V C.1
Spch
FDIC
W

FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

NEWS RELEASE

FOR RELEASE UPON DELIVERY

PR-57-75 (7-21-75)

Legislative proposals under FDIC consideration
as a result of the failure of United States
National Bank and related enforcement problems

Presented to the

Subcommittee on Financial Institutions,
Supervision, Regulation and Insurance
House Committee on Banking, Currency and Housing,
House of Representatives

by

Frank Wille, Chairman
Federal Deposit Insurance Corporation

July 21, 1975

This statement outlines a number of legislative proposals the FDIC is considering which might curb some of the abuses that led to the downfall of United States National Bank and have or could lead to the failure of similarly operated banks.

I. AFFILIATES: A broader definition of affiliate for lending purposes

USNB, which was in fact controlled by C. Arnholt Smith, extended massive credit to other enterprises controlled by Smith, yet these credit extensions apparently did not violate the provisions of § 23A of the Federal Reserve Act limiting loans to "affiliates" of member banks (made applicable to non-member banks by § 18(j) of the Federal Deposit Insurance Act). Section 23A incorporates the definition of "affiliate" found in Section 2a of the Banking Act of 1933 (12 U.S.C. § 221a). As presently written, Section 2a limits the term "affiliate" to those entities which are controlled by shareholders who control more than 50 percent of the shares of a bank's voting stock, and Smith himself did not directly control a majority of the voting shares of USNB. We believe that this definition should be changed to encompass shareholders who have actual control over the management or policies of a bank even though they own less than a majority of its voting shares.[1/]

This change was previously suggested by the Comptroller of the Currency in his prepared statement before this Subcommittee on December 11, 1974.

1/ The term "affiliate", as defined in Section 2a, is used in other sections of the Federal Reserve Act as well as Section 23A. Each of those sections will be separately examined to determine whether the recommended broadening of the definition of "affiliate" is similarly desirable.

II. CONGLOMERATES: Tighter limits on lending to entities under common control

Although there are federal and state laws which limit loans to a single borrower, many corporate borrowers have been able to avoid such limits through the simple expedient of having each of their subsidiaries borrow separately from the same bank, with the parent company refraining from any direct borrowing from that bank. The danger is that laws or regulations which treat corporate subsidiaries as separate entities for bank lending limit purposes will result in aggregate excessive loans to ostensibly separate entities which are in reality part of a single enterprise. When that enterprise fails, normally the loans to all of the entities go "sour".

For example, USNB extended credit to the Westgate-California conglomerate in amounts far in excess of the legal limit imposed on loans by a national bank to any one borrower (12 U.S.C. § 84). It was able to do so because the parent company (now in Chapter 10 proceedings) didn't borrow directly. In construing § 84, the Comptroller of the Currency has ruled that obligations of subsidiary corporations are generally not considered obligations of the parent if the parent corporation is not itself borrowing from the same bank (12 C.F.R. § 7.1310), and this construction in the view of most lawyers is supported by the language of the statute.

To counter this problem, the FDIC favors changes in both federal and state lending limits, where necessary, which would allow the supervisory authorities to treat loans to entities under common control as loans to a single borrower.

III. INSIDERS: Tighter limits on lending to insiders and their related business interests

Lending limits should prevent banks from incurring undue risks by lending excessive amounts to insiders and their related business enterprises. A bank may be less subject to the restraints imposed by prudence and sound judgment when making loans to these insiders and their related interests than it would be in making loans to unrelated individuals or business enterprises.

In line with Governor Holland's testimony last Wednesday, we recommend that § 22 of the Federal Reserve Act (12 U.S.C. § 375a) be amended so as to cover directors and controlling shareholders of a member bank in addition to its executive officers, and to business enterprises which such directors, controlling shareholders and executive officers control. We also agree that loans to these individuals should be aggregated with loans to companies controlled by them for the purpose of applying state and federal lending limits. Since many states impose no legal restraints on loans to a bank's own executive officers, directors or controlling shareholders, we recommend that Section 22 of the Federal Reserve Act be extended to encompass those State-chartered banks which are insured by the FDIC but do not belong to the Federal Reserve System.

Parenthetically, I might add that the FDIC is considering regulations which would impose on banks tighter internal controls and recordkeeping requirements for transactions with insiders. We plan to publish these proposed regulations for public comment within the next few weeks.

IV. FINES: Administrative fines for major banking law violations

A special problem has to do with the absence of penalties for violations of major federal banking laws, such as §§ 22 and 23A of the Federal Reserve Act. I previously recommended that § 22 be extended to cover insured nonmember as well as member banks. Section 23A already applies to insured nonmember banks by virtue of § 18(j) of the Federal Deposit Insurance Act. Neither section includes any provision for a fine in the event of its violation, yet both sections are important in preventing the kinds of abuses often found in problem banks.

We recommend that Congress authorize the appropriate bank regulatory agency to assess a fine against any bank or individual willfully violating § 22 or § 23A, or willfully refusing to obey any lawful regulation issued pursuant thereto. Such fine would be in the nature of a civil rather than a criminal penalty and would vary in amount, within the maximum set by law, at the discretion of the agency.

We recognize the severity of this remedy but feel that it often constitutes the only effective method of deterring harmful violations. Termination of a bank's insurance has long been recognized as too severe to be used in any but extreme situations. Cease and desist proceedings are useful but the threat of a cease and desist order, standing alone, has not always proved to be a sufficient deterrent to those who would willfully violate laws or regulations. Hopefully, the threat of a fine would deter conduct that could cause irreparable injury to a bank.

We also recommend the imposition of a fine for the willful violation of any effective and outstanding cease and desist order issued by an agency under

§ 8(b) or § 8(c) (12 U.S.C. §§ 1818(b) and (c)) of the Federal Deposit Insurance Act where the order has become final. In this case, the fine would be imposed for each day that the offending bank or individual willfully refuses to obey the order. The imposition of a fine for violating a cease and desist order which has become final would serve to emphasize the gravity of such an order. Under § 8(k) (12 U.S.C. § 1818(k)), a cease and desist order does not become final unless entered into by consent or until the time has run for filing a petition for review with the appropriate U. S. court of appeals and no petition has been filed or perfected, or the petition so filed is not subject to further review by the Supreme Court. In either event, the party must have exhausted the administrative and judicial remedies afforded him under the Act. If the party then continues to disobey an order, the appropriate agency can apply to the proper U. S. district court to secure its enforcement. However, the threat of court enforcement and possible contempt proceedings should not be the only deterrent at this point. The party has been given every opportunity to have his day in court. He should not be allowed to further impede the effect of the order simply to secure another delay and should be subject to a substantial monetary penalty for each day that he does so.

V. REMOVAL: Individuals who willfully disregard the safety and soundness of an institution

As you know, § 8(e) (12 U.S.C. § 1818(e)) of the Federal Deposit Insurance Act authorizes the removal of 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 where his actions also involve personal dishonesty and are seen as causing substantial financial loss to the bank or damage to its depositors. This effectively bars the removal of an officer or director who has repeatedly demonstrated gross negligence or willful disregard for the safety and soundness of his bank, thereby causing it substantial financial injury, but who has not been shown to have engaged in any act amounting to personal dishonesty.

Although we recognize the effort on the part of Congress to shield those who are innocent of any personal wrongdoing from arbitrary or capricious administrative action, we feel that some effort should be made to balance the interests of the individual bank officer or director against those of its depositors and shareholders, and ultimately the Federal deposit insurance fund. This can be done by adding to the Act as an alternative to the standard of personal dishonesty, a new standard which would recognize the need to remove those whose reckless conduct threatens the financial safety of their insitutions. Since removal under § 8(e) is an administrative remedy which may not be put into effect until a hearing has been afforded the party in question, providing him with an opportunity to put on his defense, he is adequately protected against arbitrary and capricious administrative action. In addition, he has the right to petition a court of appeals to modify or set aside the removal order.

VI. CEASE AND DESIST: Extension of order to certain persons

Our experience suggests that a bank may be harmed not only by the misconduct of its own management but also by the misconduct of others who are in a position to influence its affairs. However, it is often difficult to reach such persons through a cease and desist proceeding brought against the bank itself.

Section 8(b) (12 U.S.C. § 1818(b)) of the Federal Deposit Insurance Act empowers the appropriate federal banking agency to bring a cease and desist proceeding against a bank that is engaged in a violation of a law, rule or regulation, or an unsafe or unsound practice. We recommend that § 8(b) be amended to expressly include persons such as directors, officers, controlling shareholders and others participating in the conduct of the affairs of the bank. This would enable the appropriate agency to control the participation in the affairs of a bank of those persons who have either violated a law, rule or regulation, or engaged in an unsafe or unsound practice, or participated with others in such violations or practices.