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Statement by

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Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

S. 2304

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I am pleased to appear before this Committee on behalf of the Board of Governors of the Federal Reserve System, to discuss the Board's reasons for recommending the enactment of legislation embodied in S. 2304. Let me try to summarize the proposals and the Board's views thereon in rather general terms, and then respond to any specific questions.

These proposals arise from a number of studies which the Federal Reserve conducted in the aftermath of the banking difficulties of recent years. One objective of those studies was to determine whether there were some feasible new measures that would decrease the incidence of specific banking difficulties or would increase the effectiveness of remedial regulatory action once a particular bank difficulty was identified. In fact, those studies have turned up a number of constructive suggestions for reducing banking problems without at the same time unduly interfering with the effective conduct of banking business.

Some of those suggestions involved changes in procedures or regulations which the Federal Reserve

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could introduce under its existing authority, and we have done so. But several suggested steps needed statutory authorization. We have refined those ideas, in coordination with the other Federal bank regulatory agencies, and they are now embodied in the present S. 2304, submitted jointly on behalf of all three agencies.

The legislative proposals in S. 2304 can be divided into three general categories: (1) proposals for civil penalties for violations of various provisions of Federal banking law which presently carry no penalties or carry only criminal penalties; (2) a proposal to restrict dealings with insiders; and (3) proposals to increase and streamline the ability of the agencies to take remedial actions.

An examination of the present restrictions on the operation of banks and actions of bank officers, directors, and employees indicates that in many instances violations of those restrictions carry either no penalties or solely criminal penalties. The Board's experience with the operations of the criminal penalty provisions under the Bank Holding Company Act

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is that the application of these provisions is a slow and tedious process. Furthermore, in order to obtain a conviction it must be established that the violation was willful. Courts in the past have read this as requiring a showing not only that the individual intended to take the action, but that in so doing the individual intended to break the law. This is a very difficult matter to prove, and it is believed that these difficulties of proof have decreased the effectiveness of the criminal remedy as a deterrent to particular actions in violation of the Act.

There are other provisions of banking law for which there are either inadequate or no deterring penalties attached to any violation. For instance, section 23A of the Federal Reserve Act places stringent limitations on transactions between affiliates. Violation of this provision, however, currently carries no civil or criminal penalties. In recent experience, two examples have come to the Board's attention which, in the Board's opinion, involved violations of section 23A with respect to transactions between the banking and

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nonbanking affiliates of a holding company. In both instances, these transactions contributed heavily to the ultimate failure of the banking subsidiary. Once these transactions came to the attention of the appropriate regulatory authorities, the only available remedy would have been a cease-and-desist order under the Financial Institutions Supervisory Act of 1966 requiring reversal of the transaction. However, since the funds were no longer available to accomplish such a reversal, this represented a hollow remedy indeed.

The Board strongly believes that the existence of an expeditious civil penalty procedure will act as a deterrent to this kind of activity and should significantly decrease the incidence of it. For this reason, the Board has recommended in the proposed legislation that civil penalties be applied to violations of the Bank Holding Company Act, section 23A of the Federal Reserve Act, section 22 of the Federal Reserve Act relating to loans to officers and directors, (as proposed to be amended), violations of final cease-and-desist orders, and certain other provisions.

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In order to help insure that these penalties would only apply in an appropriate and equitable manner, the proposed bill provides that, in assessing the amount of the penalty, the responsible agencies must take into account the financial resources and good faith of the person or organization charged with the violation, the gravity of the violation and the history of previous violations. Any penalty so assessed may be collected by Court action and would be subject to judicial review.

The second area covered by this bill is the establishing of appropriate limitations on banking transactions with insiders. The history of banking difficulties over the last few years indicates that, in numerous instances, banks have encountered difficulties by virtue of having incurred excessive risks through a high concentration of loans to "related persons." The Board recognizes that, in the banking industry as a whole, major abuses by insiders are not common. The Board further recognizes that the board of directors of a bank or bank holding company typically includes a number of community leaders, not the least of whom are officials

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of various businesses in the area. Lending to such insiders and their enterprises follows naturally and, in the case of smaller financial institutions in smaller communities, is almost inevitable. Such lending, to the extent it is made on an arm's-length basis to creditworthy borrowers, is not objectionable in and of itself, and in fact such loans may well help the community and at the same time benefit the bank.

If an insider is prepared to abuse his banking connections, however, and the bank is compliant, he may effectively pyramid the resulting risks to the bank by exploiting his position to obtain credit for or through firms he controls. Accordingly, the Board has concluded that on balance it would be wise to place aggregate limits on the amount of lending on behalf of any insider by his bank in order to prevent the incurring of excessive risk through such lending. The proposed legislation would therefore place a limitation on loans to any officer, director, or shareholder who owns more than 5 per cent of the stock of the lending bank. This limitation would

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aggregate all loans or extensions of credit to such an officer, director, or shareholder and his controlled corporations and provide that the aggregate may not exceed the statutory limit on loans to any one borrower established by Federal or State law. I should alert the Committee that, among the three kinds of insiders I have just mentioned -- officers, directors, and important shareholders -- public policy considerations weigh least heavily toward adoption of these restrictions when it comes to aggregating loans of all interests of an "outside director". Such restrictions might well discourage some individuals from serving as directors who would otherwise provide valuable experience and advice for the bank. On balance, however, the Board believes that the establishment of such a limitation for each of these insiders is a prudent step.

The third problem area which this bill addresses is a strengthening of supervisory power to take remedial actions once difficulties have been discovered in a financial institution. We see a particular need to strengthen the remedial powers provided in the Financial

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Institutions Supervisory Act of 1966, and we have recommended a number of changes in that Act.

The most important of these changes relates to the ability of the banking agencies to remove an officer or director, or prohibit a shareholder from participating in the conduct of the affairs of a bank, when such individual's conduct is causing or is likely to cause substantial financial harm to the bank. Under present law, to take such action, the agencies must establish that the individual (1) has participated in a violation of law or of a final cease-and-desist order, breaches of fiduciary duty, or unsafe and unsound practices, (2) that his action is seen as causing substantial financial loss to the bank or damage to depositors and, further (3), that the acts complained of constitute personal dishonesty on the part of such individual. The Board believes that, if an individual is grossly negligent or inept in the operation of a banking institution, and the findings set forth in (1) and (2) above are made, he should be removed regardless of whether his

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actions constitute personal dishonesty. Accordingly, we recommend the adoption of the proposed provisions, which would authorize the appropriate regulatory agencies to remove the offending individuals in such circumstances. We believe that the present hearing and judicial review provisions of the Act are sufficient to shield innocent individuals from arbitrary and capricious agency action.

We have also recommended a number of other technical changes to the Financial Institutions Supervisory Act which we believe would increase its effectiveness. I would be happy to answer questions about any of them at the conclusion of my statement.

Another urgent remedial power requested for the Board is that it be given the power under the Bank Holding Company Act to order the divestiture of a banking or nonbanking subsidiary whenever it has reasonable cause to believe that the continuation of that nonbanking activity or ownership of a banking

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or nonbanking activity constitutes a serious risk to the financial safety, soundness, or stability of a bank holding company's subsidiary banks.

We recognize that such a remedy is an extreme one. However, we believe that a key function of a bank holding company is to contribute to, rather than detract from, the financial stability of its subsidiary banks. Several instances have come to the Board's attention in which adverse developments and publicity with respect to a bank holding company's nonbanking activities have had a very adverse impact upon, and even caused the failure of, a banking subsidiary. We therefore believe that it is important for the Board to have such legislation available in order to protect banking subsidiaries in appropriate instances. The proposed legislation provides for due notice and opportunity for hearing. It provides that the divestiture may be by sale or by _pro rata_ distribution and, in order to assure that the activity threatening the bank is terminated as rapidly as

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possible, sets a relatively short time frame within which this is to be accomplished.

A final remedial provision that I would call to your attention lies outside the bill presently before the Committee. That is our proposal to allow a failing bank to be acquired by an out-of-State holding company when no satisfactory alternative for preserving the bank's services exists. This proposal was earlier introduced as part of S. 890, but it has generated some opposition from observers concerned over breaching the traditional bar to interstate banking. Yet since that bill was introduced, two significant instances have arisen requiring sales of a failing bank when the communities involved might have been better off if an emergency interstate acquisition of that size had been permissible. I urge this Committee to consider and act favorably on this proposal, even as it already has on the companion bill to eliminate the statutory 30-day delays in emergency bank holding company acquisitions.

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I believe the people in the few unfortunate communities affected would be well served.

We realize that each one of the proposals I have mentioned this morning can be said to involve certain costs or burdens as well as benefits. We have tried to aim only at demonstrated problems, not hypothetical ones. We have designed the proposed legal powers so as to minimize unwanted side effects, and we have included provisions that give protection or room for accommodation to legitimate business needs. The remaining inconveniences or inefficiencies that this legislation may cause we believe are justified by the added protection it affords to banks and the banking system.

In conclusion, we believe that these proposals zero in on specific identified weaknesses in the regulation and supervision of bank holding companies and banks. Adoption of these proposals would, in the Board's opinion, have a deterrent effect and thus decrease the number of occasions on which

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supervisory action would be necessary in order to correct problems existing in banking institutions. Furthermore, in those instances where the problems do occur, these provisions would increase the effectiveness of agency response. We urge favorable consideration by this Committee.

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