FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

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[Responsibilities and functions of bank directors]

Address By . . .

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Dr. Dobson and Mr. Moreman indicated that I might interpret the title, "Responsibilities and Functions of Bank Directors," somewhat broadly. I would like to take that license and discuss a specific problem faced by bank director and regulator alike--the matter of how best to curb abuse in transactions between a bank and insiders or their interests.

Before proceeding with that discussion, it is well to review the basic principles which define the responsibilities and functions of bank directors. The FDIC's Manual of Examination Policies, which provides guidance to our examination force, states:

> "In the final analysis, the board of directors is charged with the responsibility of the conduct of the bank. It is not expected to carry on the details of the bank's business; the details may be delegated to the bank's officers--but not delegated and forgotten. The power to manage and administer carries with it the duty to supervise. Thus directors must periodically examine the system of administration which they established to see that it functions; should it become obsolete, it should be modernized; should the bank's officers fail to function as intended, they should be replaced; and last but not least, the directors must supervise the conduct of the business of the bank."

This parallels the admonition of a Kentucky court in a case, Society v. Underwood, decided early in the 19th century. The court stated:

> "It is the duty of the board to exercise a general supervision over the affairs of the bank, and to direct and control its subordinate officers. The community has a right to assume that the board does its duty. They invite the public to deal with the corporation, and when anyone accepts the invitation he has a right to expect reasonable diligence and good faith at their hands, and, if they fail in either, they are responsibile for the result."

In essence, a director has a duty to supervise the business of his bank diligently and in good faith. Shareholders, depositors and creditors have the right to expect no less.

By examining a specific problem area, it is possible to see in concrete terms the meaning of these rather broad and abstract statements. I have also chosen to concentrate on the matter of insider transactions because the subject is likely to be the focus of regulatory and Congressional attention in the coming months and because there are, in my opinion, substantial reasons why such transactions should be subject to more rigorous board and regulatory discipline.

As you may be aware, the Comptroller has published for comment a proposed regulation requiring that records be kept of insiders' interests and dealings with their bank. At the FDIC, a committee of senior staff is actively working on the development of tools to curb abuses in this area.

The most dramatic impetus for official concern and action has been, of course, the role played by self-dealing in the failure of U.S. National Bank in San Diego last October. Opening hearings on the proposed Financial Institutions Act of 1973, last November, Senator McIntyre 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.
>
> "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 and addressed more quickly by Federal regulators or the bank's board? 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. USNB's insolvency resulted from the wholesale and unsound extension of credit to persons and entities controlled by or associated with the controlling stockholder and former board chairman. Or, in the words of Comptroller of the Currency Jim Smith, insolvency was largely the result of a "...riot of self-dealing."

In effect, U.S. National Bank was not one, but two banks. One, an apparently sound and efficient institution, served 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.

If U.S. National were the only indication that self-dealing constitutes a serious problem, it might be dismissed as an aberration. This, however, 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 then 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. Under the effective control of the same individual, 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 for the same reasons, had the FDIC not provided assistance in the form of a $35.5 million infusion of capital. While the billion dollar Bank of the Commonwealth was not allowed to fail, its plight 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 statistics reveals that self-dealing is not limited to the spectacular bank failure as an important causative factor. 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. As of last week, 60% of the cases classified "Serious Problem - Potential Payout" and 63% of those classified "Serious Problem" reflect self-serving practices on the part of management or controlling interests.

Standing alone, evidence that insider transactions are a primary factor in failed and problem banks indicates the need for special scrutiny of such transactions by boards of directors and for innovation in the agencies' approach to the abuses of self-dealing. Cause for concern does not end here, however. The consequence of self-dealing in healthy banks is similarly pernicious.

A bank is necessarily adversely affected when an insider exacts terms not available to members of the public. This is true whether the deal reflects a conscious intent to milk the bank or is merely the result of tainted judgment. In either event, the bank is harmed, since the economic benefit which redounds to the insider represents a cost or loss of earnings which is borne by non-benefiting shareholders and/or in some way passed through to the bank's customers.

For this reason, 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 not be tolerated by a bank's board of directors. Moreover, in my view, where such conduct is tolerated by a bank's board, it should 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 misallocated 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 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 that it would have been built or run as it was if USNB and other enterprises related to the interests of the dominant shareholder had not stood ready to, and did, subsidize the operation of the hotel.

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 financial and political arenas, powerful and respected individuals have ignored legal, institutional and ethical restraints in their drives for power or profit.

Fundamental institutional considerations are at stake -- considerations which may have been laid aside for the moment's expediency. 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 country bank. Whether the consequence is large or relatively small, 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 by bank supervisors to protect this interest? And, what are the responsibilities and functions of bank directors with respect to dealings between a bank and its fiduciaries?

Two general approaches might be taken by the banking agencies. On one hand, insider transactions of a certain kind or magnitude might be forbidden or significantly limited. This would not only eliminate the insider's advantage vis-a-vis the public, but also place him at a disadvantage. The second approach would seek to insure that insiders derive no benefit not available to non-insiders. In essence, this is the approach presently followed at the FDIC, and it is the one which I favor. However, supervision might be made more rigorous.

The Comptroller's Office has issued for comment a proposed regulation which would require all national bank directors and principal officers to keep on file at the bank a written statement of their outside business interests and of any extension of credit or other transaction between those interests and the bank. These statements of interest would be available for review by the national bank examiners, the bank's board of directors, management, lending officers, auditors and attorneys. According to the Comptroller's "Notice of Proposed Rule Making":

> "The purpose of this Regulation is to establish an informational base upon which bank management and the Comptroller's Office may assess more accurately the extent and manner by which a national bank may be engaging in transactions with its own directors and senior officers."

To insure effective regulation, disclosure requirements might go still further. For example, such disclosure requirements might include: (1) the requirement that information demonstrating the fairness of insider transactions be reported; (2) the inclusion of dominant or substantial shareholders among those required to make disclosures; (3) the requirement that self-dealing disclosures be made available to all stockholders; and (4) the requirement that all or a certain class of such transactions be disclosed in call reports or along with other disclosures made under the Securities Laws. The agencies might require board approval of all or certain insider transactions prior to consummation. 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.

In addition to the imposition and enforcement of disclosure requirements, the supervisory agencies should 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. The FDIC Board presently takes such corrective action when presented instances of 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 enforcement.

Such regulation would go far to curb overreaching and could, I believe, be accomplished with a minimum of interference with the conduct of a bank's business. Ultimately, however, the most effective check on abuses by insiders is a Board of Directors with sufficient information, inquisitiveness, and independence to critically scrutinize and pass upon a bank's dealings with insiders and their interests. While judicial pronouncements regarding directors' responsibilities and liabilities, such as my earlier quotation from Society v. Underwood, do not describe a mode of conduct which will apply to all circumstances, it is possible, I believe, to articulate certain guidelines which surely constitute good faith and reasonable diligence in the treatment of insider transactions.

First, a director should insist that he have adequate information to evaluate the soundness of the bank's dealings with insiders. Whether supervisory authorities require it or not, it seems to me that the bank's board should:

(1) Require the reporting of all significant interests of directors, officers, other key employees and substantial shareholders who are not members of the board;

(2) Require the reporting of all significant transactions between such individuals and the bank, including sufficient information on which to base an independent judgment with respect to the fairness of the transaction vis-a-vis the bank; and

(3) Require board approval of all or certain insider transactions and the establishment of procedures to insure the proper treatment of those for which approval is not required.

Second, in assessing a transaction between a bank and an insider, each director should satisfy himself that the transaction is a fair one and that the insider has not derived benefit at the bank's expense by virtue of his relationship to the bank. In making this judgment, it is well to recall the statement of the Supreme Court in the case of Pepper v. Litton. There, the Court addressed the matter of who must bear the proof in a court of law where an insider transaction was challenged. It seems to me that a director should engage in much the same critical exercise in his own review of an insider transaction. The Court stated:

> "A director is a fiduciary.... So is a dominant or controlling stockholder or group of stockholders.... Their powers are powers in trust.... Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein.... The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain."

I am aware that preferential credit terms or a premium paid for assets are often viewed as a means of supplementing the compensation of an insider or as one of the benefits of association with a bank. However, the standard to be applied should be that of the market and, where the party on the other side of a deal is an insider, a director should take special care to satisfy himself that the terms and conditions of the transaction are at least as favorable to the bank as they would have been had the deal been negotiated with a non-insider. Application of a less rigorous standard is, in effect, to allow a wasting of bank assets.

Finally, it is important to emphasize the necessity of each board member's exercising and expressing his own independent judgment. Whenever a bank director functions as a rubber stamp for management or controlling interests, or merely goes along with the majority as a result of reticence or ignorance, he has ceased to serve his institutional function and has thereby abdicated his legal responsibility. It has been said and I agree that there are times when a "director should risk his position to the extent of brinkmanship if he is to contribute to the welfare of the bank and to discharge his trust." Where dealings between a bank and insiders are involved, the need for such independence is compounded. It is well to recall that a common element in many major bank failures of recent years has been a single individual who dominated his board.

To summarize, it seems to me that there are three key elements involved in a director's adequately fulfilling his institutional role and satisfying his legal responsibilities. These apply not only to the evaluation of insider transactions but to all decisions made in the supervision of a bank's business.

-- he should insist upon sufficient information to make a considered decision;

-- he should analyze and question critically the information provided until satisfied that a given transaction or policy is in the bank's best interest;

-- and he should exercise and express independent judgment, not fearing to go on record as a dissenter.

In conclusion, I should emphasize that I do not mean to be a doomsday prophet nor to suggest that insider transactions are bad per se. On the contrary the vast majority of such relationships are more than fair to the bank concerned. Indeed, in many communities, dealings between a bank and its directorate are the life blood of the institution. At the same time, we must recognize that overreaching does occur, whether the result of tainted judgment or dishonesty, and that its impact can be severe, as it was in San Diego.

As I have outlined, we do have the tools, which can be employed without undue burden, to better insure that abuse is minimized and that the public does not come to believe that conduct such as that which occurred at USNB is standard operating procedure for bankers. It seems to me that the result of the imposition of these constraints will necessarily enhance public confidence in more efficient financial institutions. In light of the attention focused at San Diego and economic uncertainty generally, it seems to me that the time is ripe to employ these tools.

Because we at the FDIC are actively considering these issues, I would greatly appreciate thoughts which you may have on the subject. I thank you for inviting me to share my thoughts with you.

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