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Statement of

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Chairman, Board of Governors of the Federal Reserve System,

before the

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of the

Committee on Government Operations

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With mixed feelings, I must inform you that I am unable to contribute as much as previous witnesses have to your study of recent bank failures. Happily, none of these failures has involved a bank examined by the Federal Reserve System. In some measure, I believe this reflects the competence and dedication of our examiners, and the wisdom of the policies laid down for their guidance. At the same time, any urge to boast of our accomplishments is tempered by at least two considerations. First, we must expect some failures in spite of all our efforts to prevent them. Second, the Federal Reserve System examines only State-chartered banks that are members of the System. Fewer failures are to be expected among State member banks, if only because there are fewer of them than there are national banks or nonmember insured banks, particularly in the somewhat more vulnerable smaller size ranges. Then, too, member banks (both State and national) have the privilege--not enjoyed by insured nonmember banks--of borrowing from their Federal Reserve Banks to meet emergency needs.

At the end of 1964, there were 13,761 commercial banks in the country. Of these 4,773 were national banks; of the State-chartered banks, 1,452 were members of the Federal Reserve System; 7,262 banks were FDIC-insured, but not members of the System; and 274 were uninsured. While deposit figures are not yet available for the end of the year, the following figures for June 30, 1964, indicate how deposits are distributed among these different classes of banks:

Type of Bank	Deposits (In billions of dollars)	Per Cent of Total Deposits
National	$156	55%
State member	82	29%
Insured nonmember	45	16%
Noninsured	1	less than 1%
Total	$284	100%

Examination of State member banks is carried on by the twelve Federal Reserve Banks, under the general direction of the Board of Governors, which coordinates the supervisory work of the Reserve Banks, reviews the results of their examinations, and determines broad supervisory policies. Each Federal Reserve Bank has a Bank Examination Department, under the supervision of a Vice President, whose appointment as an examiner and officer in charge of the department is subject to the approval of the Board of Governors, as are the appointments of all the Reserve Bank examiners.

State member banks are examined at least once each year by the Reserve Bank examiners, with additional examinations if considered desirable. The Reserve Banks do not examine national banks, since the Comptroller of the Currency is directly charged with that responsibility; in this way the two agencies avoid duplicating examinations. Inasmuch as State member banks are subject to examination by State authorities, the Reserve Banks and these authorities cooperate, whenever feasible, in joint or alternate examinations.

Your hearings have shown your concern with the problem of "raiding"--gaining control of a bank in order to strip it of its assets. There are three factors that make banks vulnerable to this kind of attack. First, banks are more liquid than the ordinary business corporation; so it is easier to turn a bank's assets into cash quickly. Second, banks have a relatively high ratio of assets to capital; so they offer the prospect of gaining control of sizable assets with a relatively small investment. Third, this country has a diversified banking system with thousands of small community banks, as opposed to the highly concentrated banking structures of most other countries. These smaller American banks, particularly, offer an inviting target, because their capital is small; a bank with $3 million in deposits may have a capital of about $300,000, so that a controlling interest might be purchased with a little over $150,000, and in many cases the bulk of that investment could be borrowed. Once control of one bank is obtained, there is a danger that its funds may be used to finance purchases of control of other banks.

For this reason, the Board of Governors supported the legislation enacted last year (Public Law 88-593) to require reports of change in control of Federally-supervised banks, and reports of loans made by an insured bank that are secured by 25 per cent or more of the voting stock of another bank, which added to the previously existing safeguards against raiding. Normally, news of a change in control of a State member bank reaches its Federal Reserve Bank promptly--and this was true even before Public Law 88-593 was enacted. If a new owner tries to strip a bank of its assets, the first line of defense is the board of directors. Acting in concert with the supervisory agencies, directors have on occasion blocked a move to use a bank's funds to promote the interests of a new owner at the expense of the bank. Fortunately, however, such cases have been rare in our experience, because the attempts have rarely been made.

Some of the recent bank failures have focused attention on the certificate of deposit, a financial instrument that has proved its usefulness over the years, and has recently come into wider use in a new form.

In some areas of the country CDs have long been issued by banks as receipts for savings on deposit. Those CD's differed from ordinary savings deposits legally and technically, including the fact that they often were legally "negotiable," i.e., in form to permit easy legal transfer from one holder to another. But in their essential economic characteristics they were much the same as ordinary savings deposits represented by a "passbook"--they were in relatively small amounts, and the depositor usually had other customer relations with the bank or was located near the bank. In other words, the funds represented by those CDs tended to be relatively stable, because it usually served the depositor's convenience or other self-interest to keep them with the bank; while the rate of interest was of some significance, it was not of paramount importance.

Many CDs still have these characteristics. However, in recent years some banks have issued large volumes of CDs in greatly different circumstances. In appearance and legal form these CDs are quite similar to those that have been used for many years as the rough equivalent of savings "passbooks." In economic effect, however, they are drastically different because they have tapped an essentially different source of funds. Whereas CDs formerly were issued principally to individuals and in relatively small amounts, the recent expansion of CDs has been principally in large denominations and to corporate and other large interest-sensitive purchasers. The rate of interest has become vitally important. The documents are not only legally "negotiable" but to an increasing degree are in practice marketable and marketed, that is, they are often traded impersonally and even issued originally on that basis. In short, a substantial portion of CDs now represent impersonal and volatile funds.

In view of the growing importance and changing economic characteristics of CDs, the Federal Reserve System made a survey of amounts outstanding at December 5, 1962, and for each of the two preceding year-ends. For the 410 banks surveyed, CDs increased from just over $1 billion at the end of 1960, and $3.2 billion at the end of 1961, to $6.2 billion at December 1962.

Since January 1, 1964, the Board has published weekly information of CDs outstanding at the so-called "weekly reporting member banks." This is a sample of about 350 member banks that give information each week on their financial position. This sample is slightly smaller than that in the earlier survey, and CDs for these reports are limited to those of $100,000 denomination or larger. On March 3, 1965, these weekly reporting member banks had about $13.9 billion of such CDs outstanding. This represented about 8% of the total deposits of these banks.

The new uses of CDs have enabled banks to acquire loans and investments they could not otherwise finance. But the more volatile CDs also involve new hazards. Ordinary prudence dictates that a bank should schedule its CDs to avoid undue concentrations of maturities; but this is only part of the story. A bank should also avoid having an undue proportion of its deposits in the volatile CDs. In most cases a bank should hold at least as much liquidity against volatile CDs as against demand deposits--and in some instances it should hold more. Volatile CDs can expose a bank's assets to severe tests of liquidity and soundness, since such CDs increase the risk of the bank's having to sell or borrow on the assets.

CDs, whether the more volatile kind or the more stable variety, tend to represent high cost money. In order to earn a profit a bank using them must place the funds in higher yielding loans and investments. A bank can easily fall into the trap of reaching for high cost funds through volatile CDs and then reaching for high yield--and high risk--assets. A bank's apparent ability to get funds readily by issuing volatile CDs can lull it into a false sense of security--can cause it to mistake mere size of deposit totals for sound growth.

In order to avoid these pitfalls, a bank issuing volatile CDs must have special skills that are not always found in every bank. The hazards are intensified if the bank is relatively small or is newly chartered. Such a bank may have a ready market for its CDs one day and none whatever the next; unless it has maintained proper liquidity and soundness in its assets, it cannot pay its volatile CDs as they fall due.

The problems can be compounded if a bank markets volatile CDs through a broker, possibly paying an extra fee for obtaining the funds. Some banks have even loaned the funds so obtained to unknown borrowers suggested by the CD broker, who was also acting as loan broker.

Questions regarding the soundness of CD activity of individual banks require analysis of the assets, liabilities, capital, and management skills of such banks. This is the kind of analysis that examiners typically apply. It is a continuing responsibility of the examination departments of the Federal Reserve Banks. In most of the instances in which CDs have been abused, the practice has been symptomatic of generally unsound activity in the bank. In other words, the bank with CD problems has usually had other problems, including unsound lending practices.

A bank's executive officers, and particularly its board of directors, have the first and foremost responsibility for preventing or correcting unsound situations. As stockholders, as members of the community, and as possible defendants in litigation against them for negligence or misfeasance, they have much to gain from correction of unsound conditions and much to lose from unsound activities. In examining and supervising State member banks, the Reserve Banks and the Board stress the necessity for boards of directors to provide sound management for their banks. When an examination shows unsound conditions in a State member bank, the Reserve Bank presents the facts to the executive officers and, if necessary, the directors. The purpose is to have the management of the bank recognize and carry out its responsibility to operate the bank soundly. Solution of CD problems in such cases usually requires solution of related problems. Besides avoiding further expansion of volatile CDs, the bank's management must stop making unsound loans, and do everything possible to collect or strengthen any such loans already made. To the fullest extent practicable, the bank must collect, sell, or borrow on loans where necessary to pay off maturing CDs. In troublesome situations the Reserve Bank may examine the bank more frequently than once each year, and may request interim reports from the bank.

The Federal Reserve Board has authority to terminate a State member bank's membership in the Federal Reserve System and its deposit insurance for unsafe or unsound practices. It also may remove an officer or director of a State member bank for continued violation of law or continued unsafe or unsound practices. These are drastic remedies and under the law can be invoked only by following carefully prescribed procedural safeguards. It best serves the public interest to use these sanctions only in extreme cases. Thus far it has not seemed appropriate to invoke them in any case involving CD problems in a State member bank.

The Board is not now asking for increased authority to deal with these problems; thus far we have been able to meet our responsibilities with the tools at hand. We have, however, submitted legislation to increase the usefulness of the Federal Reserve Banks as a source of liquidity for member banks. This legislation, which we first submitted in 1963 and resubmitted yesterday to the Chairmen of the two Committees on Banking and Currency, would permit member banks to borrow from their Reserve Banks on any sound assets without paying a penalty rate of interest. Under present law, a member bank must pay interest at a rate one-half of one per cent higher than the Federal Reserve Bank's normal discount rate if it borrows on any collateral other than U. S. Government obligations or limited types of paper that meet certain outmoded eligibility tests. The proposed legislation would repeal these restrictive provisions.

Our experience to date does not demonstrate any clear need in my judgment for legislation providing stricter controls over the marketing of certificates of deposit or over transfers of bank stock. I share your concern, however, over the potentialities for trouble in these areas. The Federal Reserve System stands ready to cooperate with your Committee and with the other bank supervisory agencies in making sure that adequate safeguards are maintained to protect the public against unsound banking practices.