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LeMaistre

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FDIC CHAIRMAN PROPOSES CHANGES IN FEDERAL SUPERVISION OF BANK HOLDING COMPANIES

George A. LeMaistre, Chairman of the Federal Deposit Insurance Corporation in a speech before the Exchequer Club today in Washington, D. C., stated, "Events of the past three years have demonstrated that the fragmentation of bank holding company supervision is a serious inadequacy of the present bank regulatory framework." Noting that under the present system a single bank holding company may be supervised by as many as one state and three federal banking agencies, Mr. LeMaistre said, "... the existing regulatory framework has not only been inefficient because of the overlapping and conflicting jurisdiction involved, but also simply has not functioned properly in some notable instances."

Citing the problems experienced by the Beverly Hills National Bank, The Hamilton National Bank of Chattanooga, American National Bank and Trust Company, Milwaukee, and Palmer First National Bank and Trust Company of Sarasota, Mr. LeMaistre stated, "These cases have demonstrated that one segment of a holding company organization cannot easily be insulated from the remainder of the system. These cases also have shown that because a holding company tends to be operated as an integrated enterprise, it is simply a form of self-deception to assume that the lead bank, or any other holding company banking affiliate for that matter, is in a safe and sound condition just because its last examination was satisfactory."

Mr. LeMaistre suggested that many of the existing difficulties could be resolved by assigning the federal agency that supervises the lead bank in a holding company system primary supervisory responsibility for the entire system. He said that his proposal would make the FDIC "... the sole federal supervisory agency for an entire bank holding company system where the lead bank is a state-chartered, nonmember, insured bank. The FDIC would have jurisdiction over all other banks in the group, whether national, state member or nonmember, over the parent company, and over any nonbanking subsidiaries. The Comptroller of the Currency would have the same responsibility where the lead bank is a national bank and the Federal Reserve where it is a state-chartered member bank."

Chairman LeMaistre emphasized that if this proposal were adopted, "Each individual bank holding company system would have to deal with one, and only one, federal bank regulatory agency. And each would be treated as an integrated organization. In my opinion, this would be in the best interest not only of the bank holding companies but of the public as well."

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Events of the past three years have demonstrated that the fragmentation of bank holding company supervision is a serious inadequacy of the present bank regulatory framework. A single bank holding company may be supervised by as many as one state and three federal banking agencies. As I testified recently before the Senate Banking Committee, it makes little sense for several agencies to have jurisdiction over various operating units of a single integrated business enterprise. Inevitably, coordination among the agencies has been a problem, and conflicting approaches frequently have occurred. In fact, the existing regulatory framework has not only been inefficient because of the overlapping and conflicting jurisdictions involved, but also simply has not functioned properly in some notable instances.

These problems have been recognized by others besides myself. For example, early this year the General Accounting Office criticized the present structure of bank holding company supervision. Moreover, during the same September hearings of the Senate Banking Committee before which I appeared, Comptroller of the Currency John Heimann and Deputy Secretary of the Treasury Robert Carswell also were critical of the existing system of bank holding company supervision.

I would like to share with you today some thoughts about problems that exist in bank holding company supervision and then to suggest a possible new approach. In discussing bank holding company supervision, I intend to consider two issues. The first is the necessary extent and method of holding company supervision. The second is the assignment of supervisory responsibility among the three federal bank regulatory agencies.

During the congressional debate that preceded the passage of the 1970 amendments to the Bank Holding Company Act, which not only brought one-bank holding companies under the Act's jurisdiction but also expanded the kinds of activities in which holding company subsidiaries could engage, holding company safety and soundness supervision and regulation were seldom discussed. The emphasis at that time was on providing safeguards against undue concentration of economic power stemming from bank holding company acquisitions of banking and nonbanking subsidiaries.

After passage of the amendments, the Federal Reserve System, which was charged with the responsibility of administering the Bank Holding Company Act, focused its attention on determining the kinds of nonbanking activities in which holding companies could engage and on establishing the criteria and procedures to be used in evaluating applications both to form bank holding companies and to acquire banking and nonbanking subsidiaries. Although the Bank Holding Company Act required the Federal Reserve to consider several factors in evaluating applications, preeminence was given to competitive factors.

Immediately following the passage of the 1970 amendments, debate developed, primarily centered in the Federal Reserve System, as to the appropriate degree of regulation of bank holding company organizations. Some argued that the holding company should be treated as a single integrated enterprise. They reasoned that the linking of nonbank and bank affiliates through a holding company would result in certain efficiencies in organization and operation. In other words, the total system could be operated more efficiently as a single integrated unit than as a consortium of independently operated affiliates.

Proponents of a second line of argument virtually ignored economic and management considerations and dwelled almost exclusively on legal considerations.

They reasoned that the operation of the corporate veil would effectively insulate all other bank holding company affiliates from any troubles that might develop in any single affiliate. Many took exception to this view, arguing that a holding company could not disavow the obligations of any of its affiliates and expect to retain market and public confidence. Subsequent events did prove that the expectation of legal insulation of an affiliate from the troubles of related affiliates was inconsistent with the realities of the business world.

In any event, at the outset attention was devoted to processing applications while safety and soundness supervision of nonbank affiliates and of the parent holding company organization was permitted to languish. Then in 1973, default by the Beverly Hills Bancorp on its commercial paper obligations, when loans made by various of its nonbank subsidiaries to a single firm were not repaid, resulted in a confusion of identification between the holding company and its subsidiary, Beverly Hills National Bank, which ultimately culminated in the sale of the bank. This established the link between an affiliated bank, its parent holding company, and the nonbanking affiliates. At about the same time, the Federal Reserve began more serious development of supervisory procedures. It established a policy of visiting (or inspecting) all bank holding companies at least once every three years. The first to be inspected were those that were known to be experiencing some kind of problem.

The collapse of the real estate market in 1974 and the subsequent severe economic recession placed stresses on many bank holding companies. Several were not able to survive. Perhaps the most graphic case involved Hamilton Bancshares. Hamilton Mortgage Corporation, based in Atlanta, Georgia, got into difficulty during 1974 when its borrowing capacity evaporated and it was unable to fund its loans or commitments to lend. More than $130 million out of a portfolio of over $200 million in real estate loans, concentrated primarily in speculative land acquisition and construction loans, were funded by Hamilton banking subsidiaries through the purchase of loan participations. Many of the loans originated by the mortgage company were of inferior quality and when the real estate market collapsed in 1974 Hamilton banking affiliates, particularly Hamilton National Bank of Chattanooga, were left holding a large volume of bad loans. The Hamilton National Bank of Chattanooga eventually failed as a direct consequence of the essentially unsupervised activities of the nonbanking mortgage company affiliate.

In addition, massive unsafe and unsound lending practices occurring in the essentially unsupervised environment of the nonbanking holding company affiliates of American City Bank and Trust Company, N. A., Milwaukee, Wisconsin, and the Palmer First National Bank and Trust Company of Sarasota, Florida, were among the factors that led to the eventual demise of both banks and created difficulties for other bank affiliates in both holding company systems.

These cases have demonstrated that one segment of a holding company organization cannot easily be insulated from the remainder of the system. These cases also have shown that because a holding company tends to be operated as an integrated enterprise, it is simply a form of self-deception to assume that the lead bank, or any other holding company banking affiliate for that matter, is in a safe and sound condition just because its last examination was satisfactory. The ease of transferring assets among affiliated companies can change a banking affiliate's soundness abruptly.

As we have gained experience with bank holding companies, it has become increasingly apparent that each holding company should be regulated as a single enterprise and not as a conglomerate of individual, independent firms. Although this fact has long been recognized by the capital market, bank regulators have realized this only gradually. However, to the extent possible given the strictures of existing law, there is increasing momentum toward supervising a bank holding company as an integrated organization. This does not necessarily mean that the activities of the nonbanking subsidiaries must be subject to the same degree of regulation and supervision as the banking subsidiaries. It does imply, however, that the activities of nonbank affiliates and the parent holding company should be monitored through frequent reports and analyses of intracompany payments and transfers of assets and periodic on-site examinations or inspections. Moreover, we are now well aware of the importance of simultaneous, on-site examinations and inspections of all system components.

This brings me to my second point. The implementation of an integrated approach to holding company supervision dramatizes the current incongruous arrangement whereby oversight of any one holding company may be shared by the three federal banking agencies. If the holding company contains national bank affiliates and insured state-chartered nonmember bank affiliates, the parent organization and the nonbanking affiliates, with certain exceptions, are legally subject to examination by each of the three federal banking agencies (and by state authorities, too).

To understand how the present situation came about, it is instructive to review the legislative history of the 1970 amendments to the Bank Holding Company Act. During the Senate hearings on these amendments, one issue was the assignment of supervisory authority over the companies. As originally introduced, the bill would have completely dispersed the regulation of the holding companies among the three federal banking agencies, even as to determining the permissible nonbanking activities and approving the formation and expansion of holding companies. Administration would have been assigned to the agency that supervised the largest proportion of banking assets within a given system. However, it was eventually decided that administration by a single agency would be more conducive to uniformity in developing guidelines for holding company formations and acquisitions. At those hearings, former FDIC Chairman Wille recognized that although this was probably the easiest solution to the problem, "it could be disruptive of established supervisory relationships over the subsidiary banks...." This was a prophetic statement. Nevertheless, it was decided to vest supervisory power in one federal agency and, because of its experience in administering the 1956 Bank Holding Company Act, that agency was, as you know, the Federal Reserve Board.

Initially, cooperation among the agencies was informal, occurring most often when a serious problem was discovered. However, in the last two years more strenuous efforts have been made on all sides to improve the supervision of a bank holding company system. Early in 1976, the Federal Reserve developed written guidelines for on-premise visits and more in-depth inspections of the operations and condition of all parent companies and significant nonbanking subsidiaries. Beginning January 1, 1978, the Federal Reserve is extending this policy to include the annual inspection of most holding companies with more than $300 million in total assets. Also, all Federal Reserve Banks will use a standardized "report of bank holding company inspection" for about 225 large bank holding companies, which represent 90 percent of total bank holding company assets. The new report will contain considerable detail, particularly with respect to the quality of the assets of the parent company and the nonbank subsidiaries. This report will be supplemented by analysis of financial statements. The Federal Reserve plans to develop a standardized report for approximately 1,730 small bank holding companies sometime in the future.

At the present time, the Federal Reserve routinely provides copies of its inspection reports of holding companies to the other two agencies, and we furnish the Federal Reserve copies of our examination reports of the holding company member banks that we supervise. In addition, all three agencies have established written procedures for advising each other as soon as information is uncovered about significant problems in holding company components over which another agency has jurisdiction.

Despite these cooperative efforts, the FDIC has found that it has not always been able to obtain information of the quality or timeliness that it requires in reaching an informed decision about the condition of a bank it is examining. When we examine a bank, we need to know the situation in the other banking and nonbanking affiliates in the holding company at that time. A concurrent, in-depth examination of all affiliates is not always necessary, but in some cases nothing else will suffice. In the past, the FDIC has participated with the Federal Reserve, conducted its own independent examinations, or requested information from various holding companies, but only when problems or potential problems have been uncovered during normal supervision of state nonmember banks affiliated with holding companies or when an insured bank is in danger of failing.

One resolution of the inadequacies inherent in the present supervisory system would be to consolidate all bank and bank holding company regulatory and supervisory powers into a single federal agency such as the Federal Banking Commission that Senator Proxmire has proposed. On grounds of efficiency and supervisory uniformity, valid arguments can be mustered for such an approach. However, I am of the opinion that a system that provides regulatory alternatives would be superior to a single agency. It has been my experience that such a system is more responsive to changing conditions and tends to assure responsible supervision and regulation.

In my judgment, a better resolution of the bank holding company supervisory problem would be to charge the federal agency that supervises the lead bank in a holding company system with primary supervisory responsibility for the entire system. A comparable alternative, proposed in the original version of the 1970 amendments to the Bank Holding Company Act and recently advocated by the Comptroller of the Currency, would be to assign to the federal agency that supervises the largest proportion of the total banking assets of a given class of banking affiliates the supervision of that holding company.

However, I would not alter the Federal Reserve's responsibility for determining permissible activities and for approving holding company formations and acquisitions. With respect to the approval of formations and acquisitions, I would recommend that the Federal Reserve defer to the judgment of the primary federal supervisor on matters pertaining to the financial and managerial resources and future prospects of the affected banking affiliate. This has been a problem in the past and was highlighted by the recent decision of the U. S. Court of Appeals of the Seventh Circuit to set aside a Federal Reserve ruling denying the acquisition of the First National Bank of Lincolnwood by

First Lincolnwood Corporation (No. 560 F.2d.258, dated July 13, 1977). The court found that affiliation with the holding company would not adversely affect the soundness of the bank and stated that the matter of the soundness of national banks was reserved to the Comptroller of the Currency. The Federal Reserve has relied heavily on the applications process as a means of regulating bank holding companies, and there is potential here for conflict with the other supervisory agencies.

The supervisory change that I recommend is a major one. If enacted, the FDIC would be the sole federal supervisory agency for an entire bank holding company system where the lead bank is a state-chartered, nonmember, insured bank. The FDIC would have jurisdiction over all other banks in the group, whether national, state member or nonmember, over the parent company, and over any nonbanking subsidiaries. The Comptroller of the Currency would have the same responsibility where the lead bank is a national bank and the Federal Reserve where it is a state-chartered member bank.

My proposal would mean that approximately 700 state-chartered banks currently supervised by the FDIC would be supervised instead either by the Comptroller of the Currency or the Federal Reserve. On the other hand, fewer than 100 national and state member banks would find themselves examined by the FDIC. The number of banks supervised by the FDIC, thus, would decline by 600, while the Comptroller and the Federal Reserve would experience net increases of 480 and 120 respectively. If the Comptroller of the Currency's proposal were adopted instead, the number of banks supervised by the FDIC would be reduced by about 525 banks. Thus, it should be clear that in making this proposal, I do not have ulterior motives, or, stated in the vernacular, I am not merely trying to protect my "turf."

Regardless of which method might be used for the assignment of supervisory jurisdiction, both my proposal and that of the Comptroller would divide bank holding company supervision among the three federal agencies. However, each individual bank holding company system would have to deal with one, and only one, federal bank regulatory agency. And each would be treated as an integrated organization. In my opinion, this would be in the best interest not only of the bank holding companies but of the public as well.

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