who are now serving on the boards of directors of financial institutions are the best that can be obtained; therefore, there will be every reason to believe that replacements will be second-best choices.

It is our opinion that financial institutions will be the hardest hit for the simple reason that persons serving as officers or members of the boards of directors of corporations will retain their affiliation with those corporations and give up their affiliations with the financial institutions of their community. We should submit that in this process of replacing members of the boards of directors of banks and savings and loan associations, savings and loan associations will be the hardest hit as the best available people will accept positions on the boards of directors of banks which will preclude them from serving on the boards of directors of savings and loan associations. So the prospect of having less capable persons serve on savings and loan boards of directors will be very real.

The provisions in this bill, generally speaking, will make it practically impossible for persons now serving as officers or directors of business corporations to serve in any capacity on the board of director of a financial institution. Generally speaking, persons who do not use the facilities of financial institutions are not businessmen; therefore, there will be an automatic adverse selection if the choice of directors of financial institutions will have to come from outside the ranks of the businessman. There will be a further adverse selection in view of the fact that not every businessman has the type of qualifications to serve on the board of directors of a financial institution. A manager or owner of a laundry is not anywhere near as concerned in his regular business with interest rates and money markets as are those who are dealing generally in the field of finance. On the other hand, those who have identification with financial institutions have special qualifications which make those persons in demand as directors of other corporations.

The futility of this legislation can be shown by an example. Many savings and loan attorneys serve as directors. Many competent attorneys represent several savings and loan associations, particularly in large metropolitan areas such as Los Angeles. It is of enormous benefit to have the attorney who is representing you serve on your board of directors. In order to have this advantage, you can not require that he refuse other directorships of financial institutions.

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If this legislation should pass, the end result is that the same attorney would attend all of the directors' meetings and participate therein in his capacity as counsel rather than as a director and nothing would be really accomplished.

In our opinion, the passage of this bill with the severe restrictions as to those who can serve on the board of directors of banks and savings and loan associations. In such new financial institutions it is particularly important that a board of directors be composed of those who are knowledgeable in the field of finance. If such types of people are not available to serve, there will be very few new banks or savings and loan associations formed in this country.

In the smaller communities of this nation there are always a limited number of competent businessmen who are available to serve on the boards of directors of banks and savings and loan associations. If the best of these businessmen are not available, there will be a level of mediocrity evolve on the boards of directors of financial institutions which will create problems. The successful management of financial institutions is dependent upon the direction of operating officers and their boards of directors. In other words, in the smaller communities, if you substitute the successful owner of the grain elevator with a housewife in his seat on the board of directors of a savings and loan association or bank, you will lose a quality of competence and business background which will take its toll in supervisory problems for the future.

Section 7. Employee Welfare Plans.—With regard to the prohibition of any director, officer or employee of a financial institution from serving on the board of directors of any corporation which manages an employee welfare or pension plan, we see no reason for such a severe limitation. We agree wholeheartedly with the principle that funds in a welfare or pension plan should be carefully safeguarded in an irrevocable status. On the other hand, if this committee is going to be concerned with this area, it should look at other pension plans which are not managed by bank or corporate directors to see whether or not those plans are being administered prudently.

Section 9. Continuing Business Relationships.—The Congress in the past has enacted legislation which permits a federal savings and loan association to organize and invest in a wholly owned corporation called a service corporation. These provisions of H.R. 5700 would prohibit the officers and directors of such associations from being officers and directors of the service corporation which it wholly owns in view of the fact it is contemplated that there shall be "substantial and continuing relationships with respect to the making of loans, discounts or extensions of credit" between the service corporation and the savings and loan association. We note that under Subsection (b) of Section 9 there is an exemption from this provision for those corporations wholly owned under the bank holding company or savings and loan holding company acts. We submit that if this provision is to be retained, an exclusion must be given for all wholly owned subsidiaries of financial institutions whether or not the parent company is a holding company.

Section 11. Influencing Banking Transactions.—We believe that present law covers a great deal of the ground which the proposal would cover. Where present law or regulation does not exist, business ethics would preclude corporate officers and directors and employees from being financially induced to make decisions about corporate transactions which they would not do otherwise. There are a significant number of such officers and directors who have been fined or are serving jail terms because they have transgressed this basic principle. Thus, while we agree with the concept of Section 11, we believe it is unnecessary to put such severe penalties in the law. Furthermore, we believe there is sufficient vagueness in the wording of this section to make it difficult to determine what really is contemplated.

Section 13. Trust Departments of Banks.—This section would preclude a trust department of a bank from holding more than 10% of any class of stock in specified corporations, which would make it exceedingly difficult for some persons owning businesses to provide that a trust company act as executor of an estate. We see no reason why the holding of stock by the trust department of a bank affects the soundness of that bank. While the framers of this legislation may be fearful of the power of trust officers to vote the stock of corporations in the estates which they are administering, we believe that it would be fatal to the proper administration of an estate to force a fiduciary to split up an estate among several trustees and have no authority or obligation to look into the operations of a corporation whose stock is a part of an administered estate.

We do not believe that you can divorce the responsibilities of an administration of an estate from the obligation to be aware of the corporate operations of

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the company whose stock is involved. We know that persons who own considerable stock in savings and loan associations will want competent administration of their estates upon their death and, therefore, they turn to trust officers in commercial banks.

Section 14. Equity Participation.—The plight of the long-term real estate lender that makes its loans at a guaranteed interest rate for a 25- or 30-year period has been well demonstrated to members of this Committee during the last five years. Such lenders which must attract their funds in the short-term market have seen their cost of money skyrocket upward while the yields on their long-term loans have remained static. This not only applies to the private financial institutions but likewise to those government agencies providing a secondary market for mortgage loans.

The equity participation is one means by which a long-term lender may get an adjustment in its interest rate on loans when general interest rates rise. The variable interest rate is another means of accomplishing the same objective. Thus the California League believes that the prohibition of equity participation should not cut off the right of mortgage lenders to use the variable interest rate. Furthermore, we fear that the wording of this section would cut off the ability of lending institutions to joint-venture with builders in various housing projects. So long as interest rates are as volatile as they have been during the last five years, some type of adjustment of yields on mortgage portfolios is a necessity or the entire mortgage market will be adversely affected.

Sections 15, 16, and 17. Disclosures of Financial Transactions.—The California League supports the basic principle of these sections, which is that of full disclosure to supervisory officials of all transactions between financial institutions and their officers, directors and principal stockholders. We would go even further and require the disclosure of any loan or extension of credit to these same persons by other financial institutions. We do not see any necessity for including employees in this category, particularly employees who have absolutely no executive authority in the institutions. Of course, employees who are relatives of officers, directors and principal stockholders are something else and should be included.

In our above reference to disclosure we have indicated our approval of maximum disclosure to supervisory officials. For emphasis, we do not favor availability to the general public of the information disclosed to supervisors regarding financial transactions with those who are directly connected with financial institutions. Financial institutions have always considered that their relationships with their customers are confidential, and we believe that this confidential relationship should remain intact. The role of public supervision has always been to permit supervisors to have access to all the individual transactions between a financial institution and its customers but not to grant the public, generally, access to this same information.

If it is the purpose of the framers of this legislation to prevent preferential treatment of some customers by making such information generally available to the public, then we recommend that a policy statement be made by the Congress about credit being extended on a basis which is equal to all in relationship to their credit worthiness. The public supervisor has the power to act if he detects abuses of financial relationships between financial institutions and their corporate officers and directors. The public has no such power; therefore, there is no purpose to be served in violating the age-old confidentiality of financial transactions between financial institutions and their customers.

Sections 19, 20 and 21. Finders' Fees.—Savings and Loan associations throughout the nation have long lived with regulations limiting the amount of deposits for which a brokerage fee could be paid. Thus we do not believe that it is necessary to abolish this practice, but only to require that regulations be formulated to control this activity and any abuses which have occurred, particularly in the banking field. The way these sections now read, it would be impossible for any one of the financial institutions involved to conduct a contest for new savings among its employees and pay any financial rewards to the winners. We do not believe the Committee intended that the restrictions on the payment of finders' fees for savings accounts should be so tight. Supervisory officials know the practices which can be utilized to attract new accounts legitimately. Supervisors also know that there are dangers in accepting savings accounts where there are tie-ins with loans. We much prefer, therefore, to see that the supervisory authorities are given power to regulate in this field rather than to cut off the brokerage of funds completely.

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Sections 22, 23, and 24. Certain Giveaways Prohibited.—The principles enunciated in these sections are approved by the California Savings and Loan League. These provisions are somewhat more restrictive than the current regulations applicable in California which permit the use of premiums under very limited conditions. The Committee's attention, however, is called to differences in the wording of these three sections which probably is not intended. The word "open," in reference to opening an account, appears in Section 23, but not in Sections 22 and 24. Furthermore, we fail to see the differences between "make" a deposit and "add to" a deposit so we believe the word "make" is redundant. In supporting these sections, the California Savings and Loan League does so on the assumption that these sections would prohibit only the giving of any gift or any stamp, ticket, obligation or memorandum which is redeemable in merchandise, money or credit.

Section 26. Full Insurance of Public Funds.—The savings and loan business in California supports unanimously this proposal as a means of attracting from government bodies surplus funds that may be used for mortgage loans. This insurance would be in lieu of the collateralization of such deposits with municipal bonds and other government obligations. Unless public deposits are protected with insurance rather than collateral, such deposits would not increase mortgage funds. Savings and loans do not have the same tax incentive to buy municipal bonds as do commercial banks. Since state and local governments need the market for their bonds, there is much sentiment to prevent banks from eliminating the collateral pledged against their public deposits as contemplated in this proposal. We suggest that perhaps all sides would be served if 100% insurance were available to savings and loan associatiaons for public deposits up to, say, 5% of total savings while leaving banks to collateralize their public deposits with municipal bonds.

In conclusion ,the California League believes that the restrictions on interlocking directorships ought to be confined to those active officers of financial institutions who would be prevented from serving as directors or officers or other financial institutions. We do not believe it is essential that the prohibition be extended to businessmen who serve only in the capacity of directors on boards of more than one financial institution. In order to avoid serious dislocation in the corporate stewardship of financial institutions, any legislation in this area should include a grandfather clause for existing directors so that replacements and changes in the future will abide by the restrictions imposed by this legislation. The Committee should consider some outright exemptions from the requirements of this bill for persons living in cities of 25,000 or under.

STATEMENT OF JOHN D. CHISHOLM, PRESIDENT, OLMSTED COUNTY BANK & TRUST COMPANY, ROCHESTER, MINN.

Mr. Chairman and members of the Committee, I am John D. Chisholm, President of the Olmsted County Bank & Trust Company, Rochester, Minnesota, a former Banking Commissioner for the State of Minnesota, and a member of the Comptroller of the Currency's Advisory Committee on Banking in 1962. I am most appreciative of the opportunity to appear here today to express my views on H.R. 5700, the proposed Banking Reform Act of 1971.

I appear here on my own behalf in an attempt to relate to you the effect this proposed legislation would have on the smaller banks. In this effort, my opinion will be contrary in some instances to the recommendations you have received from the trade associations and from the regulators representing the various government agencies. These are not basic disagreements, but differences which would result from almost any attempt to legislate for banks of different deposit size.

INTERLOCKS AMONG FINANCIAL INSTITUTIONS

(Sections 2, 3 and 4)

The Advisory Committee on Banking to the Comptroller of the Currency in 1962, after a comprehensive study of the functioning of the National Banking System, recommended Regulation L and R of the Federal Reserve Board governing interlocking directorates between member banks and specific financial institutions be continued, but amended to include savings and loan associations, banks and savings banks, whether chartered under Federal or State law. Although no specific

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abuses were reported. as the result of then existing interlocks, it was recognized, because of the increasing competitive situation between deposit oriented institutions, individuals could not serve two different types of these organizations. It was also felt that the philosophy behind the statutory prohibitions of Section 8 of the Clayton Antitrust Act (15 U.S.C. 19) would logically require the extension of the statutory prohibitions to cover directors of savings and loan associations and mutual savings banks. The only exception noted was a situation where one person or a family controlled more than one bank, and the best interests of all the institutions involved would be served by such an interlock.

H.R. 5700 would expand the advisory committee's recommendation to include credit unions, insurance companies, banks and savings and loan holding companies and brokerage firms. I concur. the prohibition of interlocks should extend to all competing deposit-type institutions. Brokerage firms and insurance companies are not competitors of banks in this respect. There is a possibility in the future for both types of companies to encroach on the deposit function of thrift institutions through the sale of mutual funds. I would not, however, recommend the prohibition of interlocks between banks and these two types of firms be made a permanent part of the law on the basis of such speculative prognostication. With that exception, I would endorse the legislative proposals as they refer to prohibition of interlocks among deposit-type institutions.

100 PERCENT INSURANCE FOR PUBLIC FUNDS

(Sections 25 and 26))

There are extensions of deposit insurance coverage that would better serve the public interest than 100 percent insurance for public funds.

Indirectly, the F.D.I.C. is presently insuring these deposits by permitting selected investment assets to be pledged as collateral to guarantee payment in the event of liquidation. If the Committee is convinced public funds should receive such preferred treatment, I would suggest, in lieu of the insurance protection, you give some consideration to the recommendation public deposits be favored with a statutory prior claim in liquidation over all other liabilities of the bank. If this recommendation is favored, then the F.D.I.C. assessment or premium paid by banks to insure public deposits be eliminated, as well as the premium paid on balances held at the Federal Reserve Banks.

It can be argued that pledging of assets to secure Public Funds impairs the liquidity of the banks, reduces the supply of loanable funds, and discriminates against other classes of depositors. But having to pledge is a self limiting factor for the smaller banks as to the dollar amount of this type of volatile deposit they can accept and, also, acts as an important restraint on the handling of funds.

It is my opinion the public interest and the interest of the smaller banks would be better served by continuing the present method of pledging to secure public deposits. If this practice is continued, then, in all equity, the F.D.I.C. assessment on public deposits should be eliminated. As it is apparent from the F.D.I.C.'s willingness to insure public funds, the amount of the reserve fund is sufficient to permit an extension of some type of insurance coverage. I would recommend the present $20,000 limit be extended separately to checking and savings accounts. Also, some consideration might be given to allow banks a credit on their F.D.I.C. assessment to compensate for the expense they incur when providing excess fidelity coverage.

PROHIBITION OF EQUITY PARTICIPATION ON LOANS

(Section 14)

The practice of arranging for equity participation in consideration for making a loan first came to the attention of the smaller banks in our area during the recent "tight" money period. To obtain a loan commitment for a bank customer on a commercial building from an insurance company or institutional investor, the lenders insisted on additional compensation, represented by a certain percentage of specified income from the borrower's business. Such suggestion met with quiet rebuff from our conservative, independent, midwest. small businessman and. in most instances, he shelved or postponed his building plans. To ask of sole proprietorship, a partnership or small corporation for an actual equity participation or ownership interest in consideration for making a loan would be abhorrent for me and I think for most country bankers. Consequently, I do not

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regard this type of conditional lending as soon becoming commonplace with the country banks or acceptable to the smaller commercial borrowers we service.

The situation could well be different with the large corporate borrower. It is presumed, in the eyes of the law, such corporate management has a greater degree of sophistication, and more business acumen than the individual. Because of this presumption, most states exempt corporate borrowing from the usury statutes. Consequently, I can visualize instances when such equity lending might not only be acceptable, but warmly received.

The SBA 502 and SBIC programs have equity financing and equity participations as an integral part of their lending authority. Both programs have been most successful and have been of great assistance to small business.

If, in the next decade, we are to become a capital-short nation, as many economist predict, this type of equity participation financing may become a necessary tool for large and small banks alike.

Unless violations in this type of lending have become widespread and regulatory agencies are unable to cope with the abuses, I would hesitate to endorse the recommendation for outright prohibition of equity participation lending by legislation.

INSIDER LOANS

(Section 15)

There is a special section in the examination reports of all regulatory agencies, listing any and all so-called insider loans as defined by Section 15. This procedure automatically alerts the supervisory authority to the borrowings and acquaints the directors and officers with the advances if they have not been previously notified. If there is any violation in the legal amounts of these borrowings it is so noted in the 'Violations of Law' section of the examination report. Supervisory authority in all of the agencies have the necessary regulatory tool to correct any abuses in these categories.

In a small bank, it is not unusual to name a director or to retain an individual as an employee with the expectation on the part of management that such association will result in the bank being favored by the business of the director and/or the family of the employee. While it might be desirable if such association could result in only a deposit relationship, such expectation can hardly be regarded as practical. To suggest you can retain the deposits and refer the loan to your competitor in such a situation is ludicrous.

We have a policy to require all officers and employees to borrow only from our bank. We have greater confidence in the integrity of our own officers and employees than in the exchange of borrowing personnel we would have to agree to with our good competitor. We also feel more comforted knowing the financial condition of all of our employees, rather than live in happy ignorance of their financial situations by making it mandatory they borrow from a competitor. I can see no real purpose in the public disclosure of the names of these borrowers and would vigorously appose this provision.

PROHIBITION OF BROKERED DEPOSITS

(Sections 19, 20 and 21)

Probably the most common type of brokered deposit familiar to the country banks are those arranged for by finance companies to serve as compensating balances for their lines of credit. This practice is not as widespread as it was a few years ago and it is doubtful prohibition of the practice as suggested by this legislation would work any hardship on the banks affected.

I can think of no reason why any prudent banker would not support these sections, prohibiting brokered deposits. The frequency with which this device has been found to be a contributory factor in recent bank failures should justify this prohibition of its use.

PROHIBITION OF GIFT GIVEAWAYS

(Sections 22, 23 and 24)

All of the regulatory agencies have offered testimony to the effect this practice has lead to no abuse. Also, all have indicated they have sufficient authority to correct any problem which might subsequently develop. Consequently, all contend

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statutory prohibition as proposed in this legislation is unnecessary. I disagree and support the prohibition of gift giveaways for all thrift institutions.

While it is true a regulation can specifically state the maximum amount a bank can spend on a premium and define the frequency gifts can be used to stimulate deposit activity, this regulated cost is but a small part of the total expense for such a promotion. Agency and advertising costs take the largest part of any premium campaign budget. Because of this situation, smaller thrift institutions cannot compete in this "battle of the gifts."

Perhaps the most pronounced trend in the composition of bank assets and liabilities during the last decade has been the rapidly increasing reliance on interest-bearing funds. This development has meant greater competition between thrift institutions for savings-type deposits and smaller denominated time instruments which represent the larger percentage of deposit liabilities in the smaller banks. They can ill-afford to lose them.

In southern Minnesota, presently, for a $25.00 deposit you can procure a starter set of china, iron stone, silver or crystal: You can select a lamp from among a dozen varieties, or if you choose, send the coupon and deposit to Minneapolis and procure a tree for your yard—if you are the lucky winner at the coupon drawing, the "jolly green giant" will landscape your lawn. All this in the name of "thrift"!

A gift giveaway, in my opinion, is an interest ceiling bonus. I contend they do not encourage thrift, but train some depositors to become professional "premium grabbers". They do not cause a depositor to save, but direct his deposit to the most convenient institution with the largest advertising budget.

I would be pleased to discuss with the committee the remaining sections concerning interlocking relationships and loans, commercial bribery and management interlocks involving trust officers. I have not, however, prepared a written commentary on these subjects, as this presentation has already become too voluminous. While I am in sympathy with the purposes and the objectives of this legislation, I do not agree the situations of known abuse are sufficiently serious to warrant these statutory prohibitions.

In spelling out legal concepts it is all too easy to lose sight of the real problem—the relevance of morality to modern business practices and the extent to which the law does, or should, attempt to codify moral rules into legal precepts. Regulation alone will not assure high standards of conduct. Regulation, examination and audit help preserve integrity, but more is needed than just policing by regulatory agencies.

Much of this proposed legislation is designed to prevent potential conflicts of interest before they occur. While I would acclaim its purpose, I sincerely doubt its effectiveness if it were to be enacted into law.

(The following letters concerning H.R. 5700 were presented for inclusion in the record:)

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND CURRENCY,
Washington, D.C., May 11, 1971.

Hon. WRIGHT PATMAN,
Chairman, House Committee on Banking and Currency,
Rayburn House Office Building,
Washington, D.C.

DEAR MR. CHAIRMAN: I have recently received a manuscript on the subject of corporate interlocks, written by Dr. Ephraim P. Smith, Associate Professor, University of Rhode Island, and Dr. Louis R. Desfosses, Assistant Professor at the University.

The manuscript deals with directors of the "Fortune 500" and treats generically the problems posed. The Professors conclude that the Clayton Act of 1914 be amended to cover indirect or management interlocks and vertical interlocks. The Professors conclude additionally that employers of board members, as well as the members of the board of directors themselves, reveal the amount of shares held in the corporation directed.

Since this paper bears significantly on the proposed legislation before us, I am requesting that the enclosed manuscript be added to the testimony and hearings on H.R. 5700.

Sincerely,

FERNAND J. ST GERMAIN.

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Corporate Directors Under Fire

(By Ephraim P. Smith, Ph.D., Associate Professor of Accounting and Business Law, University of Rhode Island; and Louis R. Desfosses, Ph.D., Assistant Professor of Management and Industrial Relations, University of Rhode Island.)

INTRODUCTION

The purpose of this article is to discuss the adequacy of current legislation in dealing with such problems as inside information, inadequate disclosure of stock holdings, interlocking directors and interlocking entities.

The first part of the article discusses the problems of inside information and inadequate disclosure as illustrated by the recent Penn-Central Case. Problems of interlocking directors and entities are then discussed.

Studies have been done which analyze the composition of boards of directors. These studies emphasized the number of boards a particular individual sat on. This article analyzes not only the individual's board membership but also those of the entity which he represents. The data utilized in this study concerning board of director composition was generated from a matrix model which analyzes the Fortune 500 companies.

INSIDE INFORMATION AND DISCLOSURE PROBLEMS

A staff report presented by the House Banking Committee on March 28 of this year described the dumping of large blocks of Penn-Central stock by several of the larger banking institutions before the general public knew of the railroad's critical financial condition. Chairman Wright Patman, D-Tex., stated in a letter transmitting the report to the Committee that those who had bought this stock early in 1970 and had subsequently watched its value plummet "can rightfully feel that they were victums of a massive shell game carried on by financial entities in a position to know the innermost financial secrets of the Penn-Central organization."[1]

Without expressing an opinion as to whether any civil or criminal laws on improper use of inside information had been violated, Patman added that the report was to be forwarded to the appropriate state and federal agencies. The report described how the sales of stock by several large banks having access to privileged information most opportunely preceded the public disclosure of the financial plight of the Penn-Central.

Sales by nine banks and other institutions were studied. Eight of these eliminated or substantially reduced their holdings of Penn-Central stock. One other, United States Trust Company of New York, slightly increased its holdings. Patman said that this bank had no known ties to the Penn-Central. Patman called attention to the selling of 436,000 shares of Penn-Central by Chase Manhattan Bank, New York; 391,575 by Morgan Guaranty Trust Company, New York; and 590,000 by an interrelated group, Alleghany Corporation, New York and two mutual funds affiliated with it, Investors Mutual, Inc., and Investors Diversified Services. Chase Manhattan subsequently denied the allegation that any of its sales of Penn-Central stock held by its clients was based on inside information. It said it has a strong policy against the use of such information and claimed that the sales were prompted by the news of various developments which was available to the investing public.

Patman pointed out than clairvoyance was not necessarily the actions of the aforementioned institutions. Penn-Central's president, Stuart Saunders, was a director of Chase Manhattan. Morgan Guaranty Trust Company had a directorate interlock with the railroad and held $35 million of its debt. Continental Illinois did not have a connection through directorates, but had more than $23 million of the outstanding debt of the railroad and was a member of the banks steering committee which participated in the critical meetings with the Penn-Central directors and high officials of the Treasury Department.

Patman cited the coincidence surrounding the sales of 372,400 shares of

[1] *Wall Street Journal*, March 29, 1971, page 5.

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Penn-Central by these institutions under study, apparently all of the sales of the stock that day. Patman stated that "a number of private and public insitutions failed the public visably." He accused the Security and Exchange Commission, members of President Nixon's administration and the financial scribes of failing to warn the public. He follows with the statement "It seems possible that more vigorous and, critical reporting . . . might have given the public some indication of the grave nature of Penn-Central's financial problems and prevented the loss of millions of dollars by unsuspecting investors."

Patman seems to be implying that directors and other key individuals having access to privileged and potentially valuable information may in fact act as agents for entities having vital interests. Such agency would help explain the behavior of the institutions mentioned in the report. Patman was careful not to accuse, but merely to emphasize the coincidence of these institutions' behavior in the light of the information held by certain concerned directors and members of key committees. That such information was available in no way indicates that it was used. However, thte potential for its use is obvious. The question of allegiance arises. If the president of one company is also a director for another, what expectations exist concerning this conflict of roles. For instance, a company executive who is also a director for another company learns something at a board meeting having direct repercussions for his primary employer. What are his obligations as an executive? What are his obligations as a director? Further, what obligations does he have to his personal interest? Finally, what obligations does he have to the concerned public?

The answers to these questions have a direct bearing on the effectiveness of economic competition. Those not privileged to essential information are obviously suffering a competitive handicap. Steps have been taken to protect outsiders from the unethical excesses of individuals acting for their own selfish interest (e.g. The Clayton Act of 1914). However, in such instances the connections are more obvious and easier to prove. Where an individual serves as a director for one company while being employed by another having other employees acting as directors for other companies, a resulting potential for accumulation of power through privileged information results. For such a situation, little protective legislation exists and the non-privileged must depend on the ethical restraint of an individual with divided loyalties. The question arises, "does such a potentially dangerous situation exist, and should the ethical use of privileged information be left in the hands of agents with potentially divided loyalties?

BOARD COMPOSITION

To determine whether the potential for such a problem exists and also the potential scope, the boards of directors of the *Fortune's 500* were examined. The companies listed in the Fortune's "500 largest U.S. Industrial Corporations" account for almost 64 percent of total U.S. sales. Furthermore, they earn over 74 percent of the total profit. Companies are ranked by sales dollars.

Information concerning boards of directors of Fortune's 500 companies can be found in proxy statements of these companies. From analyzing the proxy statements of these companies it was found that there was a total of 6,985 director's positions. This means that the average board size is just over fourteen in membership.

TABLE I.—BOARD OF DIRECTOR MEMBERSHIP OF FORTUNE'S 500

Position	Number	Percent
Inside director	4,018	57.5
Outside director	2,967	42.5
Total directors	6,985	100.0

Of the 6985 director positions 2967 represent outside interest. These 2967 positions are filled by 2349 individuals. An analysis of the number of seats occupied by outside directors is presented in Table II.

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TABLE II.—NUMBER OF SEATS OCCUPIED BY OUTSIDE DIRECTORS

	Number of directors	Total number of positions
Number of seats individual fills:		
1	1,931	1,931
2	282	564
3	87	261
4	31	124
5	11	55
6	3	18
7	2	14
Total	2,349	2,967

When analyzing the outside director it is interesting to note their varied backgrounds. Table III shows the occupational ties of the 2,349 outside directors. Outside directors as a group appear to be fairly evenly drawn from service and non-service industries.

The problem of interlocking directors is much more complex than just seeing how many individuals sit on two or more boards of directors. A fundamental question raised earlier concerning the allegiance of the director is whether an individual serving as a director of one company while employed by another represents the interest of his employer, the board on which he sits or himself.

TABLE III.—OCCUPATIONAL TIES OF OUTSIDE DIRECTORS

Groups	Number of seats occupied								Percent of group to total
	1	2	3	4	5	6	7	Total	
Service organizations:									
Banks	210	41	7	9	4	1	1	292	12.4
Utilities	39	11	6	1	0	0	0	57	2.4
Realty	24	1	2	1	0	0	0	28	1.2
Government, religion and research	16	0	1	0	1	0	0	18	.8
Foundations	18	1	1	1	0	0	0	21	.9
Investment bankers	148	32	20	5	1	1	1	209	8.7
Insurance	27	11	1	0	0	0	0	39	1.7
Consultants	121	17	1	2	0	0	0	142	6.9
Lawyers	272	29	3	1	1	0	0	306	13.0
Educators	97	14	5	3	1	0	0	120	5.1
Nonservice organizations:									
Fortune 500	263	73	14	4	2	0	0	361	15.3
Railroads	11	2	1	0	0	0	0	14	.6
Retired or industrialists	70	6	1	1	0	0	0	78	3.5
Unlisted companies	454	40	12	2	1	1	0	510	21.0
Merchandising	26	12	4	1	0	0	0	43	1.8
Other	130	2	0	0	0	0	0	132	5.6
Total	1,931	282	87	31	11	3	2	2,349	100.0

If he represents solely the company on whose board he serves then it would be inconsequential if he served on as many as 500 other companies' boards of directors. If he represents his own interest one might argue that 418 directors occupying two or more seats from a total of 6,985 possible positions is not very significant. However, if the director occupies a seat as a representative of the company for which he works then it is necessary to determine how many companies are represented on two or more boards of directors. In Table IV information concerning the number of companies with representatives on two or more boards of directors is presented.

Out of the total group of 2967 outside director positions almost one-half come from only 401 companies. Of greater interest is the fact that 174 representatives of companies occupy 946 seats which is approximately one-third of all outside director positions.

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TABLE IV.—NUMBER OF COMPANIES WITH REPRESENTATIVES ON 2 OR MORE BOARDS OF DIRECTORS

(1)	Number of seats occupied (2)	Total number of seats occupied (1×2)	(1)	Number of seats occupied (2)	Total number of seats occupied (1×2)
Number of companies:			Number of companies:		
227	2	454	1	14	14
77	3	231	1	16	16
31	4	124	1	17	17
25	5	125	1	18	18
11	6	66	1	19	19
5	7	35	2	21	42
4	8	32	1	22	22
5	9	45	1	23	23
2	11	22	1	28	28
1	12	12	1	29	29
2	13	26			
			Total (401)		1,400

Extent of interlocking entities

The next step in the analysis is to present examples of interlocks among entities. It might prove beneficial to analyze some representative examples of companies to determine interlocking entities.

To determine the extent of interlocking entities companies were categorized into industrial groups. The groupings were those detailed by the Securities and Exchange Commission.[2] The Standard Industrial Classification (S.I.C.) code numbers were used for companies. However, because of acquisitions and mergers since 1966 not all companies are listed.

Case A—Large New York Bank

Case A presents information on a large New York City bank. This bank is represented by its officers on the boards of directors of twenty-seven companies. Table V presents data on the interlocks among entities.

Notice, that in Case A the bank had representatives on five Smelting and Refining companies. Under the present law no one individual could have his interest so represented for it violates The Clayton Act of 1914. However, by the use of agents potential power exists to violate the principle of The Clayton Act by corporate representations. In Case A, the large bank also interlocks competitors within six other industrial classifications.

TABLE V.—ENTITY INTERLOCKS—CASE A

SIC number	Industrial classification	Number of companies interlocked within industry
333	Smelting and refining	5
262	Paper and allied products	3
326	Concrete, gypsum, asbestos, and plastic products	2
331	Blast furnaces, steel works, and rolling and finishing steel	2
291	Petroleum refining	2
283	Drugs	2
203	Canning and preserving fruits, vegetables, and sea foods	2
383	Optical instruments and lenses	1
372	Aircraft and parts	1
361	Electrical transmission and distribution equipment	1
358	Service industry machines	1
342	Cutlery, handtools, and general hardware	1
284	Soap, detergents, and cleaning preparation	1
281	Industrial inorganic and organic chemicals	1
241	Lumber and wood products	1
147	Chemical and fertilizer mineral mining	1

[2] Securities and Exchange Commission, *Directory of Companies Filing Annual Reports With the Securities and Exchange Commission,* Superintendent of Documents, Washington, D.C., 1966.

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Case B—Large Utility

Case B presents an analysis of board representation of one of the nations largest utility companies. This company has its officers on ten of the 100 largest companies in the country. A complete analysis is available in Table VI. The large utility is represented on four companies in the petroleum and refining industry. This is an example of vertical integration.

TABLE VI.—ENTITY INTERLOCKS—CASE B

SIC number	Industrial classification	Number of interlocks within industry
291	Petroleum and refining	4
203	Canning and preserving fruits, vegetables, and seafoods	2
202	Dairy products	1
262	Paper and allied products	1
283	Drugs	1
284	Soap, detergents, and cleaning preparation	1
331	Blast furnaces, steel works, and rolling and finishing steel	
333	Smelting and refining	1
341	Metal cans	1
361	Electrical transmissions and distribution equipment	1
363	Household appliances	1
374	Railroad equipment	1
381	Instruments for measuring, controlling, and indicating physical characteristics	1
398	Miscellaneous industries	1

Case C—Large Investment Banking House

Case C shows the interlocks between a large investment brokerage firm and Fortune 500 companies. Table VII presents this information. Notice that this investment banking house has agents occupying seats on the boards of directors of 9 of the country's 100 largest industrial enterprises. Furthermore, it interlocks competitors in three different industries.

TABLE VII.—ENTITY INTERLOCKS—CASE C

SIC number	Industrial classification	Number of interlocks within industry
221	Textile mill products	2
281	Industrial inorganic and organic chemicals	2
357	Office, computing, and accounting machines	2
394	Toys, amusement, sporting and athletic goods	1
372	Aircraft and parts	1
365	Radio and television receiving sets except communications-type equipment	1
356	General industrial machinery and equipment	1
354	Metalworking machines and equipment	1
352	Farm machinery, construction, mining, and machinery handling	1
341	Metal cans	1
326	Concrete, gypsum, asbestos, and plastic products	1
306	Miscellaneous rubber and plastic products	1
291	Petroleum and refining	1
284	Soap, detergents, and cleaning preparation	1
231	Apparel	1
203	Canning preserving fruits, vegetables, and seafoods	1

EXISTING LEGISLATION

The Clayton Act of 1914

Presently, the main legislative control over interlocking directorates comes from Sections 7 and 8 of the Clayton Act of 1914. It specifically prohibits interlocking directorates among competitors engaging in interstate commerce. The Clayton Act contains the following provision:

> . . . *no person* at the same time shall be a director in any two or more corporations, any one of which has capital, surplus, and undivided profits aggregating more than $1,000,000, engaged in whole or in part in commerce, other than banks, banking associations, trust companies, and common carriers subject to the Act to regulate commerce, approved February fourth, eighteen hundred and eighty-seven, if such corporations are or shall have been theretofore, by virtue of their business and location of operation, com-

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petitors, so that the elimination of competition by agreement between them would constitute a violation of any of the provisions of any of the anti-trust laws.[3]

Notice, that the Clayton Act applies to individuals only not to entities. Further, the law applies only to competitors. No mention is made of interlocking directorates between buyers and sellers (vertical integration). The power to enforce The Clayton Act is vested with the Federal Trade Commission.

The Clayton Act of 1914 has not obstructed individuals or corporate enterprises from sitting on one another's boards. If a person owns substantial holdings in competing companies all that is necessary for him to be represented on both boards is that he personally sits on one board and has a colleague sit on the other board. This potential practice could be used by corporate entities in as much as they could have various officers sit on the different boards of directors. Examples of which were in Cases A, B, and C. These Cases presented data on three actual corporations and the companies with which they interlocked.

Proxy statement disclosure

Information obtained in the proxy statement is of little or no value in determining the stock holdings of the entities represented by agents on the boards of directors of the various corporations. The Securities and Exchange Act of 1934 requires directors to disclose the following information:

(1) Name each such person, state when his term of office for which he is a nominee will expire, and all other positions and offices with the issuer presently held by him.

(2) State his present principal occupation or employment and give the name and principal business of any corporation or other organization in which such employment is carried on. Furnish similar information as to all of his principal occupations or employments during the last 5 years, unless he is now a director and was elected to his present term of office by a vote of security holders at a meeting for which proxies were solicited under this regulation.

(3) If he is or has previously been a director of the issuer state the period or periods during which he has served as such.

(4) *State, as of the most recent practicable date, the approximate amount of each class of equity securities of the issuer or any of its parents or subsidiaries other than directors' qualifying shares, beneficially owned directly or indirectly by him. If he is not the beneficial owner of any such securities, make a statement to that effect.*

(5) If more than 10 percent of any class of securities of the issuer or any of its parents or subsidiaries are beneficially owned by him and his associates, state the approximate amount of each class of such securities beneficially owned by such associates, naming each associate whose holdings are substantial.[4]

Notice, that in Section (4) no mention need be made of the number of shares owned or controlled by the director's employer. Would not the stockholders or general public be interested in this information?

Legislative proposals

Congressman Patman's comments referred to earlier in the article echo some of the conclusions reached in a prior study of the situation by a research staff reporting to the House of Representatives Antitrust Subcommittee, chaired by Emanual Celler of New York. Both would agree that the limited diffusion of corporate power could act to harm corporations and public alike. Both would agree that steps must be taken to protect the economy from actual and potential abuses of such a concentration of power. Patman's recommendations for the solution of the problem will not be known until his committee's hearings scheduled to begin on April 20 of this year are completed. However, Patman's posture in this matter can be implied from his statement. "It may well become necessary to firmly and finally separate trust departments from commercial banking activities.[5]

Where Patman's hearings and proposed legislation seem to be aimed primarily at banks and their abuses of privileged information, Celler's staff report seemed concerned with not only the problem of privileged information, but also the

[3] The Clayton Act of 1914. Section 8. Emphasis added by present authors.
[4] Securities and Exchange Commission, *General Rules and Regulations Under the Securities Exchange Act of 1934*, 1935–1967, pp. 51–52. Emphasis added by present authors.
[5] Wright Patman, *Business Week*, April 3, 1971.

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wider problem of interlocking entities and their agents.[6] The recommendation of the Celler Committee was to "prohibit any person, directly or indirectly, from being a director, officer, or employee with management functions, or from having an agent for such a purpose in two or more corporations."

The prohibition would apply to:

1. Both the corporation and its agents,
2. All corporations engaged in interstate commerce,
3. All classes of corporations, and
4. All horizontal and vertical interlocks between actual and potential customers, suppliers, and sources of credit and capital.

The prohibition would not apply to:

1. Subsidiaries or related companies, or persons, that own 50 percent or more of the voting stock of the corporations involved, and
2. Those receiving permission from the Department of Justice.

This proposed legislation was to take precedence over any provisions of the existing law.

Andrew Towel in an article in the September-October, 1965 issue of HBR maintained that the report and the suggested bill had several major deficiencies. Primary among which were:

(1) The conclusions and proposals contained in the report were based on a limited sample (only 74 companies were studied);

(2) The definition of "indirect interlock" contained in the report was too vague to be meaningful;

(3) The report damned the existence of a "power elite" on the basis that this closed group was potentially harmful. This contention was not supported with fact;

(4) Inplementation of the proposed legislation would require the institution of a vast director recruiting program to replace the displaced directors;

(5) Essential corporate expertise would be diluted by the necessary inclusion of new and less talented directors;

(6) Existing legislation is adequate;

(7) Implementing the proposed legislation would diminish competition.

A question arises in the minds of the authors as to whether the cure is more harmful than the illness. As often in a reactive situation, the long range and side effects are given too little consideration. Obviously, steps must be taken to prevent situations such as the Penn-Central problem from developing. At the same time, the absolutely essential expertise provided by the boards of directors must be preserved. Unlike Towel, these authors do not feel that the present legislation is adequate. If it were, the problem would not have arisen.

RECOMMENDATIONS AND CONCLUSIONS

To remove banks, investment bankers or other service groups from the boards of large corporations would not prove to be beneficial. Large businesses need advice and information from the best sources possible, outside directors. What is needed then, is effective legislation to be applied to corporate entity interlocks. The present legislation is totally ineffective and inappropriate for the problem of interlocking corporate directorates.

The purpose of this article was to show the total absence of reporting requirements and standards over interlocking entities. In no other area of business do we find such a lack of necessary controls. These entities report their activities to no one and are accountable to no one.

In an effort to establish controls over interlocking entities and yet allow their continued existence the authors recommend the following proposals:

1. Extend Sections 7 and 8 of The Clayton Act of 1914 to include both individuals and entities,
2. Extend Sections 7 and 8 of The Clayton Act of 1914 to vertically integrated organizations, and
3. Require disclosure on the proxy statement of the stock held by both the individual and the stock held by his employer.

[6] "Interlocks in Corporate Management—A Staff Report to the Antitrust Subcommittee of the Committee on the Judiciary, House of Representatives" (Washington, D.C., Government Printing Office, 1965).

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Extending Sections 7 and 8 of The Clayton Act to entities would help to alleviate the problem presented in Case A. An entity could not, then, interlock with five competing companies. The second recommendation deals with the problem set forth in Case B where vertically integrated firms become interlocked. Recommendation three would require full disclosure on the proxy statement of all stockholdings by the director and of the company by which he is employed. All stockholders and the general public would be able to see whose interest were being represented on the board of directors.

The implementation of the proposals, in this article, would insure more adequate controls over interlocking entities and prevent potential abuses such a system could foster. What the present authors propose will not create reams of new legislation, but will extend present legislation to cover entities. This will allow the corporation the continued use of their director expertise while preventing abuses which stem from "inside information."

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., April 22, 1971.

Hon. WRIGHT PATMAN,
Chairman, House Banking and Currency Committee,
Rayburn House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: Enclosed is a copy of a letter I have received from Mr. John B. Spivey, President of the First Federal Savings & Loan Association of Swainsboro, Georgia.

You will find his comments self-explanatory and I will appreciate your Committee's consideration of his views in connection with H.R. 5700, the Banking Reform Act of 1971.

Thank you, I am.

Sincerely,

G. ELLIOTT HAGAN.
Member of Congress.

FIRST FEDERAL SAVINGS & LOAN ASSOCIATION OF SWAINSBORO,
Swainsboro, Ga., April 14, 1971.

Re Banking Reform Act of 1971 (H.R. 5700).

Hon. G. ELLIOTT HAGAN, M.C.
House Office Building,
Washington, D.C.

DEAR ELLIOTT: The officers and directors of the First Federal Savings & Loan Association of Swainsboro are quite concerned about certain provisions of the above bill which we understand is now pending in the Congress. This bill, sometimes referred to as the Patman Bill, would prohibit directors, officers, trustees and employees of any insured savings and loan, insured bank, mutual savings bank, insurance company, federal credit union, bank holding company, savings and loan holding company, or brokerage firm from holding a similar position with any other of these eight types of institutions.

We do not think that this is a practical provision in smaller communities such as ours where qualified individuals are more difficult to find to serve in these various capacities. We already have very stiff requirements regarding "conflict of interest," and are closely supervised by the Federal Home Loan Bank of Greensboro with respect to any such conflict of interest.

While the principal motive behind this legislation may be worthy, we feel that it goes much too far and would unnecessarily restrict us in our operation, and we respectfully request you to oppose the bill in its present form, and we would appreciate any advice that you can give us concerning this legislation from time to time.

It is always a pleasure to see you in Swainsboro, and we hope that you will come by to see us on your next visit.

With best personal regards to you, I am

Cordially yours,

JNO. B. SPIVEY, *President.*

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ROBERT R. NATHAN ASSOCIATES, INC.,
Washington, D.C., March 29, 1971.

Hon. WRIGHT PATMAN,
Committee on Banking and Currency, House of Representatives, Rayburn House Office Building, Washington.

DEAR CONGRESSMAN PATMAN: I am grateful to you for your letter of March 10th concerning H.R. 5700, the Banking Reform Act of 1971, and also your memorandum of March 24th indicating the delay in the hearing.

I have read through the summary which was attached and find it quite interesting. I appreciated being invited to comment, especially in view of my membership on the Commission on Money and Credit several years ago.

Unfortunately I am now involved in trying to bring to a conclusion three or four very demanding projects on which we are working and which have a considerable degree of broad economic and public interest. Beyond that, a number of my outside activities, including the chairmanship of a panel for the United Nations Association of the United States and also chairman of a task force for the National Assembly for Social Policy and Development, are demanding a great deal of my time in getting reports ready for early release. In view of this set of circumstances I am afraid that it is going to be impossible to prepare testimony or give you extensive comments which would be helpful. I am sure you are going to get a lot of good witnesses and I only wish that my own time schedule were significantly different because it is an important subject.

Best wishes.

Sincerely,

ROBERT R. NATHAN.

DECHERT PRICE & RHOADS,
Philadelphia, Pa., March 31, 1971.

Hon. WRIGHT PATMAN,
Rayburn House Office Building,
Washington, D.C.

DEAR CHAIRMAN PATMAN: This replies to your letter of March 10 in which you kindly asked my view, as a member of the Comptroller of the Currency's Advisory Banking Committee in 1962, on certain aspects of H.R. 5700.

The Committee's report in 1962 recommended that interlocking directorates be prohibited between banks, savings and loan associations and mutual savings banks, whether chartered under Federal or State law. It was my personal view at that time and still is that such interlocks should not exist.

With respect to the broader questions involved in corporate interlocks in other types of financial institutions I am obliged to say that I have not studied the matter to the point of being willing to express a view. Without a careful study, of the sort I have never made, I wouldn't presume to say where the line should be drawn.

Sincerely yours,

CARROLL WETZEL.

CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST COMPANY,
Chicago, Ill., March 30, 1971.

Hon. WRIGHT PATMAN,
Chairman, House of Representatives Committee on Banking and Currency, Rayburn House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: Thank you very much for your letter of March 10 asking for my views on the proposed bill H.R. 5700, The Banking Reform Act of 1971.

I would like to comment briefly on the issue of interlocking directorships It seems to me that the proposals in H.R. 5700 are completely unrealistic. Rather than correcting a presumed problem, I can see all kinds of new problems that would cause a major upheaval without offsetting gains. It is difficult to see under these proposals how one could assemble a really worthwhile board of directors for a bank or financial institution. Similarly, there would be obvious negative effects on the structure of business in the banking area.

When the Comptroller of the Currency's Advisory Committee on Banking considered these matters in 1962, we gave full and complete thought to these particular problems. We considered at length the need for some restriction and came up with the proposal for eliminating interlocking directorships among the various types of depository institutions along the same lines that such interlocks

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are prohibited between commercial banks and investment banking firms. However, we deliberately stopped at that point after discussing in detail the question of whether such prohibitions should be extended beyond these depository institutions.

It was our considered judgment that there would not be a gain for the public or for the depositors and shareholders of financial institutions by expanding such a prohibition. Rather we concluded that there would be a serious negative impact on the institutions themselves and also a negative impact in terms of public interest and the service that would be furnished by these institutions.

I appreciate this opportunity to make these comments for the record.

Sincerely,

DONALD M. GRAHAM.

SULLIVAN, ILL., *March 26, 1971.*

Hon. WRIGHT PATMAN,
Chairman, Committee on Banking and Currency, House of Representatives, Rayburn House Office Building, Washington, D.C.

DEAR MR. PATMAN: Mr. Marvin L. McLain, Legislative Director of the American Farm Bureau Federation, has forwarded your letter regarding H.R. 5700. I was a member of the Commission on Money and Credit, but, as I recall, the Commission did not take a position on the proposals included in H.R. 5700. Since I have retired as president of the American Farm Bureau Federation, my comments are strictly personal and do not reflect the position of the American Farm Bureau Federation.

I believe that the banking institutions of the United States are rendering good service with a minimum amount of abuse of their public trust. I recognize that there are exceptions of the type to which this legislation is directed; however, I believe that competition is a far better protection against most of these practices, no excessive legislative regulation. I would not be in favor of H.R. 5700 because I believe that it would result in excessive regulation and not be in the public interest.

Yours sincerely,

CHARLES B. SHUMAN.

THE NATIONAL BANK OF NORTHERN NEW YORK,
Watertown, N.Y., March 25, 1971.

Hon. WRIGHT PATMAN,
House of Representatives, House Office Building,
Washington, D.C.

DEAR MR. PATMAN: I am writing to give you the opinion of a small city banker about the new so-called "Bank Reform" Bill which you are sponsoring in the House. Watertown is a city of 32,000 population and our bank has total assets of $105,000,000 with nine branches. Certain parts of the Bill, I feel, are good but some would be harmful. I list the good provisions as follows:

1. Outlaw interlocking directorships among commercial banks, savings and loan associations, etc.
2. Prohibit financial institutions from accepting brokered deposits.
3. Outlaw the practice of financial institutions offering give-aways to attract deposits.
4. Bar savings banks from owning stock of other financial institutions.
5. Bar bank trust departments from holding more than 10% of the stock of a publicly owned company.

The provisions I think would be harmful are as follows:

1. Prohibit officers and directors of banks from serving as directors of nonfinancial corporations where credit relationships exist. As you know there could be many instances where a bank finds itself with a weakened loan and would feel it advisable to have a representative on the board of the debtor company in a watchdog capacity to look after the banks interests.
2. Prohibit a bank's own stock from being held by its trust department. As you know a bank's best customers are frequently its largest stockholders. Also in most cases these stockholder customers name the bank as their executor and/or trustee. If the bank were forced to dump shares of its own stock because of the prohibition of your proposed legislation it would find itself in a situation which would quite likely have an adverse affect on the interest of the testator and his beneficiaries. It would seem also to have the affect, once the provisions

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of this law were known, to drive potential stockholder customers to trust departments of competing banks where they probably would not be known or might even encounter a hostile atmosphere.

3. Require a trust department to disclose annually the holdings of all securities, the voting rights involved, and the results of any proxy voting. While I think this provision might have some merit when applied to the large city institutions such information would mean little or nothing in a bank of our size and would create a lot of extra work each year in preparation. In addition, of course, it would tend to inundate some office in Washington with a lot of useless information.

I hope you and your Committee will give serious thought to deleting the above provisions in your Bill or at least amending them so that the harmful and objectionable features will be eliminated.

I must also admit that I feel letters of this kind are a waste of time on my part because I doubt that it will ever be brought to your attention. It would be refreshing, however, to learn that it had been.

Very truly yours,

B. C. RUSHLOW,
Chairman of the Board.

FIRST NATIONAL BANK OF NEW BRAUNFELS,
New Braunfels, Tex., April 22, 1971.

Hon. WRIGHT PATMAN,
House of Representatives,
Washington, D.C.

DEAR CONGRESSMAN PATMAN: As the President of a National Bank I was very much disturbed to read some of the provisions in the bill you have styled "Bank Reform Act of 1971". This information was furnished me by the Texas Bankers Association and does not specify any particular section of this proposed bill but does point out some provisions concerning prohibitions involving directors, officers and employees in activities other then the bank they are serving. Existing laws provide adequate safeguards concerning conflicts of interest of directors, officers and employees and periodic examinations assure that these laws are carried out. Proposals as outlined in your bill would severely curtail the operations of banks insured by F.D.I.C. and would make it impossible to attract directors or officers that would be an asset to the organization. I have no objections at all to the proposed provisions prohibiting equity participations in connection with extensions of credit, the prohibition of accepting broker deposits, and the prohibition of offering gifts or premiums as an inducement to open or add to accounts but I do think the information requiring banks to make available to the public loans of bank officers, directors, trustees, or employees, or to their immediate families is grossly unequitable, unwarranted, and asinine.

While this proposed bill would also apply to the savings and loan associations, insurance companies, mutual savings banks and others, this does not alleviate the severe restrictions that would be placed on all of these financial institutions and in my humble opinion the difficulties that would be incurred by operating under these proposals would greatly impair normal commercial activities, profits, and dangerously hamper the economic growth and development of our Country.

There is no way that I can justify your personal vendetta towards the industry which has played such a great part in the development of our Country.

Very truly yours,

JOSEPH FAUST, *President.*

FIRST NATIONAL BANK OF MINNEAPOLIS,
Minneapolis, Minn., April 27, 1971.

Hon. WILLIAM FRENZEL,
House of Representatives, Longworth Building,
Washington, D.C.

DEAR CONGRESSMAN FRENZEL: Congressman Patman has introduced a bill, H.R. 5700, entitled "Banking Reform Act of 1971". This is a far-reaching bill and has parts which we feel would promote sound banking practices, but there are other parts which are unduly restrictive and thus would hinder the development of banking and broader public service.

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For example, we support the view that there should not be interlocking directorates between banks themselves, between banks and savings and loan associations, or between banks and other institutions engaged primarily in receiving deposits and making loans. Such cross relationships prima facie do carry with them conflicting loyalties for a director trying to serve two institutions. We also firmly believe it is improper for a bank to "bribe" a corporate officer to influence his choice of banking relationships.

But we do not subscribe to the proposed bill's prohibition on bank officers or directors also serving on insurance company or title company boards. There is no necessary conflict of interest in those relationships, and there may be desirable contacts and benefits to a bank in having its management in close tie with such companies. We already have legal remedies against directors who become involved in conflict of interest situations which cause damage to the companies involved, so it seems unnecessary to reinforce the existing remedies with a broad prohibition that strikes down the desirable along with the undesirable.

A second example in the bill of "overkill" is the prohibition on a bank director performing legal service for another person in connection with a transaction with the director's bank. The legal profession has a code of ethics that requires a lawyer to have undivided loyalty to his client. The lawyer can decide in a given situation if a conflict of interest is created and govern himself accordingly. He constantly is required to make such decisions in his practice in other matters. If he violates his professional code of ethics, the client has a redress through law and bar association ethics committee and the bank can remove him as a director. But why reinforce these remedies by cutting off relationships which may have no conflicts?

A third example is where the proposed bill prohibits a director of a bank from serving on the board of a company for which the bank manages an employee welfare or pension plan. It is difficult to see what conflict of interest would be so serious in this situation as to warrant a complete disengagement of interlocking directorships. One of the duties of a bank director is to try and develop new business for his bank. If this proposed restriction becomes law, the director would find himself in the unique position of getting "fired" from the company board because he brought the company's new pension fund account to his bank.

We are all aware that conflict of interest situations can arise in every avenue of business, political, and professional endeavors. To eliminate it from the start by legislation would make such a sterile environment that sophisticated commerce could not thrive. Therefore, we must meet the problem in a selective fashion so as to strike at the abuses without crippling the beneficial relationships. If breadth of knowledge and experience is desirable for corporate management, then let's not stifle banking management by making it ingrown and isolated from interaction with other business exposures.

Mr. Patman's bill also is seeking to relieve his concern that too much economic power is wielded by banks to the detriment of our society. To this end the bill prohibits a bank trust department from holding more than 10% of the stock of a company registered under the Securities Act of 1933; prohibits a bank from taking equity participation like warrants as part of its compensation for a loan; and a director of a bank cannot be a director of a company with which the bank has a substantial credit relationship or owns in trust more than 5% of the company's stock. The concern that Mr. Patman has, in relation to others who view the problem from a different perspective, is one of degree. Mr. Patman may have, in committee research studies, found evidence of certain banks having large economic power. But when you look at the whole banking industry, the competition within it, and the existing regulation by government, state and federal, the full picture reveals ample safeguards of the public interest and no concentration of power dangerous to our system of free competition. We, therefore, argue that the limitations Mr. Patman's bill is imposing are not necessary to preserve a healthy banking industry or a competitive business system. The effect of the provisions will tend in the other direction of discouraging aggressive, growing banking.

The bill also prohibits using premiums or merchandise as an inducement to gain new deposits. This sales practice has been going on for many years and, insofar as we can tell, has been very well received by the public and has had no adverse effect on banking. The Federal Reserve Board has issued rules and regulations holding down the value of such inducements and, if there are any abuses, there are already adequate methods of dealing with them without going to the extremes of H.R. 5700.

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We ask that you give consideration to the objections we have raised in this letter and, if you are satisfied with their validity, take a position opposing the Banking Reform Act of 1971 as introduced.

Sincerely yours,

GEORGE H. DIXON, *President.*

CITIZENS STATE BANK,
Dickinson, Tex., April 5, 1971.

Hon. WRIGHT PATMAN,
U.S. House of Representatives,
Washington, D.C.

DEAR WRIGHT: I have noticed with deep concern the efforts initiated by Henry Gonzalez to enact legislation which would prohibit member banks of FDIC to make loans on stocks of other member banks.

We all know that there have been many abuses with respect to loans on bank stocks; however, I do not believe the records will show that such loans have played any consequential part in Texas bank failures. You will find attached a listing of the Texas bank failures and schedules of the dollar losses. These show the amount of funds lost to depositors and the cost to the FDIC. This does not include the Sharpstown Bank because these figures are still unknown. These figures reveal that over the years 1965 through 1970, the total State bank deposits averaged $6,078,100,979.91, and the loss to depositors in all of the banks amounted to $177,000.00. This results in a loss of less than one-half cent per $1,000.00 of deposits. The loss to the FDIC was $1,765,839.00, resulting in slightly more than five cents per $1,000.00 of insured deposits. A minute change might occur in these figures due to further recoveries of assets of the closed banks or in litigation that might still be undetermined.

I feel it appropriate to give you these detailed figures in view of statements I have seen in the press which could be construed as highly derogatory towards State banks, the State Banking Department, and the manner in which the FDIC has handled its responsibility in Texas. The facts simply do not justify such contentions. I consider this relevant to loans on bank stocks inasmuch as there seems to be in the minds of some the belief that such loans have played a part in Texas bank failures and that the bank failures have been in great amounts. Certainly, no responsible banker or other citizen wants "sloppy" laws, supervision or operation of banks, but I think it is appropriate to make criticisms consistent with the facts. I know of no way to keep a few unworthy people out of the banking business, the medical profession or any other sizable group.

The ultimate result which would come from prohibiting FDIC member banks making loans on stocks or other member banks would be the acquisition of the control of many banks throughout the Nation by those who have cash with which to buy banks. There are many banks throughout the Nation which have stockholders who have borrowed some of the money they have used to purchase their bank stocks. It is quite likely that in most cases the funds were borrowed from banks. If this were made illegal, then only the very rich with great sums of cash could purchase sizable blocks of bank stock.

There is no question but that if a large bank lends to a small banker some of the purchase money for his stock, the small banker, in appreciation for the service, will keep deposits with the lending bank. Such deposits have to be kept somewhere, and I know of no case where such lending banks have attempted to dominate the borrower or his bank.

If such loans became illegal, the borrowers would be asked by the lending banks to move the loans out of the bank. Where would the small banker go to get the money with which to pay off the lending bank? Obviously, he could not go to another bank. This would force him into the arms of other lenders and under such terms and conditions which would be highly detrimental to the borrower and conceivably to his bank. Furthermore, I doubt that other lenders could be found in adequate numbers and of sufficient size to accommodate this volume of loans. The result would be a forced selling of the bank stock to pay the bank loan.

The next question is who would be buying such stocks. I think it is obvious that the large banks through their holding companies and related companies would be the buyers and at distressed prices. It is my deep conviction that this would result in a tremendous and accelerated rate of concentration of financial power in few hands. Throughout your career you have been opposed to such concentration.

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Unless there is a federally sponsored lending agency which would be required to lend on bank stocks on terms comparable to those now prevailing, the result of the proposed legislation would drive out of the banking business a great many small bankers and put little banks into the arms of the giants. It is hard for me to believe that the Federal Government would create a lending agency to help small bankers keep control of their banks.

I recognize the possibility that there are some unwholesome situations based upon bank stock loans. However, I cannot believe that these faults would be remotely equal to the damage which would come from a further concentration of bank assets into fewer hands. Furthermore, I believe that legislation can be devised that will enable the examining authority to "get the rats without burning down the barn."

There may be cases in which large banks carrying loans for owners of small banks have "pressured" them on political or economic matters. I think I would be a prime target for such "pressuring" in view of the fact that I have for over thirty years consistently taken political positions and supported political candidates opposed by most large bankers. I have never been even remotely pressured about anything political or economic. It might be stated that this is due to the fact that my loans are so small compared with the value of the security that I could easily move my loans from any bank that attempted to pressure me. Moreover, I have not heard of any banker being pressured by another because of loans on bank stocks.

This is of deep concern to me as I am sure it is to a huge number of small bankers, and I would very much appreciate hearing from you because there must be some extremely important factors about which I know nothing.

With best personal good wishes, I am

Cordially,

W. G. HALL.

The First State Bank, Aransas Pass (Sept. 2, 1969)

Closed by directors as of August 29. Speculative real estate loans and self-dealing. No evidence of criminal acts, although investigation is in process by Department of Public Safety at the request of local grand jury. *Disposition:* New bank organized to assume liabilities and to purchase acceptable assets. Opened approximately one week after closing. No loss to depositors. Estimated net loss to FDIC—$322,891.00.

Big Lake State Bank, Big Lake (Aug. 25, 1969)

Closed by directors as of August 22. Very poor loans to local and out-of-territory borrowers, to "broke" businesses, etc. Management primary factor in closing. Board repeatedly requested to make correction, to no avail. No evidence of criminal acts. *Disposition:* New bank organized to assure liabilities and to purchase acceptable assets. Opened approximately one week after closing. No loss to depositors. Estimated net loss to FDIC—$-0-.

The First State Bank, Dodson (May 12, 1969)

Closed by directors as of May 9. Loan portfolio included some of the wildest loans ever witnessed by writer, based on collateral either nonexistent or hard to locate. Management primary factor in closing. Board had been repeatedly requested to make correction, but was unable to do so. Some evidence of criminal acts and Department of Public Safety is making discreet inquiry into certain aspects of management's dealings, at our request. *Disposition:* Reorganization impossible to accomplish. Bank was closed and is being liquidated by FDIC. Only loss to depositors was interest earned on several $15,000 Certificates of Deposit. Estimated net loss to FDIC—$300,000.00.

Citizens State Bank, Alvarado (Apr. 14, 1969)

Closed by directors as of April 12. Total of $512,000 shortages in the bank, caused by three employees working together. Bank had $1,000,000 excess coverage, but representative of bonding company indicated that no claims would be honored until instructions were received from courts. Efforts to find individuals interested in reorganization failed due to possibility of finding additional shortages. FBI is investigating and trio will probably be charged before long. *Disposition:* Bank was closed and is being liquidated. New bank organized later but did not assume liabilities. Loss to depositors (14) whose accounts were over $15M was total of $107M. Estimated net loss to FDIC—$-0-.

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Lorenzo State Bank, Lorenzo (Feb. 7, 1968)

Bank was closed by directors. Loan portfolio and other assets included substantial loans to a "broke" company in which president of bank was interested, and loans to individuals who were in other business with president. Losses were greatly in excess of capital funds. Efforts to effect reorganization of existing bank were extensive but unsuccessful. Board had been repeatedly counseled to effect correction of trends. Investigation by FBI resulted in indictment and conviction of president and certain cohorts. *Disposition:* New bank was organized to assume liabilities and purchase acceptable assets. Opened less than one week after closing of old bank. No loss to depositors. Estimated net loss to FDIC—$344,542.00.

Sacul State Bank, Sacul (Sept. 24, 1967)

Closed by department, when Houston-based owners would not adopt resolution. Loan portfolio included loans to characters of questionable reputation, and loans to major owners of bank who were known to have uncollectible debts elsewhere. Board had been given ninety (90) days to correct deteriorating trend and to correct violations of law. FBI and Department of Public Safety investigated, resulting in conviction of principal owner and officer. *Disposition:* Efforts at reorganization unsuccessful. Bank was liquidated by FDIC. Loss to depositors unknown but one depositor suffered approximately $70M loss. Estimated net loss to FDIC—$56,662.00.

First State Bank of Tuscola, Tuscola (Oct. 14, 1966)

Closed by directors. Loan portfolio included numerous loans to out-of-territory borrowers whose credit was known to be poor elsewhere. Management was very liberal and was primary factor in closing. Board had been alerted to bank's problems previously, but took no action. No criminal acts apparent. *Disposition:* New bank was organized and facility never actually closed. Liabilities were assumed by new bank and acceptable assets were purchased. No loss to depositors. Estimated net loss to FDIC—$139,547.00.

Blanket State Bank, Blanket (Jan. 24, 1966)

Closed by directors. Loan portfolio included forged notes and fictitious borrowers, as well as loans to business associates of president which were illegal and of doubtful collectibility. Major defalcation not covered by insurance and criminal acts of president precipitated closing. Bank had been on our problem list for some time due to other problem loans, and the directorate were aware of their status. *Disposition:* First National Bank, Brownwood, agreed to assume deposits and purchase acceptable assets. No loss to depositors. Estimated net loss to FDIC—$132,308.00.

First State Bank, Covington (Apr. 3, 1965)

Closed by directors. Bank was grossly misused by used-car dealer who was customer. Bad loans and kiting activities resulted in losses far in excess of capital funds. Management was aware of kiting but felt he could "control" the situation. He did not. Insurance coverage inadequate to cover loss. Criminal trial resulted in hung jury. *Disposition:* First National Bank of Itasca, Itasca, assumed liabilities and purchased acceptable assets. No loss to depositors. Estimated net loss to FDIC—$-0-.

Malone State Bank, Malone (Feb. 24, 1965)

Closed by directors. Ownership and management changed approximately 45 days prior to closing, and new individuals in the bank did very fast job of breaking bank. Loans to one individual whose credit was uncollectible elsewhere far exceeded total capital accounts of bank. Insurance coverage inadequate to protect against total losses. Criminal acts apparent, but prosecution just now underway. *Disposition:* First State Bank, Hubbard, assumed deposits and purchased acceptable assets. No loss to depositors. Estimated net loss to FDIC—$155,935.00.

Winona State Bank, Winona (Feb. 5, 1965)

Closed by directors when very major shortage was discovered. Bank was smallest in the state and was family owned and controlled. President maintained two sets of deposit ledgers and other separate records. Insurance coverage was far inadequate to cover loss. Criminal trial resulted in conviction of president. *Disposition:* Reorganization was impossible to effect due to possibility of further shortages. Bank was closed and liquidated. Some loss to depositors whose amounts exceed $15M was experienced. Estimated net loss to FDIC—$313,954.00.

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BANK FAILURES IN THE STATE OF TEXAS AND TOTAL LOSSES SUFFERED BY DEPOSITORS AND COST TO FDIC

Year	Total deposits State banks	Loss to depositors	Loss to FDIC	Depositor loss per $1,000 deposit	FDIC loss per $1,000 deposit
1965	4,530,675,013.52	0	469,889	0	.1037
1966	4,864,298,010.65	0	271,855	0	.0558
1967	5,580,984,205.20	70,000	56,662	.0125	.0101
1968	6,489,357,954.32	0	344,542	0	.0530
1969	7,040,205,185.61	107,000	622,891	.0151	.0884
1970	7,963,085,510.17	0	0	0	0
Total		177,000	1,765,839		
Average loss per $1,000 of deposits				.0046	.0518

NUMBER OF STATE BANKS AND TOTAL RESOURCES AND DEPOSITS THEREIN

Date	Number of banks	Total resources	Total deposits
Dec. 31, 1965	587.0	$4,966,946,555.34	$4,530,675,013.52
Dec. 31, 1966	593.0	5,344,643,993.98	4,864,298,010.65
Dec. 30, 1967	600.0	6,128,117,932.64	5,580,984,205.20
Dec. 31, 1968	609.0	7,107,310,702.35	6,489,357,954.32
Dec. 31, 1969	630.0	7,906,054,136.40	7,040,205,185.61
Dec. 31, 1970	654.0	8,927,087,962.28	7,963,085,510.17
Average	612.2	6,730,026,880.50	6,078,100,979.91
Average size	1	10,993,183.40	9,928,293.01

THE FIRST STATE BANK,
Colmesneil, Tex., April 16, 1971.

Hon. WRIGHT PATMAN,
U.S. House of Representatives,
Washington, D.C.

DEAR MR. PATMAN: I am appalled by your proposed bill styled the "Banking Reform Act of 1971". Your provision whereas "A director, trustee, officer or employee of a bank cannot at the same time be a director, trustee, officer or employee of (a) any other bank insured by FDIC, (b) a savings & loan association, (c) a federal credit union, (d) any insurance company, (e) a bank or S&L holding company or any subsidiary of such company, (f) any stockbroker or dealer or (g) any title company, company engaged in the business of appraising property, or company which provides service in connection with the closing of real estate transactions," would finish me in the banking business and ruin my family's income.

Small town banking is my career and it takes income of (and management of) two small town banks (Chester State Bank, Chester, Texas pop. 220, and First State Bank, Colmesneil, Texas pop. 800) to support my family of 3½. I do a good job for both of these towns. What about others of similar circumstances? What will you do to their careers and family incomes? Do you burn the barn down and kill all of the nice animals to get rid of a few rats?

I beg you to withdraw this bill, revise it, and aim it as the particular persons that are doing the harm. If you will not, I hope and pray that it will be defeated.

Sincerely yours,

DAVID A. FEAGIN, *President.*

JEFFERSON STATE BANK,
San Antonio, Tex., April 26, 1971.

Mr. HENRY B. GONZALEZ,
House of Representatives,
Washington, D.C.

DEAR HENRY: I greatly regret that I was unable to be in Washington on the 19th of April to testify in behalf of H.R. 5700 and H.R. 3287. However, in lieu of my personal appearance and at your request, I am pleased to be able to make and submit the following testimony, which is substantially what I would say if I were present and testifying before the Committee; and you are authorized to file the same with the Committee or to deliver a copy to each member thereof:

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GENERAL INFORMATION

My name is A. J. Lewis. I reside at 118 Brittany Drive in San Antonio, Texas. I was born on a farm in Bosque County, Texas on August 3, 1902, nearly 69 years ago. I moved to Fort Worth in 1916, and graduated from Fort Worth High School in 1920. I then went to Austin to attend the University of Texas; and there had the rare privilege to be able to work part-time in the State Banking Department of Texas for six years while obtaining my college and legal education. After finishing the Law School of Texas University in 1926 and after obtaining my Texas license to practice law (on August 3, 1926), I was appointed Office Counsel for the Banking Commissioner of Texas and the State Banking Department and served as such until 1929, when I moved to San Antonio, where I have lived ever since (except for active Army duty as a Reserve Officer from 1940–1946). Banking law has been one of my specialties. However, I have just about retired from the active law pratcice; but I still devote a great deal of time as Chairman of the Board of Directors of the Jefferson State Bank in San Antonio, Texas.

I am appearing before the Committee in this manner as an individual and in my capacity as Chairman of the Board of the Jefferson State Bank of San Antonio, one of the independent suburban banks in northwest San Antonio which I helped organize in 1946 (25 years ago), and I have been officially connected with it ever since.

I have not and will not be paid a fee of any kind for making this appearance.

During my tenure in the Texas Banking Department from 1921 to 1929, a period of nearly eight years, I was assigned primarily to the Liquidating Division of the Department, where the Commissioner supervised the liquidation of insolvent state banks. More than 500 banks were closed and liquidated during my tenure in those terrible times. I had ample opportunity to study and become familiar with many of the mistakes which were made that resulted in such bank failures. I also gained valuable legal experience in that special sort of work.

Throughout the years in San Antonio I have tried to contribute as much as possible to civic and charitable activities in my home town: such as, for examples, serving (a) on the City-County Hospital Board of Managers, and (b) as Chairman of the Board of Trustees and charter organizer of the San Antonio Medical Foundation; and (c) as Chairman of Army and Navy Advisory Committees in liaison between the Defense Department and the local military and civilian agencies; and (d) as President of the San Antonio Chamber of Commerce in 1948. I therefore feel qualified to make these statements.

I find myself in general agreement with the over-all intent and scope of H.R. 5700 (the "*Banking Reform Act of 1971*"); and, with certain refinements, I support H.R. 3287 designed to amend 12. U.S.C. 1828.

RE: H.R. 5700

I think the practice of interlocking directors and interlocking officers between two or more affiliated or competing corporations is completely wrong in principle.

I am not opposed to corporate bigness as long as it builds itself up by its own boot straps and confines its corporate activity to its own self.

Aside from the possible anti-trust and monopolistic features, it seems clear to me that mergers and buy-ups and interlocking officers and interlocking directors provide hiding places and temptations for the crooks and promoters to take advantage of the law and sound banking principles.

A good example is the present crawling practice of the one-bank and multi-bank holding compaies. *Since* the recently enacted Amendment of the Bank Holding Company Act, some of these OBHC's and MBHC's are (with permission of the Fed) acquiring stock in many independent banks; and in many cases are thereby acquiring dominion and control of such banks. They have thus found a new device to circumvent the state laws against branching; at least in Texas they are doing indirectly what the Constitution and laws of Texas say they cannot do directly; yet with interlocking officers and interlocking directors and interlocking finances they are acquiring enough stock to control and dominate the little independent banks. They are thus acquiring the lucrative correspondent bank account (and other benefits connected therewith) the same as if they were establishing branches.

Another pertinent (specific) example is the recent acquisition and control of The Groos National Bank of San Antonio by a Mr. Manges who is a self confessed

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and convicted criminal in one of the Federal District Courts in Texas. It is clearly indicated in the press and otherwise that Manges purchased more than 50 per cent of the stock (control) in the Groos Bank with money loaned to him by the Bank of the Southwest in Houston (in the neighborhood of $6,000,000.00). In the process of buying up this bank stock (over a period of several months) (and at prices ranging up as high as three times book value) at least one of the vice presidents of the Bank of the Southwest (and at least one of its attorneys on several occasions) rode herd and directed Mr. Manges in his secret acquisitions. Incidentally, as the Committee may well already know the Bank of the Southwest has heretofore converted itself into a holding company and has been authorized by the Federal Reserve Board to acquire (as a registered bank holding company under the recent Amendment) stock in more than 20 small independent banks in Texas. It would be material and pertinent if the Committee could see its way to require the Bank of the Southwest (and others similarly situated) to appear and testify about these acquisitions and their acts (secret and otherwise) of domination and control.

It is my belief and opinion that these bank holding companies (such as the foregoing purchases by the Bank of the Southwest) are violating the spirit and intent of the constitutional and statutory prohibitions against "branch" banking in Texas. Actually, these Texas prohibitionary laws do not call it branch banking. Rather they prohibit a bank from "doing business in more than one place—the place designated in its charter." If the Committee could obtain all of the facts (secret and otherwise) there is the real possibility that the Committee would conclude to look behind and disregard the corporate shams. In the recent appeals from Florida and Georgia (where the banks organized a corporation to operate mobile facilities) the Federal Appellate Courts disregarded the corporations as a mere sham and held that the whole activity violated the state laws against branching.

I find it impossible to believe that The Congress intended to authorize any such deceit and resulting destruction of our independent unit banking system—when it amended the Bank Holding Company Act in 1970.

RE: H.R. 3287

While I realize that H.R. 3287, as presently drawn, would probably eliminate bank stock as collateral for a legitimate loan, as we have always understood that term; still, nevertheless, it points up clearly the need for Congress to legislate something in that area.

I think it is clearly wrong for anyone (even with good intention) to be able to borrow 100 per cent of the purchase price of bank stock, especially when the purchase involves a majority of the stock of a bank; and we have seen entirely too many of those transactions in the past decade. The facts will show that the borrowers (most often promoter-type of people and too often persons of limited means) promise the lender bank the juicy correspondent bank account and other benefits connected therewith. In such purchases it is clear to me that the purchaser often pays more than the stock is worth, sometimes as much as two or three or even four times book value, in order to accomplish his purpose, which is the hope of being able to sell out later to a Brancher (or a Bank Holding Company) at an even higher price and then take his capital gain. This is certainly true in Texas because the Brancher knows it cannot branch in Texas; and this is the BHC's only way to accomplish indirectly what it cannot do directly.

I wish there was some way for this Committee to inquire into these transactions (and there are at least 80 or more in Texas in my opinion) and thereupon learn first hand how nefarious they are from beginning to end. I believe they are using these loans and interlocking directors and interlocking officers (in part) as a corporate sham and illegal device to get around the legal prohibition against branching in Texas.

H.R. 3287, as presently drawn, is headed for a great deal of opposition because it would do away with bank stock as collateral. If it is to be amended in the Committee, I would suggest that the amount to be loaned against bank stock be limited to no more than 50 per cent of the book value of such stock at the time of purchase or at the time the loan was made, such book value to be certified by the president of the issuing bank.

In conclusion, if I may say so, it is my feeling that the Committee (after hearing all the evidence) should consider amending the Holding Company Act to prevent these octopuses from swallowing up our small independent unit

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banks—certainly in states like Texas where such state laws prevent a bank from branching or doing business in more than one place (the place stated in its charter).

Very respectfully,

A. J. LEWIS,
Chairman of the Board.

CREDIT UNION NATIONAL ASSOCIATION, INC.,
Washington, D.C., May 6, 1971.

Hon. WRIGHT PATMAN,
Chairman, Committee on Banking and Currency,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN. On behalf of the Credit Union National Association, Inc., may I briefly express to you some of our thoughts and reactions concerning H.R. 5700, the "Banking Reform Act of 1971". In our opinion, that is most constructive piece of legislation, particularly as it is aimed at eliminating certain interlocking relationships among financial institutions with the potential for inherent conflict of interest situations.

Concerning Section 2 of your bill, Mr. Chairman, which prohibits interlocking directorships and relationships among financial institutions, it is our understanding that the proscription of this section would not extend to an individual serving as a director, officer, or employee of two or more credit unions. As you know, many of our credit union volunteers belong to more than one credit union and it is not unusual for these volunteers to serve as a member of the board of several credit unions. Also, many of our officials have joined officer central credit unions in addition to the credit union serving their plant, parish, etc. in order to meet their own needs for credit union services. Thus, some of these officials are serving as directors of at least two credit unions. It is our earnest hope that the passage of H.R. 5700 would not contain language preventing credit union members from serving as officials for more than one credit union, as it could effectively dry up our principal source of management—the credit union volunteer.

In a similar vein, it is also our understanding that Section 2 of H.R. 5700 would not prohibit an officer, director, or employee of a credit union from serving in a similar capacity with an insurance company. In this regard, most of our credit unions participate in member-owned mutual insurance companies especially designed to serve credit union needs. We trust that the proposed legislation will not be altered so as to preclude participation by our credit union officials in the management of these credit union oriented insurance companies.

There is another section in the bill, Mr. Chairman, which causes us considerable concern because of its potential adverse impact on credit unions. Section 8 of H.R. 5700 would prohibit any officer, director, employee or trustee of any of the eight types of financial institutions from serving in a similar capacity with any corporation in which the financial institution has voting control of over 5 percent or more of any class of stock. As you may know, in some states credit unions have invested in service centers and insurance companies which provide accounting and data processing services and insurance for participating credit unions and their members. In some cases, a credit union may own more than 5 percent of the voting stock in the service corporation of credit union owned insurance company. If such is the case, the proposed legislation could prohibit credit union officials from engaging in the management of service or insurance companies, ownership of which is designed to serve credit unions and their members. As the dangers of conflict of interests would appear to be minimal and perhaps nonexistent in these situations, we would hope that these credit union owned service organizations and insurance companies could be excluded from this legislation.

Finally, Mr. Chairman, we note that your proposed legislation would permit the 100 percent insurance of public deposits in insured banks and savings and loan associations (Section 25, 26). We would respectfully ask that authority be given to the Administrator of the National Credit Union Administration to permit the deposit of public funds in an insured credit union and to insure such deposits up to 100 percent. In this regard, one of the strong recommendations made by CUNA's Special Recodification Committee on the Federal Credit Union Act was to authorize "Each Federal credit union to act as fiscal agent for and to receive deposits from the Federal and state governments or political subdivision thereof and public housing corporations and to hold tax payments

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and proceeds of obligations of the United States as well as appropriated and nonappropriated funds". The Committee's recommendation was in response to testimony received from credit union people throughout the country on this and many other recommended changes to the Federal Credit Union Act. Authority for Federal credit unions to receive public deposits, insured up to 100 percent, would eliminate an apparent inequity in comparison with other financial institutions and would permit credit unions to serve their members more effectively.

We are confident, Mr. Chairman, that the final version of H.R. 5700 will not be inimical to the interest of credit unions because of your continuing expressed desire to permit these institutions to serve people, primarily on a volunteer basis. For our part, we would hope to justify your confidence in our credit unions' ability to serve the little man.

Sincerely,

EVERT S. THOMAS, Jr., *Acting Managing Director.*

RHODE ISLAND LEAGUE OF SAVINGS AND LOAN ASSOCIATIONS,
Providence, R.I., May 10, 1971.

HOUSE COMMITTEE ON BANKING AND CURRENCY,
Rayburn House Office Building,
Washington, D.C.

Attention: The Honorable Wright Patman, Chairman.

GENTLEMEN: The Legislative Committee of the Rhode Island League of Savings and Loan Associations has examined H.R. 5700, the Bank Reform Act of 1971, relative to its impact on savings and loan associations chartered in Rhode Island. Rhode Island state law permits a savings and loan association to hold a majority of the stock of one commercial bank.

H.R. 5700 in several sections permits interlocking directors, trustees, officers and employees in the parent-subsidiary situation where the parent is either a bank holding company, as defined in the Bank Holding Company Act of 1956, or a savings and loan holding company as defined in Section 408 of the National Housing Act. These sections are: proposed Sec. 23 (b) of The Federal Deposit Insurance Act (Sec. 2 of H.R. 5700), Sec. 4 (b) of H.R. 5700 covering non-insured mutual savings banks, Sec. 8 (b) of H.R. 5700 and Sec. 9 (b) of H.R. 5700.

However, the parent-subsidiary exception in proposed Sec. 411(b) of the National Housing Act (Sec. 3 of H.R. 5700), which would apply to savings and loan associations, does not make the exception applicable where the parent is a bank holding company, but only where it is a savings and loan holding company. The members of our League which hold commercial bank subsidiaries would appear to be bank holding companies under the Bank Holding Company Act and not savings and loan holding companies under the National Housing Act.

To make proposed Sec. 411(b) consistent with the other exceptions, and particularly with Sec. 8(b) and 9(b), both of which also appear to apply to our state-chartered association members, we would respectfully request that proposed Sec. 411(b) be amended to read as follows:

Sec. 411 * * *

"(b) An individual may hold any number of positions as director, trustee, officer, or employee of any number of companies within any given group of companies if one of the companies is either a bank holding company as defined in the Bank Holding Company Act of 1956 or a saving and loan holding company as defined in Section 408 of the National Housing Act and all the rest of them are subsidiaries of that holding company."

Such an amendment is consistent with the purpose and spirit of the bill and takes into account the special situation under Rhode Island law. Mutual savings banks are also permitted under our State law to hold a commercial subsidiary and this situation has already been recognized by the Congress in Sec. 2(a)(5)(F) of the Bank Holding Company Act of 1956, as amended by the Bank Holding Company Amendments of 1970.

We would appreciate it if this letter could be inserted into the record of the hearings on H.R. 5700 held by the Committee on Banking and Currency. We would also be most appreciative if the proposed Sec. 411(b) be amended in the above manner so as to cover the unique savings and loan situation in Rhode Island.

Sincerely yours,

CHARLES C. HORTON,
Chairman, Legislative Committee.

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MILWAUKEE FEDERAL SAVINGS & LOAN ASSOCIATION,
Milwaukee, Wis., April 19, 1971.

Hon. WRIGHT PATMAN,
House of Representatives,
Washington, D.C.

DEAR REPRESENTATIVE PATMAN: In perusing bill H.R. 5700, a number of items come to my mind which cause me concern. It is my understanding that hearings will begin in the near future and I would like to go on record with the following comments:

1. Basically it is a good bill. I would particularly support the feature where one hundred percent of insurance of public funds will be provided.

2. It is my contention that the Federal Home Loan Bank Board already has sufficient powers to provide for any conflict relating to officers, directors, and family ties. There are occasions when the F.H.L.B.B. may see fit to allow interrelationship between savings and loan operations and the providing of certain services. In this Act's present terminology, there is a possibility that "service corporations" may be prohibited. This is one of the new devices that the F.H.L.B.B. has promoted for the good of the savings and loan industry.

3. The Act provides that there may be no director "tie up" between a savings association and the corporation which provides the pension plan. Does this also hold true that the F.H.L.B. Presidents could no longer serve on the Savings Associations Retirement Fund?

4. The final part of the bill provides that savings associations must report to the F.H.L.B.B. all loans to their directors, officers, employees, etc., for public inspection. The F.H.L.B.B. has already provided suitable and sufficient regulations to provide for this contingency. What is so evil about lending to persons with the qualifications that directors and officers possess? In order to obtain and retain officers and employees, the fringe benefit of allowing them a reduced interest rate on their owner occupied home is a valuable asset.

In closing, let me point out that the great majority of financial institutions are run by honest and qualified individuals. The legal principle of being innocent until proven guilty also pertains to officers and directors of financial institutions. I don't believe that it is necessary for the Congress, in all its knowledge, to protect us from ourselves to the extent of H.R. 5700.

Very truly yours,

JOSEPH J. BINSFELD,
Senior Vice President,
Attorney at Law.

TEXARKANA FEDERAL
SAVINGS & LOAN ASSOCIATION,
Texarkana, Ark., April 21, 1971.

Hon. WRIGHT PATMAN,
Member of Congress,
Rayburn House Office Building,
Washington, D.C.

DEAR MR. PATMAN: I believe that H.R. 5700 would jeopardize not only Texarkana Federal Savings and Loan Association, but the entire financial community of Texarkana. As I understand the bill, if it should pass we would be in violation of nearly every aspect of the "Interlocking Relationships" provision. I would like to outline for you certain relationships which we have with other Texarkana institutions: a savings and loan association, a bank, a law firm and a title company. These relationships are not a disadvantage and are not definitely, I believe, in the public interest. We know that this institution and the segment of the community that we serve derive substantial benefits from this mixing of personalities.

MR. WILLIAM H. ARNOLD, III

Mr. Arnold is a director of Texarkana Federal Savings and Loan Association and a nephew of Richard L. Arnold, another member of our Board. Both are partners in the law firm of Arnold and Arnold.

The Arnold law firm does all of our legal work. Southwest Title Company, in which Tom Arnold, brother of William H. Arnold. III, and also a member of the Arnold law firm, has a substantial interest, does 95% of the title work which we

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generate. Our work, however, is only a small portion of the volume of business of the Arnold law firm and Southwest Title Company. We get excellent performance out of both firms and we believe that their size proves that they are serving the people of Texarkana well. The apparent conflict of interest between this Association, the Arnold family, and the firms they control, is in reality no conflict of interest at all, but an efficient and mutually advantageous business relationship that substantially benefits our Association, its members and the public most of all.

MR. DUDLEY WORTHAM AND MR. RICHARD L. ARNOLD

Mr. Wortham is a director of The Texarkana National Bank, our Association's principal depository, and is also a director of Texarkana Federal Savings and Loan Association. Mr. Richard L. Arnold is a director of this Association and also of First Federal Savings and Loan Association of Texarkana, with which we are in competition. He is, as I have heretofore stated, the uncle of William H. Arnold, III, and also of Tom Arnold.

I have served for six years with Mr. Richard L. Arnold and Mr. Wortham as a director of the Association. Their contribution to Texarkana Federal Savings and Loan Association during that time has been immeasurable. I can truthfully say that I have never seen one example of where their directorships at other financial institutions has displayed itself in any way that could even remotely be classified as a conflict of interest. They have displayed and used frequently good judgment, wisdom and knowledge to help steer this Association toward sound growth and service to this community. I further feel that to a large degree the expertise these gentlemen lend to this Board could only be gained by their serving other financial institutions as directors. The knowledge they gain, not of individuals but the economy of this area in their dual roles is beneficial to all. The growth and reputation of First Federal Savings and Loan Association of Texarkana and The Texarkana National Bank would more than indicate they serve them in equal capacity.

MR. B. S. COOK

Mr. Cook is a director of this Association and also a substantial stockholder in The Texarkana National Bank. He is the father of B. Stan Cook, Executive Vice President of the same bank. Mr. B. S. Cook has, in the past, talked of retiring, and though this subject has been discussed only casually, some of our other directors feel that Mr. B. Stan Cook would be a worthy successor to his father and would make a major contribution should he be elected this Association's Board.

FUTURE DIRECTORS

Retirements from our present Board are inevitable as time goes on. Two of the three men who, in my opinion, would make the most significant contribution to our Board, should they be elected to it, are directors in other financial institutions. In a town the size of Texarkana, the prohibition of so-called "Interlocking Relationships" would eliminate so much talent that in my view this community's opportunity to grow and prosper would be seriously impaired.

THE TEXARKANA NATIONAL BANK

In addition to being our principal depository, The Texarkana National Bank has programmed on its computer all of this Association's savings accounts and furnishes us data processing service in connection with these accounts. The Bank's Trust Department opens and closes savings accounts with us as we can, or cannot meet the needs of trust funds they administer. Mr. William Fuller is President and Chairman of the Board of The Texarkana National Bank and is, in addition, a director of First Federal Savings and Loan Association of Texarkana.

Historically speaking this Bank has played a very important part in the success of our Association. Texarkana Federal Savings and Loan Association was founded in the year 1905 by Mr. N. P. Sanderson, who was also one of the original major stockholders and an officer and director of The Texarkana National Bank. Mr. Sanderson was President of our Association and Vice-President of the Bank until his death in 1942.

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I have been President of Texarkana Federal Savings and Loan for the last two and one-third years, and when I was elected President, I had no formal training or background in financial management. Mr. Fuller, although a director of First Federal Savings and Loan Association, of Texarkana, has from time to time counseled with me and on many occasions given me the benefit of his knowledge and experience. The other officers of this Bank have been equally helpful. I am strongly of the opinion that it is unfair and unwise to promote the passage of legislation which would prohibit or in any wise interfere with the relationships which I have outlined in this letter. The people of our community would be the losers and not beneficiaries.

Mr. Patman, I apologize for the length of this letter, but I felt that you should know the particulars of our situation. Should you so desire, I would be happy to discuss the problems which H.R. 5700 would create with you personally at a time and place of your choosing.

Yours very truly,

CHARLES LEE DAVIS,
President.

CLEAR LAKE SAVINGS ASSOCIATION,
Houston, Tex., May 6, 1971.

Hon. WRIGHT PATMAN,
Congressman, U.S. House of Representatives,
Washington, D.C.

DEAR MR. PATMAN: I have been reading with a great deal of interest the long list of names appearing before your committee with reference to the hearings you are having on H.R. 5700. I was not invited to give testimony, but being a presumptuous country boy from Deep East Texas, thought I might share with you my thoughts concerning the provisions of the bill which deal with interlocking directorates of financial institutions.

A group of my friends decided to start this institution about eight years ago and invited me to associate with them in this endeavor. Among those who originally had the idea were a number of people identified with financial institutions, and I might add that, to a great measure, the success achieved so far has been largely due to their knowledge, ability and direction.

We presently have a nine-man Board of Directors including myself, and four of us on this Board serve as directors of one or more other financial institutions. One of these gentlemen, Mr. Albert Cleere, has had a distinguished record of 52 years in the banking business in Houston. He recently retired as a senior vice president at First City National Bank and is presently serving as president of three affiliate banks of First City National. There is no way that you can place a value upon the strength, wisdom and knowledge that this man brings to our Board of Directors. H.R. 5700 if enacted as proposed will deny depositors, borrowers and stockholders, not to mention the officers and othir directors, these vast years of experience.

The other two members of our Board who are bank directors other than myself are Mr. Ralph A. Harper, who is an attorney with the law firm of Vinson, Elkins, Searls and Smith, and which firm represents the Association; and Mr. Dell Butcher, who is president of American Commercial Lines and vice president of Texas Gas Transmission Corporation. Both of these gentlemen are outstanding in their particular fields of endeavor and are always available to me for counsel and advice.

I feel further that the fact that I serve on the Board of First State Bank of Clear Lake City, which is located one block from our Association, certainly gives me a great deal of further insight into the affairs of our local community. It enables me to be a better officer for Clear Lake Savings Association.

The rest of our Board is composed of a doctor well regarded in the community, two highly placed individuals identified with the Manned Spacecraft Center, a local businessman and the president of one of the leading mortgage banking concerns in Houston.

We have had a vacancy on our Board for approximately one year and, quite frankly, have not been able to find an individual with qualifications or the commonality of purpose which would lead us to invite him to sit with us.

I would also like to state without fear of equivocation that no director of this institution has ever suggested to me or even remotely intimated anything which would compromise to any degree the best interests of this institution. H.R. 5700

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as presently written condemns these men per se. and should certainly be modified to require some showing that the interests of the related institutions have been damaged by virtue of these relationships.

We live and do business in a trade area of roughly 35.000 to 40,000 people; and it is extremely difficult to find knowledgeable, qualified director material in a community such as ours wherein the individual is not identified with some financial institution. We all love teachers, preachers and our friends who might be in the plumbing, shoe repair trade, etc.; but I am sure you will readily admit that these people could not bring much valuable knowledge to the conference table of a savings and loan institution.

Respectfully submitted,

RICHARD ALLEN,
President.

NATIONAL ASSOCIATION OF
INSURANCE AGENTS, INC.
Washington, D.C., May 14, 1971.

Re "Banking Reform Act of 1971"

Hon. WRIGHT PATMAN,
Chairman, Committee on Banking and Currency, House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This letter is submitted by the National Association of Insurance Agents, Inc.; the national federation of 50 state organizations of independent insurance agents.

The House Committee on Banking and Currency has before it for consideration your bill, H.R. 5700, as well as other recommendations. This legislation will affect a variety of financial institutions and focuses on the special position and powers of lending institutions. Of special concern are the commercial banks which play a key role in our economy. Healthy banking institutions are necessary for a sound financial system, but they do have tremendous power to control other businesses. Accordingly, the proposed legislation recognizes this power and prescribes special rules prohibiting interlocking directorate, requiring trust department disclosure and other provisions. This legislation is consistent with traditional patterns of separating banking from commerce, for the benefit of the public. Independent insurance agents have been concerned for some time with the abuses of bank power and the resulting detriment to the public. Commercial banks are the most powerful of financial institutions, and therefore they require special regulation. This has been recognized.

The legislation before your Committee also deals with other financial institutions, including savings and loan associations. Traditionally, these institutions have had fairly limited powers and are relatively small when compared with commercial banks. This has changed somewhat, at least in certain parts of the country. Particularly in California, savings and loan associations have grown to very large proportions, and now have substantial power.

For some time our association has been concerned about savings and loans which have an affiliated insurance agency. We have been encountering savings and loan associations which, as a condition for making a loan, require the borrower to place its insurance with their insurance agency affiliate. In addition, we find that savings and loans are reviewing their mortgage files, determining the expiration date of insurance on the mortgaged property, and soliciting the renewal for their own agency. These activities often constitute tie-ins, breaches of a confidential relationship and a tortuous interference with contract. These practices by savings and loan institutions have been increasing in recent times. While they seem centered in California and a few other places, the problem is national in scope.

We strongly urge that the Committee in its consideration of the Banking Reform Act of 1971 and other proposals, that this problem will be kept in mind. We recommend to the Committee that before reporting legislation concerning savings and loan associations, that it launch an inquiry into the conduct by savings and loan institutions of other businesses (including insurance agency activities), and that it ascertain their practices, and whether their participation in such businesses is in the public interest.

We wish to thank the Committee for permitting the National Association of Insurance Agents, Inc. to state its position in this letter, and request that this

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letter be made part of the record in the hearings on the captioned legislation. We would be happy to expand on our views if the Committee would find it helpful.

Sincerely yours,

HOWARD H. LEIGHTON,
President.

UTICA MUTUAL INSURANCE COMPANY,
Utica, N.Y., April 29, 1971.

Re H.R. 5700, The Bank Reform Act of 1971

Hon. ALEXANDER PIRNIE,
Longworth House Office Building,
Washington, D.C.

DEAR CONGRESSMAN PIRNIE: On behalf of my company, Utica Mutual Insurance Company, and as an individual attorney and trustee of a mutual savings bank, I wish to bring to your attention the severe and serious handicaps and restrictions that certain provisions of the above-mentioned Bill would place upon mutual property and casualty insurance companies and upon individuals who hold the same offices that I do, and to urge you to support elimination entirely of insurance companies from the purview of this Bill.

Sections 2, 3 and 4 of the Bill would prohibit any person who is a director, trustee, officer or employee of practically any banking institution from being at the same time a director, trustee, officer or employee of certain "financial institutions" among which is "any insurance company". Such a prohibition would seriously handicap mutual insurance companies in the selection and election of knowledgeable and capable directors, officers and employees by still further reducing the number of such persons available, a group which is already too small in many areas of the country.

The provisions of Section 7 prohibit the use of a mutual insurer's subsidiary life insurance company for the management of employee welfare or pension benefit plans. This would unreasonably limit the business purposes of the mutual company in creating or acquiring a life insurance company and would unfairly burden both the parent mutual company and the subsidiary life company in their ability to contribute to the markets for insurance and their ability to serve all of their policyholders.

Section 8 of the Bill includes in the definition of "financial institution" any insurance company and prohibits a director, trustee, officer or employee of a "financial institution" from serving as a director or officer of *any other corporation* with respect to which the financial institution holds the power to vote more than 5% of any class of stock. There is no exception for a subsidiary or a subsidiary holding company of an insurer, yet there is an exception with respect to a person serving a bank or savings and loan holding company when the other corporations are subsidiaries thereof. This prohibition would irreparably damage the ability of mutual property and casualty insurance companies to diversify their investments, make maximum use of their capital funds and provide the increasingly necessary broad range of insurance and ancillary services by the use of subsidiary holding companies or direct subsidiaries.

The startling and damaging affect that these prohibitions would have upon the Utica Mutual Insurance Company are as follows:

1. Of our twenty-seven directors, thirteen are directors or trustees of banking institutions and would have to resign either from our Board or from the bank Board on which they serve.

2. One of our officers (myself) is a trustee of a savings bank and would be required to resign either as an officer of our Company or as such trustee.

3. Six of the highest ranking and most important officers of the Company, namely, Chairman of the Board of Directors-President, Senior Vice President-Marketing, Vice President-General Counsel, Vice President-Financial Services, Vice President-Advertising and Public Relations and Assistant Vice President-Financial Services would be prohiibted from serving as directors or officers of subsidiary corporations of the Company.

I respectfully urge that you support the incorporation in this Bill of an exception for mutual property and casualty insurance companies and their sub-

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sidiaries with respect to the onerous and self-defeating prohibitions of Sections 2, 3, 4, 7 and 8 of this Bill.

Very truly yours,

MORGAN F. BISSELLE,
Secretary-General Counsel.

THE GERRY ELSON AGENCY, INC.,
Brookfield, Mo., April 23, 1971.

Hon. WRIGHT PATMAN,
House Office Building,
Washington, D.C.

DEAR CONGRESSMAN PATMAN: I have been reading your H.R. 5700 with extreme foreboding. I live in a country town in Missouri of approximately 6,000 good people. I am president of a small savings and loan which pays a salary of $700. per month and president of an insurance agency at a salary of the same. I am secretary of a title company which I have invested approximately $10,000. six years ago and have never received a penny in salary or otherwise.

I think your bill most unfair for small savings and loans, insurance agents, etc. in any small town. The only way we can make a living is have other income. This tends to discourage young qualified people from being interested in small business in small towns. The good Lord knows we need to keep our youth in these communities.

Very truly yours,

GERALD W. ELSON.

ATLANTIC MUTUAL INSURANCE COMPANY,
CENTENNIAL INSURANCE COMPANY,
New York, N.Y., May 14, 1971.

Hon. WRIGHT PATMAN,
House Office Building,
Washington, D.C.

DEAR CONGRESSMAN: You have introduce a bill, H.R. 5700, into the 92nd Congress which is called the "Bank Reform Act of 1971."

There is a particular section of this bill which I find to be of concern and would like to outline my thoughts. I have in mind Section 8 of your bill which, in effect, prohibits a trustee, director or officer of an insurance company from also serving as an officer or director of another insurance company if the first company owns 5% of more of the voting stock of the second company.

The Atlantic Mutual Insurance Company, the organization in which I am privileged to serve as Chairman, was incorporated in the State of New York in 1842. It is a mutual insurer which is wholly owned by its policyholders. In 1941, in order to provide broader insurance facilities, the Atlantic policyholders authorized the formation of Centennial Insurance Company. This company was formed as a stock insurance company and all of its capital stock is owned by Atlantic Mutual Insurance Company. The two companies share common directors, officers and employees; under Section 8 of this bill, it would appear that our arrangement would have to be terminated.

The insurance system that I have described above is not peculiar to Atlantic Mutual Insurance Company but is common in the insurance business. We do not believe that this type of arrangement in any way works to the detriment of the insurance industry or the public but rather we are convinced that it enables our policyholders to secure insurance coverages nationally.

I note that Section 8 does contain an exemption involving bank holding companies and savings and loan holding companies and, therefore, I urge you to amend this bill to also exempt insurance fleets or insurance company complexes from the provisions of this section.

If you or any of your staff need additional information in this area, I or Mr. Harold A. Eckmann, President, will be pleased to work with you.

Respectfully,

DAVID A. FLOREEN.

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UNIGARD INSURANCE GROUP,
Seattle, Wash., April 22, 1971.

Hon. WRIGHT PATMAN,
House of Representatives,
Washington, D.C.

H.R. 5700—Prohibition of bank officer or director serving insurance company in similar capacity

DEAR SIR: We are a mutual property and casualty insurer, licensed in all 50 states, with over one million policyholders.

We are alarmed and distressed at some of the provisions and implications of H.R. 5700, particularly those prohibiting officers or directors of financial institutions from serving as directors of insurance companies.

To properly protect the interests of our policyholders takes more than technical expertise in the property and casualty insurance business. One of the more important requirements is a broad view of developments and trends in our society as a whole, and in this one of the principal elements is some perception in matters economic and financial. The only practical way to provide this is to recruit for service on our Board one or two men of intelligence and experience whose day to day business routine keeps them informed in these areas. Almost by definition, this means men active in the service of financial institutions.

H.R. 5700, we are advised, proposes to make this unlawful by prohibiting officers and directors of financial institutions from service on our Board.

No doubt there have been some problems in this area. Any right is subject to occasional abuse. But whatever the abuses, we cannot believe so sweeping a prohibition to be justified.

We have not yet had an opportunity to analyze the bill in detail any may wish to comment on other provisions later. But meanwhile we urge that there be a serious reconsideration of this element of the bill, toward the end that it be made to deal more selectively and precisely with the actual abuses, if any. As it now stands H.R. 5700 is akin to a proposal to sink the ship to drown a few rats.

Very truly yours,

FREDERICK J. ORTH.

DUQUESNE LIGHT CO.,
Pittsburgh, Pa., April 15, 1971.

Hon. WRIGHT PATMAN,
House of Representatives,
Washington, D.C.

DEAR MR. PATMAN: As a member of several Corporate Management Boards, I am deeply concerned over several provisions of H.R. 5700 which presently resides in the House Banking and Currency Committee. As you are aware, H.R. 5700 known as the Banking Reform Act of 1971 is an omnibus bill incorporating many of the provisions of the "Safe Banking Act of 1970" in addition to a provision that would prohibit financial management interlocking relationships with regard to other financial institutions and corporations.

Although the bill contains some desirable and acceptable provisions, the provision that prohibits interlocking directorates is so devastating that it would eliminate most outside directors of financial institutions and, conversely, would eliminate bankers from all outside boards.

It has always been my position and belief that Government regulation of private enterprise is justifiable only where a clear need, in the public interest, has been shown to exist.

To my knowledge, there has been no evidence to substantiate that the public interest has been jeopardized from any specific abuses that have resulted from management interlocks to warrant such restrictive legislative action as proposed in H.R. 5700.

Since there is no justifiable basis for corrective action, I wish to register my strong dissatisfaction and opposition to the provision prohibiting interlocking directorates and hope you will give this matter the utmost consideration in your Commitee deliberations.

Respectfully,

JOHN M. ARTHUR.

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CHAMBER OF COMMERCE OF THE UNITED STATES,
Washington, D.C., May 5, 1971.

Hon. WRIGHT PATMAN,
Chairman, Committee on Banking and Currency,
House of Representatives,
Washington, D.C.

DEAR MR. CHAIRMAN: The Chamber of Commerce of the United States wishes to state its opposition to the interlock provisions of H.R. 5700.

We agree that anticompetitive interlocks should be prohibited. But no studies to date have documented either the extent or the effects of interlocks. In the absence of such informaation, the sweeping prohibitions of H.R. 5700 are unwarranted.

Because of their harm to innocent businesses, we oppose the imposition of general or industrywide controls. Rather, the Chamber favors enforcement of present antitrust and trade regulation laws on a selective, significant case-by-case basis.

We will appreciate your consideration of our views, and we request that this letter be made a part of the hearing record on H.R. 5700.

Sincerely,

HILTON DAVIS,
General Manager, Legislative Action.

NATIONAL ASSOCIATION OF MANUFACTURERS,
New York, N.Y., May 7, 1971.

Hon. WRIGHT PATMAN,
Chairman, Banking and Currency Committee,
House of Representatives,
Washington, D.C.

DEAR MR. CHAIRMAN: On behalf of the National Association of Manufacturers I am writing you with respect to H.R. 5700 now pending before your Committee. We appreciate this opportunity to present these views and would like to ask that they be incorporated in the record of your hearings on this important matter.

The bill would affect many areas not within the competence of the NAM to comment upon. However, it would affect one area where we feel our experience may have a direct bearing—that is Section 9 which deals with interlocking relationships between bank and non-bank institutions. This is an area of vital importance to the continued high level development of our economy—an objective in which we know you share a keen concern.

Section 9 of the bill would prohibit a broad range of "interlocking" relationships between persons related to financial institutions and those related to non-financial corporations whenever a substantial continuing credit relationship is maintained between the two organizations.

Specifically, it would, with limited exceptions, prohibit any director, trustee, officer, or employee of any bank insured by the F.D.I.C. and certain other banks from serving on the Board of Directors of any corporation with which that bank has a "substantial and continuing relationship" with respect to the making of loans, discounts or extensions of credit.

In general we consider Section 9 to be both unnecessary and unwise. We believe that this section is far too broad in light of experience to date: that it would interfere with capable management of both banks and non-bank businesses; that it would introduce, in some cases, artificial restraints on the ordinary course of lending or credit transactions; and that it would unnecessarily limit individual freedom of activity or occupation on the part of some individuals. Finally, Section 9 of the bill would operate to discriminate particularly against small businesses and businesses which operate in small communities.

Under present law, so-called horizontal interlocks between directors of corporations in interstate commerce are prohibited where elimination of competition could result from the relationship. If enacted, Section 9 would, for the first time, bar interlocks where there was no showing of an anti-competitive effect. It would ban interlocks without respect to whether the organizations were involved in interstate commerce. It would ban interlocks between directors and also between directors on the one hand and employees on the other.

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Experience to date does not seem to justify such sweeping changes in the law. Since the proposal departs from the anti-competitive effect standard, it is presumably aimed at abuses of financial or fiduciary responsibility in conflict of interest situations where the true interests of one party are sacrificed to those of the other. Widespread evidence of abuse of such responsibilities has not come to our attention.

The law in this area seems to be clear and well settled and where abuses have arisen they seem to have been appropriately handled. In fact bank directors are held by the courts to a higher standard than other directors. We question whether there is a widespread danger of abuse here not already covered by present law.

In cases of relationships which would be forbidden by Section 9, each organization has presumably retained the service of the individual involved with full knowledge of this connection with the other. Each side has presumably come to the conclusion that it will be well served by an individual with such dual responsibilities. It would seem that the likelihood of benefits to be derived from broad judgments which would be thus available is far greater than the possibility of abuse of fiduciary responsibility which would damage one group for the benefit of the other.

Gross abuses of trust are, of course, possible and sometimes do occur. We believe that they are better dealt with by legislation aimed at them specifically rather than by general legislation preventing individuals from occupying posts where there is a remote possibility of this occurring.

The bill would seriously restrict the number of persons on which financial institutions and other corporations might draw for their directors, officers, and key employees. Talent, knowledge, and experience in the financial field and in the business field are not so plentiful that we can afford to limit their availability severely.

The leading businessmen in any community would usually be found to be serving it in a number of different capacities—both economic and non-economic. It is common to find an official or director of an enterprise engaged in manufacturing, trade, transportation or construction serving also as a director of a local bank with which his firm does business. This is the almost universal custom throughout the country and we believe it is generally accepted and regarded as advantageous to both sides.

It is a natural and fruitful state of affairs. Each organization is served better when it is served by men who are also involved in the activities of other organizations and thus bring with them a broad knowledge of economic affairs—both local and national. Each individual is most useful when he is given the broadest possible scope for applying his talents.

Another consequence of proposals such as Section 9 is that, faced with a choice between changing directors on the one hand or changing credit sources on the other some businesses will choose to change their lending or credit sources as the lesser of the two evils. Thus, to that extent, the section would disrupt traditional business relationships between insured lending institutions and other business organizations.

A corollary of restricting businesses in their choice of directors is the restriction which would result on the right of individuals to offer their services to more than one institution and corporation. Section 9, if enacted, would have the adverse effect of narrowing the range of activities in which an individual may occupy himself. Individual freedom of choice surely merits continued attention. It is surely in everyone's interest that the skills of individuals be available as broadly as possible to the business community.

Finally, small enterprises and enterprises in small communities would tend to suffer most from the restrictions of Section 9. Small enterprises would be discriminated against because they may be unable to command the exclusive services of persons of broad knowledge in the financial field. Under existing arrangements many small enterprises retain the part-time services of financial experts. Such arrangements might in many cases become impossible if H.R. 5700 were enacted. Similarly, enterprises in small communities would experience increased difficulty in finding persons with wide financial experience or qualifications who do not fall within the proscriptions of Section 9.

For the reasons expressed above, we do not believe the requirements of Section 9 are either necessary or desirable. We therefore respectfully urge that they not be adopted.

Sincerely,

W. P. GULLANDER, *President.*

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NATIONAL FEDERATION OF INDEPENDENT BUSINESS,
Covington, Ky., April 16, 1971.

HON. WRIGHT PATMAN,
Chairman, House Banking and Currency Committee, House of Representatives, Congress of the United States, Washington, D.C.

MY DEAR MR. CHAIRMAN, HONORED SIRS, AND MRS. SULLIVAN: While I sat in a dentist's chair one morning, in recent weeks, a very young teen-ager who was preparing me for the ordeal we all experience when a drill begins to hum, asked me what subject I speak on in my talks around the country. My answer: Monopoly. Her reply:

"Oh, that was my most interesting subject, but it always made me so sad to learn about all the little people that get hurt."

Her second question was the most devastating, and it was the voice of American youth speaking to me:

"You really don't believe Congress will do anything about it, do you?"

After one of the most bitter and hard fought battles of our times, the 91st Congress did adopt curbs on the expansion of the one-bank holding companies, but proponents of amendments to banking laws that would have ended the expansion, and unwound the giants, agreed "it wasn't what we wanted, but it was the best we could get."

"The best we could get" is not enough, but now that scandals have broken out in the stockmarket, and within the banking structure itself, and since the national economy is failing to respond to the desperate attempts to revive it, and since the proposal has been voiced by Chairman Patman that it may be necessary to "divorce the commercial business of the big banks from their trust department operations, and sever all interlocking directorships with industrial corporations," a climate seems to be developing that offers the best opportunity that true believers in the free enterprise system ever confronted.

Our cities, churches, schools, state governments are going broke, and artificial attempts to remedy the conditions of unemployment, displaced farmers, 5,000,000 unemployed, frustrated youth, and the frightening liquidation of the American middle class, to say nothing of our foreign entanglements, are forcing a showdown. A "Moment of Truth", as the Spanish call it when the bleeding bull quits running back and forth in a fruitless chase of the scarlet muleta of the matador, and confronts his enemy, seems to have arrived.

The greatest enemy of a free people is concentration of economic power in the hands of the few, which is destroying America as certainly as the Sun Rules the Day and the Mon Governs the Night; a fact which Congress alone has the power to change.

For this and other good reasons, I respectfully suggest that all-out emphasis be placed on restoration of financial democracy in the United States as a desperate need of the hour, and that such incidents as the Chase Manhattan Bank unloading its Penn Central stock a few days before the latter announced bankruptcy be emphasized only as evidence that the power to commit such acts exists, and that such power should be abolished.

Thomas Jefferson warned future generations to trust NO man with power, but to bind him down "with the chains of the Constitution". Conservative Herbert Hoover wrote (1934) that we had "built up an economic autocracy upon which a political autocracy will rise," and in April 1939, Franklin D. Roosevelt called for an end to all corporate combining and interlocking directorships among the giants when he declared:

"Private enterprise has ceased to be free enterprise, and is becoming instead a cluster of private collectivisms, making itself as a system of free enterprise after the American model, but, in fact, becoming a concealed system after the European model.

"Industrial efficiency does not have to mean empire building, but empire building has evolved into banker-control of industry. We oppose that."

President Eisenhower pleaded with the people and the Congress in his Farewell Address, to "guard against the power complex building up in agriculture, industry, finance, labor, the military and government," and when has there been a greater awareness among the people and among their elected officials, that a decentralization of power may be a "Now or Never" choice of saving or losing our Heritage?

Legalized economic domination is a sickness that brought Germany, Japan and Italy to their knees in World War II. It is a sickness tha tis obsoleting capitalism in this nation. It is at the bottom of the present social, economic, political and

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intellectual bankruptcy which our youth have deplored but have found no way to escape, and only by breaking up the giants of industry and finance, and ultimately reaching back to the interstate chains with a similar breakup can we offer future generations the freedom of opportunity to which all Americans aspire—thus offering the people of the world a model of life they too can embrace.

It is a call for a "new look at the raw head and bloody bones of history," as Adams and Gray wrote in Monopoly In America; a look that takes us back to at least the year 1889 when the State of New Jersey (now claiming the worst debt-ridden, poverty-stricken city in America) found it expedient to permit a corporation to place a resident clerk in an office building within its borders, which allowed any corporation to bypass the antitrust laws of any other state. With three clerks on the payroll, a billion dollar corporation in New York could go wherever it pleased, and in any direction, and it did. They did. Fifteen years later, Senator Mason was to rise on the floor of the Illinois Senate, to moan:

> "The most important bills before Congress that deal with power, are there all the time. They are introduced at the beginning of one Congress only to die in the files of the next when the calendar is cleared; there to be introduced again and again as Congress comes and goes, and in the end to die."

. . . A kind of delay unto death battle tactic that has plagued Congress right on up to the present hour.

Consider, for example, that the same Chase Manhattan Bank that dumped the Penn Central stock (and which has become so powerful that Chairman Patman wonders if the $300,000.000,000 trust business of this and other giants should be separated from banking completely) was part of the 1936 colossus of five banks and 19 financial institutions that reported 484 interlocking directorships with corporations representing 60 percent of the then corporate assets of the nation.

Leopold Kohr, economist, educator and author of The Breakdown of Nations, says the problem of oversize has permeated all creation; that wherever something is wrong, something is too big.

Paul Jones, President, Glenview State Bank (Illinois), says the trend to "concentration of economic power in this country will end in a people's revolt, the destruction of the capitalistic system, and finally, a takeover by communism or socialism."

Both Kohr and Jones are not looking at the problem from any standpoint of when is big too big as measured by the Federal Reserve Board, or so-called banking experts, but by what effect that oversize has upon our private enterprise system and representative form of government as it relates to the development of man and his society.

Even the long accused Center for the Study of Democratic Institutions issued a pamphlet by architect Roderick Seidenberg who points to the individual "vanishing in the anonymity of the mass;" stated so much better by Walter Lipmann when he wrote from Hitler-Germany:

> "First will come the mass, then the mob, and after that, the master."

Earlier, an old Wall Street Journal editorial spoke of "first will come the men who control the monopolies, and then the man who controls the men who control the monopolies;" which is unbeatable if we continue to rationalize with power such as held by Metropolitan Life with assets of $16 billion, and interlocked with other insurance companies and banks, and tied directly and indirectly to huge chain store companies and conglomerates that grow, not from need of greater size or efficiency, or in any spirit of free enterprise, but for no other reason than to build empires—agricultural, corporate, financial—spinning a web likened unto that of the spider but without its perfection.

So what are the members of the House Banking and Currency Committee being asked to consider in the proposed Banking Reform Act of 1971 (H.R. 5700) if not the basic question of whether or not these United States are to remain free and indedpendent, and that its citizens shall enjoy the right to pursue peace, prosperity, happiness and freedom from all coercive forces. Shall there be anyone who can stand up and deny that before government may control itself, it must first control those who endanger the government?

Offenders against the commonwealth there will always be, but the worst are those who, through accumulations of economic power finally take political power, and in the end they will bring this Republic to its knees, just as our cities and states are now on their knees—beggars pleading for the alms of the central government against which they rant, blindly ignoring why they are beggars.

While the hearings on one-bank holding companies were being held in 1970,

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local banks and industries were being swallowed up, and before the signatures on the compromise-filled legislation finally adopted, were dry, more acquisitions were announced.

Wrote the Federal Reserve Board:

"These announced plans to acquire non-bank subsidiaries are subject to approval of the Federal Reserve Board."

Approval of what? A borderline violation of bankholding restrictions? How long before approval or denial? Are the restrictions so vague that the Reserve Board or other agencies of government are unable to judge when an acquisition weakens competition by "skirting" the antitrust laws? Are we to have a situation such as the Decree which prohibits the meat packers from operating retail stores, but permits retail chain store corporations to operate meat packing plants?

Are we faced with a power dilemma as noted in the helplessness of the Justice Department in the acquisition of the $2 billion Hartford Fire Insurance Company by ITT, which has already absorbed over 300 companies?

This government is losing (or it may be lost) its sovereignty in the matter of trusts, chains, combines, conglomerates, and bankholding companies. A loss foreseen by the Wall Street Journal in 1904, and predicted by Karl Marx nearly 200 years ago, for the same reasons: monopoly capitalism run wild.

It was this monopoly capitalism running wild that created the corporate banking rail colossus which lost a half-billion dollars last year; which is ushering in nationlization of the railroads, and has now led to the hearings on the proposed Banking Reform Act of 1971; which will be opposed, not as an attempt to preserve free enterprise, but an attempt to destroy it.

Our nation, this great Republic, is the last best hope of earth. It is big. It is powerful. It has enormous resources, but its greatest resource is its Constitution; its Bill of Rights; the spirit of the Declaration of Independence, and its people. . . . WE THE PEOPLE who accept bigness in business, banking, labor, some farm operations; big universities, big government—as "free enterprise at work", as inescapable, but giantism is not inescapable. Escape from this overwhelming menace is now a matter of saving civilization; of saving the Republic for which we stand, indivisible, under God, with Liberty and Justice for all. . . . or lose it all.

If the hearings on the Banking Reform Act are held to this premise, and if the Congress possesses the vision of the Founding Fathers when considering proposals that bind men to the Constitution, then oncoming generations will not be saddened by what their studies may reveal.

In the nationwide balloting of its nearly 300,000 members, the National Federation of Independent Business reported overwhelming support of legislation, both proposed and adopted, that would bring one-bank holding company expansion under the control of Congress and regulatory agencies of the government.

Signed,

ED WIMMER,
Vice President, Public Relations Director.

STEWART INFORMATION SERVICES CORPORATION,
Princeton, N.J., April 30, 1971.

DEAR WRIGHT: We deeply appreciate your continued interest in preventing large financial institutions from destroying other competitive industries by the sheer power of controlling business through financial leverage. Your vigilance in this regard is one of the bulwarks of free enterprise in America today.

We have been particularly concerned over the recent desire on the part of one bank holding companies and now savings & loan associations moving into the title insurance business. We have notified the Federal Reserve Board by telegram that we are deeply opposed to having one bank holding companies become either title insurance underwriters under sub-para. 7 of their regulations or agencies under sub-para. 8. Since the regulations specifically refers to insurance on properties on which they are lending this would sanction the complete control of title insurance policies where either they have made an interim construction loan or a permanent mortgage. Since banks have been increasingly going into the mortgage business, we can foresee that within a very short time all title insurance agencies would have to be owned by banks, or service companies of savings and loans, since they could control nearly 100% of the business.

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At the recent ALTA Convention in San Diego, an address was given by Arthur W. Leibold Jr. which advocated that the service corporations owned by savings & loan associations should be permitted and encouraged into becoming title insurance agencies. As in the case of banks we can foresee the quick demise of independent title insurance agencies across the U.S. It is our further opinion that the ownership of a title agency by either a bank or a savings & loan would encourage grave conflict of interests which would endanger the financial stability of both the financial institutions and title insurance underwriters.

With the financial institution as a title agent on property that the institution is lending upon, the unremitting pressure would be for very rapid closing without benefit of detailed title examination of the public record. Thus title insurance would be done rapidly and without discovery of the latent hidden defects of title so that large losses would be incurred on writing title insurance on a casualty basis. In addition to this there is another conflict in that outstanding liens might be purposely overlooked or "insured around" so that their borrower would not have to pay off outstanding encumbrances. It is exactly this type of practice on the part of a title insurance agency that recently broke Elliott & Waldron, one of the largest title insurers in Texas and and broke the Union Title Insurance Company of Phoenix.

On behalf of our company and our 238 independent agents across the country, we are asking for your help in preventing the disastrous consequences of allowing financial institutions to take over the title insurance business. I would deeply appreciate it if you would call these matters to the attention of the Federal Reserve Board and the Home Loan Bank Board at your earliest convenience. If there is anything further that you suggest that I do in this regard, please let me know.

Sincerely yours,

MACO STEWART.

AMERICAN LAND TITLE ASSOCIATION,
Washington, D.C., May 3, 1971.

Re H.R. 5700.

Hon. WRIGHT PATMAN,
Chairman, House Committee on Banking and Currency, Rayburn House Office Building, Washington, D.C.

DEAR CHAIRMAN PATMAN: Members of the American Land Title Association have read with interest the provisions of H.R. 5700 and herein present the Association viewpoint on this legislation for inclusion in the record of hearings conducted by the House Committee on Banking and Currency.

ALTA is a national association of more than 2,000 companies that evidence and insure land titles to protect real estate purchasers and lenders. Most title companies are members of the Association.

While ALTA commends the sponsors of H.R. 5700 on their concern with controlling conflict of interest and encouraging competition, it is the Association view that certain provisions of the Act may well produce far more harm than benefit. These provisions would prohibit individuals who are directors, trustees, officers, or employees of certain financial institutions from at the same time holding similar positions with concerns including title companies; companies engaged in the business of appraising property; and companies providing services in connection with the closing of real estate transactions.

In communities large and small throughout the nation, one of the strengths of the land title industry is the service of experienced and knowledgeable financial lenders on title company boards. Placing limitations on the availability of this outstanding financial talent to title companies—as proposed in H.R. 5700—would bring undue hardship to the land title industry, and would be a disservice to real estate purchasers and lenders.

Therefore, ALTA respectfully recommends that any provisions of H.R. 5700 calling for such restrictions of service be deleted.

The consideration of the Committee in this matter will be appreciated.

Sincerely yours,

WILLIAM J. MCAULIFFE, Jr.

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TIPPETT LAND & MORTGAGE COMPANY,
Kennewick, Wash., April 29, 1971.

Re Proposed H.R. 5700—"Banking Reform Act of 1971."

Hon. WRIGHT PATMAN,
Chairman, House Committee on Banking and Currency,
U.S. House of Representatives,
Washington, D.C.

DEAR SIR: I write as a real estate owner, manager and developer, and as mortgage loan correspondent for institutional lenders who have invested large sums of money in real estate development in my area of operations in Washington, Oregon and Idaho.

I am much opposed to the provisions of H.R. 5700, for the reason I see them as serious deterrents to the availability of investment capital from institutional lenders and other potential investors in the years to come. In my opinion, the restrictions and penalties provided for in this bill are unreasonable and a serious threat to the available and much needed future development capital of this country.

I strongly urge you take every possible action to work for the bill's defeat.

Very truly yours,

ROBERT A. TIPPETT.

GUS STATHIS CONSTRUCTION CO., INC.,
Oak Lawn, Ill., May 13, 1971.

Re Bill H.R. 5700

Hon. WRIGHT PATMAN,
Chairman, House Banking and Currency Committee,
Washington, D.C.

DEAR SIR: As a former member of the Board of Directors of a State insured Savings & Loan Association in Illinois, I feel compelled to write this letter to you and express some of my beliefs regarding pending Bill H.R. 5700 now before your committee.

In my private business I am a Real Estate Broker and small General Contractor in the general area of my community. Although I was a member of the above mentioned Board, I did not find it a conflict of interests to serve in this capacity since I was not qualified to borrow or secure a loan from this particular Savings & Loan Association. My basic knowledge of real estate made it possible for me to object on many occasions to the granting of, in my judgment, a risky loan.

My observations are that the Savings & Loan industry should not engage in real estate purchasing or in the construction business. I feel this is not their prime function, nor do they have the required knowledge to engage in such activities and which could jeopardize the depositors' funds. By permitting the officers to "wheel and deal" in such activities I feel that somewhere along the line there could easily be collusion and that the officers and Board of Directors could possible approve investments for their own benefit.

The most important experience I would like to point out is that when the officers of a Savings & Loan Association also serve on the Board of Directors, then they have the opportunity to "wheel and deal" with real estate and construction people and to grant loans for their mutual benefit, although it may not so appear on the surface. We know a lot of these deals are closed in Land Trusts.

It is my considered opinion that State licensed Savings & Loan institutions should be under Federal Insurance Corporation regulations rather than State regulations. State laws allow them to function with immunity to the Federal laws intended to safeguard the public.

I feel quite strongly, as I stated above, that Savings & Loan Associations—whether State or Federal insured—should not be permitted to buy real estate or to be engaged in the construction business. Too often the motive of certain officers and/or members of Board of Directors is to make money for the main purpose of enhancing their own financial position and without taking any personal risk—it is the funds of their depositors which they risk.

Another aspect is that by permitting the Savings & Loan industry to purchase real estate and to engage in the construction business they can drain funds which

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could be loaned for the purposes intended—to individual home buyers, small construction companies, and persons who are by profession in the real estate business.

Respectfully yours,

GUS STATHIS.

MEYERS POLLOCK ROBBINS, INC.,
New York, N.Y., March 15, 1971.

Hon. WRIGHT PATMAN,
Chairman, House Banking and Currency Committee,
House Office Building,
Washington, D.C.

DEAR SENATOR PATMAN: In 1959 I had the pleasure of meeting with you in Washington in connection with legislation affecting brokerage in the Savings & Loan industry at hearings conducted by the Federal Savings & Loan Insurance Corporation.

Those hearings resulted in the formulation of regulations which have proven that the activities of "maverick" brokers could be curbed, while permitting legitimate brokers to pursue their normal activities, with all the attendant benefits to the Associations and the general public.

We have read of the hearings presently being conducted by your Committee and the proposed legislation which would seem to prohibit brokered deposits completely in commercial banks insured by the FDIC. From the newspaper reports on these hearings, it would seem that once again an attempt is being made to harm and destroy legitimate brokers who proceed fairly in accordance with the rules and regulations laid down by the supervisory governmental authorities.

For instance our firm and its predecessors, namely, Joseph H. Meyers Corp.; Daniel Pollock, Inc. and B. Ray Robbins Co., Inc., is the oldest firm in the United States dealing exclusively in placing insured deposits for Pension. Trust and Welfare groups, as well as the general public.

In dealing with commercial banks and in placing Certificates of Deposit therein, we have never taken a fee from a bank; never discussed any bank's loan policy or any specific loan with its Officers; never attempted in any way to influence the granting of loans by any bank's Officers or Loan Committee and never had any bank pay more than its normal legal rate of interest permitted on its Certificate of Deposit.

In every phase of the financial world there are always people who break the law or who, through sharp or illegal actions, jeopardize the standing of an industry. Nevertheless, the free flow of money throughout the country has not been curtailed by legislative action because of the acts of these few people. If a Judge commits a wrongful act, no one suggests that the Judiciary be abolished.

I respectfully submit that if bank Officers make loans which are poor-risk loans or fraudulent loans, some form of penalty should be devised for them. The free flow of money throughout the country should not be stopped nor should the proper functions of a bank's management be usurped by their being denied their right to determine their monetary needs.

The legitimate needs of bonafide borrowers, who, because of either limited finances or a difficult money market, cannot borrow funds for needed expansion or continuation of their businesses, should not be penalized by being cut off by reason of the inability of their particular bank to generate funds to them. Money is a commodity subject to the law of supply and demand, and banks only accept Certificates of Deposit when they lack funds to meet their proper loan demands. Nothing could prove this point better than the present situation which exists, where banks are either refusing to accept Certificates of Deposit or paying so little interest on them, that they are not attractive as a form of investment.

The placing of compensating balances on behalf of legitimate customers and borrowers of a bank has been a legal business for many years. Properly transacted, such placements perform an extremely useful function and in many cases are the difference between small business surviving and growing or dying on the vine.

From the figures which we have seen in the papers (Wall Street Journal, March 10th) only 8 banks of 264 banks, which it is alleged handled brokered deposits, were closed. This represents approximately 3% of such banks. When one considers that there are over 14,000 banks in the United States, this percentage

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shrinks to an infinitesimal fraction and I respectfully submit that if any legislation is to be enacted, its aim should be to tighten the safeguards against poor loans or illegal activities of Officers of a bank, rather than toward wiping out the very considerable brokerage industry, which has existed in this country for so many years and has proven so valuable in times of tight money.

We therefore respectfully urge that no legislation be passed which would not permit legitimate brokers to continue their very valuable services to banks.

Respectfully yours,

MILTON E. LEVINE,
Chairman of the Board.

BERLE & BERLE,
New York, N.Y., April 26, 1971.

Re HR 5700—Institutional Securities Corporation

Hon. WRIGHT PATMAN,
Chairman, Committee on Banking and Currency,
House of Representatives, Rayburn House Office Building,
Washington, D.C.

DEAR MR. PATMAN: Under separate cover I have written to you with respect to the impact of various provisions of HR 5700 on our client, Savings Banks Trust Company. We also represent Institutional Securities Corporation which, like Savings Banks Trust Company, is wholly-owned by New York mutual savings banks and, in fact, is a twin institution with Savings Banks Trust Company in that both were formed in 1933 as instrumentalities for dealing with the baking crisis at that time. Various provisions of HR 5700 would have a serious impact on the work of Institutional Securities Corporation and this occasions my writing to you with respect to suggested amendments.

By way of background, Institutional Securities Corporation was organized in 1933 as a service corporation, serving mutual savings banks of the State of New York with respect to mortgage investments. Organized as a business corporation, it is nevertheless subject to and regularly examined by the New York State Banking Department, and its investments are limited by Banking Board regulations. It is wholly-owned by 120 New York State mutual savings banks, its stock ownership is restricted to such banks and all of its paid in capital and long term debenture funds have been furnished by them. Permission by these savings banks to own its stock and debentures is a special statutory provision in the New York Banking Law.

Institutional Securities Corporation, as I have indicated, was created during the period of the banking crisis as a twin institution of the Savings Banks Trust Company to deal with the liquidity problems of the savings banks at that time. Its principal function then, though chartered to perform a wide-range of mortgage and real estate services for the savings banks, was to serve as a conduit by which savings banks might receive assistance through the use of their mortgage portfolios from the Reconstruction Finance Corporation, thereby providing the banks at that time with liquidity based on essentially "frozen assets." The Reconstruction Finance Corporation, in fact supplied many millions of dollars to the New York savings banks at this period through the utilization of the instrumentality of Institutional Securities Corporation.

At the present time Institutional Securities Corporation provides valuable services in the housing and urban renewal field, probably one of the most critical areas in the current American economy. It provides facilities, as an agency of the savings banks, for the acquisition and administration of conventional, FHA and VA mortgages via participations, certificates of beneficial interest and debentures issued by Institutional Securities Corporation to its stockholder savings banks. Other services include direct servicing of mortgages, nationwide appraisals and inspections of real estate, examinations and ratings of mortgage servicers, and electronic data mortgage accounting. It is an FHA approved mortgagee and is a qualified seller of FHA and VA mortgages to both the Federal National Mortgage Association and the Government National Mortgage Association.

A wholly-owned subsidiary of Institutional Securities Corporation, known as Insticorp, Inc., organized under the laws of New York State in 1957, exists solely to provide facilities for the investment in mortgages by pension trusts and savings banks through the sale of its collateral trust notes. It, likewise, is supervised and regularly examined by the New York State Banking Department, is an FHA approved mortgagee and is a qualified seller of FHA and VA mortgages

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to both the Federal National Mortgage Association and the Government National Mortgage Association.

At the present time Institutional Securities Corporation and Instlcorp combined perform a vital function for New York State savings banks in financing new construction and rehabilitation of single family housing and multiple dwellings as well as hospitals and urban renewal. An Urban Affairs Report as of March 31, 1971 shows loans closed, under commitment and in process totaling $195,329,950, covering 5,183 residential units. In addition, the two Corporations administer the Revolving Fund for Home Mortgage Requirements which makes mortgage financing available to new home buyers in New York State, and the Fund for New Homes, which provides financing to home builders in New York State in the form of construction and permanent loans.

Over 100 New York savings banks participate in each of these programs which were established by the Savings Banks Association of New York State in cooperation with the Governor. As a service corporation for mutual savings banks, Institutional Securities Corporation has served innumerable times as the instrumentality through which such banks have been able to provide mortgage financing at competitive rates for vital projects which otherwise would not have been made available.

Institutional Securities Corporation does not conduct business with the general public but does business exclusively in connection with savings banks and savings banks agencies.

The directors of Institutional Securities Corporation, except for its President, are all either officers or trustees of savings banks in the State of New York, i.e., insured banks. Such directorships could be outlawed under this Bill as drafted.

The problems which we face under HR 5700 arise from the following section.

Under Section 2, the Federal Deposit Insurance Act is amended by adding a new Section 23 which provides, among other things, under subsection (a) (7) that a person who is a director, trustee, officer or employee of any "insured bank" may not at the same time be a director, trustee, officer or employee of a company, such as Institutional Securities Corporation, with which the insured bank:

> "has a substantial and continuing business relationship" (and is)
>
> (B) "A company engaged in the business of appraising property, or (C) "a company which provides services in connection with the closing of real estate transactions."

All of these functions and relationships are involved in the mortgage and housing services which Institutional Securities Corporation performs for the New York State savings banks.

Section 2 of the Act also provides for the addition of Section 24 to the Federal Deposit Insurance Act which has the some impact in prohibitions in connection with a company engaged in the business of appraising property or a company which provides services in connection with the closing of real estate transactions. This latter phrase, "services in connection with the closing of real estate transactions," could be interpreted to cover a wide variety of functions which Institutional Securities or its subsidiary, Instlcorp, Inc., either directly or indirectly perform for the savings banks.

Similarly, Section 8(a) would prevent certain trustees or officers of savings banks from serving as directors of Institutional Securities Corporation because their bank owns more than 5 per cent of its stock. A few New York banks hold more than 5 per cent of Institutional's stock. Again, Section 8(a) would prohibit savings banks from owning more than 5 per cent of the stock of housing corporations under the New York State Private Housing Finance Law, which would negate the State purpose to encourage such investment through limited dividend housing companies as well as similar legislation which specifically authorizes such investment by savings banks.

The unique position of Institutional Securities Corporation has been recognized in the Banking Law of the State of New York and Regulations of the New York State Banking Board in that exemptions in a number of instances are accorded to savings banks with respect to any corporation organized under the laws of this State to an extent and on such conditions which are or have been authorized by the Banking Board "provided all of the stock of such corporation is owned by not less than 20 savings banks." This, as you know, is the same type of exemption extended to Savings Banks Trust Company, itself likewise owned wholly by savings banks in the State of New York.

The National Association of Mutual Savings Banks, as you know, has submitted a number of proposed amendments to H.R. 5700. Copies of the three perti-

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nent amendments which would cover the problem of Institutional Securities Corporation, namely, Amendment No. 1, No. 4, and No. 5 are attached hereto. The portion of Amendment No. 1, which more particularly concerns Institutional Securities Corporation, is that which provides for the insertion at the end of line 2, page 3, of the Bill the language:

"(b) in the case of a person who is a director, trustee, officer or employee of an insured bank, which is a mutual savings bank, the prohibitions contained in paragraphs 4, 5, 6 and 7 of subsection (a) hereof shall not apply."

Amendment No. 4 and Amendment No. 5 in their entirety are important to Institutional Securities Corporation except that Institutional Securities Corporation is not concerned with the subject matter of the proposed subsection (d) to be added to Section 9.

We should deeply appreciate consideration being given to these proposed amendments since the effectiveness of Institutional Securities Corporation could be sharply diminished, if not lost, if the Bill in its present form were applied to it.

Sincerely yours,

RUDOLF P. BERLE.

AMENDMENT No. 1

To Limit Application of the Interlock Prohibition to Interlocks Between Institutions Accepting Deposits From the Public in the Same Market Area

Amend the amendments made in Section 2 of H.R. 5700 by deleting the semicolon at the end of the word "bank" in line 8, page 2 and inserting the phrase: "competing in the same market area as such area shall be defined by the Board of Directors of FDIC"; by removing the semicolon following the word "Act" in line 10, page 2 and inserting the phrase: "competing in the same market area as such area shall be defined by the Board of Directors of the Federal Home Loan Bank Board; and by removing the semicolon at the end of the world "union" in line 11, page 2 and inserting the phrase: "competing in the same market area as such area shall be defined by the Administrator of the National Credit Union Administration." Further amend the amendments made in Section 2 of H.R. 5700 by inserting at the end of proposed subsection 23(a) of the Federal Deposit Insurance Act the following at the end of line 2, page 3:

"(b) In the case of a person who is a director, trustee, officer, or employee of an insured bank which is a mutual savings bank, the prohibitions contained in subparagraph 4, 5, 6 and 7 of subsection (a) hereof shall not apply."

Redesignate present proposed subsection (b) as subsection (c).

Amend § 4 of H.R. 5700 by deleting the semicolon at the end of the word "bank" in line 2, page 6, and inserting the phrase: "competing in the same market area as such area shall be defined by the Board of Directors of FDIC"; by deleting the semicolon at the end of the word "Act" in line 4, page 6, and inserting the phrase: "competing in the same market area as such area shall be defined by the Board of Directors of FDIC"; by deleting the semicolon at the end of the word "Act" in line 6, page 6, and inserting the phrase: "competing in the same market area as such area shall be defined by the Board of Directors of the Federal Home Loan Bank Board"; by deleting the semicolon at the end of the word "union" in line 7, page 6 and inserting the phrase: "competing in the same market area as such area shall be defined by the Administrator of the National Credit Union Administration." Further amend § 4 of H.R. 5700 by deleting lines 8 through 23 on page 6.

AMENDMENT No. 4

To Exempt Mutual Savings Banks From the Prohibition Against Controlling Title, Appraisal or Closing Companies

Amend the amendments made in section 2 of H.R. 5700 by inserting in line 10, page 3, following the term "insured bank" the phrase "other than a mutual savings bank;" and in line 11 following the term "insured bank" the phrase, "other than a mutual savings bank" and in line 13 following the term "insured bank" the phrase "other than a mutual savings bank."

On page 7 strike Section 5 in its entirety by deleting lines 7 through 18.

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AMENDMENT No. 5

To Preclude the Application of Sections 8 and 9 of H.R. 5700 to Directors, Officers, Trustees and Employees of Savings Banks Trust Companies and Related Organizations

Amend Section 8 of H.R. 5700 by amending line 22, page 8, to read:

"Sec. 8(a) Except as provided in subsections (b) and (c), a".

Further amend Section 8 by adding the following new subsection at the end of subsection (b) on page 10:

"(c) an individual who is a director, trustee, officer or employee of an organization all of the stock or shares of which, other than stock or shares required by law to qualify directors, is owned by a mutual savings bank, mutual savings banks, or by a mutual savings bank or banks and other financial institution or institutions, shall not by virtue of subsection (a) hereof be precluded from serving as a director, trustee, officer or employee of any other financial institution."

Amend Section 9 of H.R. 5700 by amending line 5 on page 10 to read:

"Sec. 9(a) Except as provided in subsection (b), (c), and (d), a".

Further amend Section 9 by adding the following new subsection at the end of subsection (b) on page 11:

"(c) an individual who is a director, trustee, officer or employee of an organization all of the stock or shares of which, other than stock or shares required by law to qualify directors, is owned by a mutual savings bank, mutual savings banks, or by a mutual savings bank or banks and other financial institution or institutions, shall not by virtue of subsection (a) hereof be precluded from serving as a director, trustee, officer or employee of any corporation."

"(d) an individual who is a director, trustee, officer or employee of a mutual savings bank shall not by virtue of subsection (a) hereof be precluded from serving in any capacity a nonprofit charitable institution as defined in section 501(c) of the Internal Revenue Code notwithstanding any relationship between the savings bank and the institution with respect to the making of loans, discounts or other extensions of credit."

LEE, TOOMEY & KENT,
Washington, D.C., May 4, 1971.

COMMITTEE ON BANKING AND CURRENCY,
Rayburn House Office Building,
House of Representatives,
Washington, D.C.

GENTLEMEN: On behalf of the Council of Profit Sharing Industries, 20 North Wacker Drive, Chicago, Illinois 60606, comments are hereby submitted on H.R. 5700, the proposed Banking Reform Act of 1971.

The Council

The Council of Profit Sharing Industries is a non-profit association of employers having a common interest in profit sharing and the belief that it offers a solution to industrial strife and the means of maintaining the free economy of this country. Almost every type of industry in America is represented by its members. At the present time there are approximately 1,500 employers who are members of the Council, employing approximately two million employees.

General Statement

The proposed legislation would adversely affect the operation of profit sharing plans in a number of ways, both direct and indirect. In addition, the legislation contains a number of ambiguities, the effect of which is uncertain. These comments, however, will focus upon four areas in which the impact of H.R. 5700 upon such plans would be particularly direct and severe, specifically: the 10% limitation on aggregate investment as a fiduciary in the registered stock of one corporation (§ 13); the prohibition against interlocking officers and directors (§§ 7, 8, 9); the prohibition against an insured bank holding stock it has issued (§ 13); and the increased reporting responsibilities placed upon fiduciaries (§ 12).

These sections of the bill could cause irreparable damage to some profit sharing plans, disrupting beneficial and long-established practices. The competitive position of fiduciaries would be greatly impaired, and the number of fiduciaries

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available to service profit sharing trusts would be reduced. In addition, the investment options of the fiduciaries would be restricted, thereby lessening the profit potential for profit sharing trusts, and subverting the legitimate business desires of companies dealing with the fiduciaries. Finally, the bill would overlap existing laws and regulations in these areas which already provide substantial protection against any abuses which could occur.

Specific Comments

(1) *Ten Percent Limitation on Aggregate Fiduciary Investment in the Stock of One Corporation* (*§13*).—The 10% limitation imposed by Section 13 of the proposed legislation would impose exceedingly harmful restrictions upon the numerous profit sharing plans which are based upon the legitimate philosophy of holding company stock. Many companies, including a large number of Council members, believe that the purchase of company stock by a profit sharing plan is not only a sound investment, but improves the morale of employees, increases their incentive for productive work, and provides a vital personal interest in the welfare of the company. The Federal tax structure, and other areas of Federal regulation, have, for many years, permitted or encouraged plans that invest wholly or largely in stock of the employer. At the same time the law has protected employees against self-dealing and other abuses.

The proposed limitation forbidding banks to hold as fiduciary more than 10% of the registered stock of any one company would, in many cases, destroy such plans. At the very least, this section could require Council members to seek out additional fiduciaries as the holdings of company stock increase. The result would be inefficient administration and increased cost. In addition, persons owning stock of a company would be restricted in their choice of executors, agents, or personal trustees, in those cases in which a prospective corporate fiduciary already holds an amount of such stock nearing the magic 10% level. Indeed, the proposal may reduce rather than increase competition, by removing fiduciaries from the marketplace.

Finally, the objectives of this section presently are covered by controls of the Comptroller of the Currency, Securities and Exchange Commission, Federal Reserve, and fiduciary liability laws.

(2) *Interlocking Directorates* (*§§7, 8, 9*).—The provisions of this legislation, which *absolutely prohibit* a director, trustee, officer or employee of a financial institution from serving as a director of any corporation for which that institution manages an employee benefit plan, is distinctly not in the public interest. The similar prohibitions with respect to companies in which a financial institution holds 5% voting power, or with which it conducts a continuing business relationship, also are unduly restrictive.

Officers or directors of banks, in their individual capacities, often serve as officers or directors of other companies, and vice versa. These men are of high caliber. They have varied backgrounds and business experience, which can add much to the field of finance, and other areas of business. In almost all cases such inter-relationships are a positive benefit to the economy. In this connection, particular thought should be given to the situation in small towns or rural areas, in which few fiduciaries are available. A local bank naturally may seek the expertise of a leading industrialist in the area of its Board of Directors. Conversely, companies often have local bankers on their Boards, in order to draw on their knowledge and experience in the field of finance. It would be particularly detrimental to the companies in these areas if such services were curtailed or lost.

Moreover, the day to day operations of a bank usually are separate from, and not subject to the practical control of, the Board of Directors. Moreover, there is no substantial connection between the trust department and executive department of a bank. For these and many other reasons the proposed restrictions would do little good. Again, the Securities and Exchange Commission's regulations on insider information, tax laws prohibiting self-dealing, the Comptroller General's close scrutiny of trustee investment, and the Labor Department's regulation through the Welfare and Pension Plans Disclosure Act, and fiduciary liability laws would seem to serve the objectives of this section without the need for further regulation.

(3) *Banks Holding Bank Stock* (*§ 13*).—Many bank stocks are good, sound investments. For that reason, profit sharing trusts frequently are attracted to them. The goal of sound investment for a profit sharing trust may be affected adversely by prohibiting investment in the stock of a bank trustee. This requirement might even force a company to seek a different trustee in order to invest in a good stock.

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Again, it should be noted that possible abuses in this area are covered by existing regulations and laws. Comptroller's Regulations (12 USC 61) restrict the rights of a bank with respect to voting of its own stock and, also, forbid banks to purchase their own stock unless a specific trust agreement directs and controls such investment.

(4) *Increased Reporting Responsibilities for Fiduciaries* (§ *12*).—The Council is greatly concerned that the additional and overlapping reporting requirements placed upon fiduciaries by this proposed legislation will add substantially to the already severe administrative burden of fiduciaries that administer employee benefit plans. Such increased duties would result in additional costs for profit sharing companies, and ultimately for the employee beneficiaries.

Conclusion

For the foregoing reasons the Council believes that the proposed legislation offers little that is constructive and much that is harmful. The proposal would cripple long-established and beneficial operations of profit sharing plans, inhibit competition by restricting the choice of fiduciaries for such plans, narrow the range of investment choice, add to the costs of administration, and proliferate already severe administrative requirements.

Respectfully submitted,

CHARLES W. GILCHRIST.

ELLIS, HOLYOKE & CO.,
Lincoln, Nebr., April 27, 1971.

Representative WRIGHT PATMAN,
House Banking and Currency Committee,
Washington, D.C.

DEAR REPRESENTATIVE PATMAN: I have read with interest your comments about separating trust business from commercial banking. I personally think this would be a good and constructive move. This is true not only because of their inside information which you speak of, but because it also sometimes keeps them from buying certain securities. I have had a recent experience where a trust company refused to buy a good stock because one of the members of their board of directors was a member of the board of directors of the company whose stock I recommended.

On a slightly different subject, it is my own opinion that brokerage firms should not manage mutual investment funds. I think the business of advising and merchandising should be entirely separate. My opinions come from having been in the investment business since 1928.

Sincerely,

ELLIS, HOLYOKE & CO.,
JAMES H. ELLIS.

SCOTTSDALE, ARIZ., *April 6, 1971.*

HON. WRIGHT PATMAN,
House of Representatives,
Washington, D.C.

DEAR SIR: I am quite concerned over a Bill which, apparently, you have recently introduced to the House concerning the interlocking Directorship of small banks. Specifically, I serve as a Director of two banks. One is a $85,000,000 institution on the north side of Chicago at which my Grandfather was one of the founders. It is the Upper Avenue National Bank and I am the third generation to have served on the Board, inasmuch as we have the largest block of stock, but not actual control. I am in Chicago for a week out of every month to handle the business I have there and also attend the Board Meeting, as I have not missed a single meeting since going on the Board in 1966.

My other affiliation is with The Arizona Bank, a $500,000,000 bank here in Phoenix. I represent a group of investors which own actual control of this bank, and I am very much interested in its activities, even though I am not active in the day-to-day management or affairs of the bank.

In no way, can I see any conflicts with my being a Director of these two institutions and yet, from what I understand of your proposed Bill, I would be forced to resign from one of them. I see no reason for forcing me to do so and in fact, it would mean the end of a long-lasting family relationship with these

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institutions. They are both neighborhood and regional in nature and I feel quite certain that if a survey were made, the number of accounts representing a conflict would be infinitesimal.

I would appreciate your reasoning behind this Bill, and an analysis of why I should not be permitted to continue this relationship which, I feel, has been to the advantage of both banks and certainly not to the detriment of the public or the banks' customers.

Very truly yours,

BERT A. GETZ.

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., April 27, 1971.

Hon. WRIGHT PATMAN,
Chairman, House Committee on Banking and Currency,
U.S. House of Representatives,
Washington, D.C.

DEAR MR. CHAIRMAN: I am receiving a number of letters on the Banking Reform Act proposal which is presently being studied by your Committee.

I would sincerely appreciate your serious consideration of the attached letters which I have received on this measure, and your including them in the record of your hearings.

Thank you for taking care of this for me.

Warmest regards,

GRAHAM PURCELL.

THE FIRST NATIONAL BANK OF HENRIETTA,
Henrietta, Tex., April 15, 1971.

Hon. GRAHAM PURCELL,
House of Representatives,
Washington, D.C.

DEAR CONGRESSMAN PURCELL: I have reviewed a brief summary of the Banking Reform Act of 1971 by Wright Patman on which hearings will be held April 20 by the House Committee on Banking and Currency.

It is my sincere opinion that if such a bill was ever passed, it would seriously damage the banking industry, and I am very much opposed to the provisions contained in this bill.

I trust that you have or will review this Act and give it your serious consideration and advise your opinion of this bill.

I appreciate your services in Congress for our district. Anytime you are in this area, please drop by for a visit.

Sincerely,

BILL HOLMAN, *President.*

FIRST NATIONAL BANK,
Bridgeport, Tex., April 16, 1971.

Hon. GRAHAM PURCELL,
Member of Congress,
House Office Building,
Washington, D.C.

DEAR GRAHAM: We have received information concerning Patman's Banking Reform Act of 1971, No. 71–15, on which we understand hearings will commence April 20th before the Committee of Banking and Currency.

We wish to let you know that we will be very definitely opposed to this bill for many reasons. Among them one is that it would be very hard for this or any other bank to attract capable people to be directors since they might be already a director of another company; and although I think it is wise for diretcors, officers and employees to report their indebtness to a bank's Board of Directors and the Bank Examiners, I certainly do not feel that it should be made a matter of public record.

For these and other reasons we will find ourselves in a position to oppose this bill and hope that you can join with us in this opposition.

We will likewise oppose the Gonzalez Bill, No. 3287, and will again hope that you can join with us in opposition to this bill.

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It was good to see you at Graham the other night during the Charles Walker Day Dinner, and if there is anything that you know or can find that we can be of assistance to you in this area, please do not hesitate to let us know.

With all good wishes,

Sincerely yours,

W. WILSON RAY, *President.*

THE FIRST NATIONAL BANK,
Seymour, Tex., April 15, 1971.

Hon. GRAHAM PURCELL,
House of Representatives Office Building,
Washington, D.C.

DEAR MR. PURCELL: After reading a brief description of the Banking Reform Act of 1971, (71-15) authored by Mr. Wright Patman, I find it quite difficult to imagine the efficiency and competency of bank management and Boards of Directors under these terms. This proposed legislation would undoubtedly curb the progressiveness within our banking industry, thus presenting an extreme hindrance to all citizens utilizing the services of these institutions.

Other proposed legislation such as HR-3287, authored by Mr. Henry B. Gonzalez, held in conjunction with Mr. Patman's Banking Reform Act, would also result in a drastic effect upon our banking industry. In my opinion, this act would no doubt eliminate ambitions of desirous, as well as highly capable young men from entering our profession. It appears to me this bill would parallel the old story of "completely burning down the barn to kill a rat or two."

I sincerely urge and hope you will vigorously oppose these two bills of proposed legislation.

Thank you.

Yours very truly,

GENE D. ADAMS, *President.*

CITY NATIONAL BANK,
Wichita Falls, Tex., April 19, 1971.

Congressman GRAHAM PURCELL,
House Office Building,
Washington, D.C.

DEAR GRAHAM: It was a real pleasure to see you and Nancy in Graham, Texas last week and I am particularly thrilled to see how happy you each look. As I have told you before, I have a very special place in my heart for Nancy and it is wonderful to see her looking so happy.

Graham. I am very concerned with Wright Patman's Banking Reform Act of 1971. Although the Act appears to cover a number of areas, most of them would be terribly detrimental to the economic betterment of this country in my opinion. Banks and other financial institutions have long been in the fore-front of providing through private capital and individual initiative the economic strength that has made this country great. Mr. Patman's misconceptions as to the effect and power held in a few hands is laudable in design but misrepresented in fact.

In my opinion this regressive type of legislation would severely inhibit not only the economic community but the nation as a whole. I urge you to earnestly seek the defeat of this legislation as I am sure any number of interest groups could provide a far more meaningful legislation, if in fact the evils Mr. Patman fears in fact do exist.

Your cooperation in this matter would be appreciated and I am,

Yours very truly,

DICK WAGGONER.

SEYMOUR, TEX., *April 20, 1971.*

Hon. GRAHAM PURCELL,
House of Representatives,
House Office Building,
Washington, D.C.

DEAR MR. PURCELL: I have given a great deal of study to description of the Banking Reform Act of 1971 by Mr. Wright Patman. This legislation would place an undue burden on financial institutions covered by the act and for that reason I am asking that you oppose this legislation if it comes to a vote in Congress. It places unnecessary restrictions on the activities of people who would be most

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interested in assisting with the policy making of the institution and would thus be a detriment to their operation. Some of the provisions of the Bill are worthy of consideration, such as the Prohibition of Solicitation and Acceptance of Brokered Accounts or the offering of gifts as an inducement to open or add to an account and the insuring of deposits of public funds. However, these matters could be handled in a separate bill without attaching the undesirable aspects of the proposed legislation.

Also, Mr. Purcell, I would like to register my opposition to Mr. Henry B. Gonzalez House Resolution 3287 concerning loans for the purchase of stocks of other banks.

Thanking you for your consideration in this matter, I remain

Yours very truly,

L. D. JONES, Jr.

COMMONWEALTH NATIONAL BANK,
Dallas, Tex., April 20, 1971.

Congressman GRAHAM PURCELL,
House of Representatives,
Austin, Tex.

DEAR SIR: I am writing this letter to inform you of my violent disapproval of Wright Patman's Banking Reform Act of 1971 and Henry Gonzalez's Bill HR 3287. Both of these bills will serve no useful purpose other than to further Mr. Patman's distorted viewpoint regarding the banking industry. I would encourage you and your colleagues strong opposition to these bills.

Very truly yours,

JOHN H. PITTMAN,
President and Co-Chairman.

THE FIRST NATIONAL BANK OF SANGER,
Sanger, Tex., April 15, 1971.

Hon. GRAHAM PURCELL,
Congress of the United States,
House of Representatives,
Washington, D.C.

DEAR GRAHAM: Attached is a copy of the T. B. A. Bulletin #71-15. I think from reading the bulletin you can easily see the dire effect these bills would have on the banking industry. After you have had an opportunity to study both sides and make up your mind, please let me know your position.

Sincerely,

J. A. COFFEY, *President.*

TEXAS BANKING ASSOCIATION,
Austin, Tex., April 13, 1971.

(Re: Bills Pending in Congress)

Patman's Banking Reform Act of 1971

The House Committee on Banking and Currency will commence hearings on April 20 on a comprehensive and revolutionary bill by Wright Patman which is styled the "Banking Reform Act of 1971." The drastic effect the bill would have upon banking can be readily seen from the following provisions:

1. A director, trustee, officer or employee of a bank cannot at the same time be a director, trustee, officer or employee of (a) any other bank insured by FDIC, (b) a savings & loan association, (c) a federal credit union, (d) any insurance company, (e) a bank or S&L holding company or any subsidiary of such company, (f) any stockbroker or dealer or (g) any title company, company engaged in the business of appraising property, or company which provides service in connection with the closing of real estate transactions.

2. A person who is a director, trustee, officer or employee of an insured bank may not at the same time serve on the board of a corporation with respect to which such bank manages an employee welfare or benefit plan.

3. A director, trustee, officer or employee of a bank may not at the same time serve as an officer or director of any other corporation with respect to which such bank holds in the aggregate, with power to vote, more than 5% of any class of stock of such corporation.

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4. A person who is a director, trustee, officer or employee of any insured bank shall not at the same time serve on the board of directors of any corporation with which the bank has a substantial and continuing relationship with respect to the making of loans, discounts or extensions of credit. The Federal Reserve Board is authorized to define the meaning of the phrase "substantial and continuing relationship."

5. With respect to all securities held by a bank as trustee, executor, administrator, guardian or other fiduciary capacity, the bank shall submit annually to the FDIC: (a) a list showing the name, class, value and number held of each security; (b) a report indicating the extent to which it has authority to exercise voting rights with respect to each security; and (c) a report indicating the manner in which it has exercised proxies, if at all, with respect to voting rights in connection with each security.

6. Equity participations are prohibited in connection with extensions of credit.

7. Banks shall report to the FDIC the nature of all loans to bank officers, directors, trustees or employees or to their immediate families. This information shall be open to the public.

8. No bank shall make any loan to any corporation with respect to which 5% of the total outstanding shares of any class of stock is owned in the aggregate by the directors, trustees, officers or employees or the members of their immediate families, of such insured bank.

9. The solicitation and acceptance of brokered deposits is prohibited.

10. Gifts offered as an inducement to open or add to an account are prohibited.

11. The deposit of public funds would be fully insured.

Equal application to financial institutions

The proposed bill would not only apply to banks and bank personnel but would apply equally to savings and loan associations, insurance companies, mutual savings banks, federal credit unions and any broker or dealer registered under the Securities Exchange Act of 1934.

The bill is reported to have substantial support in the House Committee. Your Congressman would appreciate being advised of your views concerning this proposal.

Gonzalez bill also set April 20

Chairman Patman has also set HR 3287 by Henry B. Gonzalez for hearings in conjunction with the Banking Reform Act. The Gonzalez bill simply provides:

"No insured bank shall make any loan, discount, or extension of credit to provide for the purchase of stocks, bonds, debentures or other obligations of any bank."

Conclusion

Neither of the proposals mentioned can be dismissed lightly. The former would drastically affect the ability of banks to attract competent and interested directors and to continue to serve the public interest in a variety of ways. The latter proposal is like burning down the barn to kill a rat or two. All Texas Congressmen should be informed of the views of their banker constituents on both measures promptly.

SAM O. KIMBERLIN, Jr.,
Executive Vice President.

THE HUNTINGTON STATE BANK,
Huntington, Tex., April 22, 1971.

Hon. GRAHAM PURCELL,
House Office Building,
Washington, D.C.

DEAR MR. PURCELL: In the Texas Bankers Association Bulletin, dated April 13, 1971, a comprehensive outline is given of Representative Wright Patman's Banking Reform Act of 1971 and a bill known as HR 3287 by Representative Henry B. Gonzalez that will attempt to restrict loans made by commercial banks.

The Board of Directors of the Huntington State Bank, after careful consideration, feels that both of these bills now pending in the House Committee on Banking and Currency would have drastic effects on commercial banks and therefore wishes to express its opposition to both of these bills.

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Should either or both of these bills be reported out of the House Committee on Banking and Currency favorably and come before the full House of Representatives, it is sincerely hoped that you will see fit to vote against both of these measures.

Sincerely yours,

MARTIN JOSCH, Jr., *Vice President.*

GRAYSON COUNTY STATE BANK,
Sherman, Tex., April 20, 1971.

Hon. GRAHAM PURCELL,
House of Representatives,
Washington, D.C.

DEAR SIR: "Wright Patman Banking Reform Act of 1971" if allowed to progress would have a drastic and detrimental effect upon banking in this country. The ability of banks to attract competent directors and to serve the public interest in a variety of ways would be detrimentally affected.

I also request your help in defeat of H.R. 3287 by Honorable Henry B. Gonzalez which proposal is entirely too stringent and is uncalled for in correcting a situation that can be more easily and efficiently handled by self-policing.

The officers, directors, and stockholders of this bank, and I am sure all other banking institutions in the state, will appreciate your close attention to the above matters.

Sincerely,

JERRY L. TALLEY, *President.*

HEREFORD STATE BANK,
Hereford, Tex., April 23, 1971.

Hon. GRAHAM PURCELL,
House Office Building,
Washington, D.C.

DEAR MR. PURCELL: I wish to express my personal opposition, as well as what I think would be the opposition of the majority of the banking industry and the general public, on two Bills now being considered by the House Banking and Currency Committee.

(1) The "Banking Reform Act of 1971" by Congressman Wright Patman;
(2) H.R. 3287 By Congressman Henry B. Gonzalez.

The proposal by Mr. Patman in having to do with the Section restricting ownership, directorship, and employment to only one bank or savings association would drastically damage the ability of banks to secure experienced and capable Directors and Officers. Every institution strives to secure the best talent available, so why penalize the one institution because of prior affiliation with some other institution?

Contained in the Bill by Mr. Gonzalez, the restricting of a bank to make loans for the purchase of bank stock, debentures and bonds, could destroy the ability of bankers to stay in banking. Where else should and could this credit be secured? Banks are the only legitimate source, otherwise, the door might be opened for bank purchases to be financed only by underworld money. Do we want and can we stand for this nation's industry to be controlled by this group?

Certainly there have been instances of wrong doing in this field as there have been in most industries, but the percentage is extremely small. These should be dealt with on an individual basis, and not at the expense of the majority who are doing an exceptional job of handling our nations credit. What will happen if the confidence of the everyday bank customer is destroyed in his bank, the confidence that has taken many, many years to establish?

Not all of Mr. Patman's proposal's are this extreme and many have merits; these being the 100% insurance of public funds, prohibiting the offering of gifts as an inducement to open an account, the prohibiting of brokered deposits, as well as others.

We appreciate your deep consideration of the long range consequences of these Bills and will appreciate your making our views known to your associates.

Thank you very much for your continuing dedication to the well being of our nation.

Yours very truly,

HARLAN D. VANDER ZEE,
President.

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MIDWAY NATIONAL BANK
OF GRAND PRAIRIE,
Grand Prairie, Tex., April 16, 1971.

HON. GRAHAM PURCELL,
House of Representatives Office,
Washington, D.C.

DEAR GRAHAM: I have been meaning to drop you a note and congratulate you on your recent marriage. May I wish you and your wife all the happiness in the world.

This is also written to let you know my views on the Wright Patman Bank Reform Act of 1971.

There are some things in the Act that I think would be good, particularly the part prohibiting solicitation and acceptance of brokered deposits, not allowing gifts offered as inducement to open or add to accounts, and the fully insuring of public funds.

I feel the rest of the provisions of the Act would be detrimental to the nation's financial institutions in many ways. I would be glad to discuss each of the remaining provisions individually and give my reasons for opposing them if it would be of some service to you.

Thank for your time in hearing me out on this Act and be sure and let me know if I may serve you in any way.

Very truly yours,

ROLAND W. WALDEN.

THE MILLERS MUTUAL FIRE INSURANCE CO. OF TEXAS,
Fort Worth, Tex., April 16, 1971.

HON. GRAHAM PURCELL,
U.S. House of Representatives,
Cannon Building, Washington, D.C.

DEAR CONGRESSMAN PURCELL: House Bill No. 5700—Prohibition of Bank Officer or *Director Serving Insurance Company in Similar Capacity.*

It is my sincere hope that you will use your influence to defeat any favorable consideration of the above captioned bill.

It is my opinion that if such a bill were enacted it would affect greatly all of the financial institutions in our United States to such an extent as to weaken their capabilities through the prohibition of people trained and skilled in the field of finance from serving in corollary capacities with other financial institutions.

One can't help but wonder what prompted Congressman Patman to introduce such a bill, and especially so when one looks at the track record of integrity established by the various banking and insurance corporations in these United States.

The enactment of such a bill would provide unfair discrimination against a mutual insurance company, in that it makes no provision of an exception for a "downstream" holding company subsidiary of a mutual insurer, or for any other subsidiary of a mutual insurer. It is interesting that stock insurers owned by "upstream" holding companies would escape much of the effect of this exception.

As a matter of fact, if such a bill were passed, this company—Texas' oldest insurer—would lose four of its nine directors. Further, because of the fact that it is a mutual corporation, it would be placed in an unfairly discriminatory position as far as competition within the insurance market is concerned.

Thank you very much for giving this bill your careful consideration.

Sincerely,

ORAN F. NEEDHAM,
Chairman and Chief Executive Officer.

ABILENE NATIONAL BANK,
Abilene, Tex., April 15, 1971.

Re: "Banking Reform Act 1971"

HON. GRAHAM PURCELL,
House of Representatives,
Washington, D.C.

DEAR CONGRESSMAN PURCELL: It has just been called to my attention that the House Committee on Banking and Currency will soon begin hearings on Congressman Patman's banking reform act.

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As a member of the banking profession, I guess it has only become natural to take a stand of opposition to Mr. Patman's proposals. Separate and apart from this "built-in antipathy" I am having difficulty understanding the proposals set forth in this particular legislation.

Although there are some "bad apples" in the banking business, I still feel that most of us are honest and sincere and are trying to do a fair and equitable job in serving the banking needs of our customers. For this reason I find myself considerably upset by this proposed legislation and respectfully request your influence and assistance, if you have similar feelings, in opposing this measure.

Sincerely,

JOE H. HODGES, *President.*

Dallas, Tex., April 14, 1971.

Hon. GRAHAM PURCELL,
U.S. House of Representatives,
Washington, D.C.

DEAR GRAHAM: There is presently before the Banking Committee, a bill proposed by Congressman Patman which has some very, very bad things in it.

First, this interlocking directorship suggestion would eliminate the possibility of competent, informed people directing the affairs of financial institutions and would limit the ability of those who direct financal institutions to stay informed by involving themselves in the affairs of other and different institutions.

Second, the prohibition of persons who have interest, such as directors or stockholders or otherwise, from doing business with financial institutions would eliminate the possibility of having the direction of these important financial institutions—banks, insurance companies and others—by persons who do have basic knowledge and experience in this regard, and would weaken them all. These two rules will put institutions in the control of inexperienced incompetents to a large degree.

Another major wrong in this law is the prohibition against insurance companies, banks, or other lenders taking an equity ownership in projects which they finance. As you may know, my business is building projects and borrowing money with which to do so. We have made give-ups from time to time, and sometimes perhaps more than we felt we should. Yet these are market circumstances, and the lenders are basically working for the account, not of themselves individually, but of their policy holders and their depositors. I think this is an unwarranted limitation to put upon them.

In the last two years there have been exorbitant interest and other charges made from time to time, but we must not forget that back in 1945–46–47 the situation was exactly opposite, and funds were loaned by insurance companies at 2½, 3, and 3½%, which rates were equally unfair the other way. We can't have, always, a complete balance, but a market can do a better job than legislation.

Best regards,

TRAMMELL CROW.

Dallas, Tex., April 15, 1971.

Hon. GRAHAM PURCELL,
House Office Building,
Washington, D.C.

DEAR MR. PURCELL: Recently there has been introduced legislation in Congress entitled "Bank Reform Act of 1971". This act includes several provisions which, though they might seem to be constructive and helpful to the citizens who borrow money from financial institutions, would actually work to the detriment of these citizens. The purpose of this letter is to express my opposition to those sections which fall in this category.

The proposed legislation would prevent the financial institutions of the country who lend money from engaging in a participation contract, or in effect from engaging in joint venture endeavors. Joint ventures are a necessary part of the financing pattern of the future. It is not inappropriate for insurance companies to include an element of "inflation protection" in their long term loan arrangements in order that long term financing commitments may extend to 25, 30, or even 35 years.

Not only is it desirable for such arrangements to be made from the standpoint of the lender, but the borrower is frequently advantaged by obtaining the funds which otherwise would simply not be available. These arrangements in the

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form of a joint venture often include funds which would be normally construed as mortgage loan amounts and, in addition to that, amounts which would be construed as the equivalent of the equity capital. It is right and proper that the entity which furnishes such funds be compensated by a right to participate beyond the flat interest rate.

The suggested provisions which would preclude a person from serving on the Board of Directors of various entities who have business relationships as borrowers and lenders are not realistic. It is simply necessary to have knowledgeable people on the Boards of these institutions, and it is inevitable that such persons will have a broad range of connections. There is no justification for attributing to these connections any venal or destructive knowledge of influence.

There is further proposed a prohibition against borrowing by persons who have either a stock ownership or directorship or other interest in these institutions, and I feel this is also unrealistic.

I will greatly appreciate your interesting yourself in this legislation and in opposing the sections which I have outlined above.

Most sincerely yours,

ROBERT E. GLAZE.

PEAVY & SHANDS,
Lufkin, Tex., April 19, 1971.

Re The proposed *Banking Reform Act of 1971* and *HR 3287* by Representative Henry R. Gonzalez.

The Honorable U.S. Senators and Representatives in Congress from the State of Texas.

GENTLEMEN: I urgently request that you oppose and vote against the above two proposed laws because, in my opinion, each of them, and in particular, the Banking Reform Act of 1971, will unduly and harmfully affect banking business, not only in the State of Texas, but throughout all states of the Union.

If these bills are enacted into law, it would be practically impossible for banks to attract competent, interested and business oriented directors, and to continue to serve the public interest of the people in their respective areas of coverage. The enactment of these bills would force the great majority of directors of all banks to choose between being directors in corporations who do business with the respective banks or to resign from the boards of banks whom they now serve.

The same objections apply to the activities of savings and loan associations, insurance companies, mutual savings banks, federal credit unions and brokers and dealers registered under the Securities and Exchange Act of 1934.

The fact that abuses have been discovered in a few banks throughout the nation provides no justification for the enactment of such drastic legislation.

Yours very truly,

NED SHANDS, Jr.

SOUTHWEST NATIONAL BANK,
Wichita Falls, Tex., April 26, 1971.

Hon. GRAHAM PURCELL,
U.S. Congress,
Cannon House Office Building, Washington, D.C.

DEAR MR. PURCELL: I am writing you concerning bills pending in Congress at this time. One bill introduced by Wright Patman, styled THE BANKING REFORM ACT of 1971, in my opinion would seriously affect the ability of banking institutions to attract competent and interested directors enabling them to continue to serve the public interest in a variety of ways. I personally support the parts of the bill that would prohibit financial institutions from offering gifts as inducement to open or add to an account and I support the section that would provide 100% insured deposits to public funds.

The second bill was introduced by Henry B. Gonzalez, No. HR 3287, which in my opinion, if passed, would restrict banks from providing loan services to many customers that deal in stocks and bonds in a completely honest and reliable manner.

Your careful consideration of these two bills, which in my opinion, would directly and adversely affect the financial institutions in this state, will certainly be appreciated.

Yours very truly,

WILLARD J. STILL,
President.

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(The following material compiled by the Federal Reserve Board at the request of Chairman Patman was submitted for the hearing record by Chairman Patman:)

BOARD OF GOVERNORS,
OF THE FEDERAL RESERVE SYSTEM,
Washington, April 30, 1971.

HON. WRIGHT PATMAN,
Chairman, Committee on Banking and Currency,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: I am submitting with this letter final tabulations of responses the Board has received to your Committee's survey of interest calculations banks use on loans. This final submittal includes data which our staff supplied your office in March prior to the mailing of your follow-up letter.

Of the 370 questionnaires that you mailed to the sample of banks, 234 have been received by the Board, although two proved to be unusable. This is a 63 percent response rate. About 82 percent of the respondents (191) indicated that they calculate at least some loan interest rates on a 360-day basis. Ninety percent of the banks doing so said they have followed this practice for more than ten years. The sample used for the survey included 30 banks in each Federal Reserve District, plus ten banks chosen without regard to District boundaries and having $1 billion or more in deposits.

One technical comment is in order. The tabulation sheet for the group of ten largest banks shows results from eight responses. A ninth large bank did respond, but its questionnaire could not be positively identified. This bank's answers are grouped in the over $200 million category in District 7 (Chicago).

I appreciate very much the courtesy and cooperation your staff has shown during the survey period and I trust the results will prove helpful to you.

Sincerely,

J. L. ROBERTSON.

TABLE 1.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—TOTAL BANKS FROM ALL FEDERAL RESERVE DISTRICTS PLUS 8 OF 10 LARGEST BANKS IN COUNTRY

	Total banks responding	Bank size by total deposits (millions of dollars)			
		Less than $25	$25 to $100	$100 to $200	$200 and over
1. Any interest rates on 360 day basis?					
(a) Yes	191	42	61	35	53
(b) No	41	24	12	1	4
2. Loan types with 360 day interest calculation:					
(a) Personal loans, secured:					
1. Demand	132	26	40	25	41
2. 1 year or less	140	31	44	23	42
3. 1 to 5 years	105	21	36	21	27
(b) Personal loans, unsecured:					
1. Demand	129	25	39	24	41
2. 1 year or less	141	30	45	24	42
3. 1 to 5 years	107	22	36	21	36
(c) Construction loans:					
1. Commercial	129	23	39	27	40
2. Residential	125	25	38	25	37
(d) Mortgage loans:					
1. Commercial	132	30	42	24	36
2. Residential	128	30	41	23	34
(e) Loans to commerce or industry:					
1. Demand	143	24	43	29	47
2. 1 year or less	152	27	49	27	44
3. 1 to 5 years	122	23	40	24	35
4. More than 5 years	107	19	33	22	35
(f) Other	22	6	5	4	7
3. Is amount of loan a factor?					
(a) No	158	31	50	32	45
(b) Yes; $5,000 to $10,000	3	2	1	0	0
(c) Yes; $10,000 to $100,000	4	3	1	0	0
(d) Yes; over $100,000	1	0	0	0	1
4. How long has 360-day basis been applied?					
(a) 1 year or less	2	1	1	0	0
(b) 1 to 2 years	4	2	2	0	0
(c) 2 to 5 years	4	2	1	1	0
(d) 5 to 10 years	9	5	4	0	0
(e) More than 10 years	171	34	51	34	52

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TABLE 1.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—TOTAL BANKS FROM ALL FEDERAL RESERVE DISTRICTS PLUS 8 OF 10 LARGEST BANKS IN COUNTRY—Continued

	Total banks responding	Bank size by total deposits (millions of dollars)			
		Less than $25	$25 to $100	$100 to $200	$200 and over
5. Changed to 365-day calculation?					
(a) Yes: in last 5 years	22	3	5	5	9
(b) Yes; in last 10 years	2	1	0	1	0
(c) No; not for over 10 years or never	162	40	51	29	42
6. For which loan types have you changed?					
(a) Personal loans, secured:					
1. Demand	10	2	3	2	3
2. 1 year or less	9	2	2	2	3
3. 1 to 5 years	7	2	2	2	1
(b) Personal loans, unsecured:					
1. Demand	11	3	3	2	3
2. 1 year or less	9	2	2	2	3
3. 1 to 5 years	7	2	2	2	1
(c) Construction loans:					
1. Commercial	5	1	2	0	2
2. Residential	5	1	3	0	1
(d) Mortgage loans:					
1. Commercial	5	1	3	0	1
2. Residential	2	1	1	0	0
(e) Loans to commerce or industry:					
1. Demand	6	3	2	0	1
2. 1 year or less	4	2	2	0	0
3. 1 to 5 years	5	2	2	1	0
(f) Other	5	0	1	2	2
7. Disclose 360 annual rate?					
(a) Yes; in loan agreement	56	14	14	8	20
(b) Yes; otherwise in writing	37	3	13	5	16
(c) Yes; orally	38	10	11	4	13
(d) No	86	19	27	19	21

TABLE 2.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—8 OF 10 LARGEST COMMERCIAL BANKS IN UNITED STATES

	Total banks responding
1. Any interest rates on 360 day basis?	
(a) Yes	8
(b) No	0
2. Loan types with 360 day interest calculation:	
(a) Personal loans, secured:	
1. Demand	6
2. 1 year or less	6
3. 1 to 5 years	2
(b) Personal loans, unsecured:	
1. Demand	6
2. 1 year or less	6
3. 1 to 5 years	2
(c) Construction loans:	
1. Commercial	7
2. Residential	6
(d) Mortgage loans:	
1. Commercial	6
2. Residential	5
(e) Loans to commerce or industry:	
1. Demand	8
2. 1 year or less	8
3. 1 to 5 years	5
4. More than 5 years	5
(f) Other	2
3. Is amount of loan a factor?	
(a) No	8
(b) Yes; $5,000 to $10,000	0
(c) Yes; $10,000 to $100,000	0
(d) Yes; over $100,000	0
4. How long has 360-day basis been applied?	
(a) 1 year or less	0
(b) 1 to 2 years	0
(c) 2 to 5 years	0
(d) 5 to 10 years	0
(e) More than 10 years	8

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TABLE 2.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—8 OF 10 LARGEST COMMERCIAL BANKS IN UNITED STATES—Continued

	Total banks responding
5. Changed to 365-day calculation?	
(a) Yes; in last 5 years	3
(b) Yes; in last 10 years	2
(c) No; not for over 10 years or never	5
6. For which loan types have you changed	
(a) Personal loans, secured:	
1. Demand	1
2. 1 year or less	1
3. 1 to 5 years	0
(b) Personal loans, unsecured:	
1. Demand	1
2. 1 year or less	1
3. 1 to 5 years	0
(c) Construction loans:	
1. Commercial	1
2. Residential	0
(d) Mortgage loans:	
1. Commercial	1
2. Residential	0
(e) Loans to commerce or industry:	
1. Demand	0
2. 1 year or less	0
3. 1 to 5 years	0
(f) Other	1
7. Disclose 360-day annual rate?	
(a) Yes; in loan agreement	5
(b) Yes; otherwise in writing	2
(c) Yes; orally	3
(d) No	3

TABLE 3.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—BANKS RESPONDING FROM FEDERAL RESERVE DISTRICT 1

	Total banks responding	Bank size by total deposits (millions of dollars)			
		Less than $25	$25 to $100	$100 to $200	$200 and over
1. Any interest rates on 360-day basis?					
(a) Yes	16	4	5	3	4
(b) No	4	3	0	0	1
2. Loan types with 360-day interest calculation:					
(a) Personal loans, secured:					
1. Demand	12	4	3	3	2
2. 1 year or less	13	4	4	3	2
3. 1 to 5 years	13	4	5	3	1
(b) Personal loans, unsecured:					
1. Demand	12	4	3	3	2
2. 1 year or less	13	4	4	3	2
3. 1 to 5 years	13	4	5	3	1
(c) Construction loans:					
1. Commercial	8	1	2	3	2
2. Residential	8	1	2	3	2
(d) Mortgage loans:					
1. Commercial	11	2	4	3	2
2. Residential	11	2	4	2	3
(e) Loans to commerce or industry:					
1. Demand	12	2	3	3	4
2. 1 year or less	12	2	3	3	4
3. 1 to 5 years	10	2	3	3	2
4. More than 5 years	9	2	2	3	2
(f) Other	0	0	0	0	0
3. Is amount of loan a factor?					
(a) No	13	3	5	2	3
(b) Yes; $5,000 to $10,000	0	0	0	0	0
(c) Yes; $10,000 to $100,000	0	0	0	0	0
(d) Yes; over $100,000	0	0	0	0	0
4. How long has 360-day basis been applied?					
(a) 1 year or less	0	0	0	0	0
(b) 1 to 2 years	0	0	0	0	0
(c) 2 to 5 years	0	0	0	0	0
(d) 5 to 10 years	1	1	0	0	0
(e) More than 10 years	14	2	5	3	4
5. Changed to 365-day calculation?					
(a) Yes; in last 5 years	1	0	1	0	0
(b) Yes; in last 10 years	1	1	0	0	0
(c) No; not for over 10 years or never	14	3	4	3	4

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TABLE 3.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—BANKS RESPONDING FROM FEDERAL RESERVE DISTRICT 1—Continued

	Total banks responding	Bank size by total deposits (millions of dollars): Less than $25	$25 to $100	$100 to $200	$200 and over
6. For which loan types have you changed?					
(a) Personal loans, secured:					
1. Demand	1	1	0	0	0
2. 1 year or less	1	1	0	0	0
3. 1 to 5 years	1	1	0	0	0
(b) Personal loans, unsecured:					
1. Demand	1	1	0	0	0
2. 1 year or less	1	1	0	0	0
3. 1 to 5 years	1	1	0	0	0
(c) Construction loans:					
1. Commercial	0	0	0	0	0
2. Residential	0	0	0	0	0
(d) Mortgage loans:					
1. Commercial	1	0	1	0	0
2. Residential	0	0	0	0	0
(e) Loans to commerce or industry:					
1. Demand	1	1	0	0	0
2. 1 year or less	2	1	1	0	0
3. 1 to 5 years	2	1	1	0	0
(f) Other	0	0	0	0	0
7. Disclose 360-day annual rate?					
(a) Yes; in loan agreement	6	2	1	1	2
(b) Yes; otherwise in writing	1	0	0	1	0
(c) Yes; orally	2	0	0	1	1
(d) No	11	3	4	2	2

TABLE 4.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—BANKS RESPONDING FROM FEDERAL RESERVE DISTRICT 2

	Total banks responding	Bank size by total deposits (millions of dollars): Less than $25	$25 to $100	$100 to $200	$200 and over
1. Any interest rates on 360-day basis?					
(a) Yes	15	4	6	3	2
(b) No	3	2	1	0	0
2. Loan types with 360-day interest calculation:					
(a) Personal loans, secured:					
1. Demand	12	3	4	3	2
2. 1 year or less	9	2	4	1	2
3. 1 to 5 years	9	2	4	1	2
(b) Personal loans, unsecured:					
1. Demand	10	3	3	2	2
2. 1 year or less	11	2	5	2	2
3. 1 to 5 years	10	2	5	1	2
(c) Construction loans:					
1. Commercial	10	2	4	2	2
2. Residential	8	2	4	1	1
(d) Mortgage loans:					
1. Commercial	9	2	5	0	2
2. Residential	9	2	5	0	2
(e) Loans to commerce or industry:					
1. Demand	12	3	5	2	2
2. 1 year or less	11	2	6	1	2
3. 1 to 5 years	11	2	6	1	2
4. More than 5 years	10	2	5	1	2
(f) Other	2	1	0	1	0
3. Is amount of loan a factor?					
(a) No	10	2	4	2	2
(b) Yes; $5,000–$10,000	0				
(c) Yes; $10,000–$100,000	0				
(d) Yes; over $100,000	0				
4. How long has 360-day basis been applied?					
(a) 1 year or less	0				
(b) 1 to 2 years	1	1	0	0	0
(c) 2 to 5 years	1	0	0	1	0
(d) 5 to 10 years	1	0	1	0	0
(e) More than 10 years	12	3	5	2	2
5. Changed to 365 day calculation?					
(a) Yes; in last 5 years	0	0	0	0	0
(b) Yes; in last 10 years	0				
(c) No; not for over 10 years or never	15	3	6	3	3

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TABLE 4.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—BANKS RESPONDING FROM FEDERAL RESERVE DISTRICT 2—Continued

	Total banks responding	Bank size by total deposits (millions of dollars): Less than $25	$25 to $100	$100 to $200	$200 and over
6. For which loan types have you changed?					
(a) Personal loans, secured:					
1. Demand	0				
2. 1 year or less	0				
3. 1 to 5 years	0				
(b) Personal loans, unsecured:					
1. Demand	0				
2. 1 year or less	0				
3. 1 to 5 years	0				
(c) Construction loans:					
1. Commercial	0				
2. Residential	0				
(d) Mortgage loans:					
1. Commercial	0				
2. Residential	0				
(e) Loans to commerce or industry:					
1. Demand	0				
2. 1 year or less	0				
3. 1 to 5 years	0				
(f) Other	0				
7. Disclose 360-day annual rate?					
(a) Yes; in loan agreement	7	1	3	2	1
(b) Yes; otherwise in writing	3	1	1	0	1
(c) Yes; orally	1	0	1	0	0
(d) No	7	2	3	1	1

TABLE 5.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—BANKS RESPONDING FROM FEDERAL RESERVE DISTRICT 3

	Total banks responding	Bank size by total deposits (millions of dollars): Less than $25	$25 to $100	$100 to $200	$200 and over
1. Any interest rates on 360-day basis?					
(a) Yes	22	5	9	3	5
(b) No	2	0	2	0	0
2. Loan types with 360-day interest calculation:					
(a) Personal loans, secured:					
1. Demand	16	4	7	1	4
2. 1 year or less	13	2	7	1	3
3. 1 to 5 years	12	2	6	1	3
(b) Personal loans, unsecured:					
1. Demand	16	4	7	1	4
2. 1 year or less	13	2	7	1	3
3. 1 to 5 years	12	2	6	1	3
(c) Construction loans:					
1. Commercial	18	4	9	2	3
2. Residential	18	4	9	2	3
(d) Mortgage loans:					
1. Commercial	19	5	7	3	4
2. Residential	19	5	7	3	4
(e) Loans to commerce or industry:					
1. Demand	16	4	7	1	4
2. 1 year or less	15	3	8	1	3
3. 1 to 5 years	13	2	7	1	3
4. More than 5 years	13	2	7	1	3
(f) Other	2	1	0	1	0
3. Is amount of loan a factor?					
(a) No	19	3	9	3	4
(b) Yes; $5,000 to $10,000	0				
(c) Yes; $10,000 to $100,000	1	1	0	0	0
(d) Yes; over $100,000	0				
4. How long has 360-day basis been applied?					
(a) 1 year or less	0				
(b) 1 to 2 years	0				
(c) 2 to 5 years	0				
(d) 5 to 10 years	0				
(e) More than 10 years	22	5	9	3	5
5. Changed to 365-day calculation?					
(a) Yes; in last 5 years	2	1	0	1	0
(b) Yes; in last 10 years	0				
(c) No; not for over 10 years or never	20	4	9	2	5

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TABLE 5.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—BANKS RESPONDING FROM FEDERAL RESERVE DISTRICT 3—Continued

	Total banks responding	Bank size by total deposits (millions of dollars): Less than $25	$25 to $100	$100 to $200	$200 and over
6. For which loan types have you changed?					
(a) Personal loans secured:					
1. Demand	0				
2. 1 year or less	0				
3. 1 to 5 years	0				
(b) Personal loans unsecured:					
1. Demand	1	1	0	0	0
2. 1 year or less	0				
3. 1 to 5 years	0				
(c) Construction loans:					
1. Commercial	0				
2. Residential	0				
(d) Mortgage loans:					
1. Commercial	0				
2. Residential	0				
(e) Loans to commerce or industry:					
1. Demand	1	1	0	0	0
2. 1 year or less	0				
3. 1 to 5 years	0				
(f) Other					
7. Disclose 360-day annual rate?					
(a) Yes; in loan agreement	5	2	3	0	0
(b) Yes; otherwise in writing	7	1	4	1	1
(c) Yes; orally	6	2	3	0	1
(d) No	8	1	2	2	3

TABLE 6.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—BANKS RESPONDING FROM FEDERAL RESERVE DISTRICT 4

	Total banks responding	Bank size by total deposits (millions of dollars): Less than $25	$25 to $100	$100 to $200	$200 and over
1. Any interest rates on 360-day basis?					
(a) Yes	14	2	3	4	5
(b) No	4	2	2	0	0
2. Loan types with 360-day-interest calculation:					
(a) Personal loans, secured:					
1. Demand	10	1	1	3	5
2. 1 year or less	14	2	3	4	5
3. 1 to 5 years	12	1	2	4	5
(b) Personal loans, unsecured:					
1. Demand	10	1	1	3	5
2. 1 year or less	14	2	3	4	5
3. 1 to 5 years	12	1	2	4	5
(c) Construction loans:					
1. Commercial	8	0	2	3	3
2. Residential	9	1	2	3	3
(d) Mortgage loans:					
1. Commercial	11	1	2	4	4
2. Residential	11	1	2	4	4
(e) Loans to commerce or industry:					
1. Demand	10	0	2	3	5
2. 1 year or less	12	0	3	4	5
3. 1 to 5 years	11	1	1	4	5
4. More than 5 years	10	0	1	4	5
(f) Other	0				
3. Is amount of loan a factor?					
(a) No	14	3	3	4	4
(b) Yes; $5,000 to $10,000	0				
(c) Yes; $10,000 to $100,000	0				
(d) Yes; over $100,000	0				
4. How long has 360-day basis been applied?					
(a) 1 year or less	0				
(b) 1 to 2 years	0				
(c) 2 to 5 years	0				
(d) 5 to 10 years	0				
(e) More than 10 years	16	4	3	4	5
5. Changed to 365-day calculation?					
(a) Yes; in last 5 years	2				2
(b) Yes; in last 10 years	1	0	0	1	0
(c) No; not for over 10 years or never	13	4	3	3	3

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TABLE 6.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—BANKS RESPONDING FROM FEDERAL RESERVE DISTRICT 4—Continued

	Total banks responding	Bank size by total deposits (millions of dollars): Less than $25	$25 to $100	$100 to $200	$200 and over
6. For which loan types have you changed?					
(a) Personal loans, secured:					
1. Demand	1	0	0	0	1
2. 1 year or less	0				
3. 1 to 5 years	0				
(b) Personal loans, unsecured:					
1. Demand	1	0	0	0	1
2. 1 year or less	0				
3. 1 to 5 years	0				
(c) Construction loans:					
1. Commercial	1	0	0	0	1
2. Residential	1	0	0	0	1
(d) Mortgage loans:					
1. Commercial	0	0	0	0	0
2. Residential	0	0	0	0	0
(e) Loans to commerce or industry:					
1. Demand	1	0	0	0	1
2. 1 year or less	0				
3. 1 to 5 years	1	0	0	1	0
(f) Other	2	0	0	1	1
7. Disclose 360-day annual rate?					
(a) Yes; in loan agreement	6	1	0	2	3
(b) Yes; otherwise in writing	1	0	0	0	1
(c) Yes; orally	3	0	0	1	2
(d) No	8	2	3	2	1

TABLE 7.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—BANKS RESPONDING FROM FEDERAL RESERVE DISTRICT 5

	Total banks responding	Bank size by total deposits (millions of dollars): Less than $25	$25 to $100	$100 to $200	$200 and over
1. Any interest rates on 360-day basis?					
(a) Yes	13	2	4	1	6
(b) No	8	5	3	0	0
2. Loan types with 360-day interest calculation:					
(a) Personal loans, secured:					
1. Demand	12	2	3	1	6
2. 1 year or less	11	1	3	1	6
3. 1 to 5 years	9	1	2	1	5
(b) Personal loans, unsecured:					
1. Demand	11	1	3	1	6
2. 1 year or less	11	1	3	1	6
3. 1 to 5 years	9	1	2	1	5
(c) Construction loans:					
1. Commercial	11	1	3	1	6
2. Residential	11	1	3	1	6
(d) Mortgage loans:					
1. Commercial	11	2	3	1	5
2. Residential	11	2	3	1	5
(e) Loans to commerce or industry:					
1. Demand	11	1	3	1	6
2. 1 year or less	11	1	3	1	6
3. 1 to 5 years	9	1	2	1	5
4. More than 5 years	8	1	2	1	4
(f) Other	1	0	0	0	1
3. Is amount of loan a factor?					
(a) No	12	2	3	1	6
(b) Yes, $5,000 to $10,000	0				
(c) Yes, $10,000 to $100,000	0				
(d) Yes, over $100,000	0				
4. How long has 360-day basis been applied?					
(a) 1 year or less	1	0	1	0	0
(b) 1 to 2 years	0				
(c) 2 to 5 years	0				
(d) 5 to 10 years	1	0	1	0	0
(e) More than 10 years	12	3	2	1	6
5. Changed to 365-day calculation?					
(a) Yes; in last 5 years	1	0	1	0	0
(b) Yes; in last 10 years	0				
(c) No; not for over 10 years or never	11	2	3	1	5

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TABLE 7.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—BANKS RESPONDING FROM FEDERAL RESERVE DISTRICT 5—Continued

	Total banks responding	Bank size by total deposits (millions of dollars): Less than $25	$25 to $100	$100 to $200	$200 and over
6. For which loan types have you changed?					
(a) Personal loans, secured:					
1. Demand	1	0	1	0	0
2. 1 year or less	0				
3. 1 to 5 years	0				
(b) Personal loans, unsecured:					
1. Demand	1	0	1	0	0
2. 1 year or less	0				
3. 1 to 5 years	0				
(c) Construction loans:					
1. Commercial	1	0	1	0	0
2. Residential	1	0	1	0	0
(d) Mortgage loans:					
1. Commercial	0				
2. Residential	0				
(e) Loans to commerce or industry:					
1. Demand	1	0	1	0	0
2. 1 year or less	0				
3. 1 to 5 years	0				
(f) Other	0				
7. Disclose 360-day annual rate?					
(a) Yes; in loan agreement	5	3	1	0	1
(b) Yes; otherwise in writing	5	0	1	0	4
(c) Yes; orally	2	0	1	0	1
(d) No	3	0	1	1	1

TABLE 8.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—BANKS RESPONDING FROM FEDERAL RESERVE DISTRICT 6

	Total banks responding	Bank size by total deposits (millions of dollars): Less than $25	$25 to $100	$100 to $200	$200 and over
1. Any interest rates on 360-day basis?					
(a) Yes	10	2	4	1	3
(b) No	3	3	0	0	0
2. Loan types with 360-day interest calculation:					
(a) Personal loans, secured:					
1. Demand	6	0	3	1	2
2. 1 year or less	6	1	3	0	2
3. 1 to 5 years	4	1	2	0	1
(b) Personal loans, unsecured:					
1. Demand	6	0	3	1	2
2. 1 year or less	6	1	3	0	2
3. 1 to 5 years	4	1	2	0	1
(c) Construction loans:					
1. Commercial	6	1	2	1	2
2. Residential	5	1	1	1	2
(d) Mortgage loans:					
1. Commercial	5	1	2	0	2
2. Residential	4	1	1	0	2
(e) Loans to commerce or industry:					
1. Demand	6	1	2	1	2
2. 1 year or less	8	1	4	0	3
3. 1 to 5 years	5	1	3	0	1
4. More than 5 years	5	1	3	0	1
(f) Other	0				
3. Is amount of loan a factor?					
(a) No	7	2	2	1	2
(b) Yes; $5,000 to $10,000	0				
(c) Yes; $10,000 to $100,000	0				
(d) Yes; over $100,000	1	0	0	0	1
4. How long has 360-day basis been applied?					
(a) 1 year or less	0				
(b) 1 to 2 years	1	1	0	0	0
(c) 2 to 5 years	0				
(d) 5 to 10 years	1	1	0	0	0
(e) More than 10 years	7	0	4	1	2
5. Changed to 365-day calculation?					
(a) Yes; in last 5 years	1	0	0	0	1
(b) Yes; in last 10 years	0				
(c) No; not for over 10 years or never	8	2	3	1	2

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TABLE 8.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—BANKS RESPONDING FROM FEDERAL RESERVE DISTRICT 6—Continued

	Total banks responding	Bank size by total deposits (millions of dollars): Less than $25	$25 to $100	$100 to $200	$200 and over
6. For which loan types have you changed?					
(a) Personal loans, secured:					
1. Demand	0				
2. 1 year or less	0				
3. 1 to 5 years	0				
(b) Personal loans, unsecured:					
1. Demand	0				
2. 1 year or less	0				
3. 1 to 5 years	0				
(c) Construction loans:					
1. Commercial	0				
2. Residential	0				
(d) Mortgage loans:					
1. Commercial	0				
2. Residential	0				
(e) Loans to commerce or industry:					
1. Demand	0				
2. 1 year or less	0				
3. 1 to 5 years	0				
(f) Other	0				
7. Disclose 360-day annual rate?					
(a) Yes; in loan agreement	2	1	0	0	1
(b) Yes; otherwise in writing	1	0	0	0	1
(c) Yes; orally	3	0	2	1	0
(d) No	4	1	2	0	1

TABLE 9.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—BANKS RESPONDING FROM FEDERAL RESERVE DISTRICT 7

	Total banks responding	Bank size by total deposits (millions of dollars): Less than $25	$25 to $100	$100 to $200	$200 and over
1. Any interest rates on 360-day basis?					
(a) Yes	17	5	3	5	4
(b) No	4	2	1	0	1
2. Loan types with 360-day interest calculation:					
(a) Personal loans secured:					
1. Demand	9	2	1	3	3
2. 1 year or less	13	4	2	4	3
3. 1 to 5 years	7	3	0	3	1
(b) Personal loans unsecured:					
1. Demand	9	2	1	3	3
2. 1 year or less	13	4	2	4	3
3. 1 to 5 years	7	3	0	3	1
(c) Construction loans:					
1. Commercial	7	2	0	3	2
2. Residential	7	2	0	3	2
(d) Mortgage loans:					
1. Commercial	12	5	1	5	1
2. Residential	12	5	1	5	1
(e) Loans to commerce or industry:					
1. Demand	10	2	1	4	3
2. 1 year or less	14	4	2	5	3
3. 1 to 5 years	8	3	0	4	1
4. More than 5 years	6	2	0	3	1
(f) Other	3	1	0	1	1
3. Is amount of loan a factor?					
(a) No	14	4	2	4	
(b) Yes; $5,000 to $10,000	1	1	0	0	4
(c) Yes; $10,000 to $100,000	2	2	0	0	0
(d) Yes; over $100,000	0				
4. How long has 360-day basis been applied?					
(a) 1 year or less	1	1	0	0	0
(b) 1 to 2 years	0				
(c) 2 to 5 years	0				
(d) 5 to 10 years	2	1	1	0	0
(e) More than 10 years	14	3	2	5	4
5. Changed to 365-day calculation?					
(a) Yes; in last 5 years	2	0	1	1	0
(b) Yes; in last 10 years	0				
(c) No; not for over 10 years or never	15	5	2	4	4

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TABLE 9.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—BANKS RESPONDING FROM FEDERAL RESERVE DISTRICT 7—Continued

	Total banks responding	Bank size by total deposits (millions of dollars): Less than $25	$25 to $100	$100 to $200	$200 and over
6. For which loan types have you changed?					
(a) Personal loans, secured:					
1. Demand	1	0	1	0	0
2. 1 year or less	1	0	1	0	0
3. 1 to 5 years	1	0	1	0	0
(b) Personal loans, unsecured:					
1. Demand	1	0	1	0	0
2. 1 year or less	1	0	1	0	0
3. 1 to 5 years	1	0	1	0	0
(c) Construction loans:					
1. Commercial	1	0	1	0	0
2. Residential	1	0	1	0	0
(d) Mortgage loans:					
1. Commercial	0				
2. Residential	0				
(e) Loans to commerce or industry:					
1. Demand	1	0	1	0	0
2. 1 year or less	1	0	1	0	0
3. 1 to 5 years	1	0	0	1	0
(f) Other	1	0	0	1	0
7. Disclose 360-day annual rate?					
(a) Yes; in loan agreement	3	0	1	1	1
(b) Yes; otherwise in writing	0				
(c) Yes; orally	3	1	0	0	2
(d) No	11	4	2	4	1

TABLE 10.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—BANKS RESPONDING FROM FEDERAL RESERVE DISTRICT 8

	Total banks responding	Bank size by total deposits (millions of dollars): Less than $25	$25 to $100	$100 to $200	$200 and over
1. Any interest rates on 360-day basis?					
(a) Yes	15	3	5	2	5
(b) No	3	2	0	0	1
2. Loan types with 360-day interest calculation:					
(a) Personal loans, secured:					
1. Demand	9	2	1	2	4
2. 1 year or less	10	3	2	1	4
3. 1 to 5 years	8	3	2	0	3
(b) Personal loans, unsecured:					
1. Demand	9	2	1	2	4
2. 1 year or less	10	3	2	1	4
3. 1 to 5 years	8	3	2	0	3
(c) Construction loans:					
1. Commercial	10	3	1	2	4
2. Residential	10	3	1	2	4
(d) Mortgage loans:					
1. Commercial	11	3	2	2	4
2. Residential	10	3	2	2	3
(e) Loans to commerce or industry:					
1. Demand	10	2	2	2	4
2. 1 year or less	12	3	3	1	5
3. 1 to 5 years	11	3	3	2	3
4. More than 5 ears	9	2	2	0	5
(f) Other	5	1	3	1	0
3. Is amount of loan a factor?					
(a) No	13	3	4	2	4
(b) Yes; $5,000 to $10,000	0				
(c) Yes; $10,000 to $100,000	0				
(d) Yes; over $100,000	0				
4. How long has 360-day basis been applied?					
(a) 1 year or less	0				
(b) 1 to 2 years	0				
(c) 2 to 5 years	0				
(d) 5 to 10 years	0				
(e) More than 10 years	14	3	4	2	5

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TABLE 10.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—BANKS RESPONDING FROM FEDERAL RESERVE DISTRICT 8—Continued

	Total banks responding	Bank size by total deposits (millions of dollars): Less than $25	$25 to $100	$100 to $200	$200 and over
5. Changed to 365-day calculation?					
(a) Yes; in last 5 years	0				
(b) Yes; in last 10 years	0				
(c) No; not for over 10 years or never	12	3	4	2	3
6. For which loan types have you changed?					
(a) Personal loans, secured:					
1. Demand	0				
2. 1 year or less	0				
3. 1 to 5 years	0				
(b) Personal loans, unsecured:					
1. Demand	0				
2. 1 year or less	0				
3. 1 to 5 years	0				
(c) Construction loans:					
1. Commercial	0				
2. Residential	0				
(d) Mortgage loans:					
1. Commercial	0				
2. Residential	0				
(e) Loans to commerce or industry:					
1. Demand	0				
2. 1 year or less	0				
3. 1 to 5 years	0				
(f) Other	0				
7. Disclose 360-day annual rate?					
(a) Yes; in loan agreement	4	0	2	1	1
(b) Yes; otherwise in writing	4	1	0	0	3
(c) Yes; orally	2	1	1	0	0
(d) No	5	1	1	1	2

TABLE 11.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—BANKS RESPONDING FROM FEDERAL RESERVE DISTRICT 9

	Total banks responding	Bank size by total deposits (millions of dollars): Less than $25	$25 to $100	$100 to $200	$200 and over
1. Any interest rates on 360-day basis?					
(a) Yes	16	3	6	5	2
(b) No	4	2	1	1	0
2. Loan types with 360-day interest calculation:					
(a) Personal loans, secured:					
1. Demand	12	1	5	4	2
2. 1 year or less	13	3	4	4	2
3. 1 to 5 years	10	1	4	4	1
(b) Personal loans, unsecured:					
1. Demand	12	1	5	4	2
2. 1 year or less	12	2	4	4	2
3. 1 to 5 years	10	1	4	4	1
(c) Construction loans:					
1. Commercial	10	0	4	4	2
2. Residential	8	0	4	3	1
(d) Mortgage loans:					
1. Commercial	7	1	3	1	2
2. Residential	7	1	3	1	2
(e) Loans to commerce or industry:					
1. Demand	12	0	5	5	2
2. 1 year or less	12	1	4	5	2
3. 1 to 5 years	11	1	4	4	2
4. More than 5 years	10	1	4	4	1
(f) Other	1	0	1	0	0
3. Is amount of loan a factor?					
(a) No	13	2	4	5	2
(b) Yes; $5,000 to $10,000	1	1	0	0	0
(c) Yes; $10,000 to $100,000	0				
(d) Yes; over $100,000	0				
4. How long has 360 day basis been applied?					
(a) 1 year or less	0				
(b) 1 to 2 years	0				
(c) 2 to 5 years	0				
(d) 5 to 10 years	0				
(e) More than 10 years	15	3	5	5	2

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TABLE 11.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—BANKS RESPONDING FROM FEDERAL RESERVE DISTRICT 9—Continued

	Total banks responding	Bank size by total deposits (millions of dollars): Less than $25	$25 to $100	$100 to $200	$200 and over
5. Changed to 365-day calculation?					
(a) Yes; in last 5 years	2	0	1	1	0
(b) Yes; in last 10 years	0				
(c) No; not for over 10 years or never	13	3	4	4	2
6. For which loan types have you changed?					
(a) Personal loans, secured:					
1. Demand	2	0	1	1	0
2. 1 year or less	2	0	1	1	0
3. 1 to 5 years	2	0	1	1	0
(b) Personal loans, unsecured:					
1. Demand	2	0	1	1	0
2. 1 year or less	2	0	1	1	0
3. 1 to 5 years	2	0	1	1	0
(c) Construction loans:					
1. Commercial	0				
2. Residential	1	0	1	0	0
(d) Mortgage loans:					
1. Commercial	0				
2. Residential	0				
(e) Loans to commerce or industry:					
1. Demand	0				
2. 1 year or less	0				
3. 1 to 5 years	0				
(f) Other	1	0	1	0	0
7. Disclose 360-day annual rate?					
(a) Yes; in loan agreement	3	2	0	0	1
(b) Yes; otherwise in writing	2	0	0	1	1
(c) Yes; orally	2	1	1	0	0
(d) No	9	0	4	4	1

TABLE 12.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—BANKS RESPONDING FROM FEDERAL RESERVE DISTRICT 10

	Total banks responding	Bank size by total deposits (millions of dollars): Less than $25	$25 to $100	$100 to $200	$200 and over
1. Any interest rates on 360-day basis?					
(a) Yes	15	5	3	3	4
(b) No	2	1	1	0	0
2. Loan types with 360-day interest calculation					
(a) Personal loans, secured:					
1. Demand	9	3	2	2	2
2. 1 year or less	12	5	2	2	3
3. 1 to 5 years	4	0	2	2	0
(b) Personal loans, unsecured:					
1. Demand	9	3	2	2	2
2. 1 year or less	12	5	2	2	3
3. 1 to 5 years	6	3	0	2	1
(c) Construction loans:					
1. Commercial	14	4	3	3	4
2. Residential	15	5	3	3	4
(d) Mortgage loans:					
1. Commercial	8	1	3	2	2
2. Residential	8	1	3	2	2
(e) Loans to commerce or industry:					
1. Demand	13	4	3	3	3
2. 1 year or less	15	5	3	3	4
3. 1 to 5 years	10	2	3	3	2
4. More than 5 years	9	1	3	3	2
(f) Other	1	0	0	0	1
3. Is amount of loan a factor?					
(a) No	7	2	1	3	1
(b) Yes; $5,000 to $10,000	1	0	1	0	0
(c) Yes; $10,000 to $100,000	1	0	1	0	0
(d) Yes; over $100,000	0				
4. How long has 360-day basis been applied?					
(a) 1 year or less	0				
(b) 1 to 2 years	0				
(c) 2 to 5 years	2	1	1	0	0
(d) 5 to 10 years	1	1	0	0	0
(e) More than 10 years	12	3	2	3	4

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TABLE 12.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—BANKS RESPONDING FROM FEDERAL RESERVE DISTRICT 10—Continued

	Total banks responding	Bank size by total deposits (millions of dollars): Less than $25	$25 to $100	$100 to $200	$200 and over
5. Changed to 365-day calculation?					
(a) Yes; in last 5 years	5	1	1	1	2
(b) Yes; in last 10 years	0				
(c) No; not for over 10 years or never	10	4	2	2	2
6. For which loan types have you changed?					
(a) Personnel loans, secured:					
1. Demand	1	0	0	0	1
2. 1 year or less	2	0	0	0	2
3. 1 to 5 years	1	0	0	0	1
(b) Personal loans, unsecured:					
1. Demand	1	0	0	0	1
2. 1 year or less	2	0	0	0	2
3. 1 to 5 years	1	0	0	0	1
(c) Construction loans:					
1. Commercial	0				
2. Residential	0				
(d) Mortgage loans:					
1. Commercial	1	0	1	0	0
2. Residential	0				
(e) Loans to commerce or industry:					
1. Demand	0				
2. 1 year or less	0				
3. 1 to 5 years	0				
(f) Other	0				
7. Disclose 360-day annual rate?					
(a) Yes; in loan agreement	2	1	0	0	1
(b) Yes; otherwise in writing	5	0	1	2	2
(c) Yes; orally	2	2	0	0	0
(d) No	7	2	2	1	2

TABLE 13.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—BANKS RESPONDING FROM FEDERAL RESERVE DISTRICT 11

	Total banks responding	Bank size by total deposits (millions of dollars): Less than $25	$25 to $100	$100 to $200	$200 and over
1. Any interest rates on 360-day basis?					
(a) Yes	12	2	6	1	3
(b) No	1	1	0	0	0
2. Loan types with 360-day interest calculation:					
(a) Personal loans, secured:					
1. Demand	9	2	4	1	2
2. 1 year or less	9	2	4	0	3
3. 1 to 5 years	8	2	4	0	2
(b) Personal loans, unsecured:					
1. Demand	9	2	4	1	2
2. 1 year or less	9	2	4	0	3
3. 1 to 5 years	8	2	4	0	2
(c) Construction loans:					
1. Commercial	10	2	5	1	2
2. Residential	10	2	5	1	2
(d) Mortgage loans:					
1. Commercial	8	2	6	0	0
2. Residential	8	2	6	0	0
(e) Loans to commerce or industry:					
1. Demand	9	2	4	1	2
2. 1 year or less	8	2	4	0	2
3. 1 to 5 years	7	2	4	0	1
4. More than 5 years	5	2	2	0	1
(f) Other	3	1	1	0	1
3. Is amount of loan a factor?					
(a) No	12	2	6	1	3
(b) Yes; $5,000 to $10,000	0				
(c) Yes; $10,000 to $100,000	0				
(d) Yes; over $100,000	0				
4. How long has 360-day basis been applied?					
(a) 1 year or less	0				
(b) 1 to 2 years	1	0	1	0	0
(c) 2 to 5 years	0				
(d) 5 to 10 years	1	1	0	0	0
(e) More than 10 years	10	1	5	1	3

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TABLE 13.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—BANKS RESPONDING FROM FEDERAL RESERVE DISTRICT 11—Continued

	Total banks responding	Bank size by total deposits (millions of dollars): Less than $25	$25 to $100	$100 to $200	$200 and over
5. Changed to 365-day calculation?					
(a) Yes; in last 5 years	0				
(b) Yes; in last 10 years	0				
(c) No; not for over 10 years or never	12	2	6	1	3
6. For which loan types have you changed?					
(a) Personal loans, secured:					
1. Demand	0				
2. 1 year or less	0				
3. 1 to 5 years	0				
(b) Personal loans, unsecured:					
1. Demand	0				
2. 1 year or less	0				
3. 1 to 5 years	0				
(c) Construction loans:					
1. Commercial	0				
2. Residential	0				
(d) Mortgage loans:					
1. Commercial	0				
2. Residential	0				
(e) Loans to commerce or industry:					
1. Demand	0				
2. 1 year or less	0				
3. 1 to 5 years	0				
(f) Other	0				
7. Disclose 360-day annual rate?					
(a) Yes; in loan agreement	6	0	3	0	3
(b) Yes; otherwise in writing	2	0	2	0	0
(c) Yes; orally	4	1	0	1	2
(d) No	3	1	2	0	0

TABLE 14.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—BANKS RESPONDING FROM FEDERAL RESERVE DISTRICT 12

	Total banks responding	Bank size by total deposits (millions of dollars): Less than $25	$25 to $100	$100 to $200	$200 and over
1. Any interest rates on 360-day basis?					
(a) Yes	18	5	7	4	2
(b) No	3	1	1	0	1
2. Loan types with 360-day interest calculation:					
(a) Personal loans, secured:					
1. Demand	10	2	6	1	1
2. 1 year or less	11	2	6	2	1
3. 1 to 5 years	7	1	3	2	1
(b) Personal loans, unsecured:					
1. Demand	10	2	6	1	1
2. 1 year or less	11	2	6	2	1
3. 1 to 5 years	6	1	2	2	1
(c) Construction loans:					
1. Commercial	10	3	4	2	1
2. Residential	10	3	4	2	1
(d) Mortgage loans:					
1. Commercial	14	5	4	3	2
2. Residential	13	5	4	3	1
(e) Loans to commerce or industry:					
1. Demand	14	3	6	3	2
2. 1 year or less	14	3	6	3	2
3. 1 to 5 years	11	3	4	3	1
4. More than 5 years	8	3	2	2	1
(f) Other	2	1	0	0	1
3. Is amount of loan a factor?					
(a) No	16	3	7	4	2
(b) Yes; $5,000 to $10,000	0				
(c) Yes; $10,000 to $100,000	0				
(d) Yes; over $100,000	0				
4. How long has 360-day basis been applied?					
(a) 1 year or less	0				
(b) 1 to 2 years	1	0	1	0	0
(c) 2 to 5 years	1	1	0	0	0
(d) 5 to 10 years	1	0	1	0	0
(e) More than 10 years	15	4	5	4	2

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TABLE 14.—SUMMARY OF BANK SURVEY ON CALCULATING INTEREST CHARGES ON LOANS—BANKS RESPONDING FROM FEDERAL RESERVE DISTRICT 12—Continued

	Total banks responding	Bank size by total deposits (millions of dollars)			
		Less than $25	$25 to $100	$100 to $200	$200 and over
5. Changed to 365-day calculation?					
(a) Yes; in last 5 years	3	1	0	1	1
(b) Yes; in last 10 years	0				
(c) No; not for over 10 years or never	14	5	5	3	1
6. For which loan types have you changed?					
(a) Personal loans, secured:					
1. Demand	2	1	0	1	0
2. 1 year or less	2	1	0	1	0
3. 1 to 5 years	2	1	0	1	0
(b) Personal loans, unsecured:					
1. Demand	2	1	0	1	0
2. 1 year or less	2	1	0	1	0
3. 1 to 5 years	2	1	0	1	0
(c) Construction loans:					
1. Commercial	1	1	0	0	0
2. Residential	1	1	0	0	0
(d) Mortgage loans:					
1. Commercial	2	1	1	0	0
2. Residential	2	1	1	0	0
(e) Loans to commerce or industry:					
1. Demand	1	1	0	0	0
2. 1 year or less	1	1	0	0	0
3. 1 to 5 years	1	1	0	0	0
(f) Other	0				
7. Disclose 360 day annual rate?					
(a) Yes; in loan agreement	2	1	0	1	0
(b) Yes: otherwise in writing	4	0	4	0	0
(c) Yes; orally	5	2	2	0	1
(d) No	7	2	1	1	3

(The following additional material was submitted for inclusion in the record:)

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., May 18, 1971.

Hon. WRIGHT PATMAN,
Chairman, Banking and Currency Committee,
House of Representatives,
Washington, D.C.

DEAR MR. CHAIRMAN: The Chairman of the Board of a State bank in my Congressional District has written to me concerning H.R. 5700.

He opposes the provision which requires 100% insurance coverage of public deposits and which would give the insuring agency the authority to limit the amount of funds which could be deposited in an insured bank.

This man contends that the deposits in his bank made by state and local government are secured by the pledge of good and sufficient collateral. He feels that this provision could result in the transfer of funds now on deposit in smaller community banks in my district to larger banks in the Minneapolis-St. Paul area. He believes that banks should be allowed to accept deposits in excess of the amount authorized by the insuring agency as long as the excess portion is insured by collateral.

I would appreciate your committee giving consideration to this viewpoint.

With every good wish, I am

Sincerely yours,

ALBERT H. QUIE,
Member of Congress.

THE STATE BANK OF FARIBAULT,
Faribault, Minn., May 12, 1971.

Hon. ALBERT H. QUIE,
Congressman from Minnesota, House Office Building,
Washington, D.C.

DEAR AL: We have given careful consideration to the provisions in H.R. 5700, The Banking Reform Act of 1971. One of the provisions in the bill provides for 100% insurance coverage of public deposits, especially those of state and

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local governments with the proviso that the insuring agency be given authorization to limit the amount of such funds that can be accepted by an insured bank.

With the information at hand, we feel that this provision could be hazardous to the so-called small state and national banks, including ourselves, in this area. We are fortunate in that we have substantial deposits of both the state and local government that are secured by the pledge of good and sufficient collateral. If the decision is left to an insuring agency as to the limit of the amount of such funds that can be insured in any particular bank, it could become most embarassing and in our particular case, it could be that some of these funds now on deposit in the local banks would have to be deposited in, for instance, the Twin City banks. Now, if this becomes a reality, does this preclude the bank from accepting deposits in excess of the amount authorized by the insuring agency providing that the excess portion be secured by collateral?

So far as we are concerned, we have no quarrel with the other provisions of the Act, but we are concerned about the 100% insurance coverage.

Yours very truly,

JOHN CARLANDER,
Chairman of the Board.

COMMENTS OF THE FIRST NATIONAL BANK OF ATLANTA ON H.R. 5700

The First National Bank of Atlanta would like to submit the following comments on H.R. 5700 now under consideration by the House Banking and Currency Committee. We have examined with great care the proposed provisions of this Act, and while there may be problems in the banking industry with which this Act purports to deal, we feel, nevertheless, that the Act is a classic case of "overkill". Many of the solutions proposed will result in greater evils than those they are designed to cure.

Before turning to specific sections we would like to make some general comments about proposed prohibitions of interlocking relationships. A blanket prohibition of such interlocking relationships is unwarranted. While probably there are some isolated abuses the answer is not to prohibit all interlocking relationships but to cure the few abuses that exist which can be done by giving the appropriate regulatory authorities (which have proved in recent years to be able and willing to deal with such matters) the authority to prohibit such relationships where abuses are found to exist. As the committee well knows, Section 8 of the Clayton Act now deals with such interlocking relationships within confined geographic limits, and the Federal Reserve Board has the authority now to prosecute violations of the Clayton Act to the extent that they involve member banks of the Federal Reserve System. If there have been abuses because of interlocking directorates, then the authority which the Federal Reserve System now has should be broadened to cover other financial institutions.

We object strongly to the idea that there is anything inherently wrong in businessmen who happen to be interested in other financial institutions from serving on boards of banks. To serve their communities well banks need to obtain a broad knowledge of and involvement in all aspects of their communities and therefore should seek for their Board of Directors men of broad and diverse financial and business experience. Other financial institutions have the same interest and motivation. The effect of a blanket prohibition would be to limit the ablest men to service on the board of only one financial institution even though others may seek and need their advice too. The result would be detrimental to the entire financial community.

The entire idea of a prohibition seems to assume that the individual director involved in a possible conflict would be able to sway the wisdom and judgment of the other directors. We think it is safe to assume that the other directors could not be thus swayed.

Turning now to specific situations, we have the following comments:

1. The proposed Bill will prohibit any officer, director, employee or trustee of any of eight particular types of financial institutions from serving in a similar capacity for any of the other eight types of financial institutions. Naturally, we can speak best from our own experience, and while we recognize that the experience of any given bank may not be the experience of the nation or the community as a whole, still we feel that the specific situation of this bank is typical enough of the experience of most banks to be relevant. We have now serving on our Board of Directors as one of our most valued members, a prominent businessman of a city some 50 miles away from Atlanta. This gentleman happens to be

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the principal stockholder and a director of a bank in that community which also is a correspondent bank of The First National Bank of Atlanta. This situation has existed for many years, and his experience in bringing to the Board the problems of banks in smaller communities with which our bank must deal has been invaluable. In addition he has been one of the most successiul businessmen in the state and has a broad range of business knowledge aside from his bank connections. Because of the distance involved and because of the branching prohibitions of the Georgia law, there has been no conflict (anticompetitive or otherwise) of any kind between the two banks of which he serves as a director. Yet this Bill would prohibit his continuing to serve both banks, and his valuable services would be lost to one or the other of the banks. In addition, a previous director, now deceased, was one of the organizers of and director of a local savings and loan association which has long been and still is one of the bank's better customers. At least in this geographic area the type of loan made by this savings and loan association, and the type of service rendered by the bank has not in any sense been competitive. Again, his valued advice and services would have been lost to one or the other of the institutions, and a long-existing customer relationship damaged. While in some cases such a relationship could be detrimental, this has not been the case with this bank, nor with many, many other banks in which similar relationships have long existed. The regulatory authorities could easily control objectionable situations without disturbing those situations that are beneficial to both institutions.

Both the Chairman of the Federal Reserve Board and the Chairman of the Federal Deposit Insurance Corporation in their testimony before this committee stated that the interest of the financial community and the public can best be served by broadening the powers of the regulatory agencies to deal with specific situations in lieu of a blanket prohibition which would do more harm than good. If the concern of Congress is to prevent anticompetitive trends from developing, such trends can be controlled through regulatory agency action when the need arises without restricting the whole financial community, and without denying to financial institutions the experience of capable and knowledgeable businessmen.

2. The Bill would also prevent any officer, director, employee, or trustee of the eight types of financial institutions enumerated from serving in a similar capacity with a corporation for which these financial institutions manage employee benefit accounts. Turning again to our specific situation, we have interlocking directorships between the bank and public utilities for which the bank serves as trustee of pension and profit sharing plans. It is very difficult to see how any harmful conflict can arise here. In these situations, as in all fiduciary relationships, the bank is subject to very stringent restrictions imposed by Reg. 9 of the Comptroller of the Currency and the appropriate section of the Georgia Code. Perhaps the committee has in mind the possibility of a director undertaking to direct investments in the plan affecting his company. There is already law enough and penalities enough to prevent this pressure from being effective.

3. The Act would prohibit any officer, director, employee or trustee of the eight types of financial institutions enumerated from serving in a similar capacity with any corporation in which the financial institution has voting control of 5% or more of any class of stock. We would assume this includes control through the facilities of a bank's trust department. In our own bank, we have a number of family businesses, whose principal officers and directors have also been officers and directors of the bank. Their natural inclination is to deal with the bank with which they have long been associated. At the same time, their day to day principal interest lies in the operation of their family businesses. The bank has neither the power nor the desire to interfere in any manner with these operations. Yet, should this prohibition become law, it is obvious that they would resign from the board of the bank rather than from the corporation that provides their day to day livelihood. Once again the bank would be needlessly deprived of valued services of these experienced businessmen.

4. The Act would prohibit officers or employees of a bank from serving on the board of a corporation that has a substantial and continuing relationship with the bank. In many respects this could be the most damaging prohibition of all, particularly in the situation where a long existing and substantial relationship has existed over the years. Many small businesses rely on the advice and counsel of their "banker" in many aspects of their business. Many times the banker is

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invited on the customers board of directors to insure the complete accessibility to his advice and counsel. In the overwhelming number of situations, this is one of the main reasons for the bank representative to serve on the board of the customer. To destroy these types of relationships because of some fancied abuse is to ignore the realities of business relationships and to deprive business of a valuable source of financial aid and advice. This prohibition with others like it in the Act would eliminate a valued pool of financial advice, leaving the entire community the poorer for it.

5. Section 25 of the proposed Act reads:

"A person who is a trustee, director, officer, or employee of an insured bank may not at the same time perform legal services, in connection with a loan or other business transaction with such insured bank, for or on behalf of any person."

Our first objection is its vagueness. Is it the intent to prohibit the bank's attorney (who may happen to be a director) from representing the bank in any loan or other business transaction irrespective of who the borrower might be, or is it the intent to prohibit the attorney from representing the *borrower* in any such transaction with the bank? The proposed Act merely says "for or on behalf of any person" which could include the bank, as well as the borrower. This section as written was presented to two different lawyers in the bank's law firm. One of them came up with the interpretation that its intention was to prohibit the bank's attorney, who might be a member of the board, from representing the bank in any transaction with any third person. The other interpretation was that its intention was merely to eliminate the attorney from representing the third person in a transaction with the bank of which he is a director. At any rate, the language is vague and confusing regardless of what is intended.

If we assume that its intention is to prohibit a bank director-attorney from doing any business on behalf of the bank, obviously such a prohibition would be absurd. This would be the equivalent of saying that the bank's attorney could not serve on its board.

While we recognize that there has been some criticism of attorneys serving on corporate boards, we do not agree with the criticism. There are obviously many advantages to the bank's attorney serving on its board of directors, the most obvious of which is the fact that the attorney is there as a voting member to advise the board on the legal effect of matters coming before it. Any attorney worth his salt is going to advise the board honestly and within the Canons of Ethics of the various bar associations; to think otherwise is to indict the whole legal profession.

If its intent is merely to prevent the attorney from representing other clients of his, who might have business with the bank, the normal conflicts of interest provisions provided by Canons of Ethics of various bar associations should be adequate protection for his non-bank client. Situations frequently arise in the law firm which represents this bank involving dual representation by the firm of both the bank and the bank's customer. The lawyer is aksed to draft a loan agreement incorporating provisions already agreed upon by the parties themselves, and because the lawyer is already familiar with the problems of both clients, he can handle the situation in a far more economical and effective way. In such situations, the attorneys are always careful to advise both clients of possible conflicts of interest, of which they are obviously aware anyway. Furthemore, in most such cases, the conflicts are more imagined than real, or the parties would not be entering the relationship in the first place. Should situations of real conflict later arise, the Canons of Ethics would not only suggest but require that the attorney disassociate himself from one party or the other and leave that representation to independent counsel. This too is common practice and bank counsel do in fact disqualify themselves when real conflicts arise or may arise.

6. The Bill would prohibit commercial banks from holding in their trust departments more than 10% of any class of stock of any corporation whose stock is required to be registered under the Securities and Exchange Commission Act of 1933. We concur with the comments of Chairman Burns in which he doubts the wisdom of such a prohibiiton. Obviously it would deny individuals with very substantial holdings of stock of a corporation access to the services of a bank trust department and force them to rely on individual fiduciaries. These situations may well be those in which the services of a corporate trustee are the most desirable and the most needed. A forced reduction of the holdings to 10% or less would force a distribution of the excess to beneficiaries or sale of the excess

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which might well be at sacrifice prices. No need for this type of control has been demonstrated, and the Securities and Exchange Commission Institutional Investor Study Report bears this out.

7. Another prohibition of the Bill would prohibit a commercial bank from holding their own or their parent's stock in its trust department. This, we assume, would include holdings in its own pension or profit sharing plan. There are many practical and benficial reasons for having employee pension and profit sharing plans acquire stock of the company. Such ownership gives employees a proprietary interest in the company and an incentive for better performance. Here again these beneficial effects would be eliminated without necessity. In many small banks substantial blocks of a bank's stock are held by individuals who would certainly want their affairs looked after by "their bank." Such a prohibition would require a trust department to refuse to serve or to dispose of large blocks of stuck under what could be disadvantageous circumstances. This section would apply retroactively to already existing trusts.

8. Another section of the Act requires annual disclosure by commercial bank trust departments of their fiduciary holdings, of securities, the voting rights of the bank with respect thereto, and the manner in which such securities are voted. This information is made subject to public inspection. Such a requirement would result in the disclosure of confidential information which could readily be associated with trust customers who might validly consider such disclosure an invasion of their privacy. This could result in a transfer of business to trustees not thus regulated. The record keeping and reporting requirements would be needlessly burdensome. If the committee feels, which we don't, that such a disclosure is required, at least the requirement should be confined to large holdings or to securities registered under the Securities Exchange Act of 1933.

9. Equity kickers—This type of lending became prevalent during the tight money period in the last two years and is to a large extent disappearing. The stated objection seems to be two fold—(1) To protect the borrower from the lenders request for equity participation and (2) To prevent the lender from being lured into making poor loans by the hope of profit from the equity kicker.

Banks are already regulated and examined on the quality of their loans, so there is no reason for this further regulation specifically directed to one type of loan.

Borrowers in situations where equity "kickers" have been used are sophisticated borrowers and are perfectly able to care for their own interests. There is no more reason to regulate equity participations than to set a miximum rate, for such participations are a function of the cost of money.

We concur with the statements of Chairman Burns and Wylie before the committee on this subject.

10. Another section of the Act would prohibit banks from extending credit to a corporation which is more than 5% owned by directors, officers or employees of the bank making the loan. This is the so-called "insider loan" section. Again, referring to our own experience, some of our soundest credit risks are family-owned enterprises whose officers or directors serve on the board of the bank. Their business success and experience and their long association with the bank make them especially good directors. To prohibit this relationship from continuing would deprive the bank of some of its soundest customers or its soundest directors. Again, a classic case of "over kill" will result in a situation where little or no abuse has been shown to exist. Bank examiners are already instructed to examine carefully any loans to officers and directors, and if, in their judgment normal credit considerations have not been followed, to direct the bank to take the necessary corrective action.

11. We have no objection to the proposal to prohibit brokered deposits.

We understand abuses have resulted from the brokering of deposits and tend to support the approach suggested by Chairman Wylie in his comments before the Committee.

Now as to "give aways." We have not used this form of merchandising enough to have a firm feel for the effects. In general, we feel, however, that the present position of the regulatory authorities is sound and has worked, and we see no reason to take away the flexibility now provided by these regulations and would propose that the matter be left alone.

12. We feel there are several valid objections to the requirement that public deposits be 100% insured.

Most states (including Georgia) require that certain types of deposits be adequately secured by pledges of marketable government securities. Such statutory requirements would not be abrogated by the proposed Federal Statute.

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Secondly, a requirement of insurance in lieu of the present requirement of a pledge of government securities could well result in a softness in the treasury and municipal bond market. For example, banks which now purchase these securities to use as collateral for government deposits would no longer feel the need for such purchases. Statistics show that over half of the treasury obligations held by commercial banks are pledged to secure public deposits. An extension of insurance coverage as proposed by this Bill would reduce the attractiveness of such securities as investment and might tend to raise the cost of public borrowings.

NEW YORK CLEARING HOUSE,
New York, N.Y., May 24, 1971.

Mr. WRIGHT PATMAN,
Chairman, Committee on Banking and Currency,
Rayburn Office Building, Washington, D.C.

DEAR MR. PATMAN: During the course of Mr. Renchard's testimony before the House Banking & Currency Committee on April 29th, it was suggested that we attempt to draft language to assist the Committee when the bill is marked up in Executive Session. Accordingly, we are attaching language amending Section 19 of Title 15 which we deem to be appropriate to provide statutory modification of the law presently governing interlocking directorates. Similarly, we have attached language which would, in our view, be appropriate to control brokered deposits in banks.

We trust you will find this language helpful.

Very truly yours,

JOHN F. LEE.

PROPOSED AMENDMENT TO SECTION 19 OF TITLE 15 OF THE BANKING REFORM ACT OF 1971

Section 19 of Title 15 of the United States Code is amended by striking out the first paragraph and adding in its place the following:

"No person holding an executive position in any financial instiution shall be at the same time a person holding an executive position in any other financial institution; but the foregoing prohibition shall not apply in the case of any one or more of the following:

"(1) A financial institution, more than 90 per centum of the stock of which is owned directly or indirectly by the United States or by any corporation of which the United States directly or indirectly owns more than 90 per centum of the stock.

"(2) A financial institution which has been placed formally in liquidation or which is in the hands of a receiver, conservator, or other official exercising similar functions.

"(3) A corporation principally engaged in international or foreign banking or banking in a dependency or insular possession of the United States which has entered into an agreement with the Board of Governors of the Federal Reserve System pursuant to Section 25 of the Federal Reserve Act or which is organized under Section 25(a) of the Federal Reserve Act.

"(4) An individual insofar as he holds an executive position in two or more such institutions not located and having no branch in the same city, town, or village, or in any city, town, or village contiguous or adjacent thereto; provided, however, that any individual who holds an executive position in any holding company or financial institution which is a subsidiary of a holding company shall not also hold an executive position in any other financial institution not a subsidiary of such holding company in a city, town, or village in which any other financial institution which is a subsidiary of the same holding company is located, or in any city, town, or village contiguous or adjacent thereto; and provided further that no individual shall hold an executive position in two or more financial institutions, each of which has more than $ in total assets, regardless of where located, unless the Board of Governors of the Federal Reserve System waives the prohibition in this proviso, upon a showing by such financial institutions that they operate in separate markets and that such waiver will not result in decreased or unfair competition, conflicts of interest; or unsound banking practices.

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"(5) An individual insofar as he holds an executive position in two or more financial institutions both or all of which are subsidiaries of the same holding company.

"(6 An individual insofar as he holds an executive position in two or more financial institutions, more than 50% of the common stock of both or all of which is collectively owned directly or indirectly by the same persons who each individually own directly or indirectly at least —% of the common stock of each such financial institution.

"(7) An individual insofar as he holds an executive position in any financial institution, and any other financial institution more than —% of the stock of which has been acquired by the former financial institution in securing or collecting a debt previously contracted in good faith.

"The Federal Deposit Insurance Corporation may exempt any individual or financial institution from any of the foregoing prohibitions, if in its judgment such exemption is in the public interest. In determining whether an exemption is in the public interest, the Federal Deposit Insurance Corporation shall consider whether the benefits to the public outweigh possible adverse effects to the public."

and it is further amended by adding the following as the last paragraph of this Section:

"As used in this Section:

"(1) The term 'holding company' means any bank holding company as that term is defined in the Bank Holding Company Act of 1956 or any savings and loan holding company as that term is defined in Section 408 of the National Housing Act;

"(2) The term 'subsidiary' means (a) with reference to any bank, a bank which is controlled by a bank holding company within the meaning of the Bank Holding Company Act of 1956; (b) with reference to any savings and loan association, a savings and loan association which is controlled by a savings and loan holding company under the terms of the National Housing Act;

"(3) The term 'financial institution' means any institution insured under the Federal Deposit Insurance Act or which is an insured institution as defined in Section 401 of the National Housing Act; and

"(4) The term 'executive position' means a director, or an officer or employee who exercises executive functions or a partner in any private bank."

PROPOSED AMENDMENT TO SECTION 18 OF THE FEDERAL DEPOSIT INSURANCE ACT

Section 18 of the Federal Deposit Insurance Act (12 U.S.C. 1828) is amended by adding at the end thereof a new subsection, to be subsection (k) to read as follows:

"(k) No insured bank shall accept or receive any deposit on the condition that it pay or agree to pay compensation for obtaining such deposit to a broker, finder or other person, if there shall be an understanding, express or implied, with such broker, finder or other person in connection with the acceptance or receipt of such deposit, that such bank shall make a loan, discount or other extension of credit to any person, co-partnership, association or corporation. Any violation by an insured bank of the provisions of this subsection or of regulations issued hereunder shall subject the bank to a penalty of not more than 10 per centum of the amount of the deposit to which the violation relates. The Corporation may recover the penalty, by suit or otherwise, for its own use, together with the costs and expenses of the recovery."

EASTMAN KODAK CO.,
Rochester, N.Y., May 19, 1971.

Subject: H.R. 5700, The Banking Reform Act of 1971.

Hon. WRIGHT PATMAN,
House Office Building, Washington, D.C.

Dear SIR: I should like strongly to urge the elimination from this Bill of the prohibition against "interlocks" except those between commercial banks, savings banks and savings and loan associations. The prohibition as drafted would likely remove from service on Boards of Directors of banks and industry the

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people most qualified to add to the quality of management without any compensating advantages.

I will not elaborate in the belief that the issues have already been well presented to the House Banking & Currency Commission; and repetition here would serve no further purpose.

Very truly yours,

HARMAR BRERETON,
Vice President and General Counsel.

GREATER HARTFORD CHAMBER OF COMMERCE,
Hartford, Conn., May 19, 1971.

Hon. WRIGHT PATMAN,
Chairman, Banking and Currency Committee,
House of Representatives,
Washington, D.C.

DEAR MR. PATMAN: The Board of Directors of the Greater Hartford Chamber of Commerce on May 12, 1971 adopted a resolution opposing the Banking Reform Act of 1971.

In the opinion of the Chamber, the bill is both unnecessary and punitive. We feel that the prohibition of interlocks would be disruptive in a small community such as Hartford.

It is our opinion there is strong and vigorous competition among the financial institutions of Hartford and that interlocks do not interfere with this competition. One of the most adverse sections of the act is Section 14 the prohibition against equity participation by financial institutions.

Enclosed for your information is a copy of the Chamber's resolution.

Cordially,

ARTHUR J. LUMSDEN, *President.*

POLICY STATEMENT RE: BANKING REFORM ACT OF 1971

Congressman Patman's Banking Reform Bill is, in the opinion of the Greater Hartford Chamber of Commerce, both unnecessary and punitive.

The mechanical prohibition of interlocks would be particularly disruptive in a smaller community such as Hartford. Although one of the larger capital markets in the country, Hartford is 49th in size among metropolitan areas. Because of the number of large companies which have their headquarters here, interlocks are much more difficult to avoid than in such communities as New York or Los Angeles.

There is no indication of coercive or monopolistic practices, nor does there appear to be any evidence of any other kind of anti-competitive practice in Hartford. In fact, there would appear to be nothing in the Patman studies, aside from the mere citation of numbers of interlocks, to demonstrate even a potential for such practices. Yet, in the absence of any such findings, the proposed Act would prohibit an effective technique for sharing top management talent in the Hartford area and would thereby impede the selection of responsible and experienced leadership.

An interlock means nothing more than service on the board of more than one company. The Clayton Act presently provides for a means of dissolving interlocks where an adverse effect on competition could occur. We therefore believe that the Clayton Act can dispose of any problem which might arise in the area of interlocsk among financial institutions.

Section 14, the prohibition against equity participation by financial institutions is in our opinion the most adverse section of the Act. This section would greatly complicate the already difficult task of financing the renewal and replanning of the Greater Hartford area that has been undertaken by the Greater Hartford Corporation.

The basic purpose of the Greater Hartford Corporation is to serve as the private enterprise arm of a community-wide effort to prepare Greater Hartford for the future. The Greater Hartford Corporation is spearheading the application of systems analysis to solving urban problems. It is based on recognition that the problems of housing, transportation, education, public health, recreation, public safety, pollution and municipal solvency transcend municipal boundaries and can only be resolved by an area-wide effort.

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The Greater Hartford Corporation has already invested three years and over three million dollars by Hartford business in the study of this problem. It has been apparent from the start, that financing of the total effort would be extremely difficult. The development arm of this DevCo, is seeking a capitalization of $30 million which would serve as equity money to initiate the process, recognizing that an equity of probably $200 million will be needed ultimately with perhaps $800 million of long-term financing.

Section 14 would place our financial institutions, local and foreign, in a situation where they could either provide equity money or debt money but could not combine them. Yet, neither is a viable alternative. As a result, because of a legal peculiarity that two things, each of which are perfectly legal, become illegal when done together, the millions of dollars of financing which will be necessary will not be available.

The need for such vast sums of money is clear. It is our view that today's urban problems can best be resolved by permitting the undercapitalized building and development businesses to undertake projects of a size and scope that will permit adequate provision of amenities, of open space, of environmental features: incorporating modern planning and development practices. Only if equity funding is permissible will the progress of the Greater Hartford Corporation and other such corporations come to fruition. We hope Congress will permit this to happen.

For these reasons, the Greater Hartford Chamber of Commerce voices its strong opposition to H.R. 5700, the Banking Reform Act of 1971.

INVESTMENT BANKERS ASSOCIATION OF AMERICA,
Washington, D.C.
ASSOCIATION OF STOCK EXCHANGE FIRMS,
New York, N.Y., May 21, 1971.

Hon. WRIGHT PATMAN,
Chairman, House Committee on Banking and Currency, Rayburn House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: This letter is being submitted by the IBA–ASEF Legislative Council for inclusion in the record of your hearings on H.R. 5700, the Banking Reform Act of 1971.

The IBA–ASEF Legislative Council was created recently by the Investment Bankers Association of America and the Association of Stock Exchange Firms to speak with a united voice on legislative proposals which affect the securities industry.

In reference to the various sections of H.R. 5700 we take the following positions:

1. On provisions to prohibit interlocking relationships with any one corporation with respect of which a financial institution holds in the aggregate more than 5% of any class of stock of such corporation (Section 8), we urge that such a provision not apply to any broker or dealer registered under the Securities Exchange Act (which would include investment banking firms advising and underwriting corporations) because (a) in many cases a corporation and the public benefit by having a representative of the investment banking firm on the board of a corporation in which the investment banking firm holds a block of stock, particularly in developing new venture capital companies and (b) it is essential for such brokers or dealers to hold securities in their name to permit operation of central clearing facilities which have been developed to expedite transfer of securities.

2. On provisions to prohibit any lenders (defined to include any insurance company, F.D.I.C. insured banks, mutual savings banks or any bank holding company, savings and loan company or subsidiary of such holding company) from accepting any equity participation in the making of any loan (Section 14b), we strongly urge that such a provision not be adopted because the opportunity for a lender to obtain an equity participation has been beneficial to borrowers, particularly in times of high interest rates, in enabling borrowers to obtain funds at a lower interest rate or to obtain funds which might not have been available without such equity participation.

3. On provisions to require each insured bank to submit annually to the F.D.I.C. with respect to all securities (other than government securities) it holds in a fiduciary capacity certain lists and reports regarding those securities (Section 12), we note that the SEC *Institutional Investor Study Report* in March,

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1971 recommended that the Securities Exchange Act of 1934 be amended to provide the SEC with general authority to require reports of securities holding and transactions from all types of institutional investors. We recommend that the SEC proposal be adopted to permit collection of such information in a single federal agency, preferably the SEC.

4. On the provision to amend the Federal Deposit Insurance Act to prohibit an insured bank from holding more than 10% of any class of securities in a fiduciary capacity in any one corporation which has securities registered under the Securities Act of 1933, we support this provision to prevent any insured bank from assuming excessive risk in the stock of any one corporation and from controlling any corporation with securities. However, since many companies to which this should apply would not have securities registered under the Securities Act of 1933, we recommend that it apply to companies registered or reporting under the Securities Exchange Act of 1934, which would include listed companies and companies registered under Section 12(g) of that Act.

5. On provisions to prohibit interlocking relationships among certain classes of financial institutions (Sections 2, 3 and 4) and to prohibit interlocking relationships between financial institutions and corporations with respect to which such financial institutions manage an employee welfare or pension benefit plan (Section 7), we believe that control over such interlocking relationships should be effected, not by the proposed blanket prohibition of such relationships, but by provisions permitting some administrative flexibility by the agencies regulating the various classes of financial institutions, recognizing that certain prohibitions already exist under Section 8 of the Clayton Act and Section 32 of the Banking Act of 1933.

6. On the provision to prohibit interlocking relationships of insured banks or mutual savings banks with any corporation with which such institution has a substantial and continuing relationship with respect to the making of loans or extensions of credit (Section 9), to prohibit brokered deposits (Sections 19 and 20), and to provide for full deposit insurance on the account of any public funds of the United States or any state, municipality or subdivision thereof (Section 25), we take no position.

We very much appreciate your consideration of these views on this important bill.

Sincerely,

ALGER B. CHAPMAN, Jr.,
President, Shearson, Hammill & Co. Inc.
ROBERT M. GARDINER,
Managing Partner, Reynolds & Co.

THE D. C. BURNS REALTY & TRUST CO.,
Denver, Colo., May 20, 1971.

HON. WRIGHT PATMAN,
The House of Representatives, The Banking and Currency Committee, Rayburn House Office Building, Washington, D.C.

DEAR SIR: In regard to Banking Reform Act of 1971, H.R. 5700, I wish to make the following comments.

I strongly concur with witnesses who have testified before the committee that the governing bodies presently have sufficient authority to protect the banking and financing industry in cases of conflict of interests, and steps should be taken through these agencies where necessary rather than a broad, all encompassing legislation as provided in H.R. 5700.

I particularly see no reason for the inclusion of real estate companies and insurance companies as set forth.

I also wish to express my opposition to the proposed limitation on equity participation. I have been a member of the National Association of Real Estate Boards and a charter member of the National Association of Home Builders, but do not agree with the position taken by both of these organizations.

I have attempted to arrange financing for my own properties during the last few years, and the only funds available, granted, were where a participation was to be a part of the deal. I decided not to accept said financing, but at least I had a choice. I am fully satisfied that, if participations had been prohibited, there would have been no funds available for multiple housing projects in the last several years. At least it was possible to obtain financing for multiple hous-

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ing programs while it was almost impossible to obtain any kind of funds for FHA and GI loans.

Very truly yours,

FRANKLIN L. BURNS.

(The information requested by Hon. William B. Widnall from Dr. Arthur F. Burns on page 288 for a suggested form of an amendment to H.R. 5700 follows:)

REPLY FROM DR. ARTHUR F. BURNS TO REQUEST OF HON. WILLIAM B. WIDNALL FOR A SUGGESTED FORM OF AN AMENDMENT TO H.R. 5700

Page 2, strike line 2 and all that follows through page 13, line 11, and insert in lieu thereof the following:

SEC. 2 (a) *Definitions and rules of construction.*

(1) The definitions and rules of construction set forth in this subsection apply for the purposes of this section.

(2) The term "depositary", used with reference to any organization except a holding company, characterizes it as a bank, a savings bank, or a savings and loan association.

(3) The term "depository holding company" means a bank holding company as defined in section 2(a) of the Bank Holding Company Act of 1956 or a savings and loan holding company as defined in section 408(a)(1)(D) of the National Housing Act.

(4) The characterization of any corporation (whether a depositary institution or not) as an "affiliate" of, or as "affiliated" with, any other corporation means that

(A) one of the corporations is a depositary institution and the other is an affiliate thereof, or both corporations are affiliates of the same depositary institution, as the term "affiliate" is defined in relation to a member bank by section 2(b) of the Banking Act of 1933 (12 U.S.C. 221a(b));

(B) one of the corporations is a depositary holding company and the other is a subsidiary thereof; or both corporations are subsidiaries of the same depositary holding company, as the term "subsidiary" is defined in section 2(d) of the Bank Holding Company Act of 1956 or section 408(a)(1)(II) of the National Housing Act; or

(C) more than 50 per cent of the voting stock of one corporation is owned in the aggregate by one or more persons who would also own more than 50 per cent of the voting stock of the other corporation if no person's ownership of any voting stock of either corporation were taken into consideration to the extent that it exceeds, as a percentage of all outstanding voting stock of that corporation, twice the percentage owned by that person of all outstanding voting stock of the other corporation.

(5) The term "management official" means an employee with management functions, an officer, or a director, or any person who has a representative or nominee serving in any such capacity.

(6) The term "office", used with reference to a depositary institution, means either a principal office or a branch.

(7) Nothing in this section authorizes any relationship otherwise prohibited by section 8 of the Clayton Act (15 U.S.C. 19) or any other provision of law.

(b) *Large institutions.*—A management official of a depositary institution having total assets exceeding $1,000,000,000 may not serve as a management official of any other depositary institution not affiliated therewith and having total assets in excess of that amount.

(c) *Geographical proximity.*—A management official of a depositary institution may not serve as a management official of any other depositary institution not affiliated therewith if, within any area comprised of any city, town, or village and any adjoining city, town, or village there are located an office of one of the institutions or any depositary affiliate thereof and an office of the other institution or any depositary affiliate thereof; except that this prohibition does not apply during any period not exceeding six months' duration when, according to the records of both institutions, they are giving active consideration to their merger or consolidation, or to purchase of a substantial portion of the assets and assumption of a substantial portion of the liabilities of one by the other.

(d) *Competition with nondepositary corporations.*—A management official of a depositary institution having capital, surplus, and undivided profits aggregating

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more than $1,000,000 may not serve as a management official of any corporation not affiliated therewith which is not a depositary institution and which has capital, surplus, and undivided profits aggregating more than $1,000,000 if that corporation is in a position to engage in such substantial competition with the depositary institution that the elimination of competition by agreement between them would constitute a violation of the Act of July 2, 1890 (the Sherman Antitrust Act), the Act of October 15, 1914 (the Clayton Act) or any other Acts in pari materia.

(e) *Depositary holding companies.*—The prohibitions of subsections (b), (c), and (d) on service by a management official of any given depositary institution also apply to service by any management official of any depositary holding company with which it is affiliated.

(f) *Penalty.*—Whoever willfully and knowingly violates any provision of subsection (b), (c), (d), or (e) of this section shall be fined not more than $5,000.

CONFORMING AMENDMENT TO EFFECTIVE DATE PROVISIONS, H.R. 5700

Page 27, strike lines 13 through 16 and insert:

(b) Section 2 and the amendments made by section 13 become effective on the first day of the fourth calendar year which begins after the date of enactment.

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