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NEWS RELEASE

FOR IMMEDIATE RELEASE PR-50-74 (8-19-74)

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AUG 20 1974
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[What is expected of a bank director?]

Address By

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Before the

33rd Annual Texas Bankers Conference
Austin, Texas

August 20, 1974

Directors of Corps

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The question "What is Expected of a Bank Director?" and questions regarding the responsibilities of bankers and the banking industry generally have attained a significance unmatched since the nineteen thirties. In recent weeks, bankers have been accused of being "too greedy" by Kenneth Rush and warned against "financial adventuring" by Arthur Burns who expressed concern about "carelessness that has crept into our financial system." David Rockefeller has been quoted as saying, "...the situation is uncertain enough so that one shouldn't discard the possibility of panic."

While each statement was tempered by the belief that our banking system is fundamentally sound, they reflect a high level of concern on the part of knowledgeable men. Confidence in our financial institutions and the money markets has not been lost or even fundamentally shaken. There exists, however, a high degree of uncertainty about both the causes and cures of our economic difficulties. Moreover, certain markets and institutions or groups of institutions are under severe strain.

In this context, it is especially appropriate to discuss expectations with respect to the obligations and conduct of those who oversee operation of our nation's financial institutions and the standards which define those expectations. Confidence, the key to our economic system, does not flow primarily from the size of the FDIC's fund nor from the Fed's willingness to open the discount window--though these considerations do have their impact. Rather it is derived from the public's collective expectations about the soundness and integrity of these institutions.

One view of what is expected of corporate board members was articulated more than a decade ago by a prominent Englishman who himself sat on eight or nine such boards. Explaining to an audience of Yorkshire ladies just what a corporate directorship entails, he said:

> "No effort of any kind is called for. You can go to a meeting once a month--a car supplied by the company. You look grave and sage and on two occasions say 'I agree.' Say 'I don't think so' once, and if all goes well get $1,440 a year. If you have five of them it is total Heaven, like having a permanent hot bath."

If five directorships is "like having a permanent hot bath," the bliss of a certain Boston banker must have been beyond description. This elderly gentleman sat on 46 corporate boards--to the best of my knowledge the American and probably the world record.

The attitude of our English friend is by no means universal. Unhappily, however, it is a fair reflection of reality in some instances. Certainly, recent large bank failures offer evidence in this regard. At USNB, at Birmingham-Bloomfield, and at Sharpstown, an acquiescent board served to rubber-stamp the self-serving

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and unsound policies of a dominant individual. Moreover we are all aware of less extreme cases where board membership is viewed strictly as an honorary position; where directors are chosen solely for the business which they can bring to the bank; or where bank directorships are seen as a means of obtaining preferential treatment or inside information.

Membership on a bank's board should be considered an honor and the ability to attract or bring business to a bank may be a relevant factor in the choice of a director. However, these do not define the function of a bank director nor describe the important responsibilities which he assumes in joining a bank's board of directors.

These responsibilities have, of course, been the subject of countless conferences, speeches, and articles. The American Bankers Association's publication, The Bank Director, and the compendium published by the Comptroller of the Currency Duties and Liabilities of Directors of National Banks, make excellent textbooks for 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."

One of the best general expressions of the obligations of a bank director is that 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 responsible for the result."

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

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The practical application of these broad and somewhat abstract standards can be seen by examining a specific problem area. I have chosen to concentrate on the matter of insider transactions because it will be the focus of Congressional and regulatory attention in the coming months and because there are substantial reasons why such transactions should be subject to more rigorous board and regulatory discipline. In addition to describing guidelines which define the meaning of "due diligence" in this particular context, I shall suggest what I believe to be the appropriate regulatory response to the problem posed by abusive self-dealing. Finally, with this perspective, I shall make some general remarks regarding what the courts, the supervisory agencies, and most importantly, the public should expect of bank directors.

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. 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 the 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. The result was the largest single bank failure in the history of this country.

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 stockholder.

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

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$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 under a provision of the Act whereby the FDIC can assist a failing bank upon a Board finding that the bank is essential to the community which it serves. 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.

Statistics developed by our Liquidation Division reveal 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 portfolio management accounted for only 6, or 9.5%. A quick review of our "Problem Bank" files reveals much the same pattern.

Standing alone, evidence that insider transactions are a primary factor in failed and problem banks would indicate the need for special scrutiny of such transactions by board 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 redounding to the insider represents a cost or loss of earnings which is borne by non-benefiting shareholders and/or in some way passes through to the bank's customers.

For this reason, any transaction between a bank and an insider or his interests that is significantly more favorable to the insider than a comparable transaction with a non-insider is an unsound banking practice and should not be tolerated by a bank's board of directors. 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 nonbanking 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

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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 indicate that fundamental institutional considerations are at stake. 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 play by the rules of the game.

At this juncture 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.

Two general approaches might be taken by the banking agencies to curb abuse in this area. 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. In addition, it would require such individuals to report "material changes" (defined as changes of 25% or more) in their accounts or those of their interests. These statements of interest would be available for review by the national bank

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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."

The American Banker reports that the comments received by the Comptroller's office have "generally favored the main thrust of the regulation." For example, The Capital National Bank here in Austin pointed out:

> "...that virtually every recent bank failure in the United States has been directly or indirectly the result of some conflict-of-interest situation. It is unfortunate that the banking profession has not taken it upon itself to establish a code of ethics which would prevent such situations from recurring."

The American Bankers Association announced its "basic agreement" with the goals of the regulations, but proposed certain specific changes, emphasizing that "it is imperative on the part of the Comptroller to insure that bank directors and principal officers are not overly burdened with reporting this type of information."

As I have indicated elsewhere, I strongly support the promulgation of regulations aimed at curbing the abuses of self-dealing. To do otherwise is to ignore the lessons of recent banking history. I favor a somewhat broader approach than that of the Comptroller. At the same time, I agree with the ABA that reporting requirements should be kept at the absolute minimum consistent with effective regulation.

First of all, it seems to me that board approval should be required for all but the trivial or very routine insider transactions. At the same time it should be made plain through regulation that, based on the facts which I have enumerated, any transaction between an insider or his interests and a bank which, taking into account all the relevant circumstances, is more favorable to the insider than a comparable transaction with a non-insider is an "unsafe or unsound" banking practice within the meaning of Section 8 of the Federal Deposit Insurance Act.

The FDIC presently takes corrective action when overreaching is discovered in review of an application for branch approval, deposit insurance or one of the other applications which the Board must scrutinize. For example, a branch

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application reflecting a "sweetheart lease" between a bank and an insider or his interests will not be approved. With all insider transactions disclosed to supervisory personnel, this policy would be applied more systematically. Where voluntary compliance with the standard embodied in the regulation is not forthcoming, a cease and desist order under Section 8(b) of the Corporation's Act is an effective vehicle for enforcement.

Finally, I must admit that the question of disclosure and reporting requirements is a difficult one for me as a former banker. The privacy of individuals and the need to avoid costly and time-consuming reporting procedures must be balanced with the demonstrated need to curb abuse by insiders in this area. Great care should be taken to avoid creation of a complex set of disclosure procedures which become an end in themselves and do little to advance the ultimate end of the requirement. For example, the Comptroller's requirement that insiders report 25% changes in their own accounts or those of their interests is particularly troublesome. While the regulation is not overly complex, it would be extremely burdensome, requiring constant monitoring of numerous accounts and filing of supplemental reports, often several a month. Moreover, because such changes often occur seasonally or cyclically in the ordinary course of business, they are not reliable indicators of misconduct.

On the other hand, the nature and seriousness of the problem necessarily requires a certain amount of disclosure and reporting. The paramount need is that insiders be required to disclose their interests and that insider transactions should be flagged for examiner personnel and other individuals. In addition, I would require that board approval of insider transactions be supported by information recorded in the minutes demonstrating the fairness of the transaction and that such information be readily available to examiner personnel. Also, I would seek to bring dominant and substantial shareholders within the scope of the regulation. To insure accurate and complete disclosure the agencies must demonstrate the clearcut intention to impose criminal and civil sanctions when the requirements are not complied with.

Ultimately, however, the most effective check on abuse by insiders is a board of directors with sufficient information, inquisitiveness, and independence to scrutinize critically 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 reasonable diligence and good faith 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

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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 the same rigorous scrutiny and where any of their contacts 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 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 transactions 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.

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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.

It seems to me that this description of what is appropriate in the self-dealing context suggests the basic elements of what must be expected of boards of directors generally. In summary --

-- A director should insist upon sufficient information to make a considered decision; moreover, he should satisfy himself that the bank's information and decision-making systems provide him an accurate picture of what is going on in the institution.

-- A director should analyze and question critically the information provided until satisfied that a given transaction or policy is in the bank's best interest and constitutes a safe and sound banking practice.

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

-- And, of course, the requirement of good faith demands a director respect his fiduciary duty in his own dealings with the bank, exercising extreme caution and resolving close questions in the bank's favor.

These principles are applicable whether a director is reviewing a transaction between the bank and its dominant stockholder, deciding whether the opening of a new branch is warranted or coming to grips with his bank's entry into international markets. By applying them, a director protects himself from potential liability and, more important, satisfies his obligation to the public which relies on the soundness and integrity of his institution. The failure and difficulties of a few large financial institutions in recent years offer illustrations of what can occur when they are not applied.

In conclusion, I will state plainly what is implicit in these remarks. I am

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well aware that the principles I have outlined are not new and have been the subject of literally hundreds of similar articles and speeches. Yet, while giving lip service to these standards, many banks and bank directors do subscribe in practice to the cavalier attitude of the Englishman quoted earlier. In simpler and more stable times, the costs of this approach might have been acceptable. The failure of U. S. National Bank alone certainly indicates that it is no longer acceptable. The public has a right to expect that bank directors take seriously their fiduciary duties. Accordingly, it seems to me that the banking agencies and industry associations must consider seriously what more can be done to insure compliance with standards which are generally agreed upon.

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

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