FDIC NEWS RELEASE

FEDERAL DEPOSIT INSURANCE CORPORATION

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Special Survey of Bank Stock Loans, Loans to Officials
and Major Stockholders of Other Banks,
Insider Loans and Overdrafts

Statement by

George A. LeMaistre, Chairman
Federal Deposit Insurance Corporation

Before the

Senate Committee on Banking, Housing and Urban Affairs,
United States Senate

March 16, 1978

Mr. Chairman, I welcome the opportunity to provide my own comments and evaluation of the results of the survey on bank stock loans, loans to officials and major stockholders of other banks, loans to insiders of reporting banks and overdrafts. The survey represents a substantial undertaking by the federal banking agencies, and one which I feel provides some valuable insights into the dimensions and characteristics of insider lending and overdraft policies of commercial banks.

I would like to summarize a few of the highlights. Only 902 insured commercial banks, 6.4 percent of all reporting banks, had loans secured by bank stock on their books as of September 30, 1977. A smaller percentage (4.2 percent) of insured nonmember banks reported bank stock loans. The survey revealed that bank stock lending is concentrated principally in unit banking states in the southwestern and central regions of the country. This is consistent with legitimate and understandable motives for borrowing to purchase bank stock. Unit banking states are generally characterized by a relatively large number of small banks. The ability to borrow against bank stock, with the stock serving as collateral, facilitates acquisition of an equity interest in local banks by small investors. Thus, the vehicle of bank stock lending helps preserve smaller, locally owned, independent institutions and thereby prevents further concentration of banking resources. In addition, by providing a source of liquidity to stockholders in small banks, bank stock loans more readily facilitate changes in ownership to bring new management to banks when necessary.

While recognizing that there are benefits associated with bank stock lending, such loans also pose a potential for mischief and insider abuse. The insider abuse most commonly associated with bank stock loans involves the use of correspondent balances to compensate the correspondent bank for a loan extended on preferential terms to an insider of the depositing bank and which results in an economic detriment to that bank. To determine whether widespread abuses currently exist in bank stock lending, it is necessary to examine all the lending terms of stock loans in each time period. Comparisons between interest rates charged on the loans and the average prime rates during the year of the loan origination provide some indication of the magnitude of preferential treatment extended to insiders of other banks in connection with bank stock loans. The survey showed that, since 1969, 7.4 percent of reported stock loans was made below the average prime rate. Moreover, since 1975, when most of these loans were made, the proportion was 1.9 percent.

The survey also showed that when a bank has a correspondent relationship with an institution whose stock is pledged by the borrower, the average size of the loan is larger and the interest rate charged is somewhat lower than when no correspondent relationship exists. However, it is not possible to conclude whether there are abuses of correspondent relationships without examining other information such as the timing of the establishment of the correspondent relationship and whether the amount of correspondent balances held are commensurate with the services provided. However, on balance, the survey data do not indicate to me that such abuses as may exist in bank stock lending are widespread in the banking system.

In my testimony before this Committee on September 26, 1977, I commented on the extent of abuses relating to bank stock loans in insured nonmember banks. My remarks were based on a sample investigation of examination reports and a survey of banks under examination at that time. Because we found that only six banks out of 303, or 2 percent, demonstrated preferential practices involving correspondent balances, I concluded that such abuses may be an isolated phenomenon. The data from this larger, more complete survey reveals that 10 percent of the bank stock loans of nonmember institutions made to insiders of other banks was made at interest rates clearly below the average prime rate during the period of loan origination. The loans making up this 10 percent were extended both with and without a correspondent relationship. This additional evidence seems to support my earlier conclusion that correspondent abuses associated with bank stock lending, although perhaps greater than I suspected earlier, are not prevalent among insured nonmember banks.

It is important to bear in mind that abuses related to correspondent relationships are not limited to those abuses arising out of bank stock lending. The survey data provide some evidence of a link between insider lending in general and correspondent banking, that is, a pattern of systematically lower interest rates prevail on loans to insiders of other banks when the other bank has a correspondent relationship with the lending bank. This pattern holds true for state member, national and state nonmember banks.

Most of the fixed-rate loans to insiders of other banks with rates below the average prime rate were made during periods characterized by tight money and rapidly changing interest rates (1970, 1973, 1974, and the first half of 1975). Under conditions of great uncertainty, such as occurred during these periods, it might not have been unreasonable to make short-term loans at rates below prime to individuals with whom the lending bank has had business dealings for a long time. Nevertheless, special circumstances would still have to be demonstrated to satisfy me that preferential treatment did not exist in such cases. I might add that state nonmember banks charged higher rates (both fixed and floating rates) on loans to insiders over the time period of the survey than the national average as reported in the survey. This was true regardless of whether correspondent balances were maintained at the lending institution.

Overall, I find that the survey tables provide interesting and relevant, although as I have stated, incomplete information on insider lending. Because of the special caveats mentioned in the joint agency report, information in the portion of the survey dealing with overdrafts is not as revealing. What is apparent to me is that the volume of overdrafts is greater than I would have expected. Banks reported a daily average of two million overdrafts amounting to a daily average of approximately $1.9 billion. Based on 1976 estimates of the number and dollar volume of checks debited to the accounts of individuals and businesses, overdrafts represented 2 percent of the number but 13 percent of the dollar volume of daily checks. For reasons mentioned below, these figures may not reflect fairly the actual extent of overdrafts.

In my September 26, 1977 testimony before this Committee, I reported that of the 189 nonmember banks that were examined during the week beginning

September 12, 1977, approximately 64 percent recorded overdrafts of insiders during the 90-day period preceding the examination date. By comparison, in the survey under discussion, about 44 percent of the 8,580 state nonmember banks reported overdrafts over $500, including 2,706 banks (31 percent) with overdrafts of their own insiders, 368 (4 percent) with overdrafts of insiders of other banks, and 735 (9 percent) with overdrafts of public officials. The larger overall percentage of banks in the 189 sample of state nonmember banks reporting overdrafts occurred because overdrafts of under $500 were included. Nevertheless, the percentages of nonmember banks reporting overdrafts of insiders of other banks and public officials were about the same in both surveys.

Although overdrafts are permitted by a large percentage of banks, abuse or violations of law are not widespread. In our review of overdraft practices from a survey of 261 bank examination reports which we conducted last fall, we discovered that examiners criticize approximately 3 percent of all insured state nonmember banks for bank insider overdraft abuses. Furthermore, we noted that most overdrafts are not criticized because the insiders' accounts are seldom overdrawn for more than a few days, and overdrafts occur infrequently. Overdrafts that are substantial or persist over time are criticized in the examination report as a matter of course.

It is not possible to compare the size, duration and frequency of overdrafts on an individual basis from data reported in the survey tables. For this reason I am skeptical about how meaningful data in Table 5A showing a substantial number of banks with large, free overdrafts of insiders are in addressing the question of overdraft abuses. Similarly, Table 7, which appears to show a policy of leniency with regard to waiving fees and charges to insiders of the bank on their overdrafts, does not take account of the relationship between size and frequency of overdrafts for each person and the fee policy imposed. However, no real sense of the extent of potential abuses relating to overdrafts is possible without comparing bank overdraft policies for insiders and others. Such an inquiry extends beyond the scope of the special survey. These and other matters related to the survey will be explored by examiners. Examination procedures and the report of examination will be reviewed in light of the survey to determine what changes should be undertaken.

Follow-up Procedures

The issue of what constitutes abuse by insiders of their relationship with their financial institution evokes some disagreement. My own view and the predominant one at the FDIC is that insider conduct is abusive and constitutes an unsafe or unsound banking practice when an insider obtains a benefit which is not available to a noninsider otherwise similarly situated and which results in an economic detriment to the bank. Where a bank's board tolerates abusive conduct, unquestionably firm supervisory action should be taken. As the Supreme Court has stated, the broad visitational power of federal bank examiners is perhaps the most effective weapon of federal regulation of banking (see United States v. Philadelphia National Bank, 374 U.S. 321, 329 (1965)).

I would like to outline some of the steps that the FDIC has taken, and anticipates taking, to follow up on possible abusive practices indicated by the survey data. As a first step, the Corporation, in conjunction with the Comptroller of the Currency and the Federal Reserve System, undertook a telephone survey of those banks that reported large overdrafts. This was done because of the information gaps on overdrafts in the survey as was indicated in the joint agency staff report.

Originally, it was planned to contact all those banks that reported overdrafts of $50,000 and above. However, because of time constraints, the telephone calls actually made were limited to those banks reporting overdrafts of $100,000 or more. Of the 191 banks reporting such overdrafts, 130 were contacted.

Overall, the results of the telephone follow-up show that 103 of the 130 banks should not have been included in the survey on overdrafts, largely because of reporting errors or because the overdrafts reported were not, in my judgment, overdrafts.

Of the 130 banks contacted, 38 either had no exposure because the overdraft was covered in a timely fashion or because the bank was never obligated to pay the overdraft. It should be kept in mind that, in virtually every state, banks by statute, clearing house rule, or agreement have a certain period of time to return or dishonor a demand item without incurring a legal obligation to pay it. In 20 of the 38 banks, the facts ascertained from the telephone survey indicated that the overdrafts reported were covered within the generally accepted time frame in which the bank could have returned the item. This time frame is usually referred to as the "midnight deadline." Thus, the 20 banks were apparently never legally obligated to pay the overdrafts reported. In any event, even if they could be considered overdrafts, in all 20 cases they were outstanding only one day.

Of the remaining 18 banks, overdrafts in 8 were covered by timely transfers from other bank accounts in the reporting bank, but were reported as overdrafts because of delays in posting the deposit to the customer's checking accounts; overdrafts in 8 were the result of delays in disbursing loan proceeds of a prior already approved loan to the customer's checking account; and overdrafts in 2 resulted from computer error which had the effect of not posting the deposit to the proper account in a timely manner.

Another 65 of the 130 banks erroneously reported overdrafts to corporate interests of insiders. The survey instructions did not include corporate interests within the reporting requirements. These 65 banks therefore, by definition, constitute a reporting error. Although shortness of time precluded detailed questioning about the nature of each corporate overdraft some questions were asked which revealed the same lack of exposure on the part of these banks as the 38 discussed above. Thus, 28 of the 65 corporate overdrafts were covered before the midnight deadline and 12 others were reported because of delays in: (1) posting intra-bank transfers; (2) disbursing prior approved loan proceeds; or (3) wire transfers from other banks.

In 7 of the 130 contacted, the banks experienced no exposure on the overdrafts because they were covered by wire transfers. In each of these 7 cases, the wire transfer was delayed for technical reasons. In 6 of the other instances, the bank reported, or the FDIC's computer picked up, an incorrect amount which, if reported correctly, would have reduced each of the 6 below the $50,000 level.

With respect to the remaining 14 of the 130 banks contacted, 6 appear to involve an abusive practice. However, the information obtained from the telephone contacts indicated that correction has been made in 5 of the 6 instances either through a change in ownership of the bank, a change in policy at the bank, or resignation or dismissal of the individuals involved. In 1 case, an interest charge was imposed. In the other 8, the overdrafts were those of insiders who were significant customers of the bank, and the overdrafts were of short duration (no more than 5 days) in all but one case. In 2 of these cases, rates above the bank's normal lending rates were charged. In the one instance which extended beyond 5 days, the overdraft was outstanding for at least 60 days but was collateralized by marketable securities and was 1 of the 2 on which interest was charged (the interest rate was 10 percent).

In summary, based upon this limited and hurried telephone follow-up of reported overdrafts of $100,000 or more, it seems clear that the numbers in the tables do not accurately portray industry practice and may be misleading. Furthermore, only 3 of 86 banks reporting no interest rate assessed against the overdraft showed evidence of abusive preferential treatment. In 1 of the 3, the overdraft was covered in 3 days. The FDIC will instruct its Regional Offices to investigate each state nonmember bank where abusive overdraft practices are indicated by the survey data, regardless of the amount reported.

In a more general follow-up, the Corporation will identify each state nonmember bank which reported anything in the survey which implies a possible abusive practice with respect to loans secured by the stock of other banks or bank holding companies; loans to insiders of the lending bank; loans to insiders of other banks; and overdrafts to insiders of the bank, to insiders of other banks, and to public officials. A list of these banks will be forwarded to the appropriate Regional Office with instructions to take whatever steps, are necessary to determine whether the bank has in fact engaged in, or is engaging in, any of these practices. This list will include all those state nonmember banks identified in the survey which extended credit to their own insiders at rates of interest clearly below the average prime rate. The list also will include those banks on both ends of stock loans transactions which involved low interest rates and a demand deposit balance placed at the lending bank by the bank whose stock secures the loan. In addition, in those cases where abusive practices exist, the Regional Offices will be instructed to point out to the bank how correction can and should be effected and then to ensure that correction is taken. If necessary, formal enforcement action will be instituted.

As you will recall, in my testimony before this Committee on September 26, 1977, I discussed at length the various guidelines provided to examiners and the examination methodologies employed to assist in the detection of abuses relating to insiders of a bank; possible preferential treatment accorded to insiders of other banks, especially in connection with bank stock loans and compensating balances; loans to favored customers; and overdrafts (see Hearings before the Senate Committee on Banking, Housing and Urban Affairs, 95th Cong., 1st Sess., pp. 57-79, and 89-99, Sept. 26, 27, and 28, 1977). The FDIC believes that the current guidelines and examination techniques are adequate to detect the vast majority of these types of abusive practices. Furthermore, I am confident that our examiners assiduously and conscientiously strive to root out abuses committed in these and other areas by banks under the FDIC's direct supervision by carefully commenting on them in the reports of examination.

In the course of each examination, examiners are required to list all loans to officers of other banks, except for loans of insignificant amounts, on FDIC Form 6500/23. The form was included as an exhibit to my testimony before this Committee on September 26, 1977 in the Hearings print referred to previously on page 122. Loans secured by stock of other banks, which in the aggregate amount to 5 percent or more of each bank's outstanding shares, must also be listed at each examination by examiners on FDIC Form 6500/22. This form was also reprinted in the Hearing print of September 26, 1977 on page 121. Furthermore, Section 7(j) of the Federal Deposit Insurance Act (12 U.S.C. 1817 (j)) requires that federal authorities be notified when there is a change of control of an insured bank or when there is a loan secured by 25 percent or more of an insured bank's outstanding stock.

To detect overdrafts to insiders, a list of bank directors, officers and employees is obtained from the bank or it is developed independently by examiners or by some combination of the two preceding methods. Identification of insider relatives is a difficult process. However, an adequate list usually can be put together by reviewing the stock ledger, insider transactions records, and the minutes of meetings of the loan committee and the board of directors. Any overdrafts to insiders are flagged to ensure follow-up action at a later point in the examination. The overdraft listing is also compared with loans to individuals made by other departments of the bank to determine tie-in relationships. Also, since the issuance of the FDIC's insider regulation, which specifically mandates record keeping requirements for insider transactions, the identification of overdrafts, as well as other insider activities, has been enhanced.

Examiner review and analysis of overdrafts also result in the detection of overdrafts to officers, directors and stockholders of other banks. Large overdrafts and frequent use of overdrafts are flagged automatically for an appraisal of repayment capacity. Furthermore, it is standard proceduce to determine the obligor's place of employment and position for those overdrafts that are relatively large and are not repaid during the course of an examination. This procedure permits detection of overdrafts to other bankers.

I believe that these procedures are generally successful in detecting insider abuses. Nevertheless, in light of some of the findings in the special survey, I have instructed the staff to review in detail and, where necessary, to take or recommend any requisite actions to improve the current guidelines provided to examiners and examination techniques used in the supervision of insider or other preferential practices. We are also in the process of evaluating the practicality and utility of incorporating the data gathered from these various sources into our computer base for ready access and analytical review in keeping track of trends.

Regulation and Recommended Legislation

I do wish to emphasize that the FDIC is deeply concerned about and responds vigorously to overreaching and abusive conduct by bank insiders. Although I do not believe that data from the survey indicate basic weaknesses in the bank regulatory structure, I do believe that the tools of law and public policy must evolve apace with changing times and events. To underscore the fact that I am not wedded to the existing framework and approaches of bank regulation, the FDIC published for comment on January 30, 1978 proposed amendments to the Corporation's regulations dealing with insider transactions. Included in the proposal are a number of substantive amendments:

1. A new provision specifying that an insider transaction is an unsafe or unsound practice if it is preferential and results in, or is likely to result in, loan losses, excessive cost, undue risk, or other economic detriment to the bank. The amendment also would clarify that the FDIC will take appropriate supervisory action against a bank whose insider transactions are found to be unsafe or unsound and that technical compliance with the regulation's requirements would not be a basis for justifying an otherwise unsafe or unsound insider transaction. Thus, the proposed amendments would make it clear that the FDIC will not tolerate any insider transaction that affords preferential treatment to an insider or person related to an insider and results, or is likely to result, in economic detriment to the bank.

2. A new provision would be added relating specifically to correspondent accounts. A survey finding that troubles me is that lower rates are charged on loans to insiders when a correspondent relationship exists with the insider's

bank than when such a relationship does not exist. To determine whether an abuse exists in such cases, we would require each insider to report in writing to the bank's board of directors all extensions of credit that are (a) made by a financial institution with which the bank maintains a correspondent account, and (b) made for the purpose of enabling the insider to purchase, carry or own a beneficial interest in securities issued by the bank, its holding company, or any other insured bank or holding company. The bank's board would be required to review, at least annually, all of the bank's correspondent accounts with other financial institutions to ensure that these accounts are fair and in the best interests of the bank. In making the review, the board would have to consider, among other things, bank stock loans reported by insiders. Furthermore, any deposit placed by a bank in another financial institution solely to compensate that institution for making a loan to an insider of the depositing bank would, ipso facto, be considered an insider transaction.

3. The proposed amendments would expand the definition of "person related to an insider" and substantially revise the definition of "business transactions."

4. Under the proposed revision, the bank's board of directors would be required to review and approve insider transactions when practical prior to consummation of the transaction. In any case, review and approval would be required no later than the next regularly scheduled board meeting following consummation of the transaction.

There are other amendments to the insider regulation which are mainly of a clarifying nature or are intended to tighten the regulation. Overdrafts by insiders of a bank have been and are included within the meaning of insider transactions under the amended regulation. We have attached for your convenience a copy of the January 30, 1978 press release on the proposed amendments to the FDIC insider regulation as well as the entire proposal itself.

Focusing specifically on the amendments addressed to bank stock loans and correspondent accounts, the approach proposed would ensure meaningful analysis of the bank's correspondent relationships by boards of directors and would thereby significantly minimize the likelihood of abuse. Of even greater importance, this approach would also provide FDIC examiners with a better and more convenient data base for use in detecting other abuses associated with bank stock loans.

As I have already testified, I also support passage of several proposed amendments to the statutory powers of the federal banking agencies which are now pending in Congress.

We urge the enactment of S. 71. Our cease end desist power under Section 8(b) of the Federal Deposit Insurance Act would be more effective if it could be used directly against the individual or individuals responsible for the commission of the abusive practice. In addition, to suspend or remove certain individuals under Section 8(e) of the FDI Act, the FDIC has the burden of proving, among other things, that the individual's act involved personal dishonesty, a burden of proof not unlike that required in a criminal proceeding. It is a difficult burden to carry and, therefore, inhibits the usefulness of the suspension or removal power. S. 71, as recently passed by the Senate, would largely remedy these shortcomings and generally enhance our ability to deal with abuse. Thus, the proposed amendments to Section 8 would enable the FDIC to proceed directly against officers, directors and persons in control of a bank who abuse the resources of the bank.

S. 71 would also permit suspension or removal of officers, directors and other persons from participating in a bank's affairs where their actions evince a willful disregard of the bank's safety and soundness. Although this amendment would certainly be an improvement over the current heavy burden of showing personal dishonesty, we would prefer a less burdensome test. As we indicated in our comments on S. 71, we would prefer, in addition to the personal dishonesty standard, to be able to suspend or remove the individual within the class covered who operates or manages the bank in a grossly negligent manner, or threatens the safety and soundness of the bank by evincing a continuing disregard for its financial safety.

We also favor the various civil penalty provisions contained in S. 71, especially the provision authorizing the imposition of a monetary penalty against individuals and banks for violation of a final cease and desist order. Similarly, the proposed amendments to Section 22 of the Federal Reserve Act, which would impose additional restrictions on loans extended by state member and nonmember banks to their own officers, directors and major stockholders and to corporations affiliated with those individuals, are desirable.

Another desirable legislative provision is that which allows the three federal bank regulatory agencies to disapprove changes in bank control on the basis of express standards spelled out in the statute. Although I assume the power to disapprove changes in control would be used sparingly, this type of legislation, if properly employed, would enable the agencies to anticipate and avoid problems which they can only react to at present. I believe that its mere presence would have a far-reaching deterrent effect and would minimize certain types of abuses. We would be happy to coordinate drafting of such legislation with this Committee

As I have stated on many occasions, 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 on loans and deposits. I will not burden you at this time with the details of my rationale on this subject. Suffice it to say that it is my firm belief that allowing the payment of interest on correspondent balances would be a major step in minimizing the potential for abuse arising out of the use of correspondent balances in connection with bank stock loans.

In summary, I perceive that the most pressing legislative need at present is the passage of S. 71, with perhaps the amendment I suggested previously regarding the agencies' suspension and removal power. Passage of S. 71 would significantly buttress existing enforcement tools.

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FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

NEWS RELEASE

FOR IMMEDIATE RELEASE PR-8-78 (1-30-78)

FDIC PROPOSES AMENDMENTS TO INSIDER TRANSACTION REGULATION

Chairman George A. LeMaistre of the Federal Deposit Insurance Corporation today announced that the Board of Directors has proposed amendments to Section 337.3 of the Corporation's regulations which deals with "insider transactions" of FDIC-insured State-chartered banks that are not members of the Federal Reserve System (insured State nonmember banks). The insider transaction regulation, which has been in effect since May 1, 1976, is intended to minimize abusive self-dealing and overreaching by bank insiders through the establishment of procedures designed to ensure that bank boards of directors supervise insider transactions effectively, and to better enable FDIC examiners to identify and analyze insider transactions.

The proposed amendments would (1) specify the circumstances under which the FDIC considers an insider transaction to be an unsafe or unsound banking practice, (2) make clear that the FDIC will take appropriate supervisory action when it determines that an insider transaction is an unsafe or unsound banking practice, (3) clarify what transactions are subject to the regulation's requirements, (4) clarify the regulation's recordkeeping requirements, and (5) prescribe specific reporting and review requirements with respect to correspondent accounts and certain bank stock loans.

Chairman LeMaistre stated that "The proposed amendments are designed to emphasize and clarify the FDIC's policy with respect to insider transactions. The Corporation believes that transactions with insiders, their close relatives, or their business interests are not improper *per se*. Accordingly, the proposed amendments seek to treat as unsafe or unsound banking practices those transactions in which insiders or their interests receive preferential treatment not afforded to noninsiders under comparable circumstances and which result in, or are likely to result in, loan loss, excessive cost, undue risk, or other economic detriment to the bank. Upon determining that a bank has entered into an insider transaction which is an unsafe or unsound banking practice, the Corporation will take appropriate supervisory action against the bank -- ranging from informal efforts to obtain voluntary correction to formal proceedings under Section 8 of the FDI Act." (Section 8 of the FDIC Act provides, among other things, for the issuance of cease and desist orders against banks that engage in unsafe or unsound banking practices.)

One of the principal proposed amendments is a specific provision relating to correspondent accounts. The new provision would require each insider to report in writing to the bank's board of directors all bank stock loans made to the insider and certain of the insider's relatives by a financial institution with which the bank maintains a correspondent account. The bank's board of directors would be required to review, at least annually, all of the bank's correspondent

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accounts to ensure that such accounts are fair to and in the best interest of the bank. In making the review, the board would be required to consider all relevant facts, including the bank stock loans reported by the bank's insiders.

In addition, a number of other amendments are proposed, some having substantive effect and some simply for purposes of clarity. All the proposed amendments are being published for comment in the FEDERAL REGISTER. Interested persons are invited to submit written data, views, or arguments regarding the proposed amendments no later than March 10, 1978, to the Office of the Executive Secretary, Federal Deposit Insurance Corporation, 550-17th Street, N.W., Washington, D. C. 20429. All written comments submitted will be made available for public inspection.

A copy of the proposed amendments as submitted for publication in the FEDERAL REGISTER is available from the Corporation's Information Office at the above address.

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Distribution: Insured State Nonmember Banks (Commercial and Mutual)

FEDERAL DEPOSIT INSURANCE CORPORATION

[12 C.F.R. Part 337]

UNSAFE AND UNSOUND BANKING PRACTICES

Insider Transactions

AGENCY: Federal Deposit Insurance Corporation (FDIC).

ACTION: Proposed amendments to regulation.

SUMMARY: The FDIC proposes to amend 12 C.F.R. § 337.3 dealing with "insider transactions" of insured State nonmember banks to: (1) specify the circumstances under which the FDIC considers an insider transaction to be an unsafe or unsound banking practice; (2) make clear that the FDIC will take appropriate supervisory action when it determines that an insider transaction is an unsafe or unsound banking practice; (3) clarify what transactions are subject to the regulation's requirements; (4) clarify the regulation's recordkeeping requirements; and (5) prescribe specific reporting and review requirements with respect to correspondent accounts and certain bank stock loans. The proposed amendments are generally designed to clarify the FDIC's policy with respect to insider transactions and to respond to questions that have been raised since the FDIC's insider transaction regulation took effect on May 1, 1976.

DATE: Comments must be received on or before March 10, 1978.

ADDRESS: Interested persons are invited to submit written data, views or arguments regarding the proposed amendments to the Office of the Executive Secretary, Federal Deposit Insurance Corporation, 550 17th Street, N. W., Washington, D. C. 20429. All written comments submitted will be made available for public inspection at the above address.

FOR FURTHER INFORMATION CONTACT: Alan J. Kaplan, Attorney, Federal Deposit Insurance Corporation, 550 17th Street, N. W., Washington, D. C. 20429, telephone (202) 389-4433.

SUPPLEMENTARY INFORMATION: THE FDIC's insider transaction regulation (12 C.F.R. § 337.3) took effect on May 1, 1976. As was stated at the time of its proposal and adoption, the regulation is aimed at minimizing abusive self-dealing by "insiders" of insured State nonmember banks through the establishment of procedures designed (1) to ensure that bank boards of directors supervise insider transactions effectively and (2) to better enable FDIC examiners to identify and analyze such transactions. The regulation seeks to achieve these goals by prescribing review, approval, and recordkeeping requirements with respect to certain transactions which are defined in the regulation as "insider transactions."

In addition, the regulation currently in effect states that notwithstanding compliance with the prescribed review and approval requirements, the FDIC will take appropriate supervisory action (including, in an appropriate case, the institution of formal proceedings under Section 8 of the Federal Deposit Insurance Act) against the bank, its officers, directors, or trustees if the FDIC determines that an insider transaction is indicative of unsafe or unsound practices. The regulation lists several factors which the FDIC will consider in determining the presence of unsafe or unsound banking practices involving insider transactions, but does not specifically describe the circumstances under which an insider transaction will be considered an unsafe or unsound banking practice.

Since the regulation took effect, questions have been raised from time to time as to the proper interpretation of various provisions and as to the FDIC enforcement policy with respect to those insider transactions that may involve abusive self-dealing. Accordingly, the FDIC has reviewed the regulation in light of the purposes it was designed to serve and now proposes to amend the regulation to better achieve those purposes and to promote greater clarity and understanding.

Numerous provisions of the regulation have been rewritten for purposes of clarity and readability, without affecting the substance of the regulation. However, a number of substantive amendments are also proposed, the most significant of which are described as follows:

1. A new definition would be added, defining the term "preferential" as it is applied to insider transactions. Under this definition, an insider transaction is preferential if, in light of all the circumstances, an insider or person related to an insider obtains a benefit or advantage which would not be afforded in a comparable arm's length transaction to a noninsider of comparable creditworthiness or otherwise similarly situated.

2. A new provision would be added to specify those circumstances under which the FDIC considers an insider transaction to be an unsafe or unsound banking practice. Under this provision, an insider transaction is an unsafe or unsound banking practice if the transaction is preferential and results in, or is likely to result in, loan loss, excessive cost, undue risk, or other economic detriment to the bank. The regulation would also make clear that the FDIC will take appropriate supervisory action against a bank whose insider transactions are found to be unsafe or unsound. Depending on the nature of the transaction and the circumstances involved, such supervisory action may range from informal efforts to obtain voluntary correction to, in an appropriate case, institution of formal proceedings under Section 8 of the Federal Deposit Insurance Act. Technical compliance with the regulation's review, approval, and record-keeping requirements would not be considered justification for an insider transaction which is an unsafe or unsound banking practice.

Thus, in order to dispel any confusion that may exist with respect to the current regulation, the proposed amendments would make it clear that the FDIC will not tolerate any insider transaction that affords preferential treatment to an insider or a person related to an insider and results in, or is likely to result in, economic detriment to the bank. Insured State nonmember banks can and should expect such transactions, should they occur, to be the subject of examiner comment and FDIC supervisory action.

With reference to the factors enumerated in subsection (g) of the current regulation which the FDIC will consider in determining the presence of unsafe or unsound banking practices involving insider transactions, two of those factors have been deleted in the proposed amendments in favor of a revised single standard. It should be emphasized, however, that the revised single standard is not intended to be narrower in scope than the three factors enumerated in present subsection (g).

It should also be emphasized that any insider transaction that meets the stated criteria will be considered an unsafe or unsound banking practice, regardless of the dollar amount of the transaction. The inclusion in the regulation of a schedule of minimum dollar amounts which "trigger" the regulation's review, approval, and recordkeeping requirements in no way limits the FDIC's ability to take supervisory action against a bank that enters into an insider transaction which is an unsafe or unsound banking practice, even if the dollar amount of the transaction falls below the applicable "triggering amount."

3. A new provision would be added relating specifically to correspondent accounts. It would require each insider to report in writing to the bank's board of directors all loans or other extensions of credit that are both (a) made by a financial institution with which the bank maintains a correspondent account, and (b) made for the purpose of enabling the insider, the insider's spouse, or any relative of the insider who lives in the insider's home to purchase, carry, or own a beneficial interest in securities issued by the bank, its holding company, or any other insured bank or holding company of an insured bank. The report would state the terms and conditions of the loan, including certain specified information, and would be kept with the bank's insider transaction records.

The bank's board of directors would be required to review at least annually, all of the bank's correspondent accounts with other financial institutions. The purpose of the review would be to ensure that such accounts are fair to and in the best interests of the bank. In making the review, the board would be required to consider all relevant facts, including the bank stock loans reported by insiders.

In addition to this specific provision, any deposit placed by a bank in another financial institution to compensate that institution for making a loan to an insider of the bank would be considered an "insider transaction" under amended paragraph (a)(8)(iii) and would therefore be subject to the regulation's review, approval and recordkeeping requirements.

4. The definition of "person related to an insider" would be expanded to include certain relatives of an insider not covered by the present regulation (e.g., brothers, sisters, spouse's parents).

5. The definition of "business transactions" would be substantially revised. Instead of listing certain examples of such transactions, as the present regulation does, the revised regulation would simply define "business transaction" to mean "any arrangement, activity, or transaction," except those specifically excluded. The "exceptions" relating to trust activities and activities undertaken in the capacity of securities transfer agent or municipal securities dealer would be deleted. In addition, the exception for "credit card transactions" would be restricted to those which are "pursuant to standard credit provisions applied and enforced equally as to all credit card customers of the bank," and the exception for "deposit account activities" would be restricted to those "involving the bank as depository (other than payment by the bank of interest on time deposits of $100,000 or more)."

6. The definition of "series of related business transactions," currently in a footnote, would be placed in the main text.

7. In the definition of "insider transaction," the phrase "inures to the tangible economic benefit of" would be changed to "results in economic benefit to." It is believed that the new language would be more easily understood.

8. The bank's board of directors would be required to review and approve an insider transaction prior to consummation of the transaction, unless prior review and approval are clearly impractical, in which case review and approval would be required to occur no later than the next regularly scheduled board meeting following consummation of the transaction. In those cases in which approval is given following consummation of the transaction, the board's minutes would be required to include a statement of the reasons why the board found prior review and approval to be clearly impractical.

9. The following additional amendments to the regulation's review and approval requirements are proposed: (a) the phrase "[an insider transaction] involving assets or services having a fair market value amounting to more than" would be replaced by the phrase "[an insider transaction that] involves an amount greater than," along with a clarifying footnote; (b) the minutes of the meeting at which approval is given would be required to expressly indicate that the board recognized the transaction to be an insider transaction; and (c) review and approval of a "series of related business transactions" would be required to occur at least annually.

10. The regulation's recordkeeping provisions would be amended in the following respects: (a) each file containing documents or information relating to an insider transaction would have to be conspicuously marked as such and would have to be cross-referenced to the minutes of the meeting at which the board approved the transaction; and (b) each such file would be required to include sufficient information and documentation to enable the board to make an informed decision as to approval or disapproval, including such information and documentation as the bank would require of a noninsider in a comparable transaction.

11. The existing provision relating to the discovery by the bank of an insider relationship after entering into a transaction requiring review and approval would be deleted.

Accordingly, the Board of Directors of the Federal Deposit Insurance Corporation hereby proposes to amend 12 C.F.R. Part 337 by revising § 337.3 to read as follows:

Section 337.3 Insider Transactions.

(a) Definitions.

(1) Bank. The term "bank" means an insured State nonmember commercial or mutual savings bank and any majority-owned subsidiary of such bank.

(2) Person. The term "person" means a corporation, partnership, association, or other business entity; a trust; or a natural person.

(3) Control. The term "control" (including the terms "controlling", "controlled by", and "under common control with") means the possession, directly or indirectly, of the power to direct or cause the direction of management and policies of a person, whether through the ownership of voting securities, by proxy to vote such securities, by contract, or otherwise.

(4) Insider. The term "insider" means:

(i) Any director or trustee of a bank;

(ii) Any officer or employee of a bank who participates or has authority to participate in major policy-making functions of the bank;

(iii) Any person who has direct or indirect control over the voting rights of ten percent or more of the shares of any class of voting stock of a bank; or

(iv) Any person who otherwise controls a bank.

(5) Person related to an insider. The term "person related to an insider" means:

(i) A corporation, partnership, association, other business entity, or trust which controls, is controlled by, or is under common control with an insider; and

(ii) A natural person who is

(A) an insider's spouse (except where legally separated);

(B) a parent or stepparent of an insider's spouse;

(C) an insider's parent, stepparent, child, stepchild, brother, stepbrother, half-brother, sister, stepsister, or half-sister; or

(D) any other relative of an insider who lives in the insider's home.

(6) Business transaction. The term "business transaction" means any arrangement, activity, or transaction, except: charitable transactions; deposit account activities involving the bank as depository (other than payment by the bank of interest on time deposits of $100,000 or more); safekeeping transactions; and credit card transactions pursuant to standard credit provisions applied and enforced equally as to all credit card customers of the bank.

(7) Series of related business transactions. The phrase "series of related business transactions" includes business transactions which are in substance part of an integrated business arrangement or relationship, such as borrowings under a single line of credit, law firm billings, or recurring transactions of a similar nature within a holding company system.

(8) Insider transaction. The term "insider transaction" means any business transaction or series of related business transactions between a bank and:

(i) an insider of the bank;

(ii) a person related to an insider of the bank;

(iii) any other person where the transaction results in economic benefit to an insider of the bank or a person related to an insider of the bank; or

(iv) any other person where the transaction is engaged in or made in contemplation of such person becoming an insider of the bank.

(9) Preferential. An insider transaction is "preferential" if, in light of all the circumstances, an insider or person related to an insider obtains a benefit or advantage which would not be afforded in a comparable arm's length transaction to a noninsider of comparable creditworthiness or otherwise similarly situated.

(b) <u>Unsafe or Unsound Banking Practices Involving Insider Transactions; Supervisory Action</u>.

(1) An insider transaction is an unsafe or unsound banking practice if the transaction is preferential and results in, or is likely to result in, loan loss, excessive cost, undue risk, or other economic detriment to the bank.

(2) The Corporation will take appropriate supervisory action against a 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 an unsafe or unsound banking practice. Such supervisory action may consist of informal efforts to obtain voluntary correction of the unsafe or unsound banking practice or, in an appropriate case, may involve institution of formal proceedings under Section 8 of the Federal Deposit Insurance Act. Compliance with the review, approval, and recordkeeping requirements of this section will not relieve the officers, directors, or trustees of a bank of their duties to conduct the bank's operations in a safe and sound manner, and will not be considered justification for an insider transaction which is found to be an unsafe or unsound banking practice.

(c) <u>Review and Approval of Certain Insider Transactions</u>.

(1) A bank's board of directors or board of trustees shall specifically review and approve each insider transaction that, either alone or when aggregated in accordance with paragraph (d) of this section, involves an amount 1/ greater than

(i) $20,000, if the bank has not more than $100,000,000 in total assets;

(ii) $50,000, if the bank has more than $100,000,000 but not more than $500,000,000 in total assets; or

(iii) $100,000, if the bank has more than $500,000,000 in total assets.

Such review and approval shall occur prior to consummation of the transaction, unless prior review and approval are clearly impractical, in which case review and approval shall occur no later than the next regularly scheduled meeting of the bank's board of directors or board of trustees following consummation of the transaction.

1/ If the transaction involves a disbursement of funds or an obligation to disburse funds by the bank, then the "amount" referred to in the text is the amount disbursed or the maximum amount which the bank is obligated to disburse. If the transaction involves payment by the bank of interest on time deposits of $100,000 or more, then the "amount" referred to in the text is the principal amount of the time deposit.

(2) When an insider transaction is part of a series of related business transactions involving the same insider, approval of each separate transaction is not required so long as the bank's board of directors or board of trustees has reviewed and approved the entire series of related transactions and the terms and conditions under which such transactions may take place. Any series of related business transactions shall be reviewed and approved at least annually.

(3) The minutes of the meeting at which approval is given shall (i) indicate the nature of the transaction and the parties thereto, (ii) expressly indicate that the board recognized the transaction to be an insider transaction, that review was undertaken, and that the transaction was approved or disapproved, and (iii) state the names of each director or trustee who voted to approve or disapprove the transaction or abstained from voting. In the case of negative votes, a brief statement of each dissenting director's or trustee's reason for voting to disapprove the proposed insider transaction shall be included in the minutes if its inclusion is requested by the dissenting director or trustee. In those cases in which approval is given following consummation of the transaction, the minutes shall also include a statement of the reasons why the board found prior review and approval to be clearly impractical.

(d) Aggregation of Insider Transactions. For purposes of subsection (c) of this section, any loan or extension of credit involving an insider shall be aggregated with the outstanding balances of all other loans or extensions of credit involving that insider. A loan or extension of credit involves a specific insider when the loan or extension of credit is made to that insider, to a person related to that insider, or to any other person where the loan or extension of credit results in economic benefit to that insider or a person related to that insider.

(e) Records and Information Pertaining to Insider Transactions.

(1) Each bank shall maintain a record of, and information pertaining to, insider transactions requiring review and approval under this section. To facilitate examiner review, such records and information shall (i) be readily accessible to examiners, (ii) be kept in a manner and form that will enable examiners to readily identify all insider transactions which require review and approval under this section, and (iii) be cross-referenced to the minutes of the board of directors' or board of trustees' meeting at which the insider transaction was approved. Each file containing documents or other information relating to an insider transaction shall be clearly and conspicuously marked as such.

(2) The records and information relating to insider transactions shall describe fully and accurately all insider transactions requiring review and approval under this section, and shall include all documents and other material relied upon by the board in approving each such transaction, including the name of the insider, the insider's position or relationship that causes him to be considered an insider, the date on which the transaction was

approved by the board, the type of insider transaction, and the relevant terms of the transaction. The file relating to each such transaction shall include sufficient information and documentation to enable the board to make an informed decision as to approval or disapproval, including such information and documentation as the bank would require of a noninsider in a comparable transaction.

(f) Disclosure of Proposed Insider Transactions. Any insider having knowledge of an insider transaction or a proposed insider transaction involving that insider or a person related to that insider shall give timely notice of such transaction to the bank's board of directors or board of trustees.

(g) Correspondent Accounts. 2/

(1) A bank's board of directors or board of trustees shall periodically review (at least annually) all of the bank's correspondent accounts with other financial institutions to ensure that such accounts are fair to and in the best interests of the bank. In making the review, the board shall consider all relevant facts and circumstances, including the loans and other extensions of credit reported under paragraph (2) of this subsection (g). The board's minutes shall recite the details and findings of the review.

(2) Each insider shall report in writing to the board of directors or board of trustees of the bank all loans or other extensions of credit that are both (A) made by a financial institution with which the bank maintains a correspondent account and (B) made for the purpose of enabling the insider, the insider's spouse, or any relative of the insider who lives in the insider's home to purchase, carry, or own a beneficial interest in securities issued by the bank, its holding company, or any other insured bank or holding company of an insured bank. 3/ The report shall be kept with the records maintained by the bank with respect to insider transactions and shall state the terms and conditions of each loan or extension of credit, including the following information:

2/ Compliance with the provisions of this subsection (g), or of section 337.3 generally, should not be construed to affect in any manner the liability of any person under 18 U.S.C. § 656 for willful misapplication of bank funds.

3/ As used in this sentence, the term "insured bank" includes any national bank, State member bank, or insured State nonmember bank.

(i) a brief description of the loan or other extension of credit;

(ii) the parties thereto or affected thereby;

(iii) the identity and relation to the bank of the insider involved; and

(iv) the principal terms and conditions of the loan or other extension of credit (in the case of a loan, these would include the principal amount; term or maturity; interest rate; description and valuation of collateral pledged; purpose of loan; repayment schedule; and source of repayment).

(Sec. 2[8], Pub. L. 797, 64 Stat. 879, as amended, Pub. L. 89-695, 80 Stat. 1046 (12 U.S.C. 1818); sec 2[9], Pub. L. 797, 64 Stat. 881-82 (12 U.S.C. 1819)).

By order of the Board of Directors dated January 25, 1978.

FEDERAL DEPOSIT INSURANCE CORPORATION

By: Alan R. Miller
Alan R. Miller
Executive Secretary

(SEAL)