FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

NEWS RELEASE

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Statement by

George A. LeMaistre
Chairman

on the Safe Banking Act of 1977

before the

Subcommittee on Financial Institutions Supervision,
Regulation and Insurance,
House Committee on Banking, Finance and Urban Affairs,
House of Representatives

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Mr. Chairman, I welcome the opportunity to testify at these hearings with respect to the "Safe Banking Act of 1977."

At the very outset, I wish to express my sincere appreciation -- and that of the men and women of the FDIC -- for the courtesy and respect which you showed to Mr. Quentin Thompson, Mr. James Davis and Mr. Charles Pickett who testified before you on September 14, 1977 with respect to many of the issues before us today. All too often, bank examiners are remembered only when it is time to criticize. This is particularly true now when the will and resolve of bank supervision is being called into question. Yet bank examiners have a story to tell -- not one of laxity but rather one of vigorous and effective regulation in the public interest. This is a story that they can tell far better than I. For this reason, I believe you exercised great wisdom when you chose to hear first from three men who for many years have been at the forefront in fighting abusive banking practices.

I also wish to express my appreciation for the constructive leadership and foresight of you and this Subcommittee in focusing upon abusive banking practices. Certainly, the hearings which you held with respect to the failure of Citizens State Bank of Carrizo Springs, Texas foreshadowed much that is before us today. Accordingly, we look forward to working closely with you in the coming months as we address the serious issues before us. And, we view these hearings as a productive process in which we can advise the Subcommittee and the public on the steps which we are taking to curb abusive conduct and in which we can seek to develop further tools to deal with such conduct.

Your inquiry largely focuses on abuses by bank insiders. In that regard, I must emphasize in the strongest possible terms that the FDIC is deeply concerned about and responds vigorously to overreaching and abusive conduct on the part of bank insiders. Our experience over the years and our current investigations indicate that serious abuse is not widespread. At the same time, we are fully aware that the potential for the abuse of a bank is great and that serious abuses do occur.

The FDIC has a unique perspective among the banking agencies in viewing the subject of abusive insider banking practices. Not only are we responsible for supervising and regulating the more than 9,000 insured state nonmember banks, but we also serve as receiver or liquidator for those institutions which fail. As a result, we are acutely aware of the ill effect of abusive and unsound banking practices and we know all too well the ways in which an insider may abuse his or her financial institution. Moreover, because of our responsibility to protect the insurance fund, secure confidence in the banking system generally and protect the various segments of the public which have a stake in the viability of a bank, the FDIC has a further direct institutional interest in the prevention of abusive conduct.

In this regard, I should state that I am absolutely confident of the toughness of our examiners in dealing with abusive conduct. It is essential to remember during the course of these deliberations that no system of human beings and laws is perfect. Although I do not believe that the events of recent weeks reflect fundamental weaknesses in the bank regulatory structure, I do believe that the tools of law and public policy must evolve and that profoundly troubling events often hasten the pace of necessary change. I would underscore that I am by no means wedded to the existing framework and approaches of bank regulation.

I. SUPERVISORY AUTHORITY OVER DEPOSITORY INSTITUTIONS (TITLE I)

Title I of H. R. 9086 is basically the same as S. 2304, 94th Congress, which was jointly recommended by the FDIC, the Board of Governors of the Federal Reserve System and the Comptroller of the Currency.

As indicated in Federal Reserve Chairman Arthur Burns' September 5, 1975 letter transmitting S. 2304 to the 94th Congress, the bill contains a number of "recommendations [which] arise from the agencies' concern over 'problem bank' situations and are designed to help prevent or correct such situations."

Notwithstanding recent success with existing enforcement powers, our experience over the past two years has not altered substantially our views as to the need for the statutory changes we previously requested. Although we have recently attempted, with apparent success, to utilize our existing authority to accomplish certain goals which we previously believed could only be accomplished with new legislation, we nonetheless feel that statutory changes to clarify our authority in these areas would be most helpful in dealing with abuse. In other areas, our experience over the past two years has led us to suggest certain amendments to the previous submission which have been incorporated in H. R. 9086.

Because many of the provisions of this title seek to enhance the ability of the agencies to deal with insider abuse, it is perhaps useful to put my discussion of these provisions in context by first outlining briefly the FDIC's approach to insider abuse.

A. <u>FDIC's Approach to Insider Abuse</u>

It is important to note that the problem of insider abuse is a general one not limited to overdrafts or compensating balances or extension of credit on preferential terms. For example, over the years the FDIC has uncovered and responded to insider overreaching involving exorbitant management fees, excessive legal fees, preferential treatment in the purchase and sale of assets, favorable lease arrangements, misuse of bank assets, and other devices whereby insiders use their institutions for their personal advantage.

The question of what constitutes abuse is, of course, one which generates some disagreement. My own view, and the predominant view at the FDIC, is that insider conduct is abusive and constitutes an unsafe and unsound banking practice when an insider obtains a benefit which is not available to a noninsider otherwise similarly situated and when the result of the insider's obtaining that benefit is detrimental to the bank. While such a standard is easy to apply in many cases, in other instances the question is a complex and difficult one. My own views in this regard were set forth early in my term as Director at the FDIC. Speaking at the 33rd Annual Texas Bankers Conference on August 20, 1974, I stated:

> 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.
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> 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 noninsider 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 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.

As you know, the most glaring example of the abuse of an insider relationship is the failure of U.S. National Bank in San Diego, a failure which was caused by what has been termed "a riot of self-dealing." This failure led the FDIC to reassess the effectiveness of its policy and procedures in dealing with insider abuse. The result of this appraisal was the adoption of a regulation dealing with insider transactions which became effective on May 1, 1976. The Corporation's reasons for adopting this regulation are stated further in the preamble to the regulation and in the notice published in the Federal Register which announced its adoption. This notice stated:

> This action is based on the experience of the Corporation which indicates that many banks have suffered loan losses, loss of revenue, excessive costs and other substantial economic detriment as a result of ill-considered transactions with insiders. The need for more rigorous supervision of such transactions by boards of directors and bank supervisory agencies is indicated by the fact that abusive self-dealing has been the primary cause or a significant contibuting cause in more than half of all bank failures since 1960, including the failure of 30 nonmember insured banks. The most dramatic example of the harm which can result from abusive self-dealing is the 1973 failure of the United States National Bank, San Diego, California, for which the Corporation has had to establish a reserve of $150 million for loss to the deposit insurance fund. Review of existing and past "problem" bank cases also reveals insider overreaching as a significant source of serious difficulty. Moreover, an insider transaction that is not effected on an "arm's length" basis will lead to a diminution of earnings and an erosion of capital, even where the immediate result is not the bank's failure or its designation as a "problem" institution. It follows, therefore, that insider transactions whose terms and conditions cannot be justified when viewed in light of all the circumstances surrounding the transaction, increase the risk of loss to depositors and ultimately to the deposit insurance fund. In addition, insider transactions whose terms and conditions cannot be justified constitute a diversion to insiders of resources that properly belong to all shareholders on a pro rata basis, as well as a misallocation of a community's deposited funds.

I am confident, however, that the view set forth in this statement is not a new one at the FDIC. Our examiners have always given special scrutiny to insider transactions and have vigorously sought to achieve corrective action when abuse is found. Thus, instead of establishing new policy, the FDIC's regulation sought to highlight and reenforce a long-standing policy. Historically, this approach was enforced through two vehicles: (1) the supervisory and examination process, and (2) the applications process.

Although not well understood by those unfamiliar with bank supervision, the examination process is a potent tool of enforcement and compliance. For example, in United States v. Philadelphia National Bank, 374 U.S. 321, 329 (1965), the Supreme Court stated:

> . . . [P]erhaps the most effective weapon of federal regulation of banking is the broad visitatorial power of federal bank examiners . . . . The FDIC has an even more formidable power. If it finds "unsafe or unsound practices" in the conduct of the business of any insured bank, it may terminate the bank's insured status . . . . Such involuntary termination severs the bank's membership in the FRS, if it is a state bank, and throws it into receivership if it is a national bank . . . . As a result of the existence of the panoply of sanctions, recommendations by the agencies concerning banking practices tend to be followed by bankers without the necessity of formal compliance proceedings.

When abusive insider transactions or insider transactions involving violations of law or regulation are discovered by examination, they are enumerated and criticized in the examination report. In fact, whether abusive or not, all significant insider transactions will be reflected in the report. Correction of abuses is sought by the bank examiner or his superiors, either through discussions with management or through the bank's board of directors. Great emphasis is placed upon achieving voluntary compliance, although for the last few years the Corporation has not hesitated to institute formal corrective action if "moral suasion" or "jawboning" was not effective.

Though not designed as such, the application process has also served as an effective tool of bank supervision. Corrective action is often achieved through denial or threat of denial of various actions for which a bank must seek prior FDIC approval. For example, the applicable statute provides that a bank must obtain the prior approval of the FDIC in order to establish or relocate a branch office and one of the factors the Corporation must consider is the general character of the bank's management. An otherwise routine application might be denied if abusive insider practices were existing and not being corrected.

The FDIC regulation dealing with insider transactions which was adopted in 1976 sought to add three elements to this approach. First of all, the regulation established procedures which require bank boards of directors to supervise bank insider transactions in a meaningful manner. The board of directors of each insured nonmember commercial bank is required to review each insider transaction involving assets or services greater than a specified amount, which varies with the size of the bank. In addition, certain information, including a record of dissenting votes cast by members of bank boards of directors, must be kept available in order to foster effective internal controls over such transactions by the bank itself, and to facilitate examiner review and analysis. While the regulation imposes certain recordkeeping requirements, we have not required the bank to keep new records or to establish new files. It is our view that the minutes of board meetings can serve as an appropriate listing of all insider transactions and that the regular filing system of the bank can be the repository of information required by the regulation so long as it is readily accessible to FDIC examiners.

Most importantly, the regulation itself makes clear that formal compliance with the board of director review and approval requirements does not relieve the bank of its duty to conduct its operations in a "safe and sound" manner. Nor does it prevent the Corporation from taking whatever supervisory action is deemed necessary and appropriate. And, we have made it clear that the FDIC Board views any significant insider overreaching as an unsafe or unsound banking practice, and, as such, will not be tolerated.

That this is the case is reflected in the Corporation's record in bringing 51 cease and desist orders since January 1, 1976. As discussion below reflects, 35 out of the 51 cease and desist actions brought during this period were aimed at least in part at correcting some insider abuse.

Particularly notable are 8(b) actions brought this summer against five related banks in which former and present officers and directors were charged with abuse of their authority by causing the banks to pay excessive expenses to companies owned by insiders. These cases represent a significant innovation in that recovery was sought from the individuals for the first time in the history of the use of the Section 8(b) power -- bringing what is tantamount to a derivative action. By consent, the offending insiders agreed to reimburse the banks in an amount agreeable to the FDIC and the state supervisor.

As I have indicated, our insider regulation became effective May 1, 1976. Thus, it has been in place for a little more than a year. We are now engaged in a detailed review and evaluation of its effectiveness. I anticipate that we will seek to effect certain changes in the regulation as a result of this review. It is my intention, as I will indicate below, to propose to the FDIC Board of Directors that the regulation be modified so as to provide us with the tools for dealing with abuse in the bank stock loan area.

In addition, I will propose to the Board that we amend the regulation to make more clear the standard which we expect bank boards to apply in reviewing insider transactions and which we will apply in determining whether to bring supervisory action. As the regulation now stands, Subsection (g) states:

> (g) Supervisory Action in Regard to Certain Insider Transactions. Notwithstanding compliance with the review and approval requirements of paragraph (b) of this section, the Corporation will take appropriate supervisory action against the bank, its officers or its directors or trustees when the Corporation determines that an insider transaction, alone or when aggregated with other insider transactions, is indicative of unsafe or unsound practices. Such supervisory action may involve institution of formal proceedings under section 8 of the Federal Deposit Insurance Act. Among the factors which the Corporation will consider in determining the presence of unsafe or unsound banking practices involving insider transactions are:
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> (1) Whether, because of preferential terms and conditions, such insider transactions are likely to result in significant loan losses, excessive costs, or other significant economic detriment which would not occur in a comparable arm's length transaction with a person of comparable creditworthiness or otherwise similarly situated;
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> (2) 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; or
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> (3) Whether, from the nature and extent of the bank's insider transactions, it appears that certain insiders are abusing their positions with the bank.

It is my belief that this provision should be modified to remove any doubt that a transaction which reflects a preference to an insider or his interests and results in a detriment to the bank is an unsafe or unsound banking practice which should not occur and will be dealt with severely by the FDIC. Although I have long believed that this is the appropriate standard and is, in fact, implicit in the law as it stands, spelling out in our insider regulation that such conduct is an "unsafe or unsound banking practice" in the judgment of the FDIC will have the result of more clearly notifying bankers and bank examiners what is expected of them and will significantly enhance our ability to curb abuse.

B. Authority to Levy Civil Money Penalties

In a number of areas of bank regulation there is no totally effective deterrent to violation of various limitations and restrictions imposed by Federal statute. Although such violations can severely affect a bank's safety and soundness, in some cases the only sanction a bank faces is the possible issuance of a cease-and-desist order requiring it to reverse a particular transaction or to refrain from committing similar future violations.

One example is Section 23A of the Federal Reserve Act which (in conjunction with Section 18(j) of the Federal Deposit Insurance Act) imposes stringent limitations on loans and other dealings between insured banks and their affiliates. However, since there are no specific penalties for violations, a bank holding company or other person experiencing financial difficulty could cause a subsidiary bank to violate such restrictions knowing that if the violations are discovered the most severe sanction would be the issuance of a cease-and-desist order designed to rectify the violation and prevent further transgressions.

While the cease-and-desist order is quite useful for some purposes, it is not as significant a deterrent to violations of restrictions on inter-affiliate or insider lending as a daily money penalty would be. Accordingly, Sections 101 and 107 of the bill would authorize the Federal Reserve and the FDIC to impose up to $1,000 per day civil penalties for violations of Section 23A of the Federal Reserve Act relating to interaffiliate dealings or the new Section 22(h) of the Federal Reserve Act covering bank loans to their own officers, directors and five percent stockholders.

In addition, Section 106(e) of the bill would authorize the imposition of a civil penalty against any bank or any officer, director, employee, agent or other person participating in the bank's affairs for violation of a final cease-and-desist order issued under section 8(b) or (c) of the Federal Deposit Insurance Act. This section provides for a civil penalty of up to $1,000 for each day that the offending bank or individual refuses to obey the order after it becomes "final". The authority to impose such a fine for violating a final cease-and-desist order would serve to emphasize the gravity of such an order and would be in addition to the present authority to seek court enforcement.

In imposing civil money penalties under the bill's provisions, the appropriate bank regulatory agency would be required to take into account the financial resources and the good faith of the bank or person charged with the violation, as well as the history of previous violations. We hope that the utility of such penalties would be primarily in their deterrent effect, and that the actual imposition of fines could be used sparingly.

C. Provisions Dealing With Insider Loans

We continue to believe it would be desirable to amend Section 22 of the Federal Reserve Act to impose additional restrictions on loans by a bank to its own officers and directors and to major stockholders and corporations affiliated with such individuals. However, we believe such additional restrictions should be of the type contained in Sections 103 and 107 of S. 71 as it passed the Senate. These sections provide that the existing limits under applicable Federal or State law on loans to one borrower would apply with respect to loans by any member or nonmember insured bank to any one of its officers and to any other individual holding more than 10 percent of its voting securities, including loans to companies controlled by such officer or 10 percent shareholder. S. 71 would also require that when aggregate loans to any officer, director or 10 percent shareholder would exceed $25,000, advance approval of two-thirds of the bank's board of directors would be necessary. In addition, loans to such insiders on preferential terms would be prohibited, as would the case on a broader basis with the changes in our insider regulation discussed above.

H. R. 9086, on the other hand, would limit loans to any one insider to 5 percent of the bank's capital and surplus and would limit loans to all insiders to 50 percent of capital and surplus. It would also define an "insider" as a person who owns 5 percent (instead of 10 percent as in S. 71) of a bank's voting securities.

While we agree with the principle of aggregating loans to an insider with loans to companies he controls in determining compliance with one-borrower limitations and oppose loans to insiders on preferential terms, we believe that disclosure to the bank's board of directors and to bank regulators, as required by our insider regulation, is a more appropriate remedy in this area than is the imposition of more restrictive amount limitations on insider lending. With the clarifying amendments, we believe that insider regulations of the type we have adopted would serve as an adequate basis for bank regulators to control abusive insider dealing without necessitating the imposition of inflexible statutory limitations based on a bank's capital and surplus.

D. Provisions to Strengthen the Tools of Administrative Enforcement

Although the provisions of H. R. 9086 are designed in large part to prevent problem bank situations from developing, the bill also contains several provisions intended to assist in dealing with problem bank situations once they arise.

Presently, under Section 8(e) of the Federal Deposit Insurance Act the appropriate Federal bank regulatory agency is authorized to remove a bank director or officer who has engaged in a violation of a law, rule or regulation, participated in an unsafe or unsound practice, violated a final cease-and-desist order, or breached his fiduciary duty -- but only if such violation involves personal dishonesty and where substantial financial loss to the bank or other damage to its depositors can be demonstrated. Because of the difficulty of proving circumstances amounting to personal dishonesty, presently we have no power under the law to effectively remove individuals even if they have repeatedly demonstrated gross negligence in the operation or management of the bank or continuing disregard for its safety and soundness.

We realize that the original congressional objective underlying the "personal dishonesty" requirement was to protect bank officers and directors from arbitrary or capricious administrative action. In light of our experience, however, we believe that this protection can be provided in another way while eliminating the necessity of proving personal dishonesty or personal gain. Thus, where the person's disregard of sound banking practices dictates removal, it is necessary to balance the interests of the individual bank officer or director against those of the bank's depositors and shareholders, and ultimately against the public interest in maintaining the integrity of the banking system.

To strike this balance, we strongly recommend enacting the provisions of section 106(d) of the bill, which would add to the standard of personal dishonesty an alternative standard which would recognize the need to remove those officers and directors whose gross negligence in the operation or management of a bank or whose continuing disregard of its safety and soundness threaten the financial safety of the institution. The Senate deleted the gross negligence standard, thus necessitating the proof of either personal dishonesty or willful disregard of safety and soundness. We are pleased to see that gross negligence has been reinserted and that our suggested change of "willful disregard" to "continuing disregard" has been incorporated in H. R. 9086. Willfulness would in our opinion be equally as difficult to prove as personal dishonesty. Accordingly, we strongly support this strengthening of our removal authority as set out in H. R. 9086.

Recent experience also indicates that a bank may be harmed not only by the misconduct of its own officers and directors but also by the misconduct of others who are in a position to influence its affairs. While we have exercised our power to deal with these situations through removal proceedings or through cease-and-desist action brought against the bank itself, we support the amendments contained in Section 106(a) and (c) of the bill, which would clarify our authority in this regard by amending paragraphs (b) and (c) of Section 8 of the Federal Deposit Insurance Act to provide expressly that the appropriate regulatory agency may bring cease-and-desist proceedings against directors, officers, employees, agents and other persons participating in the conduct of the affairs of the bank, as well as against the bank itself as permitted under present law. We believe that clarifying our ability to reach such officers, directors and other persons participating in a bank's affairs through cease-and-desist orders would result in an enhanced ability to correct situations which might otherwise result in serious detriment to the bank, such as overdrafts, insider loans, compensating balances and similar practices.

II. INTERLOCKING DIRECTORS (TITLE II)

Presently, Section 8 of the Clayton Act (15 U.S.C. 19) prohibits director and employment interlocks between any Federal Reserve member bank and any other competing bank (other than a mutual savings bank) located in the same or a contiguous community and not under common control therewith, except that the Board of Governors of the Federal Reserve System may permit a member bank one such interlock by regulation.

Title II of the bill would repeal this prohibition in the Clayton Act and replace it with a broader prohibition applicable to interlocks between any commercial bank, savings bank, trust company, savings and loan association, credit union, bank holding company or savings and loan holding company and any other such institution not affiliated therewith if each such depository institution has an office in the same standard metropolitan statistical area or in the same or a contiguous city, town or village. Title II would also ban interlocks between any depository institution with assets over $1 billion and any other nonaffiliated depository institution with assets over $500 million, regardless of the location of either. In addition, Title II would prohibit interlocks between any depository institution and any insurance, title, appraisal or real estate closing company and would prevent any depository institution offical from providing legal services in connection with any transaction with such institution.

The new interlock prohibitions would be narrowed in one sense, however, to apply only to interlocks at the directorate and management levels. These provisions would be enforced by the five financial regulatory agencies with respect to institutions within their primary jurisdiction and by the Justice Department with respect to other (i.e., noninsured depository) institutions. Also, the Board of Governors of the Federal Reserve System would be given authority to grant regulatory exemptions from the interlock provisions.

In 1971 the FDIC proposed legislation regarding employment interlocks between financial institutions which would have expanded Section 8 of the Clayton Act to cover interlocks involving an insured bank and any other bank or savings and loan association (or any holding company of either), except that the appropriate Federal bank regulatory agency could permit such interlocks where it found that the existence of such interlocking relationship was the result of common control through stock ownership or the result of a scarcity of experienced management talent.

While we support the substantive provisions in Title II and are particularly happy to note its expansion to cover insurance, title and appraisal companies, we perceive no valid basis for assigning to the Federal Reserve plenary rulemaking and exemptive authority in this area. We believe a financial institution's primary regulator is better able to assess the anti-competitive effects of such interlocking relationships and would therefore recommend that each Federal regulator of financial institutions be granted rulemaking and exemptive authority with respect to interlocking relationships involving institutions it regularly examines. Where different regulators are involved on each side of such an interlock, a possible conflict exists. Various possible ways of resolving such conflicts are currently under study by our staff. We will be happy to provide you the results of this study when available.

III. FOREIGN BRANCHING (TITLE III)

Title III is the FDIC's so-called "Housekeeping" bill containing a number of legislative recommendations which we believe are essentially noncontroversial in character. I will mention only the highlights of this title and request the addition of one provision to the bill.

Perhaps the most significant part of this title is Section 301 which would require FDIC consent in connection with the establishment of foreign branches or the acquisition of foreign bank stock by nonmember insured banks. While member banks of the Federal Reserve System are presently required to obtain Federal Reserve Board consent under Section 25 of the Federal Reserve Act to branch abroad or to acquire foreign bank stock, no Federal approval is necessary for such actions by nonmember insured banks. Since the foreign activities of nonmember insured banks can clearly affect their safety and soundness and, therefore, have a direct impact on the FDIC's insurance risk, we strongly recommend that this gap in Federal law be closed by giving the FDIC authority over such banks comparable to that which the Federal Reserve has over member banks.

Another significant provision in Title III is Section 305(b) which would change the definition of "affiliate" in Section 10 of the Federal Deposit Insurance Act to conform to the definition of that term presently in section 23A of the Federal Reserve Act. Under the present scope of this term as used in our Section 10, the FDIC has authority to examine a bank holding company owning more than 50 percent of the stock of any insured bank, as well as any subsidiary of such holding company.

Section 305(b) would merely expand the definition of "affiliate" for this purpose to also include any bank holding company or subsidiary thereof as defined in the Bank Holding Company Act -- i.e., in effect reducing the stock ownership threshold from 50 percent to 25 percent (or to such lower percentage as the Federal Reserve Board may determine to be effective control). Essentially, therefore, the bill only substitutes the Bank Holding Company Act definition of control for that contained in the Banking Act of 1933 as a measure of the scope of the FDIC's existing authority to examine "affiliates" under Section 10 of the FDI Act. Thus, this provision does not create any new type of authority in the FDIC to examine "affiliates," but merely makes a limited and logical extension of already existing authority in this area.

We would also recommend adding a section to Title III which would amend the enforcement provisions of the Home Mortgage Disclosure Act of 1975 to transfer enforcement jurisdiction as to noninsured savings and loan associations from the FDIC to the Federal Home Loan Bank Board and to give both the FDIC and the FHLBB express authority to conduct investigations (including on-site examinations) and require reports from noninsured institutions subject to their respective enforcement jurisdiction under that Act. Presently, Section 305(b) of that Act confers enforcement jurisdiction on the FDIC with respect to both noninsured banks and noninsured savings and loan associations. Authority over the latter would more appropriately reside with the FHLBB. These suggested amendments could be effected by (1) amending Section 305(b)(1)(C) to substitute "any other commercial or savings bank" for "any other depository institution"; (2) revising Section 305(b)(2) to include reference to "any other savings and loan, building and loan or homestead association (or cooperative bank)" and (3) adding at the end of the second sentence of Section 305(c) "; and any such agency may, for such purpose, conduct investigations (including on-site examinations) of and require reports and other data from any institution over which it has enforcement jurisdiction under subsection (b)."

IV. CONFLICTS OF INTEREST (TITLE IV)

Title IV would expand the present conflicts-of-interest provisions in the Federal Deposit Insurance Act and the Federal Reserve Act to prevent an FDIC Director (including the Comptroller of the Currency) and a Federal Reserve Governor from being an officer, director, employee, attorney, consultant or agent of an insured bank, a bank holding company or an affiliate thereof for a period of two years after he or she leaves office. Present law applies only to employment with insured banks in the case of FDIC Directors and with member banks in the case of Federal Reserve Governors and then only where they leave office prior to completion of their appointed term. Title IV would also apply similar prohibitions for the first time to Federal Home Loan Bank Board members. These prohibitions would also cover the voluntary acquisition of any interest or the exercise of any voting rights in any regulated institution or affiliate thereof. I do not oppose these provisions, but suggest that they be considered in the context of government-wide regulation of conflicts of interest.

As you know, Title V of the "Public Officials Integrity Act of 1977" (S. 555) as recently passed by the Senate would revise 18 U.S.C. 207 (a) to permanently bar any former Federal employee from becoming involved in any specific case in which he was personally and substantially involved at any time during his government service, (b) to prohibit such an employee, for a period of two years after leaving Federal service, from representing anyone other than the United States in any specific case which was under his official responsibility during his last 12 months of government service, and (c) to prohibit any former top-level Federal official, for a period of one year after leaving Federal service, from initiating any contact with his former department or agency relating to matters actually pending before such department or agency.

These provisions are designed to prevent the misuse of influence acquired through public service. Moreover, the prohibitions are government-wide in their applicability and are not limited to the financial regulatory agencies. We believe that logic dictates dealing with these conflicts-of-interest questions in the broader, government-wide context, rather than singling out the financial regulatory agencies for special legislation of this nature. To the extent that they exist, these problems are certainly not limited to the regulators of financial institutions. Accordingly, we support the approach of S. 555 in this area and suggest that Title IV be deleted from H. R. 9086.

V. CHANGE IN BANK CONTROL ACT (TITLE VI)

Title VI, the "Change in Bank Control Act of 1977," contains provisions relating to changes in the control of insured banks.

Presently, Section 7(j) of the Federal Deposit Insurance Act (12 U.S.C. 1817(j)) requires notification of Federal regulatory authorities when there is a change in control of an insured bank or a loan secured by 25 percent or more of an insured bank's outstanding stock. These reports are sent to the Comptroller of the Currency as to national banks, the Federal Reserve as to State member banks, and the FDIC as to insured nonmember banks. The Comptroller and the Federal Reserve are required to immediately furnish copies of reports sent to them to the FDIC.

Title VI would make two major changes in present procedures. First, all reports would go directly to the FDIC as insurer of bank deposits. Second, FDIC approval would be required before any change in control of an insured bank could occur. FDIC could impose a civil penalty of up to $10,000 per day on any person who willfully violates the Title or any regulation issued thereunder.

The bill would also require reports by any person making a loan secured by 25 percent or more of an insured bank's stock and would require certain additional types of information to be submitted under Section 7(j), including any relevant information required by the FDIC. Finally, the bill would subject any loans secured by stock of an insured bank to prevailing margin requirements established by the Federal Reserve.

We support the basic thrust of Title VI but would recommend amending the bill in several respects. First, we believe that instead of requiring advance approval in each and every case, the bill's purposes could be achieved equally as well by requiring 60 days' prior notice of any change in control of an insured bank and empowering the bank's primary Federal regulator to step in within such time period and disapprove the change in control on the basis of one or more of the standards contained therein. We believe such a notice approach would provide greater flexibility in achieving the Act's goals without unduly burdening the process with a cumbersome advance approval procedure.

Second, we would recommend that enforcement authority under this bill be vested in the three Federal bank regulatory agencies rather than being consolidated in the FDIC. Certainly, the Comptroller of the Currency and the Federal Reserve System are better able than the FDIC to recognize and deal with undesirable changes in control of national and State member banks which those agencies regularly examine.

I strongly support passage of this type of legislation. Although I assume that the power to disapprove changes in bank control would be rarely used, it would, if properly employed, enable the agencies to anticipate and avoid problems which they can only react to at the present. In my judgment, its mere presence would go far to minimize certain types of abuse.

VI. EXTENSIONS OF CREDIT AND CORRESPONDENT BALANCES (TITLE VIII)

Title VIII would prohibit extensions of credit to officers, directors or 5 percent shareholders of correspondent banks. As you know, among the most serious abuses associated with bank stock loans are those involving the use of correspondent balances by a banker to compensate a correspondent bank for abusively preferential loans extended to him or his interests. This abuse has been most prevalent in states in which there are restrictive branching policies and the loans are used to finance the purchase of control of smaller banks. It should be noted, of course, that abuses of correspondent balances are not only associated with bank stock loans but may also involve any extension of credit to someone who can exercise control over a correspondent account. Moreover, there is a variety of other abuses which may be associated with bank stock loans not involving a correspondent relationship. Often, for example, these occur when a principal has overextended himself and must overreach to meet this obligations.

The arguments for prohibition are substantial. Forcing the borrower to deal with a bank other than his bank's correspondent would eliminate a major possibility for abusive conduct. Moreover, prohibitions are easier to administer than a strategy which involves examiner scrutiny of transactions to determine whether they involve overreaching -- a highly subjective process.

Nevertheless, it must be recognized that there are significant disadvantages to such an approach. First, it has generally been my experience that legal restrictions or prohibitions are rarely effective in eliminating the most significant abuse. Rarely are agencies or legislatures willing to draft a prohibition sufficiently broad that it cannot be easily avoided. Second, a prohibition in this area would cut off a ready means of financing which has helped to broaden the base of bank ownership in this country and has provided a source of capital in some "distress" bank situations.

Because I believe that these disadvantages are significant, and because I believe that prohibitions and restrictions should be adopted only as a last resort, I oppose the provisions of Title VIII. In doing so I am well aware that many of the FDIC's senior staff including, I believe, the three gentlemen who testified before you on September 14, 1977, disagree. Indeed, it is my view that the strength of their commitment to root out abuse is one of the strongest reasons why we do not have to take the step suggested in Title VIII. It is precisely because of the action of these men that the most serious instances of abuse in this area have been largely eliminated. Moreover, there are less drastic steps which can be taken by the agencies and the Congress which will obviate the need for such measures. I shall outline five.

A. Modification of the FDIC's Insider Transaction Regulation to Address Stock Loans

I intend to propose to the Board of Directors of the FDIC that Part 337.3 of our Rules and Regulations be amended to provide that "insiders," as defined in that regulation, be required to report to the bank's board of directors any loans obtained from or other business transactions with another bank with which the insider's bank maintains a correspondent balance, and that the terms and conditions of such loans or transactions be reflected in the bank's minutes or other records readily available to FDIC examiners. In addition, the regulation as amended would require that the board of directors periodically review the bank's various correspondent relationships in light of these transactions to assure that insiders are not benefiting from such relationships to the bank's detriment. The details of such a review should be reflected in the bank's minutes.

This approach would insure meaningful analysis of the bank's correspondent relationships by its board of directors and would thereby significantly minimize the likelihood of abuse. And more importantly, it would provide FDIC examiners with a better data base for use in detecting other abuses associated with bank stock loans.

B. Use of Section 8(b) Cease and Desist Powers

Heretofore, the FDIC has responded vigorously to compensating balance cases. It is our judgment that the use of supervisory tools has largely eliminated substantial abuse even in the absence of a significant number of criminal prosecutions. However, as I have indicated, the FDIC has not made use of its cease-and-desist authority in dealing with correspondent balance cases. We may well find the use of this tool appropriate in the future.

C. Enactment of the Provisions of Title I of this Bill

The provisions of Title I recommended by the FDIC would greatly enhance the effectiveness of efforts to deal with abuses associated with bank stock loans and correspondent relationships. As I have indicated, I strongly support its passage.

D. Enactment of Title VI of this Bill

As I have indicated, I strongly support the thrust of Title VI of this legislation. As I have indicated, I assume that this power would be rarely used. It would, however, if properly employed, enable the agencies to anticipate and avoid problems which they can only react to at present. In my judgment, its mere presence would go far to minimize certain types of abuse.

E. Elimination of the Prohibition on the Payment of Interest on Demand Deposits

I have long favored the elimination of the prohibition on the payment of interest on demand deposits, as well as the elimination of interest rate ceilings generally. This is based on my belief that the pricing mechanism is a far more efficient means of allocating resources than systems involving restrictions and controls. Moreover, almost inevitably restrictions and controls lead to undesirable and often unanticipated side effects. Abuses arising out of the use of correspondent balances in connection with bank stock loans is an excellent illustration of this phenomenon. The fact that interest cannot be paid on correspondent balances leads to a murkiness in pricing which results in great potential for abuse. Allowing the payment of interest on these balances would help to minimize the potential for abuse in this area.

Having said this, I should hasten to add that the "unbundling of services" would not totally eliminate the potential for abuse, because many of the services which are provided by correspondent banks are intangible and inherently difficult to price.

F. Conclusion Regarding Title VIII of this Bill

In my judgment Title VIII should be deleted from this bill. I recommend this because I believe that existing tools plus those which I have recommended would be more than adequate to deal with abuses in this area. At the very least, the Subcommittee should defer judgment on this title with the understanding that the FDIC would after a reasonable time report in detail on the effectiveness of its approach.

VII. DISCLOSURE OF MATERIAL FACTS (TITLE IX)

Title IX would require annual public disclosure of the identity of each bank officer, director and 5 percent shareholder and the aggregate amount and terms of credit extensions to such insiders by each insured bank, as well as the amount of loans classified substandard, doubtful, and loss at the last examination of the bank. The first two of these provisions are aimed at the problem of insider abuse. As I have indicated, I believe that the FDIC strategy in this area is an effective and appropriate one. Before adopting a disclosure provision which would at best provide only a partial picture of the bank's position and practices, I would rely on the FDIC approach to the problem. I would urge you to study and monitor our program before taking this step.

The disclosure of the aggregate amounts of classified assets is even more troubling. Here again asset classifications would present a partial and often distorted picture -- distorted because examiners classify assets for a variety of reasons. Without disclosure of more detail, which the Congress has refused to require of smaller institutions, these figures would, at best, be meaningless and, at worst, unfairly damaging.

VIII. FINANCIAL INSTITUTIONS EXAMINATION COUNCIL (TITLE X)

Title X would establish a Financial Institutions Examination Council with power to prescribe uniform examination standards for all insured banks, savings and loan associations and credit unions and to make recommendations for uniformity in other supervisory matters. The Council would consist of the Comptroller of the Currency, the FDIC Chairman, the Federal Reserve Board Chairman, the Federal Home Loan Bank Board Chairman, the National Credit Union Administration Board Chairman and the head of a State banking authority appointed by the President. The Council's first Chairman would be the Federal Reserve Board Chairman.

I support the essential thrust of this legislation, with certain modifications. First of all, I do not believe that uniform examination and supervisory standards should be established. One of the great virtues of our existing regulatory structure is the possiblity for creativity and innovation. The examination process is one of those activities that benefit most from competition and experimentation among bank regulators. A study of bank examination would reveal that numerous innovations, changes and improvements have been proposed and many have been adopted during the past four years. I, for one, believe that this would have been less likely to occur if uniformity had been mandated. For this reason, I strongly recommend that the Council perform advisory, coordinating and watchdog functions and that it not be required to set uniform standards.

Second, I would assign to the Council the functions of the existing Interagency Coordinating Committee.

Third, I oppose designating the Chairman of the Federal Reserve Board as Chairman of the Council for two reasons. First of all, I believe that the Chairman should be able to devote considerable time and effort to the activities of the Council and I seriously doubt that the Chairman of the Board of Governors would have time to do so. And second, with respect to supervisory matters, I can see no special advantage or expertise that the Federal Reserve System possesses over the other agencies that should lead to the designation of its Chairman as Chairman of the Council.

IX. RIGHT TO FINANCIAL PRIVACY (TITLE XI)

Title XI contains provisions relating to the right to financial privacy of financial institution customers. It is broader than many similar proposals in the past in that it covers the release of customer information to private persons as well as to Federal and State governmental officials. It also contains a new provision designed to secure the privacy of customers using electronic funds transfer facilities.

Traditionally, banks normally accorded confidential treatment to information in their files about customers' financial affairs and did not permit unauthorized disclosure of such information. However, in 1970 the so-called Bank Secrecy Act imposed extensive recordkeeping procedures on banks in order to enable law enforcement authorities to obtain evidence needed to prosecute white collar criminals. Then on April 21, 1976 the Supreme Court held in United States v. Miller that a bank customer had no constitutionally protected right of privacy with respect to information about him in a bank's files. The pendulum began to swing in the other direction later in 1976 when Congress amended the Internal Revenue Code to permit taxpayers whose bank records were subpoenaed by the Internal Revenue Service to challenge in court the Service's right to the records before the bank produced them. The purpose of Title XI and similar bills in this and previous sessions of Congress is to reverse the cumulative effect of the Bank Secrecy Act and the Miller case and to reestablish generally the confidential relationship between a financial institution and its customers.

To do this, Title XI would provide that the financial records of a customer may be disclosed by a financial institution only if the disclosure is authorized by the customer or if it is pursuant to a search warrant or to an administrative summons or judicial subpoena which has been served on the customer as well as the financial institution. The customer could contest the proposed disclosure in a court of competent jurisdiction. Also, under the bill a court could grant an agency a subpoena with a 90-day delay of notice to the customer upon a finding that notification would jeopardize a continuing investigation of a felony. Financial institutions would be reimbursed by the U. S. Government for the cost of producing records required by governmental agencies. The bill would exempt from its disclosure restrictions Internal

Revenue Service summonses (because they are now covered by similar procedures under the Internal Revenue Code), statistical data, information furnished to financial regulatory agencies, and any information required to be reported under the Federal securities laws. The bill provides both criminal and civil sanctions.

We have supported similar proposals in the past and have recommended a number of amendments to previous bills. As to the amendments we previously suggested, various revisions incorporated in Title XI have obviated the need for most of these changes.

One remaining difficulty we have is that Section 1109 might possibly be interpreted to preclude the FDIC and other supervisory agencies from disclosing to appropriate law enforcement authorities information indicating a violation of law which is discovered in the course of their supervisory activities. We strongly recommend amending this section to make clear that the bill is not intended to prevent such disclosures. This could be done by adding the following proviso to Section 1109:

> "Provided, however, That any supervisory agency receiving information in the course of discharging its statutory functions which in its judgment tends substantially to indicate a violation of law by any financial institution which it regularly examines, or by any director, officer, employee, agent or representative thereof, may release such information to any governmental entity charged with enforcing such law."

Also, Section 1111 provides that government officials must pay the costs incurred by financial institutions in producing records relating to a customer in response to a customer authorization, summons, subpoena or search warrant. The Federal bank regulatory agencies have authority under section 10 of the Federal Deposit Insurance Act to issue subpoenas in connection with the examination of insured banks and their affiliates. We do not believe that Section 1111 is intended to cover this type of subpoena and we would therefore strongly recommend an amendment to make clear that it does not apply to such subpoenas issued for bank regulatory purposes.

Your Committee might also want to consider amending the bill to extend its protection to other financial-type institutions such as nonbank credit card issuers, insurance companies, securities brokers and dealers, investment companies, loan companies and the like.

Our support of this type of legislation in the past has been premised on the implicit assumption that it would not cause significant problems for Federal and State law enforcement agencies, particularly with respect to enforcement efforts directed against organized crime and white collar criminals. We defer to such law enforcement agencies as to the effect of this legislation on their activities and would recommend against its enactment without their concurrence in its basic provisions.

Also, since this effort to codify the right to financial privacy is "breaking" new ground" in a sense, we would recommend caution in making it applicable to non-government officials. Banks and other financial intermediaries, in order to function properly, certainly must be able to exchange credit information on borrowers. We suggest that the first legislative effort in this area should not be all-inclusive but should rather be limited to cover only the release of information to government officials, the area of primary abuse in this respect.

X. CHARTERS FOR THRIFT INSTITUTIONS (TITLE XII)

Title XII of H. R. 9086 provides a Federal chartering option for mutual savings banks. I strongly favor immediate adoption of legislation which would provide that option.

Mutual savings banks have moved a long way down the road in the evolution toward being "full service family banking institutions." In some States, mostly in New England, this evolution is virtually complete. In other States, however, there are important gaps in savings bank powers and restrictions on their operations. In New York, for example, savings bank lending powers are restricted and there are important limitations with respect to demand deposits. It is true that some State laws are unduly restrictive with respect to commercial banks as well, but the choice provided by the dual banking system means that innovations which generally satisfy customer needs will be adopted over time.

It is clear that regulatory decisions in the early 1960's which gave national banks powers already possessed by some State banks helped banking meet the challenges of a changing economy. Similarly, State legislatures and State regulators have taken the lead in pursuing alternative strategies of dealing with financial reform and electronic funds transfer systems. As a result, the States often serve as laboratories where innovation can provide insights as to the best approach to take at the Federal level. In my judgment, mutual savings banks and their customers should not be denied the considerable benefit of this unique and positive feature of American financial regulation. While I do support the Federal chartering option for mutual savings banks, I would like to enumerate some suggestions for implementing this objective.

First, I do not favor restricting the Federal chartering option geographically, nor do I favor limiting this option to existing institutions. It seems to me that mutual savings banks have been effective, viable competitors in the 17 States where they exist and there is no reason to limit their benefits to these States. While H. R. 9086 imposes such limitations, the Financial Reform Act of 1976 did not. I prefer the approach taken in that bill.

Second, I think it appropriate to point out that the FDIC has more than 40 years of experience in examining and supervising the mutual savings bank industry -- experience which would be most useful to a chartering authority.

It seems to me that your Subcommittee should not overlook our long experience in this area determining the chartering authority for Federal mutual savings banks. It seems highly desirable to us that there be at least one Federal financial institution regulatory agency which is concerned with both commercial banks and thrift institutions in order to ensure a balanced regulatory perspective. I know, for example, that this is most useful in our deliberations with respect to interest rate ceilings.

Third, we strongly oppose the provision in section 1202 which requires converting mutual savings banks to conform, within 10 years, to the statutes and regulations applicable to Federal savings and loan associations. This provision would have the effect of limiting the powers of Federal savings banks to those of Federal savings and loan associations. We do not believe such a result is consistent with the thrust of recent financial reform proposals or with the objective of providing a meaningful Federal chartering option for mutual savings banks.

XI. HOLDING COMPANIES (TITLE XIII)

Title XIII contains numerous provisions relating to financial institution holding companies. Some of these provisions are technical or relatively non-controversial, such as Sections 1301-07. Among other things, these sections (1) give the Federal Reserve Board and the Federal Savings and Loan Insurance Corporation power to order divestiture by holding companies of non-bank subsidiaries where there is a risk to the financial stability of a subsidiary bank or thrift institution and power to impose fines for violations of law by holding companies, (2) repeal the Bank Holding Company Act exemption for "labor, agricultural and horticultural organizations," (3) permit the Federal Reserve Board to approve bank holding company acquisitions under expedited procedures in emergency situations, and (4) empower the Federal Reserve to mandate "outside" director representation on the boards of bank holding companies and their banking subsidiaries. We support these provisions and particularly applaud the provision giving the Federal Reserve power to require "outside" director representation on bank and holding company boards.

On the other hand, Sections 1308-13 of Title XIII contain most of the provisions of S. 72, the "Competition in Banking Act of 1977." S. 72, which has not been the subject of hearings in this Congress, contains several very controversial provisions. It is premised on the assumption that the concentration of banking resources has continued unabated and is primarily due to inadequate Federal Reserve supervision of the expansion of bank holding companies into product markets not directly related to banking, leading to a misallocation of the Nation's credit resources. These sections would prohibit all bank holding company acquisitions which would violate either the Sherman Act or the Clayton Act or which would result in a bank or bank holding company controlling more than 20 percent of the banking assets in the State where it is located. The Federal Reserve Board would also be given discretion to deny any other holding company acquisition where the anti-competitive consequences thereof would not be clearly outweighed by convenience and needs of the community.

Section 1309 would restrict permissible activities for bank holding companies under Section 4(c)(8) of the Bank Holding Company Act to those "directly" related to banking -- tightening the present "closely related" standard. Under the amended public benefit test --

(1) it would be necessary that the activity be "likely" (in lieu of "can reasonably be expected") to produce benefits to the public;

(2) it would be necessary that the activity be likely to produce increased competition over time, not just in the short run as suggested by present law;

(3) it would be necessary that the beneficial effect of the activity "clearly outweigh" adverse effects, not just "outweigh" as provided by present law;

(4) it would be necessary that the activity not have a tendency to lead to an undue concentration of "economic or financial" resources, not just "economic resources" as provided by present law;

(5) it would be necessary that the activity not lead to decreased competition over time, not just in the short run as suggested by present law;

(6) it would be necessary that the activity not risk the financial soundness of the bank holding company or its banking subsidiaries (the present law is silent on this point); and

(7) it would be necessary that the activity not interfere with the primary responsibility of the bank holding company or its banking subsidiaries to provide banking services to the public (the present law is silent on this point).

The bill would grandfather those activities in which a bank holding company was lawfully engaged on November 1, 1975, so long as the bank holding company does not expand the scope or size (in terms of volume of business) of the grandfathered activities to any significant degree.

Section 1310 would prohibit national banks or their subsidiaries from engaging in activities found by the Federal Reserve to be prohibited to bank holding companies under section 4(c)(8) of the Bank Holding Company Act of 1956. This provision is designed to prevent situations where the Comptroller of the Currency could permit national banks to do directly what the Federal Reserve had found not to be an appropriate activity under section 4(c)(8).

Also, Section 1311 would require that: (1) bank holding companies and their subsidiaries be capitalized and otherwise financed in a safe and sound manner; (2) bank subsidiaries of bank holding companies refrain from discriminating in favor of their parent or their affiliated subsidiaries in the making of loans or in the establishing of terms and conditions of loans; and

(3) bank holding companies disclose on a regular basis to the Federal Reserve the terms and conditions of all loans to or investments in bank holding company subsidiaries (the Federal Reserve in turn would be required to make the information public).

Title XIII further contains provisions related to the administrative procedures for making determinations under Section 4(c)(8) of the Bank Holding Company Act and to judicial review of all Federal Reserve orders and regulations issued under that Act.

Finally, the bill would provide interested persons with an opportunity to petition the Federal Reserve to consider the issuance, amendment or revocation of an order or regulation under the Bank Holding Company Act. Facts warranting the issuance, amendment or revocation of an order or regulation would include (1) a finding that the activities of a bank holding company no longer conform to the scope of the activity for which Board approval was originally given, (2) a finding that such activities no longer conform to new or amended Federal Reserve orders or regulations or judicial determinations, (3) a finding that such activities have ceased to produce substantial benefits to the public, or (4) a finding that such activities otherwise violate the standards established under Section 4(c)(8). This provision has the dual purpose of providing consumers with a mechanism to call questionable behavior on the part of the bank holding companies to the attention of the Federal Reserve and requiring the Federal Reserve to exercise positive responsibility for the ongoing supervision of the Section 4(c)(8) activities of bank holding companies.

Sections 1308-13 represent a major and fundamental departure from the present Federal bank regulatory structure. Empowering the Federal Reserve to determine capital adequacy for <u>all</u> banks in a holding company system, for example, goes to the very core of Federal bank supervision and represents a significant consolidation of regulatory jurisdiction. Likewise, giving the Federal Reserve power to delineate the corporate powers of national banks is a major step toward reorganization of the Federal regulation of banks.

Not only do we believe these provisions in Title XIII to be major, controversial changes in the Federal regulatory structure, we also believe as a substantive matter, that they point in the wrong direction. As recently indicated in testimony on the proposed Federal Bank Commission Act (S. 684), I am of the opinion that the most serious inadequacy in the present regulatory framework at the Federal level is the fragmentation of bank holding company supervision. Recent events have illustrated that the existing framework is not only unduly costly because of the overlapping and conflicting jurisdictions involved but also simply has not functioned properly in some instances. In three of our largest bank failures -- the insolvencies of Hamilton National Bank of Chattanooga and the American City Bank of Milwaukee and the distressed merger of the Palmer National Bank of Sarasota, Florida -- the cause was rather massive unsafe and unsound lending practices occurring in the essentially unsupervised environment of a non-banking holding company affiliate. The failure of the Hamilton Bank is perhaps the most graphic case. But for the $80 million in mortgages initiated by its Atlanta-based mortgage company affiliate, and then dumped on the bank when things went bad, the Hamilton Bank probably would be in existence today.

These cases illustrate two points which should be recognized by both the banking agencies and the Congress. First of all, the notion that one segment of a holding company system can be insulated from the remainder of the system is quite simply untrue. It is the worst form of self-deception to think that the lead bank in a holding company is in a safe and sound condition because its last examination was satisfactory, if other facets of the holding company system are not undergoing equally rigorous scrutiny. My point is that when bank holding companies were allowed to proceed in a manner that would be unacceptable in a commercial bank, some of them were encouraged, in effect, to undertake enormous risk.

The second point flows from the first, that is, it simply makes no sense for as many as four bank regulatory agencies to have safety and soundness jurisdiction over various segments of an integrated business enterprise. Inevitably, this approach will be at times conflicting and uncoordinated.

During the congressional debate over the 1970 Amendments to the Bank Holding Company Act of 1956, holding company safety and soundness were largely disregarded. The emphasis at that time was on providing safeguards against undue concentration of economic power stemming from bank holding company acquisitions of banking and non-banking subsidiaries. For example, in testimony before the Senate Banking Currency Committee on the 1970 Amendments, Charls Walker, Under Secretary of the Treasury, stated that legislation was required to stop the trend toward the merging of banking and commerce that was taking place through the vehicle of the one-bank holding company. Federal Reserve Board Chairman Arthur Burns voiced similar concern. Although there was discussion during consideration of the 1970 Amendments about dispersing supervision and regulation of bank holding companies among the three Federal bank regulatory agencies, the emphasis on the competitive and banking structure aspects of the bank holding company movement, coupled with the Federal Reserve's responsibility for administering the 1956 Bank Holding Company Act, led the Congress ultimately to delegate responsibility for administering the 1970 Amendments to the Federal Reserve System.

That such little consideration was given to the consequences of fragmenting responsibility over the different segments of a holding company system probably reflected, in part, the prevailing theory that the respective entities within a system could be effectively insulated from troubles elsewhere in the system. It also may have reflected the notion that the larger institutions in the holding company system, like the lead bank, would be a source of strength for all the components of the system. Events since the passage of the 1970 Amendments have demonstrated flaws in these assumptions and the inherent weakness of the fragmented regulatory framework which supervises the various components of a bank holding company system. In spite of the rhetoric about the legal separateness of each entity within the bank holding company, it has become more and more apparent as we have gained experience that a bank holding company should be regarded as a single, integrated unit.

Even if it were not possible to illustrate the adverse consequences of the present framework in concrete cases such as the Hamilton failure, the present framework should be rejected both because of the governmental waste that results from the unnecessary duplication of effort and because of the burden imposed upon the banker who must deal with four bank regulators as well as the SEC, the Justice Department, the FTC and miscellaneous other regulatory bodies.

In my judgment, this problem should be remedied immediately by charging the supervisor of the lead bank in a holding company system with the primary supervisory responsibility for the entire system. I would not at this time, however, shift the Federal Reserve Board's present role in determining permissible activities for bank holding companies. Nor would I shift responsibility for approving holding company formations and acquisitions. I hope to work with the Subcommittee in developing proposals for reform in this area in the near future.