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In News Rel
Not in
Speeches

Some months ago, when we settled upon the topic for this talk--"Financial Restructuring Under the Nixon Program"--I anticipated that I might be able to report with some clarity the prospects for the Hunt Commission recommendations and followup Administration proposals. Since that time, the immediacy of the oil crisis, runaway inflation, skyrocketing interest rates, and debates over when a recession is not a recession have obscured the underlying issue of institutional reform. To compound matters, the continued existence of the Nixon Administration itself has been threatened. With the attention of Congress and, to a lesser extent, the rest of Government focused upon that drama for weeks and perhaps months to come, one can indulge only in personal speculation and I certainly cannot present any authoritative statement of Administration policy.

With that in mind, rather than focus specifically on the Administration package, I would like to do three things in the few minutes that I have with you. First of all, I do want to report to you what seem to me to be some of the factors that will affect the course of financial restructuring in the near future. Second, I want to bring to your attention an issue which is likely to be the subject of regulatory action and Congressional attention in the coming months--how to best curb the abuses of self-dealing. This matter is of particular concern to us at the FDIC as we view the wreckage of U.S. National Bank in San Diego. Finally, I intend to take the liberty of preaching to you just a bit regarding the stance which bankers and their associations must take with respect to reform if banks are to remain preeminent among this country's financial institutions.

The Hunt Commission was formed in February 1970, with a broad charge to study financial structure and regulation. As you know, our own Rex Morthland was among its 20 distinguished members. In December 1971, the Commission reported its findings to the President. Not until last Fall were the Administration's legislative proposals forthcoming, when Senators Sparkman and Tower introduced S. 2591 entitled "The Financial Institutions Act of 1973" on behalf of the President. I need not review for you the substance of either set of recommendations. Suffice it to say that the Hunt Report made 89 recommendations and the Financial Institutions Act encompasses 39.

The bill was referred to the Senate's Financial Institutions Subcommittee chaired by Senator Thomas J. McIntyre. Almost immediately after the bill was introduced, the American Bankers Association indicated that it would not support the bill so long as it provided for the ultimate elimination of Federal Reg. Q authority. One by one, the various industry interest groups spoke out, each voicing opposition to one facet or another of the legislation. On November 6, 1973, three days of informational hearings commenced during which the Subcommittee received testimony from each of the Federal agencies responsible for the regulation of our financial system. At that time, Senator McIntyre cited "the resistance to these proposed changes... by several of the trade associations representing various types of financial institutions," and indicated that the Subcommittee would hold "intensive and in depth hearings" during 1974.

The first round of these further hearings will be held next week, beginning Monday, May 13, with testimony from the representatives of state regulators, the Conference of State Bank Supervisors and the National Association of Savings and Loan Supervisors. During the remainder of the week the Subcommittee will hear from the various industry trade associations, including the American Bankers Association and the Independent Bankers Association on Tuesday, the U.S. League of Savings Associations and the National Savings and Loan League on Wednesday, the Credit Unions National Association and the National Association of Federal Credit Unions on Thursday, and the National Association of Mutual Savings Banks on Friday.

It is anticipated that the Subcommittee will also devote a full week of hearings during June, July and August to obtain the views of consumers and other interest groups. Senator McIntyre has indicated that they would range broadly beyond the specific recommendations contained in the proposed legislation or in the Hunt Report, stating:

> "...in examining the proposed changes contained in the Financial Institutions Act, the Subcommittee will address itself to a number of other important areas such as: chartering, branching, one bank holding companies, interlocking directorates, mergers, and an array of other aspects contained in the phrase 'financial institution.'"

The Subcommittee's schedule, the breadth of its inquiry and conversations on the Hill indicate that certainly no bill could be reported out of Committee in time to be considered by this session of Congress.

The content and fate of any such legislation is impossible to predict at this moment. It is possible, however, to identify some of the factors which will be operative and to speculate as to their possible long and short-range effects on financial restructuring.

One early indication of the prospects will be provided by Subcommittee hearings next week. Last Fall, reacting true to form, each of the various industry groups announced strong opposition to those portions of the bill which seemed to eliminate some advantage or to allow another kind of institution greater flexibility. This, of course, ignored the fact that both the Hunt recommendations and the bill introduced by Senators Sparkman and Tower constituted comprehensive and balanced packages. If the intransigence of the Fall continues, then the cause of comprehensive restructuring faces rough sledding indeed. If, on the other hand, the hearings reflect some reasonable movement toward compromise on the part of industry groups, the prospects for a comprehensive piece of legislation during the 94th Congress will be significantly improved.

I note as a strong positive factor the remarks of Senator Tower at the CSBS Conference at Williamsburg three weeks ago. There, the Senator pointed to an "increased propensity on the part of Congress" and in his view "particularly the Senate", "to deal with problems as a whole rather than piecemeal." Similarly, Senator McIntyre also has indicated his strong belief that this is the appropriate way to proceed and that it is his Subcommittee's intention to so proceed. If the Subcommittee is supported in this regard by the Banking Committee and the Senate as a whole, industry groups, bankers, and, I might add, the regulatory agencies will be forced to broaden their horizons.

On the other hand, ongoing pressure for piecemeal action will test Senator McIntyre's and the Committee's mettle in this regard. Whatever their merits, proposals now before Congress providing for mandatory reserve requirements, a recommendation of the Hunt Commission, and one hundred percent coverage of public funds are both glaring examples of the piecemeal approach. Moreover, the present "credit crunch," with the resultant drying up of mortgage funds, is likely to provide significant impetus for some sort of legislation to relieve the housing industry. Plainly illustrating the need for Hunt-type reform, such dislocation tends to produce the sort of "band-aid" response that the Hunt Commission warned against.

Overlaying all this is the fact that we are in the midst of one of the most uncertain periods in our Nation's political history. Certainly, nothing of significance, except in response to serious crisis, is going to take place legislatively until Congress has dealt with Mr. Nixon's guilt or innocence.

Other political events of coming weeks and months may have a strong bearing on financial restructuring. I think you are all aware of the implications of the race for the Senate in Arkansas. Moreover, the anti-incumbent feeling which appears to be at work there is likely to carry over into the Fall elections, creating a significant turnover in the House and, to a lesser extent, in the Senate as well.

Finally, the outcome of the proposals for financial restructuring will be affected by interaction of the proponents of the Administration proposal and Hunt-type recommendations with consumer interests and those seeking remedy of specific abuses in banking and other financial areas. House Democratic leadership has indicated that it does not intend to hear testimony on the Administration bill since extensive hearings were held in September 1973 before the House Committee on Banking and Currency. While not necessarily expressing the views of the Subcommittee or its members, the staff report of the Subcommittee on Domestic Finance entitled "Financial Institutions: Reform and the Public Interest" is instructive. In addition to looking at the restructuring of the Federal regulatory agencies and the powers of thrift institutions, the report discussed, among other issues not addressed in the Hunt recommendations or the Administration package, the management and regulation of trust and pension funds, the allocation of credit for priority purposes, and bank holding companies.

House leadership, especially Mr. Patman, is likely to show a lack of interest in dealing seriously with what are considered to be industry proposals unless bankers evidence a parallel interest in addressing reform issues addressed in the House report. I note, also, that a wave of newly-elected Congressmen is likely to reinforce such sentiment and that this perspective is not without support within the Senate. The responsiveness of industry groups to issues of reform not dealt with in the Hunt recommendations could well affect when and in what form financial restructuring occurs.

In this regard, I noted with special interest remarks made by Senator McIntyre last November regarding the failure of U.S. National Bank in San Diego. The Senator stated:

> "Recent events have brought into focus a number of deficiencies existing in our present system. One can well ask how in our present regulatory scheme the 83rd largest commercial bank in the country can suddenly be placed in receivership.
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> "With all the intricate checks and balances that have been developed over the years, we have still experienced the largest single bank failure in the history of this country."

The question posed by Senator McIntyre can be separated into two questions: What caused a respected billion dollar bank to become insolvent? And why were the bank's difficulties not discovered more quickly? It seems to me that we as bankers and regulators must be prepared to answer these questions and, in addition, face certain underlying issues illuminated by the failure.

Why USNB became insolvent is relatively simple. In the colorless but accurate language of our Liquidation Division:

> "The cause of closing was loss classifications exceeding capital involving principally extensions to persons and entities controlled by or associated with the controlling stockholder and former Board Chairman."

In effect, U.S. National Bank was not one, but two banks. One was an apparently sound and efficient institution serving the San Diego public. The second provided credit to enterprises related to or affiliated with the dominant stockholder, ignoring both sound banking practices and regulatory requirements. Involving 200-300 corporate entities, these transactions involved between $400 and $450 million. They often were not handled in the ordinary course of the bank's business, but, instead, were processed by certain insiders. The second banking operation that existed in the San Diego offices of the U.S. National Bank was accurately described by Jim Smith when he termed it a "riot of self-dealing."

If U.S. National were the only indication that self-dealing constitutes a serious problem, it might be dismissed as an aberration. This is not the case. On January 25, 1971, the Sharpstown State Bank in Houston, Texas, with assets amounting to approximately $81 million was closed. It was at that time the second largest failure in FDIC history. The primary cause was the self-serving activities of a dominant shareholder.

Three weeks later it was dropped to third place by the failure of Birmingham-Bloomfield, until USNB, the largest failure of an FDIC-insured bank. Here, self-dealing was combined with an unsafe and unsound investment policy dictated by the dominant shareholder. For the same reason, Detroit's Bank of the Commonwealth, with combined deposits of just over $1 billion and total assets of $1.26 billion, would have failed in 1972, but for an infusion of $35.5 million in capital funds by the FDIC. While the billion dollar Bank of the Commonwealth was not allowed to fail, it underscored the lessons of Sharpstown and Birmingham-Bloomfield and served as a warning that a respected billion dollar bank might become insolvent.

A review of our Liquidation Division statistics reveals that self-dealing as an important causative factor is not limited to the spectacular bank failure. Since January 1, 1960, 63 banks have failed. Among these, self-serving transactions were a significant factor in 37, or 58.8%, of the cases. Defalcations, embezzlements and manipulations caused 20, or 31.7%, of the failures, while managerial weakness in loan portfolio management accounted for only 6, or 9.5%. A quick review of our "Problem Bank" files reveals much the same pattern. Seventy-five percent of the cases classified "Serious Problem - Potential Payout" and 54% of those classified "Serious Problem" reflect self-serving practices on the part of management or controlling interests.

Standing alone, evidence of insider transactions as a primary factor in failed and problem banks indicates the need for innovation in our approach to the abuses of self-dealing. Cause for concern does not end here, however, The consequences of self-dealing in healthy banks are similarly pernicious.

Although I know of no study or survey indicating the extent of "self-serving" transactions, I do know that the potential for abuse is large and not limited to preferential treatment in the extension of loans. Our Board has reviewed a number of cases in recent weeks requiring corrective action in the face of sweetheart leases, premiums paid or discounts made in the purchase or sale of assets and exorbitant fees for management, consulting or attorney fees.

The harm which flows from such transactions should not be ignored. Where, either because an insider or insider group is dominant or because of the inattention, logrolling or tolerance of board members, an insider exacts terms not available to the public, then the bank is necessarily adversely affected. This is true whether or not the insider consciously intends to milk his bank. Many of the abuses in this area flow from a fact of economic life aptly described by Professor E. Merrick Dodd in 1940 in testimony before the Senate Banking and Currency Committee. He said:

> "Now a man may be on both sides of a bargain and still be honest, but a man cannot be on both sides of a bargain without having his judgment affected by that fact."

Whether the result of conscious overreaching or tainted judgment, the economic benefit which redounds to the insider represents a cost or loss of earnings which is borne by non-benefitting shareholders and in some way passed through to the consumer.

In my view, any transaction between an insider or his interests and a bank which is significantly more favorable to the insider than a comparable transaction with a non-insider is not a sound banking practice and should, within the limits of our resources, be the subject of firm supervisory action. To follow any other policy is to allow banks to subsidize the non-banking financial activity of preferred insiders at the ultimate expense of minority or non-interested shareholders and, in the case of bank failure, at the expense of many creditors and depositors as well.

While it is difficult to evaluate its impact, a second consequence flows from allowing a bank's fiduciaries to exempt themselves from the discipline of the market. Not only are a bank's assets often wasted but the allocation of a community's resources as represented by the bank's deposits can be mis-allocated or allocated irrationally. The construction and operation of the Westgate Plaza Hotel, said by many to be one of the finest hotels in the world, is illustrative. Capital costs per room have been estimated at more than $100,000 and the operation was lavish to say the least. For example, a fresh pineapple was placed in the room of each guest at what was found to be a cost to the hotel of nearly $10 per pineapple. It is, I assure you, a very fine hotel. It was, however, not a sound business enterprise, and it is highly doubtful it would have been built or run as it was, but for the fact that USNB and other enterprises related to the interests of the dominant shareholder stood ready to, and did, subsidize the operation of the hotel.

I might add that we at the FDIC have noted with some interest the suit filed by Mrs. C. Arnholt Smith to foreclose a mechanics lien in the amount of $222,502 for services which she rendered in decorating the Westgate Plaza Hotel and a smaller hotel built by Smith corporations.

Finally, it seems to me that overreaching of the sort seen at USNB, at Sharpstown, and at Birmingham-Bloomfield are manifestations of the malady which troubles the present Administration and business in general. In the financial and political arenas, powerful and respected individuals have ignored legal, institutional and ethical restraints in their drives for power or profit.

Fundamental institutional questions are at stake--questions which may have been laid aside for the moment's expendiency. Commercial banks are chartered to serve a specific banking function in the economy. In the competitive free enterprise system, profit and compensation should flow to bankers as a result of their effectively carrying on the business of banking and not from their use of the institution to gain economic advantage which could not be gained independently. As we have seen where legal and institutional arrangements are avoided, distortions occur which may range from the failure of a billion dollar bank to a slight loss of earnings in a small state bank. Whether the consequence is large or relatively small, it seems to me that there is a strong societal interest in insisting that bankers as well as politicians play by the rules of the game.

What more, then, might be done to protect this interest, whether through earlier discovery of the abuse or deterrence of its occurance?

There are two general approaches which might be taken. On one hand, transactions between a bank and an insider and his interests might be forbidden or significantly limited. This approach does not attempt to place the insider on equal footing with the non-insider. Not only is the insider's advantage vis-a-vis the public at large eliminated, but he is placed at a disadvantage.

The second approach would insure that insiders derive no benefit in transactions with their bank that is not available to non-insiders. In essence, this is the approach which is presently followed at the FDIC, and it is the one which I favor. However, there are a number of ways in which supervision might be made more rigorous.

First, disclosure requirements might be greatly increased. Jim Smith has announced that the Comptroller's Office will issue for comment in the near future a proposal to require all national banks to maintain at their head offices a current list of all executive officers and directors reflecting their business affiliations. The stated objective is to enable bank examiners to more readily detect instances of self-dealing. This, of course, reflects an effort to address the question as to why the plight of U.S. National Bank was not discovered earlier.

Efforts in this area could go significantly further including, for example, the requirement that all or a certain class of insider transactions be reported to the supervisory agency; the additional requirement that information demonstrating its fairness also be provided; and requirements that all or a certain class of such transactions be disclosed in call reports or along with other disclosures made under the Securities Laws. To insure the effectiveness of such requirements the agencies must demonstrate the clearcut intention to impose criminal and civil sanctions when these requirements are not complied with.

Second, the supervisory agencies might make plain through interpretive regulations that corrective action will be taken where insiders or their interests receive benefits from their dealings with banks that are not generally available. At this juncture, I should note that the FDIC Board does presently take such corrective action when presented instances or overreaching in applications of the various sorts. With comprehensive disclosure requirements such as those I have mentioned, this policy might be applied more systematically. In cases where voluntary compliance is not forthcoming, prompt enforcement action is necessary. A cease and desist order under Section 8 (b) of the Corporation's Act is an effective vehicle for such enforcement.

Finally, emphasis should be placed on educating members of bank boards as to their responsibilities and liability for such transactions and on assuring that they have sufficient information to adequately oversee their banks' transactions. Ultimately, the most effective check on abuses by insiders is the Board of Directors with sufficient information, independence and inquisitiveness to effectively scrutinize and pass upon a bank's dealings with insiders. The agencies might, for example, require that the directors approve all or certain classes of insider transactions and that each keep a file containing the information on the basis of which approval was voted. This, coupled with a demonstrated willingness on the part of the agencies to hold directors accountable in this area, might go a long way toward elimination of abuse.

I have focused upon the issue of insider transactions because the failure of U.S. National Bank does insure that it will be a focus of concern in the debate over financial restructuring. Moreover, it is illustrative of the sort of issues which bankers and bank regulators should come to grips with before they are forced to do so, whether by Congressional or public pressure.

It seems to me that there are at least two prerequisites for obtaining the sort of comprehensive legislative package necessary to insure that banks profitably and more efficiently serve public needs with minimum governmental restraint. One is a willingness of its proponents to enter into a dialogue with and address the questions raised by critics of the banking industry. We in the industry have all too often responded to criticism and close scrutiny with defensive reactions.

This posture, it seems to me, ignores two fundamental realities. The case made by the critic is often a strong one containing many points with which we agree. Where this is so, the public and industry as well are best served by creative interaction rather than political infighting. Secondly, it is a political fact of life that such critics often wield substantial power. The career of Mr. Patman is certainly an example with which we are familiar. Moreover, given the increasing number and effectiveness of consumer and other public interest groups and given the political trends which I mentioned earlier, a failure to respond to and work with rather than against these interests will make very difficult the task of the industry in advancing its legitimate and pressing concerns in Congress.

The second prerequisite is a willingness on the part of industry groups, both commerical banks and thrift institutions, to give up apparent immediate competitive advantages in the interest of a healthier and more stable financial environment--one in which all can compete and serve the public more effectively. Without acceptance of this principle, industry groups, fighting one another, will stymie a comprehensive program of financial restructuring.

To my mind, continued opposition to comprehensive restructuring is short-sighted in the extreme. It ignores the economic reality that changing consumer needs will inevitably lead to market restructuring and that, in the long run, the basic question is whether that change will be orderly and balanced or uneven and disruptive.

It is not difficult to illustrate the ways in which drastic and unmanaged restructuring can occur. First of all, recent events in Lincoln, Nebraska, demonstrate the impact of technology on our structure of competition. Through the use of EFTS, a S&L savings account has effectively been converted into a checking account. Whether or not the courts approve of this innovation, the further impact of computer technology on the business of financial institutions will be staggering.

Second, the recent report, "Competition in Financial Services," prepared for First National City Bank by Cleveland Cristophe demonstrates the extent to which nonfinancial institutions, operating in a generally unregulated environment, are competing with increasing success in areas traditionally thought to be the province of the regulated financial institutions. The principle that all institutions offering the same financial service should be subject to essentially the same regulatory constraints would seem to apply equally well to nonfinancial institutions offering banking services. Failing to accept and fight for broad application of this principle, the regulated institutions may win legislative battles but loose the war.

Finally, if flexibility is not built into the system, inevitably there will be dislocation, such as the present scarcity of mortgage funds with its resulting impact on the housing industry. When such dislocation is prolonged or pronounced, Federal intervention will result, either in the form of a program or piece of legislation designed to respond specifically to the crisis at hand. Equally inevitably, account is not made for the impact of the response on other segments of the system or of the impact of the response under changed economic conditions. Moreover, once a Federal program is established or an institution given a competitive advantage, that response will almost certainly outlive the need.

Thus, it seems to me that financial restructuring is upon us. The form that change will take will be determined largely by whether we build upon comprehensive recommendations, such as those made by the Hunt Commission, or continue to respond in piecemeal fashion to crises and dislocations as they occur.

In assessing the likelihood that restructuring will occur through carefully considered and balanced legislation, I am not yet prepared to discard the Hunt Commission. I am just enough of an optimist to think that the turmoil of the past year has brought home to responsible people the fact that we can no longer afford business as usual in either the political or economic sphere. I sincerely hope that this optimism is well-founded.

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