An Address at the

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by

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My remarks today have two purposes: first, to indicate how the responsibilities of the Federal Reserve System affect you; and, second, to tell you what I conceive your responsibilities as bank directors to be.

The System's responsibilities extend beyond the banking field to the economy at large. We are mainly involved in U. S. monetary policy, or monetary management, which means regulating the pace at which commercial banks provide credit. Our goal is to balance the availability of money and credit against the pace of income and output in the nation's economy.

Over the years, Congress has given us tools to accomplish these objectives. Each of these tools has a distinct impact on the cost and availability of bank reserves and, therefore, on bank credit and money growth. But none of these tools permit the Federal Reserve to focus its influence on money and credit in one part or sector of the U. S. economy. Our decisions affect the nation's economy as a whole, and we can only hope that they are good for various geographic areas as part of the total picture. At the same time, we recognize that the U. S. mainland economy has an impact on Puerto Rico's economy and that you share some of the mainland's major problems of inflation and unemployment.

Besides our principal monetary policy function, the System, and particularly its twelve Federal Reserve Banks, have other responsibilities. Reserve Banks have a role in commercial bank supervision. They act as fiscal agents for the United States Government, clear checks, and provide coin and currency.

These activities relate to banks in Puerto Rico for which Reserve Banks clear checks, furnish cash, and assist with food stamps. I am proud that the Federal Reserve Bank of Atlanta has been responsible for some of these activities at one time or another. When the U. S. Treasury stopped maintaining the currency depot in San Juan in mid-1969, the Atlanta Bank stepped in and operated this cash facility. In the meantime, the Federal Reserve Bank of New York continued to provide check collection services. Later, in 1973, the Board of Governors of the Federal Reserve System felt that it was in Puerto Rico's long-term interest to consolidate all Federal Reserve services to Puerto Rico at a single Reserve Bank. Business, banking, and trade relations between Puerto Rico and the cities of the Atlanta Federal Reserve District have grown in recent years, especially with Miami. But since economic and banking ties between Puerto Rico and New York were still stronger than with the Atlanta District, total responsibilities for Puerto Rico were given to the New York Reserve Bank.

Notwithstanding, our Reserve Bank has maintained a close interest in the banking industry of Puerto Rico, and Puerto Rico's commercial banking ties to the Sixth Federal Reserve District (Atlanta) keep growing.

As bank directors, therefore, you in turn have responsibilities that bring you into close relationship to the Federal Reserve. What do I conceive your responsibilities to be?

The responsibilities of bank directors fall into two general categories--moral and legal. When elected, a director assumes a moral obligation for the interests of shareholders, depositors, and the general public who are affected by the bank's soundness. Beyond this is the director's legal responsibility stemming from statutory provisions, regulations, and judgments of the courts. Bank directors are generally held to stricter accountability for their actions--or failure to act--than are directors of corporations.

The duties of a director have undergone many changes in the last 25 years, requiring a more knowledgeable person. To serve his bank well, a director must stay abreast of related developments, not only in his community, but also throughout the banking industry. Although the duties of a director may vary in different banking situations, certain basic responsibilities can be outlined for all. Directors are responsible for insuring that the bank is managed by competent executive officers. They must effectively supervise the bank's affairs although the officers are competent. They must keep informed of the bank's condition; assure themselves that the bank follows sound policies; and avoid self-serving practices.

Let's spend a few minutes examining each of these duties individually.

First, directors are charged with the responsibility of electing officers, defining their duties, and dismissing them if they prove incapable. I would select this factor as the most critical to the successful operation of a bank. Without competent management, the directors will find it difficult, or indeed impossible, to discharge their other duties. If an officer is not doing his job, the directors may have to remove him. If an officer tends to dominate the board, the directors have it within their power to call a halt. But the directors cannot manage the bank. They can set policy; they can guide; they can bring in new accounts; they can offer new viewpoints and valuable ideas; they can assist management in avoiding mistakes. But it is not practicable for directors to operate the bank. That is the job of management. This does not mean that directors can abdicate their legal and moral responsibilities. It does mean they should keep themselves fully informed as to how their policies are being carried out, how management is performing, how the bank is doing.

This leads us into the second duty of the director--to have a general knowledge of the bank's affairs. When losses do occur--and some losses are inevitable if the bank is serving its community--neither ignorance nor inexperience may be pleaded as an excuse. Non-membership on the executive or finance committee does not normally excuse a director from liability for losses or unsafe loans. And a director serving a bank gratuitously is expected to perform with the same degree of care as one who is directly compensated. Not even gratuitous service exonerates want of proper diligence. The courts have held that a director willfully missing board meetings has abdicated his common law responsibility. This does not mean that a director is expected to give his entire time or attention to the bank's business. But he is expected to discharge conscientiously his duties in good faith with ordinary care. To do this, he should carefully study all available information regarding the bank's condition.

The advent of the computer in banking has made it possible for the director to obtain detailed information regarding the bank's operations. Other benefits of automation of which the director should be aware include improved management methods, new customer service opportunities, and the potential for significant cost savings. But with increased benefits comes the additional responsibility of providing for internal controls. Without adequate controls, the computer represents a potential source of loss to the bank through defalcation or embezzlement which the director must recognize. The auditor and his staff must be given appropriate training so that they can install proper controls in the computer system. Furthermore, it is highly desirable to have the directors themselves acquire some familiarity with the system. The directors--or at least a committee of them--should educate themselves on the essentials and learn the possibilities of the equipment.

Thirdly, directors must assure themselves that the bank follows sound policies. The initial step is to define, in writing, the policies of the bank. One of the most important of these is the bank's lending policy. A clearly defined lending policy is needed to guide the lending officers in making and collecting loans. It should be reviewed periodically and revised in the light of changing circumstances. Examples of the information which should be included in the lending policy are: the need for maintaining adequate liquidity and capital, the need for adequate diversification in the loan portfolio, the documentation required on the various types of loans, and the structure expected in repayment programs. It is the general practice of bank directorates to authorize specific executive officers or a loan committee to grant loans up to specified maximum amounts. The board subsequently approves the loans made under this authorization. Some directorates approve all loans before they are granted although practical reasons prohibit this procedure in most banks. In any event, the directors should, at one time or another, approve all loans made by the bank. In approving loans, directors must guard against violations of the law, such as exceeding the legal lending limit. Loans to directors and officers should be reviewed with special care. Credit information is no less important when lending to directors or officers than when lending to the general public, and the charging of a preferential interest rate is difficult to justify. Membership on the board of directors does not carry with it easier or enlarged borrowing privileges or add to one's creditworthiness.

Finally, the director must avoid self-serving practices. He should not seek a loan at a preferential interest rate. He should not seek an unsound loan from the bank at any interest rate. He should not collect unjustified fees, salaries, or other payments. He should not condone insider trading. He should not be blind to the potential hazard represented by conflicts of interest. Each director must hold the interests of the bank uppermost in his mind when making a decision in which his personal interests are involved. To minimize such conflicts within the banking community, the Federal Reserve System has incorporated the portion of the Clayton Act which deals with interlocking directorates into its Regulation L. In part, this regulation provides that a director of a Federal Reserve member bank cannot serve as director of another bank within the same market area unless the banks are affiliated. But, since bank directors are generally successful businessmen in the community, other potential conflicts of interest may come into play.

The most effective check on abuses of this nature is an informed, inquisitive, independent directorate. Each board member must exercise and express his independent judgment. If he serves as merely a rubber stamp for management or controlling interests, he has abdicated his legal responsibility. Neither should he follow the majority as a result of ignorance or reticence. An individual director who dissents should not neglect to have the minutes record his disagreement. Finally, he should not be frightened by the prospect of stockholders' suits. His first concern must be to fulfill his responsibilities--as supervisor of management, policymaker, and guardian of the interests of stockholders, depositors, and the general public.

Being a director has always been an important and difficult job. This job is more difficult today than it has ever been. But just as you are faced with more and more challenges, we in the Federal Reserve face enormous challenges and are held to stricter accountability for our actions than we have ever been. I submit, therefore, that we have much in common.