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Role of the Bank Director.

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In the context of the concern that has been expressed in the public press in recent months regarding the health and stability of our banking system, it is especially appropriate to discuss the obligations and conduct of those who oversee operation of our nation's financial institutions and the standards which define those responsibilities. Confidence, the key to our economic system, does not flow primarily from the size of the FDIC's trust 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 perception of the soundness and integrity of these institutions.

Too often a bank directorship has been bestowed upon and accepted as a token of honor by one who has attained somehow a high financial or social status in the community or who is considered to be representative of a well-defined clique or religious or ethnic group. He attends meetings, nods gravely, votes "aye" and generally reflects credit on the management of the institution, and, because he hears and approves proposals involving large sums of money, he has a feeling that he is exercising great power. He has been chosen because the bank's management subscribes to Caesar's view as reported by Shakespeare:

> Let me have about me men that are fat,
> sleek-headed men, and such as sleep o' nights;
> Yon Cassius has a lean and hungry look;
> He thinks too much, such men are dangerous.

Happily, the majority of our banks are governed by men of the stripe of Cassius, which is why the vast majority of our banks are completely safe, well-run institutions. Unhappily, however, the rubber stamp director still remains on too many of our boards, looking wise and quiescently nodding approval of management's every act. Certainly, recent large bank failures offer evidence in this regard. At USNB, at Birmingham-Bloomfield, at Sharpstown, and now, it appears, at the Northern Ohio Bank in Cleveland, an acquiescent board served to rubber-stamp the self-serving and unsound policies of a dominant individual. Moreover we are all aware of less extreme cases in which no failure has occurred 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.

Director's responsibilities have, of course, been the subject of countless conferences, speeches and articles. 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.

The practical application of these broad and somewhat abstract standards can be seen by examining a specific problem area: 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.

The most dramatic impetus for official concern and action has been, of course, the role played by self-dealing in the failure of the U. S. National Bank in San Diego. USNB's insolvency was caused by the wholesale and unsound extension of credit to persons and entities controlled by or associated with the controlling stockholder and former board chairman; a loan program which was described by Comptroller of the Currency Jim Smith as 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 amounted to more than $400 million. Often these loans were not processed in the ordinary course of the bank's business, but were handled by particular officers after the loans had already been disbursed.

If USNB were the only indication that self-dealing constitutes a serious problem, it might be dismissed as an aberration. However, recent history clearly shows us that this is not the case. Abuse of fiduciary obligations by insiders has been a significant causative factor in other large bank failures. 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 in Michigan which, until USNB, was 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 control of the same individual, Detroit's Bank of the Commonwealth, with 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. And, significantly, in our most recent failure of a realtively large institution, the $105. 9 million asset Northern Ohio Bank, self-dealing has again been identified as an important cause of failure.

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 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.

Although I know of no study or survey indicating the extent of "self-serving" transactions, I do know, from my experiences in FDIC, that the potential for abuse is large and that actual abuse, while not pervasive, is more widespread than I, as a banker, had imagined. Examination and problem bank reports reveal that all too often control groups view the controlled bank as a private money-machine geared to operate at their pleasure. As a result, our Board has taken corrective action in recent months in a number of cases involving "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. When an insider, whether an individual, a control group, or a holding company, receives economic benefit over and above that which a non-insider would have received in an arm's length market transaction, a bank is necessarily adversely affected. This is true even if the insider has no conscious intention to milk his bank. This cost or loss is borne by non-benefiting shareholders and serves to deplete the bank's capital accounts.

Accordingly, 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 and is detrimental to the bank, 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.

Although 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 in San Diego, 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. 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.

Commercial banks are chartered to serve a specific banking function in the economy. They are not chartered to provide preferential treatment to insiders so that they can advance their own or other business interests. 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.

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 is essentially the approach which the Federal Home Loan Bank Board has adopted in its proposed conflict of interest regulations. 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.

Last summer, the Comptroller's office issued for comment a proposed regulation aimed at uncovering abuses in this area. Generally, the regulation required 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. After receiving extensive comment with respect to the regulation, the Comptroller revised the regulation somewhat and made it effective as of March 15, 1975.

It seems to me that we should take a somewhat broader approach than that of the Comptroller. First of all, I would require that insider transactions which are of significant size and non-routine nature be approved by the bank's board of directors and that such vote be recorded in the board's minutes. Second, it should be made plain through regulation that any transaction between an insider or his interests which, taking into account all relevant economic 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 statement of such a standard in regulations having the force of law would, it seems to me, provide bank boards with a clear benchmark and incentive for carefully considering insider transactions and rejecting those which are unfair to the bank.

At this juncture, I should emphasize that such a standard would not consist of a mechanistic test focusing only on the terms of the transaction. Rather the test should be whether the transaction bears the earmarks of an arm's length bargain in light of all the surrounding circumstances. In many cases, apparently preferential terms, such as lower interest rates, can be justified by circumstances not appearing on the face of the loan agreement. Where that is the case and there is no detriment to the bank, an insider transaction is not objectionable and should not be the focus of regulatory concern or action.

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. 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. Moreover, the existence of a standard of conduct spelled out in the regulations might facilitate recovery in a derivative action where an insider violates his fiduciary duty to the bank or where a bank's board does not adequately police the conflicts of interest which are inevitable in the banking business.

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. On the other hand, the nature and seriousness of the problem necessarily require a certain amount of disclosure and reporting.

As I have indicated, the Comptroller's regulation seeks to attain this balance through requiring certain insiders to disclose these interests and any significant transactions with the bank. I would require that insiders give notice to the bank's board sufficiently far in advance of the transaction to allow the board to give it due consideration. 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 director's 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 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 authorities require it or not, it seems to me that the bank's board should:

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

(2) Require the reporting of 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 substantial 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. 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.

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.

The importance of this factor is dramatically reflected in the words of a director of the recently failed Northern Ohio Bank who is reported to have said:

> Most of us, including myself, functioned as a rubber-stamp board approving all decisions made by management and rewarding management with salary increases . . . for what we were led to believe was an outstanding performance in guiding us to fast increasing earnings and assets.

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 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 theory that the board is made up of honored citizens whose principal duty is to rubber stamp approval of the actions of management. 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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