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Before the

Executive Management Seminar

of the

First City National Bank of Houston
Houston, Texas

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When economic historians consider the mid-seventies, the period may well be seen as a watershed in the banking industry. The shape and direction of resulting change are far from clear in some respects. For example, electronic banking is upon us; yet its evolution and impact on banking structure depend on policy choices which await the attention of Congress. Similarly, Congress must resolve the difficult issues involving the structure of competition among financial institutions and interest rate regulation raised by the Hunt Commission as well as the hard questions posed by the increasing dominance of the largest holding company systems. Other forces are at work, however, where the direction of change is more clearcut. I will focus on developments in one such area: the response of bank regulators to problems revealed by large bank failures and other shocks of the past eighteen months.

However traumatic, these problems have taught us a number of valuable lessons. For example, the Franklin failure illustrated dramatically some of the risks of international operations and liability management banking. Moreover, they proved conclusively that the giants of the industry are no more exempt from the penalties of incompetence or overreaching than a $5 million unit bank in west Texas.

As a consequence, bank supervision is undergoing a reappraisal which could have more significant long-run consequences than the recent retrenchment by bankers. Each agency is undertaking careful and, at times, painful study and revision of supervisory procedures, regulations aimed at insuring safety and soundness, and enforcement powers. In addition, the tripartite framework of regulation has been questioned and is undergoing vigorous scrutiny in the Congress. The efforts of the Comptroller of the Currency are, of course, reflected in the recently released and well-publicized study of his office by an outside consulting firm. As indicated in the testimony of Chairman Wille and Governor Holland before Congressman St. Germain's House Subcommittee on Financial Institutions, Supervision, Regulation and Insurance, both the FDIC and the Federal Reserve System have conducted programs of review and modernization.

Of immediate practical consequence for you, as bankers, are recent and forthcoming changes in regulation and examination procedures. The demise of U.S. National Bank in San Diego, which awakened the country to the fact that a billion dollar bank could fail, has been responsible, at least in part, for new or proposed regulation in two areas. You are all familiar with the letter of credit regulations issued by each of the agencies last year as a direct outgrowth of USNB use of this device to avoid lending limit restrictions.

Of more far-reaching import may be the attention focused on insider abuse. 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 or, in the words of Comptroller of the Currency Jim Smith, a ". . . riot of self-dealing." Involving 200-300 corporate entities, the insider related transactions amounted to between $400 and $450 million. In response to this graphic demonstration of the harm that flows from abuse of an insider's relationship with his or her bank, the Comptroller has implemented a disclosure regulation aimed at uncovering abusive self-dealing.

The need for more vigorous supervision of insider transactions by bank boards of directors and bank supervisory agencies is not based on the USNB case alone. Abusive self-dealing has been a significant contributing factor in more than half of all bank failures since 1960, including the failure of 29 nonmember insured commercial banks. Losses to the deposit insurance fund as a result of these failures are likely to amount to at least $175 million. A review of existing and past "problem" bank cases also revealed a similarly high incidence of abusive self-dealing as a source of serious difficulty. Even where the immediate result is not the bank's failure or its designation as a bank requiring close supervision, an insider transaction that is not effected on an "arm's length" basis might lead to a diminution of the bank's earnings and an erosion of its capital -- thereby increasing the risk of loss to depositors and minority shareholders and ultimately to the deposit insurance fund.

In response to these facts the FDIC published for public comment on September 3 a proposed regulation which takes an approach somewhat different from that of the Comptroller. The proposed regulation would seek to minimize abusive self-dealing through the establishment of procedures which will insure that bank boards of directors supervise such transactions effectively and better enable Corporation examiners to identify and analyze such transactions. The Board of Directors of each insured nonmember commercial bank would be required to review and approve each insider transaction involving assets or services having a fair market value greater than a specified amount which varies with the size of the bank. In addition, certain record keeping requirements would be imposed in order to foster effective internal controls over such transactions by the bank itself and to facilitate examiner review.

Finally, the proposed regulation sets forth factors which will be considered by the Corporation's Board of Directors in determining whether such insider transaction or transactions indicate the presence of unsafe or unsound banking practices and should be the subject of supervisory action. These factors include: whether, because of preferential terms and conditions, such transactions are likely to result in significant loan losses, excessive costs, or other significant economic detriment to the bank that would not occur in a comparable arm's length transaction with a person of comparable creditworthiness or otherwise similarly situated; whether transactions with an insider and all persons related to that insider are excessive in amount, either in relation to the bank's capital and reserves or in relation to the total of all transactions of the same type; and whether from the nature and extent of the bank's insider transactions it appears that certain insiders are abusing their positions with the bank.

Although the Corporation has determined that insider transactions require special supervision by bank boards of directors and close scrutiny by the Corporation's examiners, this determination does not mean that <u>all</u> transactions with insiders or their interests are detrimental to the bank in question or that such transactions should be automatically rejected. Indeed, in many smaller communities, commercial life would be virtually impossible absent extensive dealing between financial institutions and "insiders." The Corporation has sought to avoid unrealistic prohibitions or unduly burdensome reporting requirements; rather the Corporation has emphasized Board of Directors' responsibility in overseeing the affairs of the bank. The importance of this approach 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.

The troubles of Franklin and American Bank and Trust and the distress merger of the Beverly Hills National Bank, which was precipitated by the difficulties of a non-bank holding company affiliate, have insured that other facets of banking will also receive greater emphasis in the examination and supervision process. Foreign operations and the operation of non-bank affiliates of bank holding companies will certainly be subjects of increased scrutiny. Moreover, as a consequence of excesses in practice of liability management which were highlighted by the liquidity squeeze of last summer and fall, bankers will find examiners probing more deeply and critically into a bank's liability structure. Most importantly, deference to size, born of the belief that large banks could not fail, is a thing of the past. We have learned that the adverse effects of large bank failures on public confidence, the banking system and the deposit insurance fund are of sufficient magnitude that big banks should be supervised more, not less, strictly than their smaller competitors.

In addition to careful review of the adequacy of the examination process, concern engendered by large bank failures has led to increased interest in the development of so-called "early warning systems." An integral part of the program of modernization of the Comptroller's Office proposed by Haskins and Sells is the implementation of such a system, called the National Bank Surveillance System. The purpose of an early warning system was suggested by Harry Keefe, President of Keefe, Bruyette and Woods, when he said of Franklin, "People who can read a balance sheet were out of there long ago." Essentially, early warning systems employ financial statement analysis to distinguish potential problem banks.

At the FDIC, we have been at work in this area for at least three years. Our Division of Bank supervision and our Office of Management Systems have developed a program which allows examiners to compare any bank with its "peers" in terms of twenty financial ratios. While this program does not purport to be a certain method of detecting "problem" or failing banks, it does provide supervisory personnel with a quick indication of potentially troublesome trends.

At the same time our Research Division has employed somewhat more sophisticated tools of statistical analysis to develop a model employing a group of variables that is most successful in distinguishing problem and nonproblem institutions. While we are optimistic that the use of such a system, when fully operational, may be a useful supervisory tool, I should hasten to point out the limitations of all "early warning systems." Most importantly, such a system is not a "black box" which will magically grind out a list composed of all the problem institutions existing at a particular time. Nor is it possible to develop such a system. Inevitably some banks which are identified by the model will be perfectly sound institutions, while severe problems will be missed, especially where there is fraud. Accordingly, such systems should not be blindly relied upon in evaluating an institution nor can they eliminate the function of the examiner in the bank itself. Rather, it is hoped that they will be an effective tool of examination, enabling the agencies to allocate examination resources more efficiently and, at times, identifying a potential failure that might otherwise have been overlooked until it was too late.

In addition to improving techniques for identifying problems, the agencies are seeking to improve supervisory procedures for remedying problems when they occur. This has resulted in intensified monitoring and increased senior staff review of problem situations, an increased flow of information among the federal agencies, consideration of the use of teams specializing in the work-out of problem situations and reevaluation of the legal remedies and sanctions available to the agencies to effect corrective measures.

In this last regard, the three federal banking agencies have made recommendations to the Congress which would enhance considerably our ability to deal with practices which have produced bank failures and problem institutions. First of all, we have recommended legislation which would allow the supervisory agencies to aggregate loans or other extensions of credit to insiders and their interests for the purposes of application of the lending limits thereby closing serious loopholes in these provisions. Second, the proposed legislation would greatly expand the power of the agencies to impose fines for serious violations. Third, we have proposed that the existing cease and desist powers be amended to specifically apply to officers, directors, employees, agents or other persons participating in the conduct of the affairs of the bank. Fourth, the proposed legislation would allow removal of officers who are grossly negligent or demonstrate a willful disregard for the safety and soundness of a bank. And, finally, the package would authorize the Federal Reserve Board to order divestiture of a bank holding company subsidiary or termination of a nonbanking activity when the Board has cause to believe that the ownership or activity constitutes a threat to the holding company's subsidiary bank or banks. In addition, the agencies have under serious consideration a broader definition of the term "affiliate" for lending purposes.

The most significant change that might come about as a result of recent industry difficulties would, of course, be agency restructuring. Periodically since the Depression, proposals have appeared suggesting restructuring of our tripartite system of federal bank regulation. Consistently, they have been relegated to library shelves. In the present environment, however, the impetus for change has come from a variety of sources. Describing the existing regulatory framework as a "jurisdictional tangle that boggles the mind," Chairman Burns of the Federal Reserve indicated soon after the closing of Franklin that the Board staff had been studying the subject of agency restructuring and would come forward with a proposal this spring. Since that time, two governors of the Federal Reserve Board have advanced alternative plans: one calling for consolidation of all bank supervision and regulation in the Fed and the other suggesting the creation of a new single supervisory agency separate from the Fed. However, the Board indicated in July that it does not now favor radical agency realignment as suggested by Chairman Burns, Governor Bucher, and former Governor Sheehan. Instead, it has come forward with a modest proposal involving the formation of a Federal Bank Examination Council by the three federal agencies.

Nevertheless, there appears to be strong sentiment among the leadership of the banking committees in Congress favoring substantial modification of the existing regulatory structure. Senator Proxmire has introduced legislation which would create a new bank supervisory agency along lines proposed some years ago by former Governor Robertson. The FINE study now being conducted by the House Banking Committee also addresses this issue and is likely to make specific recommendations.

As Chairman Wille indicated in his testimony before the House Banking Subcommittee on Financial Institutions, Supervision, Regulation and Insurance, neither he nor I oppose significant restructuring of the regulatory framework. At present, we are guardedly optimistic that we will be able to recommend proposals which would achieve significant improvement over the present framework without concentrating undue power in a single agency.

In assessing the likelihood of agency restructuring, I would have to say quite candidly that I do not believe that it will happen in this Congress. However, given the interest of the chairmen of the respective Congressional committees, the groundwork may well be laid for the passage of legislation in the Congress following the 1976 elections. In any event, I do think that it is safe to say that agency restructuring or no, bank supervision will be significantly improved as a result of the difficulties of recent months.

In conclusion, I would simply like to thank you for inviting me to share these developments with you. Because they involve the ongoing interaction of the FDIC and the other agencies with your banks, I hope that you will share with me your thoughts, concerns and criticisms in the next few minutes.

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