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Statement by

Robert C. Holland

Member, Board of Governors of the Federal Reserve System

before the

Subcommittee on Financial Institutions Supervision,

Regulation and Insurance

of the

House Committee on Banking, Currency and Housing

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I am pleased to appear before this Subcommittee, on behalf of the Board of Governors of the Federal Reserve System, to discuss the broad range of important banking regulatory and supervisory matters concerning which your distinguished Chairman has requested the Board's views.

The financial experiences of the last two years have raised many significant issues with regard to the regulation and supervision of the nation's banking institutions. The need for a careful review of those factors that might adversely affect the stability of the banking industry has been recognized by this Subcommittee and other committees of the Congress, by the Board, and by the other banking regulatory agencies. As I reported to this Subcommittee in my testimony of December 12, 1974, at the Board we have undertaken a careful analysis of the key problem areas that might tend to contribute to an undesirable degree of instability within the banking system and of steps that might be taken to reduce such proclivities. A number of our colleagues in Government

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have been engaged in similar efforts as well. Many bank managements have also been thinking through the implications of recent financial events for their own institutions. This degree of attention and concern regarding the health of our banking system attests to the critical role banking institutions fill in our financial system and economy, and it underlines the need to insure that no significant weaknesses impair their continued well-being.

Among those financial events of recent years that have given cause for concern, the failure of the Franklin National Bank looms large. The circumstances leading to the demise of that institution have already been publicly reported, and therefore my statements on this matter will focus primarily on the role played by the Federal Reserve in cooperation with the other bank regulatory agencies.

During the period from mid-May to October of last year, the Federal Reserve Bank of New York

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provided emergency credit assistance to Franklin National Bank in amounts rising to a peak total of $1,767 million. The actual amounts loaned to Franklin varied from day to day, depending upon its liquidity needs. The Franklin National Bank was a member bank of the Federal Reserve System; as such, it merited the privilege of accommodation at our discount window under the usual rules so long as it remained solvent, and we were advised by its primary bank supervisor that such was the case. The sheer size of the loans to Franklin, however, was extraordinary.

The primary purpose of these loans to Franklin was to prevent the immediate or imminent closing of that institution because of its liquidity problems. We believed that the closing of a $5 billion bank such as Franklin could have precipitated other bank failures with resulting large losses for many individuals and businessmen and for the Federal Deposit Insurance Corporation. This situation arose during a difficult period for financial institutions and financial markets; such a failure at that time could, in our judgment,

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have had serious adverse consequences for the stability of our nation's banking system, and for domestic and international financial markets in general.

With these considerations in mind, Federal Reserve credit, fully secured by Franklin National Bank collateral, was extended to Franklin to help offset the massive net withdrawals of funds that developed as that bank's difficulties became generally known. Between May 8 and October 8, 1974, when the bank was declared insolvent, it suffered an outflow of funds amounting to $2.8 billion -- over half its total footings. By strenuous efforts, the bank succeeded in reducing its loans, investments and cash by $1.1 billion during this interval. The eventual $1.7 billion in Federal Reserve credit assistance was necessary to offset the balance of the outflow.

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During this five-month period, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Board of Governors, together with the Federal Reserve Bank of New York, were in frequent communication with each other in a joint effort to arrive at a permanent solution to Franklin's difficulties. As you know, the Comptroller has the statutory responsibility of determining whether or not a national bank is insolvent. Upon such a determination of insolvency, the FDIC must be appointed as receiver. The FDIC then proceeds with the winding-up of the bank's affairs, seeking to achieve an orderly transfer of the insolvent institution's assets and liabilities and as little loss as possible to the deposit insurance fund it administers.

In the Franklin case, the Comptroller began consultations in May and June with major banks that might have been capable of, and interested in, acquiring Franklin by merger. In September he obtained the additional advice of a financial consultant in an effort to determine definitely whether the bank could continue as a viable, independent institution.

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In July, foreseeing the possibility that Franklin might have to be declared insolvent, the Comptroller requested the FDIC to contact other banking organizations which were potential purchasers of Franklin's assets and to develop a plan to assist such a purchasing bank in a transfer of assets and liabilities. The FDIC accordingly began negotiations with interested banks to draft an acquisition proposal upon which banks could bid competitively in the event Franklin had to be declared insolvent. Briefly, this plan, as it was developed, called for the FDIC as receiver of Franklin to transfer all of Franklin's deposits and certain other liabilities to an assuming bank; that bank would be allowed to select assets of Franklin up to an amount which, when added to the purchase price bid, would equal the liabilities it assumed. The assuming bank would be required to keep most of Franklin's offices open for at least 30 days. On its part, the FDIC would: (1) indemnify the assuming bank against losses from unassumed liabilities;

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(2) advance supporting capital to the bank in the form of a subordinated note; and (3) in return for the New York Reserve Bank surrendering its lien on the assets of Franklin that were transferred to the assuming bank, assume Franklin's obligations to the New York Reserve Bank, which would be repaid to the extent possible out of the remaining assets, but would in any event be fully repaid within three years whether or not sufficient collections had been made at that time. This last provision assured that no loss would be incurred by the Federal Reserve System as a result of either its emergency lending to Franklin or the purchase by the New York Reserve Bank of Franklin's foreign exchange contracts. This latter purchase had been undertaken by the Federal Reserve on September 24, 1974, in order to forestall possible defaults on these contracts that could have further seriously weakened confidence in foreign exchange markets, which at that time had already been shaken by defaults by a well-known German bank and by a succession of public disclosures of

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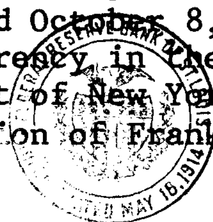
foreign exchange losses by Franklin and other banks throughout the world.

During the summer, one after another possibility that would have permitted Franklin National to continue as an independent institution was investigated. By October 8, 1974, every reasonable prospect of that kind had been explored and found inadequate. The Federal Reserve's loan had served its purpose of enabling Franklin to meet its day-to-day liquidity needs up to that point, but the total was approaching the limit of available collateral. The FDIC's plan for the transfer of Franklin assets and liabilities was ready. In those circumstances, the Comptroller declared the bank insolvent.[1/] The FDIC as receiver thereupon proceeded to implement its plan. The outcome of its negotiations with possible purchasing institutions was that European-American Bank and Trust Company purchased assets and assumed certain liabilities of Franklin National.

1/ For a more detailed explanation of this action, see the Affidavit dated October 8, 1974 filed by the Comptroller of the Currency in the U.S. District Court of the Eastern District of New York concerning the matter of the liquidation of Franklin National Bank.



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An orderly transition has followed, although it will be some time before all aspects of this transition will be finally completed. While in the end Franklin can be said to have failed, the provision for the uninterrupted continuation of its banking services through a successor institution minimized adverse repercussions.

Cooperation among the Federal bank regulatory agencies, combined with consultation with the Treasury and the New York State Banking Department, was instrumental in producing the results I have outlined. Each agency had a distinctive role to play, and each role generated its own concerns. We at the Federal Reserve were expecially interested in the adverse market attitudes and questions about banking soundness that were being generated as the Franklin case dragged on. We were concerned as to Franklin's vulnerability to any new shock that might come along. And we had a painful awareness of how Franklin's debt to the Federal Reserve kept climbing closer to the probable maximum

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loan value of the acceptable collateral which the bank could provide. For those reasons we at the Federal Reserve urged that remedial measures move forward as promptly as they could. The Comptroller and the FDIC, respectively, with their own statutory obligations to consider, had to effectively exhaust alternative solutions short of receivership and to document liabilities and minimize losses insofar as time and circumstances permitted. It should not be surprising that on occasions during those months the agencies found that their preferred priorities for actions differed. When such instances became significant, however, hard work and good will overcame them. Fortunately, no new external shocks developed, and by the time Franklin was determined to be insolvent a detailed and well-integrated plan for its succession unfolded effectively. As nearly as can be judged at this stage, not a cent of depositors' or taxpayers' money is expected to be lost in the process.

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Although the Franklin National case was concluded successfully, experience made it clear that increased attention needed to be paid to stronger preventive and follow-up measures to reduce the possibility of similar situations arising. Accordingly, the Federal Reserve System strengthened its program covering banks under its jurisdiction to place increased emphasis on the identification, surveillance and timely resolution of current and potential problem bank cases. This action had first priority among the broad sweep of studies addressing key problem areas in banking supervision and regulation that I described in my testimony before this Subcommittee last December 12, and about which I will be reporting to you later in my testimony today.

Briefly, each Reserve Bank was asked, among other actions, to make special efforts to identify member banks in its district which were or might be facing difficulties with regard to the quality of

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their assets or the balancing of financing needs with the prospective availability of funds. Second, with respect to State member banks, a greater than usual concentration of Federal Reserve examiner time and attention was to be devoted to identified problem banks during the remainder of 1974 and also through the year 1975. In each such problem bank case, an appropriate and specific program for remedying its difficulties was to be established, including if need be direct discussions with the bank's directors to confirm the commitment of top management to that task. Third, any member banks experiencing unusual liquidity difficulties because of a runoff of money market funds or because of public concern about the condition of the banks were to be informed of the basis on which accommodation at the discount window would be made available.

The Federal Reserve has thus taken requisite administrative steps to insure that greater emphasis is placed on identifying, monitoring and following up

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problem bank situations. It is humanly impossible -- and even undesirable -- for supervisors to prevent all bank problems; but it is practical to aspire, as we do, to recognizing problems early and moving promptly to try to remedy them. There remains, however, a gap in the range of feasible remedial actions that could be undertaken if preventive measures should somehow not succeed in forestalling a bank failure. In that eventuality, the most desirable ultimate action in most cases is for the bank to be taken over by another bank. Bank mergers, where permitted by State branching laws, can sometimes serve this purpose effectively. The alternative of bank holding company acquisition of a failing bank, however, even where permitted by State laws, is substantially inhibited by two Federal statutory constraints. One enforces certain time delays in the approval and consummation of all bank holding company acquisitions. The second effectively prevents any holding company acquisition of banks across State lines.

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In our view, either or both of those limitations can interfere with actions needed to protect the public interest in some cases. Accordingly, the Board has recommended to the Congress substantive statutory changes, now embodied in H.R. 4008.

The first recommendation involves procedural amendments to the Bank Holding Company Act designed to permit the immediate or expeditious consummation of a transaction under that Act in certain problem bank and bank holding company situations. The second recommendation would amend the Act to grant the Board authority to approve an acquisition of a bank across State lines by a bank holding company, when the Board determines that a large bank, or a bank holding company controlling a large bank, is in severe financial difficulty, and the public interest would best be served if the bank involved were acquired by an out-of-State holding company. I will discuss each of these recommendations in turn, referring to the current law, the main reason therefore,

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the key arguments for changing the law at this time, and the Board's reasons for recommending the specific amendments proposed in H.R. 4008.

Certain time schedules for the provision of notice and hearing [2] were enacted as part of the original Bank Holding Company Act of 1956, as a compromise between giving bank chartering authorities an absolute right to deny a holding company application to acquire a bank and giving such authorities only an informal consulting role vis-a-vis the Board's final decision in the case.

2/ Under existing law, the Board, before approving an application for the acquisition of voting shares or assets of a bank under section 3 of the Bank Holding Company Act, must: (1) give notice to the Comptroller of the Currency if the applicant or bank involved is a national or district bank or to the appropriate State supervisory authority if the applicant or bank involved is a State bank; (2) allow thirty days within which the views and recommendations of the Comptroller of the Currency or the State supervisory authority, as the case may be, may be submitted; and (3) if the supervisory authority so notified files a written disapproval of the application within the thirty-day period, the Board must provide a hearing on the application, and base its decision on the record of that hearing.

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The Board in section 1(1) of H.R. 4008 has recommended, first, that the regular thirty-day notice period be shortened to ten days if the Board advises the supervisory authority that an emergency exists requiring expeditious action. Secondly, section 1(1) as proposed would give the Board the authority to waive notice and hearing requirements entirely if the Board finds that it must act immediately on an application to prevent the probable failure of a bank or bank holding company involved in the proposed transaction.[3/] Both of these suggested amendments parallel provisions subsequently enacted in the Bank Merger Act -- provisions which have worked well in the nearly fifty instances in which they have been used over the past ten years.

3/ The Board's staff has noted that there apparently was an inadvertent omission in the printing of H.R. 4008 and H.R. 5331, as the bills provide that notice and hearing requirements may be dispensed with if the Board finds that it must act immediately "to prevent the probable failure of a bank holding company" involved in the transaction. This provision should read "to prevent the probable failure of a bank or bank holding company" involved in the transaction. Thus, it is recommended that page 3, line 17 of H.R. 5331 and page 3, line 11 of H.R. 4008 be amended by inserting "bank or" before "bank holding company" in each such line.

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In the Board's judgment, the present requirement for thirty-day notice to the relevant bank supervisor is both burdensome and unnecessary in the context of a problem bank or bank holding company situation where the public interest requires immediate or expeditious action. From a practical standpoint, the primary supervisory authority in such a situation would be actively involved in the process of screening potential acquirers and would also be desirous of having an acquisition quickly consummated. Similarly, the protracted hearing requirements in the case of recommended disapprovals by the supervisory authority are ill-suited to a failing bank or bank holding company situation where the public interest demands that decisions be made quickly on the basis of available evidence.

There is an additional statutory delay to be dealt with. Under existing law, the Board must immediately notify the Attorney General of any approval of a proposed bank acquisition, merger or consolidation transaction under section 3 of the Bank Holding Company

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Act, and such transaction may not be consummated before the thirtieth calendar day after the date of approval by the Board.

This requirement was added to the Bank Holding Company Act in 1966 in order to conform with the standard consummation procedures being established in the Bank Merger Act. The purpose of the provision was to eliminate conflicts between the Board's decisions under the Bank Holding Company Act and the Attorney General's enforcement of the antitrust laws, which might otherwise require the unwinding of a transaction after that transaction had been approved under the Bank Holding Company Act.

However, the Bank Merger Act provides for an exception to this delay in problem cases, while the Bank Holding Company Act does not. The Board is recommending that, in cases involving problem banks or bank holding companies, the consummation procedures of the Bank Holding Company Act be fully conformed to those in the Bank Merger Act.

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Accordingly, it is proposed that, when the Board has advised a supervisory authority of an emergency requiring expeditious action, consummation be permitted five calendar days after the date of approval. In cases where the Board has found that it must act immediately to prevent the probable failure of a bank or bank holding company, it is recommended that immediate consummation be permitted. In the Board's judgment, there appears to be no public policy reason for not having parallel consummation procedures for bank mergers and bank holding company acquisitions in problem bank situations, since the same reasons exist for not waiting thirty days for the Attorney General's competitive judgment in both cases. As a practical matter, the Federal banking agencies in such situations have regularly followed the practice of informally consulting with the Attorney General in advance in any case large enough to raise substantial competitive questions.

By effectively eliminating bank holding companies from bidding in emergency bank situations, the existing statutory delay provisions in the Bank Holding Company Act have unnecessarily limited

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the number of potential acquirers of a problem bank. This can increase the anti-competitive risks in such acquisitions by often limiting the pool of potential acquirers to banks already in direct competition with the problem bank, e.g., in the case of Franklin National Bank, other New York City banks. The holding company can be a pro-competitive form of bank expansion, and its use should not be effectively foreclosed in infrequent problem bank situations because of delay requirements not similarly imposed in bank mergers. Waiver of the usual delay provisions undoubtedly would be warranted in only a small number of cases, and in those cases the waiver should produce net public benefits.

Another -- and more sensitive -- constraint on bank holding company acquisitions is geographical in nature. Under the Bank Holding Company Act, the Board may not approve any further acquisition of a bank by a bank holding company across State lines.[4/] This provision was made part of the

4/ The precise words of section 3(d) provide that the Board may not approve any application under section 3 of the Bank Holding Company Act: ". . . which will permit any bank holding company or any subsidiary thereof to acquire, directly or indirectly, any voting shares of, interest in, or all or substantially all of the assets of an additional bank located outside of the State in which the operations of such bank holding company's banking subsidiaries were principally conducted on July 1, 1966, or the date on which such company became a bank holding company whichever is later."

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original Bank Holding Company Act of 1956 in order to halt the further expansion of several large multi-State bank holding companies then in existence. It was based in large part on Congress' concern that, unless this trend were halted, widespread and frequent acquisitions by major bank holding companies could eventually lead to an undue concentration of banking resources in the United States. In particular, it was thought that, absent this provision, holding companies would be used to avoid the multi-State branching provisions of the McFadden Act, and it thus was also intended to preserve the rights of the States in this area.[5/]

5/ Under the terms of this provision, a bank holding company can only acquire a bank outside of its principal State if the State in which such bank is located takes action to specifically permit such acquisition. If a State took such action, the Board would still have to decide the application under the statutory standards of the Bank Holding Company Act. At the time of this Act's passage in 1956, no State granted such permission. Except for Iowa, which has enacted a law giving a single grandfathered multi-State bank holding company permission to acquire additional banks in that State, and Maine, which recently enacted a law which would allow acquisition of a Maine bank by an out-of-State bank holding company if a Maine bank holding company is given reciprocal rights in that holding company's State, the situation remains essentially unchanged with no other States granting such permission.

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The Board is of the opinion that section 3(d) could, in the case of a large problem bank or a problem bank holding company controlling a large bank, operate in contravention of both national and local interests. The limitation to in-State bidders may, in the case of a large problem bank, severely limit the number of potential acquirers and result in an increased concentration of banking resources within a State -- contrary to an intent of Congress in passing the Bank Holding Company Act. In most of our States, the number of locally-owned banks big and strong enough to absorb a large problem bank are very few. The only smaller banks strong enough to undertake such a venture may be those affiliated with powerful commercial or financial interests domiciled either in this country or abroad.

The problem created by the constraints imposed by section 3(d) has been sharpened as banks, particularly large banks, have moved increasingly from asset to liability management. This shift in emphasis has led

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many larger institutions to search far afield for money market funds. While this has often been of considerable benefit to the customers and communities they have served -- particularly in those areas where widespread branching is not permitted and local deposit generation is thereby limited -- liability management has increased banks' exposure to the risks created by any substantial net outflow of such nonlocal and often volatile funds.

When adverse news triggers enough outflows of funds to significantly weaken a bank, it may become necessary in the public interest to fold it into a larger and stronger institution. As you know, this occurred in New York and California, where big in-State banks were available to acquire the problem banks involved. Had institutions of the size of Franklin National or U.S. National failed in many other States, however, no banks in those States would have been large enough to acquire them. In such circumstances, the need to be able to arrange acquisitions across State boundaries would become very real.

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The Board therefore recommends several amendments to the Bank Holding Company Act designed to permit out-of-State acquisitions in certain emergency and failing bank situations involving a large bank or bank holding company controlling a large bank. Under section 1(3) of H.R. 4008 as proposed, the Board would have the authority to make exceptions to the multi-State prohibitions of section 3(d) whenever the Board finds that an emergency requiring expeditious action exists with respect to a bank or bank holding company, or that it must act immediately in order to prevent the probable failure of a bank or bank holding company. The proposed authority would be limited, however, to cases involving a bank having assets in excess of $500,000,000 or a bank holding company controlling a bank having assets in excess of $500,000,000. There are three basic reasons for limiting this authority to the case of a large bank or bank holding company controlling a large bank:

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first, the failure of such an institution can have damaging effects in both national and international markets and on the national economy; secondly, there may be few, if any, prospective acquirers of such an institution within any State; and thirdly, the most likely in-State acquirers are likely to be institutions of comparable or greater size, which might often pose problems under the anti-trust laws and threaten an increased concentration of banking resources within the State.

The Board chose a $500,000,000 asset cut-off figure because it would cover major money-center and regional banks, whose failure might have an adverse effect on regional, national or even international financial markets, but yet would not be so extensive an exception as to create a potentially significant loophole to the multi-State prohibitions of the Act. Also, in cases involving smaller problem banks, local acquisitions where appropriate can be more readily arranged by the FDIC and State authorities than can transfers of the liabilities and assets of large institutions.

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The choice of any cut-off figure involves various public policy considerations by the Congress. The Board stands ready to supply the Subcommittee with additional data on this issue if that would be helpful. On the basis of data prepared by the Board's staff, a $500,000,000 cut-off would cover not only the large money-center and regional banks but also, in most cases, the largest bank in any State.[6/] From our analysis of cases in which emergency or failing bank procedures have been used under the Bank Merger Act, it appears only three banks acquired under immediate or expeditious action procedures have had assets in excess of $500,000,000 (Security National Bank of Long Island, Franklin National Bank of New York, and United States National Bank of San Diego). Thus, the Board anticipates that this

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6/ From the Board's figures, it appears this asset cut-off would include some 210 commercial banks across the country, including the largest bank in 39 States and the District of Columbia, and the two largest banks in 35 States and the District of Columbia.

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provision would be applicable in only a handful of cases where there may be significant effects upon the national and international economy.

Under section 1(3) of H.R. 4008, the Board could use this authority to approve a multi-State acquisition only when it finds, in weighing the statutory competitive and other factors, that the public interest would best be served if the bank or banks involved were acquired by an out-of-State bank holding company. The Board thus anticipates that this authority would rarely be used and only in cases presenting very special circumstances, such as those involving Franklin National Bank. In our view, these relatively rare situations would not contravene the central purpose of the multi-State prohibition of the Bank Holding Company Act, which was directed at preventing large concentrations of financial resources through frequent multi-State acquisitions of banking institutions.

The Board is sensitive to the fact that the prohibition on multi-State branching was designed to

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prevent the evolution of a few large banking institutions. While there would be only a very limited number of instances in which the Board would consider making exceptions to section 3(d), the amending language could be narrowed even more than was originally suggested. A strict limit could be placed on the number of acquisitions any single bank holding company would be allowed to make under such an exception. This limit should be more than one, in order not to encourage potential bidders to wait until an ideal acquisition opportunity was presented, but it could be less than five, in order to forestall excessive expansions of financial power. In our view, this kind of limit would serve to preclude any possibility of undue concentration of economic resources being created through exceptions to section 3(d).[7/]

7/ As a corollary to its recommended amendment of section 3(d), the Board has felt it necessary to also recommend an amendment in section 2 of H.R. 4008 overriding certain provisions of State law in situations involving a problem bank or bank holding company where expeditious or immediate action is required.

Section 7 of the Bank Holding Company Act reserves to the States their rights to exercise such powers and jurisdiction which they now or in the future (Continued)

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The distinguished Chairman of this Subcommittee has also introduced H.R. 5331, a bill which embodies

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7/(Continued) may have with respect to banks, bank holding companies, and subsidiaries thereof. In problem bank or bank holding company situations, the normal circumstances which may have led a State to enact a statute prohibiting the formation of bank holding companies within its borders or otherwise restricting the entry of out-of-State bank holding companies do not apply and therefore such provisions should not be controlling when the Board has approved such application under the immediate or expeditious action provisions recommended in H.R. 4008. In such cases, the national interest argues that Federal law be supreme. In practical terms, even though a State may favor an acquisition by an out-of-State holding company approved by the Board under its immediate or expeditious action provisions as an alternative to failure, it would probably be impossible either for a State legislature to enact in time any necessary amendments to its laws, or for a State court to interpret the terms of an unclear statute. The delays involved in trying to pursue either of the above courses of action could be crucial. Section 2 of H.R. 4008 would solve these problems by providing that in any case where the Board has approved an application under the immediate or expeditious action provisions of H.R. 4008, the holding company may acquire and operate the bank involved as a subsidiary notwithstanding section 7 or any provision of State law which would otherwise prevent the acquisition or restrict the operations of that holding company.

Section 2, however, leaves intact State restrictions on multi-bank holding companies, so that an out-of-State bank holding company which acquired a bank with the Board's approval under the immediate or expeditious action provisions could not gain a competitive advantage over an in-State holding company by acquiring a second bank under those provisions. The McFadden Act restrictions on multi-State branching would not be affected by section 2 of H.R. 4008 as such restrictions are a matter of Federal law.

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the Board's recommended procedural amendments to the Bank Holding Company Act, but which omits the recommended amendments to the multi-State prohibitions of the Bank Holding Company Act. I hope I have said enough here this morning to make clear why the Board believes that the public interest would best be served if the Congress enacted both the procedural and multi-State amendments suggested. We defer to the Congress on the question of whether these amendments might better move through the legislative process separately or linked together. We do believe that they can eliminate what might otherwise at some time prove to be a fatal constraint upon the regulators' ability to preserve a problem bank's services rather than to close it.

Having discussed the reasons why the Board believes that the proposals contained in H.R. 4008 would be particularly helpful to the Board in dealing with problem bank or bank holding company situations, I would like to proceed to comment on the other studies

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that the Board has been conducting to develop better means for preventing such situations from occurring and resolving them as effectively as possible if they should arise. You may recall that in my testimony before this Subcommittee on December 12, 1974, I described the general scope of our efforts and the problem areas on which we were focusing our attention: the attenuation of bank capital produced by the rapid expansion of bank assets; bank liquidity problems, particularly heavy reliance on liability management, the consequent creation of highly interest-and-confidence-sensitive instruments, and the making of excessive loan commitments; a deterioration in the quality of bank assets; increased foreign exchange risks; and increased risk of losses in bond trading departments of banks. (A final problem area that I touched upon at that time related to the need for more expeditious resolution of problem bank cases, but I have already commented on that subject in my previous discussion of the proposals contained in H.R. 4008.)

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The Board expects very shortly to place before the Congress several proposals for legislative action that are designed to equip us, and the other bank regulatory agencies, to accomplish better our goal of more effective prevention of potentially unsafe or unsound practices. These proposals are now in the final stages of discussion among the Board, the FDIC and the Comptroller of the Currency. I would like to outline the major ones briefly for this Subcommittee to give you a clearer sense of the thrust of our efforts.

The first of the proposals we expect to be bringing before you is directed primarily at strengthening the penalties in statutes imposing constraints on transactions among the banking subsidiaries of bank holding companies, their parent firms and other affiliates. It seeks through amendment of the Federal Reserve Act to subject member banks and their directors, officers and employees or agents to penalties for violations of, among other provisions, sections 22 (relating to transactions between member banks and their directors and loans to executive officers) and 23A (involving loans and investments in

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affiliates). Another provision of this proposal would amend the Bank Holding Company Act to permit the Board to seek the imposition of civil penalties on companies or individuals that violate the Act. This provision would, we believe, increase significantly the deterrents to unlawful or unsafe transactions within bank holding companies.

A second proposal addresses the problem of possible misuse of bank assets by insiders. Under this proposal, section 22 of the Federal Reserve Act would be amended to aggregate loans by a member bank to an officer, director or significant stockholder and to any corporations which such person controls for purposes of applying legal lending limits. This proposal would limit the amount that could be loaned to all interests controlled by one individual to the same amount as could be loaned to that person alone.

A third proposal would strengthen the Board's authority to institute executive removal actions designed to prevent the continuation of unsafe and

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unsound banking practices. Amendments would be made to section 8 of the Financial Institutions Supervisory Act to eliminate the current requirement that acts of personal dishonesty be involved before officers or directors of a banking institution can be removed by a bank regulatory authority. This change would permit such individuals to be removed for gross mismanagement in the form of practices that threaten substantial financial harm to the bank.

A fourth proposal would give the Board authority to order divestiture of subsidiaries of bank holding companies when continued ownership by a bank holding company constitutes a serious risk to the financial safety, soundness or stability of the bank holding company's subsidiary bank or banks. While such action by the Board would undoubtedly be taken only in the most serious situations, we believe the ability to require such divestitures is an important one for the Board to have. Its existence alone should serve as a strong deterrent to dangerously unsafe actions by bank holding company managements.

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We believe that these proposals, and others that may be forthcoming as a result of discussions with our colleagues in the other Federal bank regulatory agencies, will be of substantial assistance to us in implementing a program of preventive measures that should prove extremely helpful in reducing the possibilities of future unsound banking practices.

The studies that the Board has been pursuing have produced not only the legislative proposals that I have described, but have also led us to undertake a series of administrative and regulatory actions, all designed to assist us in preventing troublesome situations from materializing in the key problem areas we have identified. The Board has thus taken steps within the scope of its current authority to detect potential banking problems at an early stage in their development.

One of the first of these actions I have already mentioned, namely, the step taken last fall to improve surveillance of troublesome bank cases.

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A second step to promote early detection of such cases was taken earlier this year when an interagency early warning system was instituted by the Board in cooperation with the Federal and State banking supervisory agencies. This system has enabled all the relevant bank regulators to be promptly aware of any adverse findings uncovered in supervisory examinations of bank holding companies or the bank subsidiaries thereof.

In this same area of problem bank and bank holding company situations, the Board has formally adopted guidelines delineating a graduated range of alternative procedures to be implemented in correcting problem bank holding company cases. This step has served to set out clearly and systematically the corrective actions that the Board and the Reserve Banks had already begun to employ in remedying difficult cases.

In the area of foreign exchange operations at banks, we have recognized that floating exchange rates have increased the risk of potential losses (or gains) on a given size net open position in foreign currencies.

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In addition, the danger of losses occurring as a result of poor judgment at the management level or as a result of unauthorized trading under inadequate internal controls probably increased with the growth in the worldwide volume of foreign exchange market transactions -- in which a growing number of U.S. banks participated.

To assess better the level of foreign exchange risks now faced by U.S. banks, a review has been conducted by the Board, in consultation with the Comptroller, of the operations of a sample of banks engaged in such activities. As a result of this survey, we have concluded that additional legislative authority is not required to improve the supervision of banks' foreign exchange operations. Steps have been taken to encourage banks, where necessary, to utilize more adequate internal audit and control procedures. Furthermore, because of the special vulnerability of foreign exchange activities, the Federal Reserve is working closely with the Comptroller to improve the surveillance of these bank operations, through

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examinations and reporting systems. Perhaps the most encouraging information I can relay to you in this field, however, is the stream of reports we are receiving that bank managements of their own volition have sharply tightened their prudential controls over their foreign exchange departments.

Studies are continuing on methods of improving the entire range of bank examination practices and procedures, including the use of sophisticated reporting and management information systems to supplement the bank examination process. Work is going forward on means of detecting and limiting excessive loan commitments and other off-balance-sheet promises to lend which may expose banks to undue liquidity pressures. Still other work is focused on methods to detect and discipline poor quality bank loans more effectively. Ways are also being sought to better limit the level of risk exposure in banks' bond trading activities.

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As I mentioned previously, the Board has been much concerned with problems associated with the attenuation of bank capital and pressures placed on bank liquidity. Additional work is therefore underway at the Board to develop better standards of what constitutes "adequate" liquidity, both for our own better guidance and that of member banks. The Board has also recently restructured reserve requirements on time deposits to encourage more prudent liquidity management at banks.

Earlier this month, the Board released for comment guidelines that we propose to apply in evaluating requests for approval of new subordinated debt issues by State member banks. These guidelines were issued in connection with proposed regulatory changes to permit greater flexibility by banks in the issuance of notes and debentures to bolster their capital structure.

We anticipate that application of these proposed criteria should tend to promote the practice by State member banks of issuing new debt on an adequate cushion of equity capital. The guidelines should also help to prevent banks from unduly concentrating their maturing

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debt in any one year. In addition, these guidelines are intended to prevent the inclusion of terms in such debt issues that could be regarded as being in conflict with the public interest.

If we are successful in accomplishing those objectives with regard to issues of new subordinated debt by banks, we believe that the problems connected with the attenuation of bank capital that has been experienced over the past decade should be noticeably ameliorated.

I would also like to report briefly on the progress of the Board's efforts to improve bank holding company supervisory and regulatory policy over the longer run. I am pleased to say that considerable headway has been made in designing and moving to initial implementation of a more systematic analytical program to monitor bank holding companies' operations more closely. Reporting schedules have been developed to feed timely information covering the full range of bank holding companies' activities, including intra-company transactions, into a partially computer-based

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analytical system which is being designed to focus immediate attention on potential problem situations as they evolve. The information capability the Board will possess once this work has been completed should improve our capacity to detect and correct bank holding companies' problems at an early stage of their development.

The Federal Reserve is also endeavoring to look more broadly at the bank holding company movement as it has unfolded from 1970 to 1975. We are trying to determine to what extent, if any, bank holding companies and their expansion into nonbanking areas may have contributed to financial strengths and financial difficulties. We expect that this effort will shed some useful light on a subject that has at times stimulated sharp divergences of views.

I should also note that the Board has reviewed the recent and prospective growth of foreign-owned banking operations in this country and their proper place in our structure of banking supervision. While I do not propose

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to cover all the details of that complex subject today, I would point out the Board's conclusion that all banks, branches and agencies that are located in the United States but owned by foreign banking instituions would be most effectively and equitably regulated if they were brought under the provisions of the Bank Holding Company Act. The proposed legislation we have forwarded to the Congress in this area (H.R. 5617) contains provisions to this effect.

In looking back on this recent work the Board has done to strengthen our supervision and regulation of the nation's banking institutions, the need for a large number of changes -- some legislative, some regulatory, many administrative -- has become evident. Some of these needed changes have been minor, others have seemed sufficiently complex or significant to warrant taking the time of this Subcommittee to report. At this juncture in the history of our nation's banks, the severe pressures to which those institutions were recently subjected have been significantly reduced. We are now at a point where it is possible, as it was not then, to consider and to undertake a range of

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prudent reforms to further strengthen our banking institutions and thereby to help insure the continued well-being of this country's vital banking system.

All the faults we have found were not in the banking system, however; we have found some shortcomings in ourselves as well. Focusing as we have on the key banking problem areas has also helped us to understand more clearly in what ways inadequacies in the structure of bank regulation itself may have contributed to the development of some of these problems.

When I testified before your Subcommittee last December, I mentioned then that the concluding project in the Federal Reserve studies would be possible reforms of the Federal bank supervisory agencies. In the light of the work just described which has been pursued in other areas, we have turned our attention within the Board to the structure of the Federal banking agencies. We are also consulting with other agencies on this subject.

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As you might imagine, there have been a good many alternatives to be analyzed and many considerations to be explored. It might be informative to your Subcommittee if I were to summarize the more plausible and thought-provoking alternatives we have considered, and outline what seem to be the key advantages and disadvantages of each. One cautionary note is in order, however, before I proceed. In this delicate subject area, there are few points on which facts can prove that one view is right and another wrong. Most of the major questions are matters of judgment, usually involving speculation as to what might happen were things to be done differently. Sometimes these are judgments on which reasonable men can and do differ. I cannot eliminate that ambiguity; I can only report to you the judgments of the majority of the Board as plainly as I can.

At one end of the spectrum of alternatives that we considered was consolidation of all Federal supervisory and regulatory functions.

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A number of advantages would undoubtedly accrue from an effective consolidated Federal bank supervisory agency. The principal benefits we perceive are the following:

(a) Such an agency would bring about uniformity in Federal regulation, supervision and examination of banks. In addition it would result in uniformity on decisions concerning merger and branching applications.

(b) Presumably such a consolidation would eliminate some duplication of efforts and lead to a more efficient use of supervisory and examination personnel. It would also remove any problems arising out of consultations between the agencies and resulting delays in decision-making.

(c) We also believe there could be advantages from the development of consistent data which would permit

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fuller analysis of the banking industry as a whole and permit more prompt identification of developments which might affect the stability of the banking system.

(d) Finally, the consolidation of three Federal agencies into one would preclude the possibility of banks changing their organizational status in order to obtain more favorable treatment from a different Federal supervisor.

Objections to consolidation take several forms, such as:

(a) A single Federal supervisory agency would be very powerful, and might have a tendency to stultify the ability of commercial banks to adapt to changing circumstances or be inconsiderate of the equities of the parties affected by its rules. At the least, it would result in the

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elimination of most of the checks and balances inherent in our present bank regulatory structure, which do limit the power of individual supervisors.

(b) One agency would not offer as great a possibility for experimentation and innovation in bank regulations and supervisory procedures as now exists when three agencies divide the Federal responsibilities.

(c) Changing from the present arrangement to a single Federal agency could produce some serious transitional problems, such as the possibility of losing some of the valuable experienced examination and supervisory personnel now in the individual agencies. Serious personnel problems could develop in meshing the three present Washington and field-based forces.

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Particular problems are also presented in considering in which agency consolidation should take place. For example, a majority of the Federal Reserve Board would have some concern about consolidation in a new agency or one outside of the Federal Reserve System. The experiences of recent years have made members of the Federal Reserve Board particularly conscious of the importance of involvement in bank supervision and regulation in the consideration of monetary policy. We believe that the condition of the banking system and information about individual banks is an important input for monetary policy formulation which would be lost or substantially reduced if the Federal Reserve had no role in the regulation or examination functions.

On the other hand some in the System have reservations about the consolidation of these functions in the Federal Reserve Board. They are concerned that adding the responsibility for all

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bank supervision and regulation to the existing Board responsibilities might detract from the time and attention given to the Board's primary responsibility, monetary policy.

At the other extreme, we considered retaining the present regulatory and supervisory system.

By and large the advantages and disadvantages of this alternative are the converse of those listed for consolidation. In summary, the present regulatory system permits more innovation and experimentation in new bank activities and supervisory procedures. Any adverse effects may be confined to one segment of banking during the experimentation period. If, however, the innovation is successful, the changes can then be adopted by the other agencies. Moreover, the agencies can voluntarily communicate and cooperate to the limits of their power and good will in an endeavor to formulate uniform policies and procedures and keep them consistent and up-to-date.

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The disadvantages of the present system can be read in the number of occasions when voluntary cooperation among the agencies did not produce optimal results. Episodically over the years, voluntary cooperation has not been a sufficiently powerful incentive to consistently produce vigorous, timely Federal supervisory action that was in harmony with other supervisory policies and uniform across the Federal agencies. Moreover, the diffusion of authority among the agencies is great enough so that it is often hard to pick the agency or the officials to hold accountable for such shortfalls. In such an environment, supervisory innovations -- particularly those that pinch the subject banks -- can be inhibited if the banks that are adversely affected have another supervisory jurisdiction open to them.

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A third alternative is to divide responsibility for Federal bank supervision and regulation between two agencies.

One possibility that has been advanced is that all Federal bank regulations should be placed in one agency and all Federal bank examination and enforcement procedures in a separate agency. Many of the advantages of complete consolidation -- such as uniformity, elimination of duplication, more efficient use of personnel, and elimination of the possibility of banks shopping among Federal supervisors -- could be accomplished by this change. At the same time, such a division would maintain some significant element of checks and balances in the field of bank regulation.

However, many of the disadvantages of consolidation would also be present, such as the danger of a single regulatory body becoming wedded to the past and reluctant to adapt to changing times. The possibility of curtailed experimentation in regulatory procedures and a possible erosion of some regulatory checks and balances would also

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be present. In addition there is a serious risk that the separation of regulation from examination and enforcement would weaken the effectiveness of bank examinations and reduce cross-fertilization between functions. Such a division could detract from the stature of the field forces and hinder field examination efforts to resolve problems. Moreover, whereas some coordination and jurisdictional problems might be eliminated with this type of structure, it is certainly possible that other problems, perhaps more serious, would be created.

A fourth alternative I might mention is to provide for representation of the Board of Governors in an expanded Office of the Comptroller.

It is possible that improved coordination of key supervisory and regulatory programs could be obtained if the Comptroller's Office were converted to a board with one member being a Governor of the Federal Reserve. Direct Board representation in the

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activities of the Comptroller offers some advantage, since all national banks under the supervision of the Comptroller are also member banks of the Federal Reserve System. Moreover, under present practices the Comptroller's examiners are responsible for enforcing numerous Federal Reserve regulations applicable to national banks. Conversion of the Comptroller's Office from a one-man to a Board operation would also provide the benefit of group decision-making and provide a balancing of viewpoints in the supervision of national banks.

However, the creation of a Board for the Comptroller's Office could well have the disadvantage of producing a less expeditious and less efficient operation -- a result which can often flow from administration by a committee.

A fifth possible alternative is increased and more structured coordination of examination functions.

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Our review of the other projects undertaken by the Board's Committee on Bank Regulatory and Supervisory Policy has shown that one of the most important areas calling for attention is the problem of revising and updating examination and enforcement procedures. I understand that the Comptroller's studies have reached similar conclusions.

There is a need for more realism, consistency and uniformity in examination standards and procedures. We believe that there needs to be an increased emphasis given to more timely reports and information systems which would supplement the practice of on-site examinations.

Recent experience also demonstrates that some weakness exists in enforcement procedures. There needs to be more effective and consistent follow-up of examiners', and other supervisory, recommendations to banks, in order to assure that the banks take those actions necessary to correct the identified problems in reasonable time.

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The resolution of these problems might be helped if each of the three Federal banking agencies were to delegate some specific decision-making authority in the field of examination procedures to a representative on a new interagency group, which might be designated the Federal Bank Examination Council. The Council might be composed of Board members or senior officials responsible for bank examination from each of the three banking regulatory agencies. That group would not supplant the present Interagency Coordinating Committee, which ought to continue to provide a forum for consultation on regulatory and policy questions affecting not only banks but nonbank thrift institutions as well. The distinctive features of a new Examination Council would be that its members would be assigned responsibility for particular areas of bank examination procedures, given decision-making power in those areas, and held accountable by their agencies for the development of suitable standards and practices in such areas.

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A Council of this nature could foster greater uniformity and consistency in the modernization of numerous bank examination and enforcement activities without most of the disadvantages feared from complete consolidation. In addition, it would permit undertaking a limited and circumscribed consolidation effort promptly, on an experimental basis, with flexibility to allow for revisions that prove desirable.

To be sure, such a Bank Examination Council would have its disadvantages also. Because of its relatively narrow scope, a number of important issues in bank supervision would be beyond its ability to solve. Since it would derive its authority by delegation, there is the chance that its members would be diffident in their actions out of concern for possible termination of their delegated authority. There is also the possibility that its members might show less initiative in tackling problems than would an individual agency acting on its own.

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As the Board of Governors has reviewed all these alternatives, and the situations to which they are addressed, a majority of the Board has come to the following tentative conclusions on this subject.

First, some change in the present structuring of Federal bank supervision is desirable, although not essential. Federal bank supervision has done many things right, and it is not so flawed as to necessarily thwart key objectives of public policy in this field. On the other hand, the present diffusion of authority and responsibility among three Federal agencies is conducive to some confusion, uncoordinated initiatives, occasional delays and misunderstandings, and sometimes a subtle competition to relax or forego appropriate constraints on banking institutions. What is called for is measured action that ameliorates these weaknesses without sapping the strengths of the present agency structure.

Second, the Federal Reserve, as the nation's central bank, needs to be involved in the process of

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bank regulation and supervision. Now, more than ever before, the Fed's key roles as monetary policy-maker and as lender of last resort reach into territory conditioned by prevailing bank supervisory and regulatory policies. Each of those sets of public policies increasingly affects the effectiveness of the other. Their close coordination is much to be desired.

Third, an appropriate step forward in the Federal bank supervisory structure at this time would be the establishment by the agencies of a Federal Bank Examination Council along the lines described above. It is, as I have said, an experimental and evolutionary idea, rather than a radical and irreversible one -- and the Board believes the former rather than the latter is what is called for today.

The Board is prepared to delegate selected decision-making authority in the field of bank examination procedures to our representative on

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such a Council forthwith, and I hope our sister Federal banking agencies will be similarly inclined. We are further prepared to ask that Council to study several broader supervisory issues on a priority basis, with a view to developing recommendations to the parent agencies for uniform, up-dated policy positions.

Assuming such a Bank Examination Council is established, experience will soon show how productive it can be in actual practice and how far the scope of its activities might usefully be extended. The Council's success will require a sincere effort on the part of all three agencies to arrive at meaningful changes and to minimize disagreement on less essential items. Its performance will depend most of all on the competence and good will of the individuals designated to serve on it. But that caveat attaches likewise to virtually every other design of the structure of the Federal banking agencies.

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The Board appreciates the continuing interest of this Committee in the entire subject of banking regulation and supervision, and we look forward to your deliberations and recommendations. We will be glad to continue to report to you on our activities and will make recommendations for further legislation as we see such needs develop.

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