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WHAT IS WRONG WITH THE AMERICAN BANKING SYSTEM AND WHAT TO DO ABOUT IT

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MARY S. HEAD**

Many of the problems which currently plague the American banking system bear a striking resemblance to the financial excesses and abuses of the late 1920's and the early 1930's which resulted in the economic collapse of that period. The lack of effective bank regulation, the increasing expansion of banks into nonbanking activities, and the rapid growth of bank holding companies are developments which produced catastrophe in an earlier day and which threaten to produce similar results today if current trends in banking continue unchecked.

During the first quarter of the twentieth century, the stability of the American banking system, already weakened by a wave of financial crises which began in 1869, was further jeopardized by the large-scale entry of banks into nonbanking enterprises, notably the sale of securities. In the absence of an effective bank regulatory mechanism, the bankers' wild speculation on the stock market, coupled with the execution of high-interest foreign loans, ultimately led to the stock market crash of 1929 and the economic unrest which continued into the 1930's. Despite the passage of the Federal Reserve Act in 1913,¹ which was designed to wrest control of the banking system from the bankers, the Federal Reserve System quickly became dominated by banking interests which proved unable to put the stability of the banking system before their own immediate self-interest.

The same trend towards expansion of banks into nonbanking activity — leasing, mortgage banking, commercial factoring, and consumer finance — is evident today. With little attempt on the part of the Federal Reserve Board to limit this trend, it appears inevitable that, unless needed reforms are carried out, the banking system will face continued instability and eventual collapse.

It is the purpose of this article to explore today's problems in the field of banking in light of the experience of the 1920's and 1930's in an effort to underscore the seriousness of the present situation and to

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1. Act of December 23, 1913, ch. 6, 38 Stat. 251.

point the way toward effective solutions to these problems. The article will focus first on existing organizational and operational defects of the Federal Reserve System, and then will turn to an examination of the bank holding company structure, the Real Estate Investment Trust (REIT) industry, and the problem of foreign lending to less developed countries.

I. THE FEDERAL RESERVE SYSTEM

After more than fifty years in existence, the Federal Reserve System stands clearly in need of restructuring.² Two aspects of the operation of the Federal Reserve System require immediate reform. First, the conflict of interest inherent in the entire system, institutionalized in the composition of the Boards of Directors of the regional Federal Reserve Banks, has led to the domination of the Federal Reserve System by local banking interests and the formulation of policies favorable to those interests. Secondly, the Fed's jealously guarded "*independence*," its freedom from Presidential or Congressional influence in the formulation of monetary policy, has become not only an anachronism, but an obstacle to responsible monetary policy-making in a difficult economic period when close cooperation among all branches of government is required to achieve economic goals. In view of the dramatic impact which the Fed's monetary decisions have on "prices, the value of money, foreign exchange rates, interest rates, economic activity, and employment and unemployment,"³ the Fed's insistence on conducting its operations in total secrecy must be rejected. The Federal Reserve System must be made more responsive to the President, Congress, and the public.

Moreover, the organizational and operational defects of the Federal Reserve System have allowed the problems of bank holding company activity, the REIT industry, and foreign loans to become more serious. Due to the System's domination by banking interests, the Fed had presented no opposition to the often short-sighted wishes of the banking community, thus worsening an already deteriorating situation.

The organizational shortcomings of the Federal Reserve System, as well as the conflict of interest situations which pervade it, are

2. The Federal Reserve System was created in 1913 by the Federal Reserve Act, 38 Stat. 251, *codified at* 12 U.S.C. §§ 221-522 (1970). It consists of the Board of Governors, twelve regional Federal Reserve Banks, the Federal Open Market Committee, the Federal Advisory Council, and 5,790 privately-owned commercial member banks. See Memorandum in Support of Defendants' Motion to Dismiss at 2, *Reuss v. Balles*, Civil No. 76-1142 (D.D.C. filed Oct. 1, 1976).

3. Complaint at 6, *Reuss v. Balles*, Civil No. 76-1142 (D.D.C. filed Oct. 1, 1976).

illustrated in the following discussion of the length of office of Board members, the Chairmanship of the Federal Reserve Board, the structure of the regional Federal Reserve Banks, the operation of the Federal Open Market Committee, and the present division of responsibility for bank examination among the three banking agencies.

A. *Length of Term of Office of Board Members*

As enacted in 1913, the Federal Reserve Act called for the formation of a Federal Reserve Board of seven members.⁴ Two members were to be ex-officio, the Secretary of the Treasury and the Comptroller of the Currency, while the other five were to be appointed by the President for staggered ten-year terms.⁵ Not more than one of the five members was to reside in any one Federal Reserve district, and two were to be experienced in banking.⁶ In selecting Board members, the President was cautioned to have due regard for a fair representation of the various financial, agricultural, industrial and geographic sectors of the nation.⁷ Finally, none of the five Board members were permitted to hold any office, position or employment in a member bank while in office or for two years thereafter.⁸ In 1935, the Act was amended to remove both the Secretary of the Treasury and the Comptroller of the Currency from the Board and to allow the President to appoint all seven Board members for staggered fourteen year terms.⁹

In such a sensitive and changing area as monetary control, the lengthy terms of Federal Reserve Board members serve to insulate the Board from economic and political realities and enable the Board to design and implement monetary policy with little regard for Administration or Congressional goals. Unless members die or resign, it is impossible for a newly-elected President to name more than two members to the Board during his first term and more than three members before the end of his second term. Although the lengthy terms were designed to prevent Presidential control of the Board,¹⁰ modern economic conditions dictate close communication and cooperation between the Board and the executive and legislative branches to achieve economic goals. Thus, the first step in making

4. Act of December 23, 1913, ch. 6, § 10, 38 Stat. 260.

5. *Id.*

6. *Id.* The provision requiring two Board members to be experienced in banking was eliminated in 1922. Act of June 3, 1922, ch. 205, 42 Stat. 620.

7. *Id.*

8. *Id.*

9. Act of August 23, 1935, ch. 614, § 203(b), 49 Stat. 684.

10. See Roberts, *Monetary Policy — The Fed's Grip*, 82 AFL-CIO AMERICAN FEDERATIONIST February, 1975, at 19.

the Fed more responsive to the federal government and the public should be to shorten the terms of office of Board members from fourteen to five years.¹¹ In this way, the danger of the domination of Board policy-making by an individual member or members will be minimized. There will be increased opportunity for participation in the activities of the Board, and impetus for closer cooperation with the executive and legislative branches of government.

B. *The Chairmanship of the Federal Reserve Board*

Under the 1913 Act, the President was empowered to designate one member of the Board as Governor and another member as Vice-Governor.¹² No term of office was specified, but the practice was for the President to make annual designations.¹³

In 1935, an amendment to the Act was adopted which provided that the heads of the twelve Federal Reserve District Banks (who also termed themselves Governors) were to be called Presidents and the seven appointees were to be known as the Board of Governors of the Federal Reserve System.¹⁴ Likewise, of the Governors thus appointed, the 1935 amendment required the President to designate one as Chairman and another as Vice-Chairman for four-year terms.¹⁵

The shortcomings of the amendment lie chiefly in its institutionalization of the isolation of the Federal Reserve Board from the rest of the federal government. Almost all federal administrative agencies permit a newly-elected President to select his own Chairman.¹⁶ The appointee may serve out his term in the agency but must relinquish his Chairmanship if the incoming President so desires.¹⁷ While the term of the Chairman of the Board of Governors of the Federal Reserve Board is only four years, the Chairman does not resign with the election of a new President nor is the Chairman's term of office coterminous with that of the President.¹⁸ As a result, Presidents have been forced to deal with Chairmen who are not of their own choosing. In an attempt to force the Federal Reserve System to recognize a greater degree of accountability to the President, Congress, and the general public, the term of office of the Chairman and Vice-Chairman should be made to accord with that of

11. See Patman, *The Federal Reserve System: A Brief for Legal Reform*, 10 ST. LOUIS U. L. REV. 299, 324 (1966).

12. Act of December 23, 1913, ch. 6, § 10, 38 Stat. 260.

13. *Id.*

14. Act of August 23, 1935, ch. 614, § 203(b), 49 Stat. 704.

15. *Id.*

16. See, e.g., 5 U.S.C. §§ 901-913 (1970).

17. *Id.*

18. 12 U.S.C. § 242 (1970).

the President.¹⁹ In addition, there is currently no provision in the Act for Senate confirmation of the Chairman. While it is highly unlikely that confirmation would be denied a sitting Federal Reserve Governor, nevertheless the post is so powerful and important that the President's nomination should be submitted to the Senate for confirmation.

C. *Regional Federal Reserve Banks*

One of the aspects of the Federal Reserve System most seriously in need of reform is the composition of the Boards of Directors of the regional Federal Reserve Banks. In the original bill, which was eventually enacted as the Federal Reserve Act of 1913, Senator Carter Glass of Virginia, then Chairman of the House Committee on Banking and Currency, provided that the twelve regional banks would be operated by private corporations in which local banks would hold stock.²⁰ Today, as stockholders, these local bankers control the operations of the twelve regional Federal Reserve Banks. They elect, subject to the approval of the Fed, six of each bank's nine directors, leaving the Board to elect the other three.²¹ These banker-selected directors then select one of their number as President for a five-year term, subject to the approval of the Fed, and determine his salary.²² A review of the salaries of the twelve Presidents of the regional Federal Reserve Banks, as fixed by the local directors, shows that the Presidents of the Federal Reserve Banks receive far higher salaries than members of the Board of Governors of the Federal Reserve Board.²³

19. See Patman, *supra* note 11, at 324.

20. Act of December 23, 1913, ch. 6, § 4, 38 Stat. 260. Stock owned by member banks "cannot be transferred or sold and is clearly a fixed-income, nonproprietary asset." Patman, *supra* note 11, at 324.

21. 12 U.S.C. §§ 302, 304 (1970).

22. 12 U.S.C. § 341 (1970).

23. Members of the Board of Governors of the Federal Reserve System receive an annual salary of \$52,500, and the Chairman \$57,500. The Presidents of the regional Federal Reserve Banks receive the following salaries:

<i>Federal Reserve Bank</i>	<i>President's Salary</i>
Boston	\$72,500
New York	\$97,500
Philadelphia	\$61,500
Cleveland	\$68,000
Richmond	\$58,750
Atlanta	\$74,000
Chicago	\$88,000
St. Louis	\$66,000
Minneapolis	\$69,000
Kansas City	\$55,000
Dallas	\$59,400
San Francisco	\$90,000

The dependence of regional Federal Reserve Bank Presidents upon local bankers for their jobs builds a conflict of interest into the System which far outweighs the need for the presence and input of the Bank Presidents on the powerful Federal Open Market Committee.²⁴ The United States clearly should redeem the stock of area banks in their local Federal Reserve Bank. Since the Federal Reserve Banks are creatures of the United States, not of the private banks in their local areas, the President should have the authority to appoint Bank Presidents, with the advice and consent of the Senate, and Congress should be authorized to fix their salaries.

D. *The Federal Open Market Committee*

The Federal Open Market Committee, created by the Banking Act of 1933,²⁵ consists of the seven Governors of the Federal Reserve Board and the twelve Presidents of the regional Federal Reserve Banks.²⁶ All twelve Presidents attend the meetings of the Open Market Committee, but only five vote.²⁷

The Federal Open Market Committee controls the national economy primarily by instructing the New York Federal Reserve Bank to buy or sell federal government securities on the open market, depending on the desired monetary effect.²⁸ By buying

24. For a comprehensive study of this problem, see STAFF OF HOUSE COMM. ON BANKING, CURRENCY AND HOUSING, 94TH CONG., 2d SESS., FEDERAL RESERVE DIRECTORS: A STUDY OF CORPORATE AND BANKING INFLUENCE (Comm. Print 1976).

25. Act of June 16, 1933, ch. 89, § 8, 48 Stat. 162.

26. 12 U.S.C. § 263(a) (1970). The presence of the regional Bank Presidents on the Federal Open Market Committee is currently being questioned on another ground in a lawsuit brought against the Federal Reserve System by Henry S. Reuss, Chairman of the House Committee on Banking, Currency and Housing, *Reuss v. Balles*, Civil No. 76-1142 (D.D.C. filed Oct. 1, 1976). The action seeks to enjoin the twelve Bank Presidents from "exercising the powers of officers of the United States as members of the Federal Open Market Committee, on the ground that they have not been appointed as officers of the United States in accordance with Article 2, Section 2 of the Constitution." The action also seeks a judgment declaring section 12(A) of the Federal Reserve Act unconstitutional (12 U.S.C. § 263(a)) insofar as it "provides for membership on the Federal Open Market Committee of individuals who have not been appointed as officers of the United States in accordance with the Constitution." Complaint at 1, *Reuss v. Balles*, *supra*.

27. 12 U.S.C. § 263(a) (1970). When the Federal Reserve System was created, President Wilson envisioned that the Federal Reserve Board would control the System and that the twelve regional Federal Reserve Banks would operate independently. See Patman, *supra* note 11, at 304-05. The New York Federal Reserve Bank has always, however, bought and sold securities for the accounts of all twelve Banks. Due to his proximity to the New York money markets, the President of the New York Federal Reserve Bank is the only permanent voting member on the Federal Open Market Committee among the twelve Bank Presidents, leaving four voting positions to rotate annually among the remaining eleven Bank Presidents.

28. 12 U.S.C. §§ 263(b), 353-59 (1970 & Supp. V 1975). "Open market operations are the principal instrument used by the Federal Reserve to implement national monetary policy." Roberts, *supra* note 10, at 20.

United States securities, the Federal Open Market Committee adds to reserves in the nation's banks, thereby increasing the amount of money member banks can loan, while selling securities achieves the opposite effect, decreasing the nation's money supply.²⁹ The Federal Reserve Board's power over the economy also extends to its control of the discount rate, the rate of interest a regional bank charges a member bank which applies for a secured loan at its "discount" window.³⁰ In addition to establishing the discount rate, the Board determines the amount of reserves a member bank must keep in its local Federal Reserve Bank to secure its deposits.³¹

The Federal Open Market Committee's use of these three interlocking monetary tools ultimately determines the level of the nation's money supply.³² Since interest payments constitute perhaps the principal cost of doing business in the United States today, the Committee's control over interest rates gives it a life and death grip on the nation's economy. Setting aside the question whether power of this magnitude should be vested in a government committee whose authority is unchecked by either the President or Congress, the Federal Open Market Committee's methods of operation demand immediate review.

One of the most objectionable aspects of the Federal Open Market Committee is its proclivity for meeting in total secrecy from

29. See Roberts, *supra* note 10, at 21. See also Silk, *A Factor in Economic Outlook: Influence of the Durable Dr. Burns*, N.Y. Times, February 28, 1977, at 39, col. 1.

30. 12 U.S.C. § 357 (1970). By raising the discount rate, bank borrowing to build up cash reserves becomes more expensive. This discourages bank lending to private borrowers, increases interest rates, and tightens the money supply. A lowering of the discount rate encourages borrowing by making it profitable for private banks to borrow from the Reserve Banks, build up cash reserves, and then lend money to private borrowers at lower interest rates. See Roberts, *supra* note 10, at 20.

31. 12 U.S.C. § 461(b) (1970). Member banks of the Federal Reserve System are required to maintain specified levels of cash reserves at their Federal Reserve District Banks. *Id.* Raising reserve requirements forces private banks to put more cash into the District Banks, which leads to a restriction on available credit and higher interest rates. Conversely, to increase the availability of credit, the Fed may lower reserve requirements. Banks then have more money to lend to private borrowers and interest rates decline. See Roberts, *supra* note 10, at 19.

32. See Roberts, *supra* note 10, at 21. The nation's money supply can be measured by two standards. The money in circulation and in checking accounts is known as M-1, or "high-powered money." M-2 includes, in addition to M-1 money, all money in time deposits or savings deposits. See Roberts, *supra* note 9, at 20. Economists generally agree, however, that "M-1 is the measure most directly under the control of the FOMC [Federal Open Market Committee], and that the money supply no matter how defined will tend to move with rather than independently of M-1." Plaintiff's Opposition to Defendants' Motion to Dismiss at 8 n.4, *Reuss v. Balles*, Civil No. 76-1142 (D.D.C. filed Oct. 1, 1976).

the President, Congress, and the public.³³ The Committee publishes three statistical releases concerning the results of Federal Open Market Committee meetings one week after each meeting; these reports — the Federal Reserve Statement, the Weekly Summary of Banking and Credit Measures, and Money Stock Measures — are, however, intelligible only to experts.³⁴ Furthermore, no transcripts are made of Committee meetings.³⁵ Until recently, an enigmatic summary of what the Committee said and did was issued approximately ninety days following a meeting, and an edited summary of action taken was published five years later.³⁶ As a result of improvements made during the 94th Congress, the enigmatic summary is now made available approximately forty-five days after an Open Market Committee meeting;³⁷ in addition, Dr. Arthur F. Burns, Chairman of the Federal Reserve Board, now appears regularly before the House and Senate Banking Committees as well as the Joint Economic Committee to testify, albeit in a very general way, as to the Federal Open Market Committee's current monetary targets.³⁸

There is no excuse for denying the public an intelligible transcript of the meetings of the Federal Open Market Committee. The critical effect on the country at large of the monetary controls exercised by the Committee far outweighs any argument that such disclosure will be misinterpreted or that it will discourage the open exchange of views at Federal Open Market Committee meetings. Two dramatic examples of the consequences of permitting the

33. The Fed's refusal to make a transcript of Federal Open Market Committee meetings is based on the typical bureaucratic argument:

If the FOMC memoranda of discussion were to be released prematurely, the Committee would be faced with the choice of permitting a destructive diminution of candor in its deliberations or of preserving the members' ability to speak their minds freely and fully by terminating the preparation of such memoranda.

Letter from Arthur F. Burns to Wright Patman (June 3, 1975) (A copy of the letter is on file at the *Maryland Law Review*).

Former Board member Sherman J. Maisel suggests that the Fed pursues its policy of secrecy from "fear of political attack and public criticism and the belief that political pressures would lead to more inflation." S. MAISEL, *MANAGING THE DOLLAR* 306 (1975).

34. See Letter from Arthur F. Burns to Wright Patman (June 3, 1975).

35. At present, the Fed uses a combination of note taking and tape recording at Federal Open Market Committee meetings; these materials are destroyed as soon as the statistical reports are prepared. See Letter of Arthur F. Burns to Wright Patman (April 18, 1975) (A copy of this letter is on file at the *Maryland Law Review*).

36. 121 CONG. REC. H1774 (daily ed. March 14, 1975) (remarks of Rep. Wright Patman).

37. 12 C.F.R. § 271.5(a) (1976); see *Merrill v. F.O.M.C.*, 413 F. Supp. 494 (D.D.C. 1976).

38. H.R. Con. Res. 133, 94th Cong., 1st Sess., 121 CONG. REC. H995 (February 24, 1975).

Committee to operate in secrecy involve the 1972 election and the Tax Reduction Act of 1975.³⁹ It has been suggested that, in an effort to ensure the re-election of Richard Nixon, the Federal Open Market Committee increased the money supply to 8.7 percent in 1971-72.⁴⁰ The discount rate decreased to 4.5 percent, the federal funds rate ranged from 3.18 to 5.38 and the prime rate increased from 4.5 to 6 percent.⁴¹ This increase flooded the country with money, and Nixon was re-elected. After the election, however, the Committee tightened the money supply too sharply. The prime rate, which had been 6 percent at the end of 1971, was 12.25 percent on July 23, 1974; also in 1974, the discount rate ranged from 7.75 to 8 percent, and the federal funds rate increased from 8.45 to 13.55 percent.⁴² Needless to say, the Federal Open Market Committee's manipulation of the money supply to achieve political ends was not discovered until the recession of 1974 was in full swing.⁴³

Similarly, in 1975, when Congress decided to stimulate economic recovery by means of a tax cut and tax rebates,⁴⁴ the Federal Open Market Committee under Dr. Burns raised the federal funds rate to 6.75 percent, thereby reducing the money supply to 2.05 percent and effectively sabotaging the effect of the tax cut which Congress had ordered.⁴⁵ As Wright Patman remarked to the House on October 31, 1975: "Of course we do not know what the members of the Open Market Committee said, because Dr. Burns, despite my repeated requests, has refused to make available a transcript of remarks made

39. The Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26 (codified in scattered sections of 26 U.S.C. (Supp. V 1975)), provided for a reduction in 1975 income taxes and a \$22 billion cash rebate on 1974 taxes.

40. Sherman J. Maisel states that the Director of the Office of Management and Budget, George Shultz, informed the Board that "[i]f an election were to be won, the Federal Reserve would have to increase the money supply at far more than the 4.2 percent average of 1969-70." MAISEL, *supra* note 33, at 268.

41. See 121 CONG. REC. H1774 (daily ed. March 14, 1975) (remarks of Rep. Wright Patman). There are three important interest rates: the discount rate, which is the rate a regional Federal Reserve Bank charges a bank which applies at its discount window for a secured loan; the federal funds rate, which is the rate a bank charges for loaning excess reserves to another bank; and the prime rate, the rate of interest a commercial bank charges its best customers. See Roberts, *supra* note 10, at 19-20.

42. See 121 CONG. REC. H1774 (daily ed. March 14, 1975) (remarks of Rep. Wright Patman).

43. Since the edited transcripts do not appear until five years after Federal Open Market Committee meetings, the reports for Committee meetings in 1971-72 did not become available until 1976. See 121 CONG. REC. H1774 (daily ed. March 14, 1975) (remarks of Rep. Wright Patman). See also Patman, *What's Wrong with the Federal Reserve and What to do About It*, 61 A.B.A.J. 179, 184 (1975).

44. See note 38 *supra*.

45. See 121 CONG. REC. H10,539 (daily ed. Oct. 31, 1975) (remarks of Rep. Wright Patman).

at the Open Market Committee meeting."⁴⁶ Thus, during a period when Congress was attempting to stimulate the national economy, the secrecy under which the Federal Open Market Committee operates permitted it to effectively destroy any hope for economic recovery.

These are but two examples of the results of permitting the Federal Open Market Committee to operate in secrecy. Full disclosure should be required of a committee wielding such extensive power over the economy, but it is especially vital so long as the built-in conflict of interest due to the presence of banker-selected Bank Presidents on the Federal Open Market Committee continues.

E. *One Banking Agency*

The foregoing discussion of the organizational and operational shortcomings of the Federal Reserve System has focused on the System's internal problems. Banking in the United States today, however, involves not only the Federal Reserve System, but the Comptroller of the Currency and the Federal Deposit Insurance Corporation.

At present, the responsibility for examining state and national banks is divided among the three banking agencies. The Comptroller of the Currency examines the national banks,⁴⁷ the Governors of the Federal Reserve System regulate state member banks,⁴⁸ and the Federal Deposit Insurance Corporation supervises state nonmember banks.⁴⁹ Bank holding companies as well as Edge Act and Agreement corporations are regulated by the Board of Governors of the Federal Reserve System.⁵⁰ Neither the Comptroller, the Federal

46. *Id.*

47. The Comptroller is authorized under 12 U.S.C. § 481 (1970) to examine national banks; the statute provides for two examinations per year, although the Comptroller, in his discretion, may waive one such examination. *Id.*

48. State member banks are subject to examination by the Board of Governors of the Federal Reserve System as a condition of membership under 12 U.S.C. §§ 325, 326 (1970).

49. The Federal Deposit Insurance Corporation is authorized to examine state nonmember banks pursuant to 12 U.S.C. § 1817(a) (1970).

50. The Federal Reserve Board is given authority to examine bank holding companies under 12 U.S.C. § 1844(c) (1970). In addition, the Board is charged, pursuant to 12 U.S.C. § 625 (1970), with examining Edge Act and state Agreement corporations. Edge Act corporations are domestic businesses chartered by the Federal Reserve System solely to conduct international banking and foreign investment activities. See STAFF OF HOUSE COMM. ON BANKING, CURRENCY AND HOUSING, 94TH CONG., 2ND SESS., INTERNATIONAL BANKING: A SUPPLEMENT TO A COMPENDIUM OF PAPERS PREPARED FOR THE FINE STUDY (Comm. Print 1976). They may not "carry on any part of [their] business in the United States" except as "incidental to [their] international or foreign business." 12 U.S.C. § 616 (1970).

Reserve System, the Federal Deposit Insurance Corporation nor state banking authorities have the power to examine *all* the banks.

Not long after the failure of the United States National Bank at San Diego in 1973⁵¹ and the Franklin National Bank in New York in 1974,⁵² Dr. Burns admitted to the American Bankers Association that "some carelessness" had "crept into our banking system."⁵³ He conceded that the three agencies have "overlapping regulatory powers" which create "a jurisdictional tangle that boggles the mind" and foster a "competition in laxity" which allows bankers to evade regulation by playing off one agency against another.⁵⁴ The result of such confusion and overlapping authority among the bank regulatory agencies is that today there is no effective regulation of the banking system. It is critical that there be a single banking regulatory agency charged with the responsibility for examining all banks, bank holding companies, Edge Act and Agreement corporations and their subsidiaries.

As to where such regulatory authority should be centered, the Federal Reserve System has demonstrated small talent for effective bank regulation.⁵⁵ The Fed's deficiencies in the area of regulation have been clearly evidenced not only by its handling of the Franklin failure,⁵⁶ but also in its routine approvals of bank holding company acquisitions and bank holding company mergers.⁵⁷ While the

51. See 121 CONG. REC. H6370 (daily ed. July 8, 1975) (remarks of Rep. Wright Patman).

52. See 121 CONG. REC. H6370-71 (daily ed. July 8, 1975) (remarks of Rep. Wright Patman).

53. Address by Dr. Arthur F. Burns to the American Bankers Association, Honolulu, Hawaii, October, 1974.

54. *Id.*

55. If the Fed's demonstrated inability to regulate banks were not evidence enough, an editorial in the Wall Street Journal of November 25, 1974 suggested an additional reason against lodging comprehensive regulatory power with the Federal Reserve. "[I]f regulatory authority is centralized, it had better be centralized somewhere else than in the Fed. Combining the money-creation power with regulatory authority creates a conflict of interest." Wall St. J., Nov. 25, 1974, at 22, col. 1.

56. After studying the financial condition of Franklin National Bank for nearly one year, the Fed publicly stated on May 1, 1975 that Franklin's holding company would not be permitted to purchase the Talcott National Corporation. See 121 CONG. REC. H6370-71 (daily ed. July 8, 1975) (remarks of Rep. Wright Patman). Yet despite its knowledge of Franklin's weak condition, the Fed accepted the Comptroller's declaration that Franklin was solvent and loaned it approximately \$1.7 billion before the Federal Deposit Insurance Corporation sold Franklin's assets to the European Bank and Trust Company in October. *Id.* The \$1.7 billion was used to pay off banks which had loaned Franklin upwards of \$500 million in federal funds as well as depositors in foreign branches whose deposits were not insured by the Federal Deposit Insurance Corporation. *Id.*

57. According to a study published on June 30, 1976 by Ralph Nader and Jonathan Brown, the Fed approved 2,680 applications to establish or acquire nonbank operations between January 1, 1971 and December 20, 1975. The study also

Comptroller of the Currency also failed miserably in its regulation of both the United States Bank at San Diego and the Franklin National Bank,⁵⁸ the lack of effective regulation in each case was essentially attributable to officials at the top of the bureaucracy. Bank examiners, in reports as early as 1962, had warned top Treasury officials that the United States National Bank in San Diego was in trouble;⁵⁹ similarly, at the very time in May, 1974 when the Comptroller was proclaiming Franklin's solvency, the bank examiner assigned to the case was quoted to the effect that the bank was insolvent.⁶⁰

In any event, whether we create a new National Banking Commission or merge the three existing agencies into one, we desperately need one agency charged with complete responsibility for the examination and regulation of the nation's banks.

F. Conclusion

The foregoing discussion has included proposals for reform, but they bear reemphasis here.

1. The present staggered fourteen-year terms of office of Board members should be reduced to five years, and the four-year term of the Chairman of the Board should be made coterminous with that of the President of the United States.

2. The United States should redeem the stock held by member banks in the twelve regional Federal Reserve Banks. The President should be given the authority, with the advice and consent of the Senate, to appoint Bank Presidents, and Congress should be authorized to fix their salaries.

3. The Federal Open Market Committee should be compelled to make full disclosure of all records of its meetings and other relevant documents.

4. One federal agency should be vested with the authority to examine *all* the nation's banks and banking organizations.

These reforms are urgently needed to remove the current conflict of interest inherent in the Federal Reserve System and to strip its

indicates that the Federal Reserve Board approved new nonbank operations in 1974 for at least 17 of the 35 bank holding companies on its problem list. See Letter from Ralph Nader to Senator William Proxmire (June 30, 1976) (A copy of this letter is on file at the *Maryland Law Review*); see also R. Nader & J. Brown, *Disclosure and Bank Soundness: Non-Bank Activities of Bank Holding Companies* (1976) (unpublished study).

58. See 121 CONG. REC. H6370-71 (daily ed. July 8, 1975) (remarks of Rep. Wright Patman).

59. *Id.*

60. *Id.* See also N.Y. Times, May 13, 1974, at 51, col. 3.

operations of secrecy.⁶¹ These mutually protective features have long gone unchecked. Should they continue in effect, the problems of bank holding company activity, the REIT industry, and foreign lending can only worsen.

II. THE BANK HOLDING COMPANY: SUCCESSOR OF THE SECURITY AFFILIATE

The similarity between the security affiliate of the 1920's and the modern bank holding company should give pause to banking authorities who have permitted the bank holding company structure to engulf the American banking system. One critic who witnessed the abuses of the security affiliates and who foresaw similar abuses in the bank holding company structure was the late Winthrop Aldrich who in 1969, before Congress enacted the Bank Holding Company Act of 1970,⁶² urged Wright Patman, then Chairman of the House Committee on Banking and Currency, "to stop the trend toward mixing the business of commercial banking with all other business."⁶³ Expressing his horror at the "growth of financial and other conglomerates and the incredible proliferation of mergers between completely unrelated types of business activity," Aldrich commented that,

As one of the few men now alive who were involved in the events which led to the decisions taken by Congress in the passage of the Glass-Steagall Act, 12 U.S.C. §§ 24, 78, 377, 378, to divorce commercial banking from all other business, I have been tremendously concerned over the recent uncontrolled growth of unregistered bank holding companies.⁶⁴

Aldrich recognized that the danger of the bank holding company structure lies in its propensity for jeopardizing the stability of affiliated banks. The strain placed on banks to support the parent holding company's nonbank activities is the theme of the following discussion. To explore it further, we turn first to an examination of the security affiliates of the 1920's.

A. *The Security Affiliates of the 1920's*

Aldrich saw the same evils in today's bank holding companies that the Congress of 1933 saw in National City Bank's being allowed

61. These recommendations are supported by a recent study of the effectiveness of the three banking agencies' supervision of state and national banks. See 1977 COMPTROLLER GENERAL, FEDERAL SUPERVISION OF STATE AND NATIONAL BANKS.

62. 12 U.S.C. §§ 1841-50 (1970).

63. See *Hearings on H.R. 6778 Before the Comm. on Banking, Currency and Housing*, 91st Cong., 1st Sess. 1022 (1969).

64. *Id.*

to engage in the investment banking business through its wholly owned subsidiary, the National City Company.⁶⁵ In 1911, Attorney General George W. Wickersham and Solicitor General Frederick H. Lehmann advised President William Howard Taft that it was illegal for National City Bank, a national bank, to acquire the stock of other national banks through the formation of a subsidiary.⁶⁶ President Taft's inquiry had been provoked by National City Company's acquisition of \$3,200,000 of stock in nonbanking corporations and substantial blocks of stock in some sixteen banks, nine of them national banks.⁶⁷ Condemning National City Company's holding of the bank stock as a violation of federal banking law, Lehmann argued that National City Bank's real purpose in forming National City Company was not simply to control banks but to engage in any business whatever, even that forbidden by its charter.⁶⁸ He cautioned:

If many enterprises and many banks are brought and bound together in the nexus of a great holding corporation, the failure of the one may involve all in a common disaster. And if the plan should prosper, it would mean a union of power in the same hands over industry, commerce and finance, with a resulting power over public affairs, which was the gravamen of objection to the United States Bank.⁶⁹

65. In 1931, a Senate subcommittee was authorized to investigate the activities of the National City Bank and its security affiliates. The abuses which led to the Congressional investigation ultimately resulted in the abolition of the security affiliates under the Glass-Steagall Act of 1933. See Upshaw, *Bank Affiliates and Their Regulation: Part II*, MONTHLY REV., FED. RES. BANK OF RICH. (April 1973), at 3.

66. See F. PECORA, *WALL STREET UNDER OATH* 80 (1939).

67. See Upshaw, *Bank Affiliates and Their Regulation: Part I*, MONTHLY REV., FED. RES. BANK OF RICH. (March 1973), at 15.

68. 75 CONG. REC. 9904 (1932). "The simple effect of allowing national banks to organize affiliates . . . was to defeat the purpose of the law in limiting their powers." W. PEACH, *THE SECURITY AFFILIATES OF NATIONAL BANKS* 52 (1941). Robert S. Plotkin, a senior attorney with the Federal Reserve Board, has similar comments on the successor of the security affiliate, the modern bank holding company.

What is the purpose of the one bank holding company? The expression most commonly used by banks which have reorganized as one bank holding companies is 'to provide operating flexibility.' What is that supposed to mean? When one comes down to it, 'flexibility' in this context means 'to do things that a bank is prohibited from doing by laws concerning banks.'

Plotkin, *How the Supreme Court Viewed Bank Holding Companies*, 62 BANKING MAGAZINE 47 (1970). Furthermore, Plotkin asks,

Does it make any sense to prohibit interlocking directorships between member banks in direct competition and permit such service between one bank holding companies in control of such banks? Should a bank be prohibited from extending loans on the security of its own stock, but be allowed to lend on shares of a holding company whose sole asset is shares of the bank? Should a bank be limited in the amount of loans it can make to its own officers, but be unrestricted as to loans which it can make to officers of its parent one bank holding company?

Id.

69. 75 CONG. REC. 9904 (1932).

President Taft allowed the creation of National City Company, despite Lehmann's objections, after it sold all the shares of other banks then held by it. National City Company was permitted to retain, however, its \$3,200,000 of nonbank stock. With this nonbank stock in hand, National City Company soon became one of the country's largest securities dealers, with Chase National Bank and other large banks following National City Bank's lead in forming security affiliates.⁷⁰ The banks gained entry into the securities market by transferring their bond departments to their security affiliates and purchasing nationwide investment banking firms. As a result, National City Company acquired 50 branch offices, 11,000 miles of private wire and 89 foreign offices.⁷¹ When Chase Securities bought Harris Forbes to become Chase Harris Forbes, it was the "most extensive business of its kind in the United States" with offices in fifty-three American cities and many offices abroad.⁷²

Testimony before the Senate Banking Committee revealed that, in 1929, 151 national and 308 state banks had entered the securities business as banks. In 1927, national bank affiliates had originated only 10.1 percent of the nation's bond issues, whereas by 1930, they originated 27.6 percent.⁷³ While commercial banks were originating 22 percent of bond issues in 1927, they originated 44.6 percent in 1930. Finally, private investment bankers who in 1927 had 78 percent of the securities market were originating only 55.4 percent in 1930.⁷⁴ State and national banks sold only 36.6 percent of the nation's bonds in 1927, but were selling 61.2 percent in 1930. Private investment bankers who had sold 63.2 percent in 1927 were selling only 38.8 percent in 1930.⁷⁵

The banks saw in the securities business an opportunity to expand into an entirely unregulated area as well as a chance to engage in interstate or national enterprises which were forbidden to them as national banks under the McFadden Act of 1927.⁷⁶ Through the formation of security affiliates, the banks quickly attained a commanding position in the sale of securities in the United States, but their rapid ascendancy was short-lived. The default of three bond issues to Peru totalling \$90 million, coming on the heels of the collapse of the stock market in October, 1929, eventually led to a

70. See PEACH, *supra* note 68, at 64.

71. See *id.* at 89.

72. See *id.* at 95-97.

73. See *Hearings on S. Res. 71 before the Senate Comm. on Banking and Currency*, 71st Cong., 3d Sess. 299 (1931).

74. *Id.*

75. *Id.*

76. 12 U.S.C. § 24 (1970 & Supp. V 1975).

Congressional investigation.⁷⁷ In 1927 and 1928, disregarding the advice of its own experts that Peru was notoriously careless in the fulfillment of its contractual obligations, that the interest on many of its bonds had not been paid, and that its bad debt record made it an extremely questionable moral and political risk, National City Company floated the three issues to Peru. All three issues went into default in 1931 and are not paid today. Commenting on the issue, Ferdinand Pecora, the independent counsel who conducted the Congressional investigation, stated:

The public never had a chance. The prospectus prepared for its benefit contained an impressive list of the various Peruvian governmental borrowings, but never even mentioned that there had been a default on any of these debts. There was not one syllable, not one hint of warning of the whole long series of adverse circumstances, almost any one of which would have frightened investors far, far away.⁷⁸

The Congressional investigation into the abuses of the security affiliates in 1931 revealed "frozen loans converted into security issues," affiliates used as "receptacles for bad bank loans," "unsound and speculative investments," prospectuses containing "untruthful and misleading information," affiliates used "for the personal profit of officers of the bank," "loans to officers and directors without interest or collateral," astounding salaries and bonuses paid to bank officers, and the "mixing of commercial and investment banking functions."⁷⁹ Finally, in 1933, Congress, in the face of another series of bank failures, the dissolution of two large Michigan bank holding companies, and the report of the Senate subcommittee investigating the activities of National City Bank and its securities affiliate, passed the Glass-Steagall Act which prohibited banks from forming security affiliates.⁸⁰

77. See note 65 *supra*.

78. PECORA, *supra* note 66, at 102.

79. PEACH, *supra* note 68, at 113-14.

80. 12 U.S.C. §§ 24, 78, 377, 378 (1970 & Supp. V 1975). See Upshaw, *supra* note 65, at 3. A similar pattern emerged in the context of the public utility holding companies, which were abolished in 1935. 15 U.S.C. §§ 79 to 79z-6 (1970 & Supp. V. 1975). In 1932, approximately thirteen companies controlled 75 percent of the privately owned public utilities of the country. See *Hearings on S. 1725 Before the Senate Comm. on Interstate Commerce*, 74th Cong., 1st Sess. 3 (1935). These holding companies filed consolidated returns in which each operating subsidiary was forced to pay what its federal taxes would have been had each subsidiary paid taxes individually. Cities Service collected eleven million dollars in this way, paying the federal government only \$1.75 million in taxes. Both the consumer and the government lost in this situation — the one by paying higher utility rates, the other in lost tax revenues.

B. *The Bank Holding Company Structure Today*

Currently, there are approximately 1,800 bank holding companies in the United States, with the 100 largest holding companies controlling banks that hold at least 50 percent of all domestic bank deposits.⁸¹ The growing realization that the development of the bank holding company has weakened the soundness of the American banking system demands a cold-eyed reassessment of the entire bank holding company structure.

Theoretically, a bank holding company is an entirely separate corporate entity from the bank or banks whose stock it holds, and the failure of the holding company should not affect the stability of the bank. Practical considerations, however, rule otherwise.⁸² When a holding company fails, as was the case with the holding company of the Beverly Hills National Bank, there is a run on the bank which ends with its sale. Although the Beverly Hills bank itself was sound, depositors became alarmed after learning of the instability of the bank's holding company and withdrew their funds, causing the bank to fail.⁸³

Bank holding companies frequently enter the banking business by buying high interest loans from their banks, many of which are made abroad, often with less-developed countries.⁸⁴ Similarly, when holding companies need to borrow money, they sell their commercial paper to a bank owned by another bank holding company. Since a bank holding company is not a bank, it may engage in the banking business without regulation or safeguards; there are few restrictions on what it can borrow or lend and to whom. For example, with respect to the payment of dividends, while a bank holding company needs dividends from its bank to show a

81. Statistics supplied by the Board of Governors of the Federal Reserve System, Washington, D.C. (1976).

82. William Upshaw, formerly Vice President and General Counsel to the Federal Reserve Bank of Richmond points out that, even though separately incorporated, the activities of the affiliate can adversely affect the parent bank:

1. By borrowing from the bank;
2. By selling securities to the bank or another one of its affiliates;
3. By the parent bank's liberally lending to customers of the affiliates;
4. By selling unprofitable securities to customers of the bank;
5. By pushing sales of the bank's stock;
6. By assuming commitments less cautiously in reliance on the bank or vice versa;
7. By not advising the trust department of the bank of the securities held there.

Upshaw, (Part I), *supra* note 67, at 17.

83. AMERICAN BANKER, January 25, 1974, at 1.

84. See notes 122 to 137 and accompanying text *infra*.

profit, it is sometimes cheaper to leave the dividends with the bank to loan out at high interest and borrow to pay the dividends. Although the legality of this practice is questionable, the Federal Reserve System has not forbidden bank holding companies from paying dividends when not earned.⁸⁵

Another practice common to bank holding companies is the consolidation of the bank's balance sheet with that of the holding company, allowing the holding company to deduct its losses against the profits of the bank. In this way, bank holding companies are encouraged to operate in debt. In addition to depriving the federal government of tax revenues, the use of this tax loophole works to the disadvantage of banks by jeopardizing the safety of their depositors' funds.⁸⁶

The most alarming aspect of the bank holding company is, however, its tendency to sap the strength and earnings of affiliated banks through its attempts to protect the holding company investment. Although banks held by a holding company are forbidden to loan to the holding company under the 1970 amendments to the Bank Holding Company Act,⁸⁷ except on a secured basis, the holding company encourages its affiliated banks to bolster weak subsidiaries of the holding company with loans. A recent study of twenty-three bank holding companies by Ralph Nader and Jonathan Brown showed that the "expansion of non-bank subsidiaries of bank holding companies has substantially weakened the soundness of the banking system."⁸⁸ Nader and Brown lay part of the blame for the situation on the leniency of the Federal Reserve Board in permitting bank holding companies to establish or acquire nonbank operations.⁸⁹ Their conclusion is that the "large losses" suffered by nonbank subsidiaries of these twenty-three bank holding companies from such activities as "mortgage banking, leasing, commercial factoring, and consumer finance" have seriously eroded the stability of their affiliated banks.⁹⁰ The consequences can be disastrous. When the Hamilton National Bank of Chattanooga, Tennessee collapsed last year, the failure was directly attributable to the heavy loan losses it had acquired from one of its parent holding

85. 121 CONG. REC. H1117-18 (daily ed. Feb. 24, 1975) (remarks of Rep. Wright Patman).

86. The treatment received by bank holding companies with respect to the filing of consolidated returns can be contrasted with the treatment afforded real estate investment trusts. See note 102 and accompanying text *infra*.

87. 12 U.S.C. §§ 1841-50 (1970).

88. See Letter from Ralph Nader to William Proxmire, Chairman of the Senate Committee on Banking, Housing and Urban Affairs (June 30, 1976).

89. *Id.*

90. See Nader & Brown, *supra* note 57, at 1.

company's nonbank subsidiaries.⁹¹ The real estate loans which Hamilton National Bank was forced to pick up from its parent holding company paid "neither interest nor principal and constituted a severe drain on the bank's earnings."⁹²

In response to the bank holding company problem, Professor Roy A. Schotland has recently proposed that "Congress and the Federal Reserve Board monitor specified major trends involving bank holding companies."⁹³

Such monitoring need not be exhaustive or burdensome . . . but unless basic trends are watched — as they have not been since 1970 — we do not know whether the framework Congress built to separate banking from commerce and to assure that bank holding companies benefit the public interest is a sound structure or is being steadily eroded.⁹⁴

Although he believes that the bank holding company structure renders "considerable public service, especially in reducing out-moded geographic limits on banking,"⁹⁵ Schotland concedes that the soundness of the American banking system has been sufficiently threatened to warrant even his moderate proposals for the regulation of the bank holding company structure.⁹⁶ Since Schotland's proposal does not call for the regulation of a bank holding company's nonbank activities, which include some of the system's most potentially hazardous problems — *e.g.*, mortgage banking, leasing, commercial factoring and consumer finance — it would appear to be an ineffective solution to the bank holding company dilemma.

It is clear that the only solution to the potential disaster towards which the bank holding company structure is leading the American banking establishment is the abolition of the entire structure. Until Congress recognizes that it is the inherent structure of the bank holding company which presents the danger to the stability of our

91. Bank analysts in New York said the action by the bank holding company [declaring bankruptcy] wasn't a surprise after the failure of its flagship bank. One specialist called the bankruptcy petition "a commentary on the severity of the real estate loan market. They became too aggressive in lending to real estate interests," he said.

Wall St. J., February 23, 1976, at 4, col. 2.

92. Comptroller of the Currency, News Release, February 16, 1976, at 3.

93. Schotland, *Bank Holding Companies and Public Policy Today*, at 233 reprinted in HOUSE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, FINANCIAL INSTITUTIONS AND THE NATION'S ECONOMY (FINE): COMPENDIUM OF PAPERS PREPARED FOR THE FINE STUDY 94th Cong., 2d Sess., Book I, pt. 2, at 233 (Comm. Print 1976).

94. *Id.* at 233.

95. *Id.* at 278.

96. *Id.* at 277. Schotland acknowledges the destructive impact of the REIT industry, in particular.

banks, and that this inherent structure, despite Professor Schotland's recommendations, cannot be regulated, the stability of our banks will be threatened. President Franklin D. Roosevelt's statement on public utility holding companies in 1935 is applicable today to the bank holding company structure.

It is idle to talk of the continuation of holding companies on the assumption that regulation can protect the public against them. Regulation has small chance of ultimate success against the kind of concentrated wealth and power which holding companies have shown the ability to acquire in the public utility field. No government effort can be expected to carry out effective, continuous, and intricate regulation of the kind of private empires within the nation which the holding company device has proved capable of creating.⁹⁷

Any lesser solution than abolition will continue to expose banks associated with holding companies to the instability to which bank holding companies are prone as a result of their rapid growth and diversification, and will inevitably lead to further bank failures. It is the Federal Deposit Insurance Corporation and ultimately other banks which, in situations where banks fail, are forced to pay for the irresponsible actions of private holding companies in attempting to protect private investments with depositors' funds. Furthermore, a correspondingly greater concentration of money assets in fewer financial institutions and a lessening of competition in the banking field are additional undesirable results of holding company-induced bank failures.⁹⁸ With the lesson of the security affiliates clearly in

97. Message of Franklin Delano Roosevelt to Congress, March 12, 1935, *reprinted in Hearings on S. 1725 Before the Senate Comm. on Interstate Commerce, 74th Cong., 1st Sess. 2* (1935).

98. According to statistics supplied by the Board of Governors of the Federal Reserve System, Washington, D.C., 1976, there are 1,751 bank holding companies today, a 4.7 percent increase in 1975 over 1,672 in 1974. (A copy of these statistics is on file at the *Maryland Law Review*). Moreover, the growth of holding companies appears to be faster than that of banking organizations, with 79 more holding companies in 1975 as against 29 banking organizations — a continuation of the trend to create holding companies around existing banks. *Id.* In eight states, the number of holding companies decreased in 1975, in 26 states it remained the same, and in 17 states, the number of holding companies increased. *Id.*

Statistics also show that bank concentration is on the increase. In 20 states, one bank holds over 20 percent of all deposits in commercial banks in the state; in 23 states, four banks hold over 50 percent of all deposits; and in 36 states, 10 banks hold over 75 percent. *Id.*

A study in the January 1976 Federal Reserve Bulletin, defining bank concentration as the "percentage of total domestic deposits held by the nation's 100 largest banking organizations," concludes that, because the percentage of domestic deposits held by the 100 largest bank holding companies dropped from 49 to 47

mind, and in view of the Fed's reluctance to regulate bank holding company activity, Congress must act to abolish the bank holding company structure to prevent the deterioration of the American banking system.

III. ADDITIONAL PROBLEMS FACING BANKS TODAY

The Fed's failure to effectively regulate banks is also apparent in its acquiescence to the banks' involvement in REITs and foreign loans in the early 1970's. The disastrous results of this involvement for many of the largest American banks emphasize the Fed's inability to see the long-range consequences of short-term profits.

A. *Real Estate Investment Trusts*

Created as Massachusetts Trusts,⁹⁹ REITs sell their shares to the public through investment bankers who act as underwriters.¹⁰⁰ The REITs avoid the double taxation to which ordinary corporations are subject by agreeing to distribute ninety percent of their income each year to shareholders without writing off their losses against their income.¹⁰¹ In this respect, REITs are much different from bank holding companies, which can file a consolidated return and write off their interest payments, business expenses and losses against the income of the bank whose stock it holds.¹⁰²

REITs are created by promoters or banks. Upon organization, the promoter or the bank contracts with the newly formed REIT to act as its advisor and to manage its portfolio for a fee. In the case of

percent from 1968 to 1973, bank holding companies are not increasing bank concentration. Lawrence & Talley, *An Assessment of Bank Holding Companies*, FED. RES. BULL. (Jan. 1976), at 19. This conclusion is suspect for three reasons. First, the 1976 statistics supplied by the Federal Reserve System disclose that in 1975 the percentage of domestic deposits in the 100 largest banking organizations rose to 47.9, showing that these top 100 bank holding companies then held approximately half the nation's deposits. Secondly, measuring concentration by a percentage of domestic bank balances in bank holding companies does not take into account other assets of the holding company. Bank of America, Citicorp, and Chase Manhattan, for example, not only have large balances abroad, but they own other companies of great value and own stock in financial enterprises worldwide. Third, it is likely that different results would flow were holding companies which do not rank in the top 100 included in measuring bank concentration.

99. A Massachusetts Trust is defined as a "business corporation wherein property is conveyed to trustees and managed for the benefit of holders of certificates like corporate stock certificates." BLACK'S LAW DICTIONARY 1127 (4th ed. 1951).

100. See Robertson, *How the Bankers Got Trapped in the REIT Disaster*, 91 FORTUNE 113, 113 (March 1975).

101. The Real Estate Investment Trust Act of 1960, 26 U.S.C. §§ 856, 857, 858 (1970) was enacted as an amendment to the Internal Revenue Code, 26 U.S.C. § 1 *et seq.* (1970 & Supp. V 1975). Section 857 contains the tax provisions applicable to REITs.

102. See note 86 and accompanying text *supra*.

some thirty-nine of the REITs (32.2 percent of the assets of the REIT industry),¹⁰³ the trust was given the name of the bank acting as its advisor. For example, Chase Manhattan National Bank organized Chase Manhattan Mortgage and Realty Trust as a Massachusetts Trust and contracted to become its advisor. In this advisory capacity, between June 1, 1970 and May 31, 1974, Chase Manhattan National Bank received \$19.9 million in fees, although the net income of the REIT was only \$59.6 million.¹⁰⁴ The advisor fee structure allows a fee to the advisor of the trust based on the "income and asset size" of the REIT.¹⁰⁵ This gives the trust advisor a "strong incentive to expand the size of the REIT as rapidly as possible" and a "vested interest in the growth of the REIT."¹⁰⁶

In Chase Manhattan's case, REIT involvement has been a disastrous experience. In a desperate attempt to avoid default on existing credit, Chase Manhattan has purchased "poor quality assets from its REIT at over-valued prices" and extended additional credit to the troubled subsidiary.¹⁰⁷ As of February 29, 1974, seventy-one percent of the assets of Chase Manhattan Mortgage and Realty Trust were on a nonaccrual basis.¹⁰⁸ On September 30, 1974, in order to obtain a \$700 million credit at low interest for its REIT in an arrangement with forty-one banks, Chase Manhattan was forced to take \$141.6 million of the loan.¹⁰⁹ More recently, in September and October, 1975, Chase Manhattan bought certain loans held by its REIT "without recourse" for \$161 million cash; \$85.5 million of the loans were on a nonaccrual basis.¹¹⁰ In addition, the bank assumed the commitment of its REIT to make some \$30 million of new construction loans.¹¹¹ In the fiscal year ending March 31, 1975, Chase had also purchased \$12.8 million in loans from its REIT.¹¹²

Although REITs were organized on the naive assumption that Chase Manhattan National Bank, for example, would have no liability for the debts of its REIT, the realities of the situation dictate otherwise. Banks such as Chase who have sponsored their own REITs are obliged to maintain the stability of their REITs to protect their own reputations; they accomplish this by extending additional credit to the REITs from depositors' funds. Furthermore, the Federal

103. See Nader, *supra* note 57, at 25 n.48.

104. *Id.* at 30.

105. *Id.* at 28.

106. *Id.* at 29.

107. *Id.* at 36.

108. *Id.* at 32.

109. *Id.* at 34.

110. *Id.* at 36.

111. *Id.*

112. *Id.*

Reserve Board's authorization of banks to serve "as the advisory company for a mortgage or a real estate investment trust" may well have aggravated the REIT situation.¹¹³ Instead of ruling that managing a real estate investment trust was not "closely connected" with banking and that the fee arrangement invites trouble, the Federal Reserve Board amended Regulation Y to permit banks to act as advisors to REITs without even applying to the Fed.¹¹⁴

The REIT crisis came to a head in December 1973 when the Kassuba Development Corporation filed a Chapter XI bankruptcy petition, adversely affecting the commercial paper market.¹¹⁵ First Mortgage Investors, one of the five largest REITs, with seven percent of its \$672 million portfolio in loans to Kassuba, found itself short of cash and unable to get bank credit.¹¹⁶ FMI's founder and trustee, Jack Courshon, reportedly arranged a private meeting with Dr. Burns, telling him that "if FMI went bankrupt, others would not be far behind and that some banks might be pulled down in the process."¹¹⁷ As a result, the Fed soon took steps to assure the REITs more bank credit, pressuring banks to lend to the REITs.¹¹⁸ Eventually one hundred banks agreed to give FMI a \$400 million credit.¹¹⁹ During this same period, Chase Manhattan Mortgage and Realty obtained its \$700 million credit, Continental Mortgage Investors \$531.8 million, Citizens and Southern Realty \$329.6 million, Builders Investment \$310.6 million, and Great American Mortgage Investors \$273 million.¹²⁰

113. Federal Reserve Board Regulation Y, 12 C.F.R. § 225.4(a)(5) (1976), provides that banks are within legal limits in

Acting as investment or financial adviser to the extent of (i) serving as the advisory company for a mortgage or a real estate investment trust; (ii) serving as investment adviser . . . to an investment company . . . ; (iii) providing portfolio investment advice . . . ; (iv) furnishing general economic information and advice, general economic statistical forecasting services and industry studies, and (v) providing financial advice to State and local governments

114. 12 C.F.R. § 225.4 (1976).

115. See Robertson, *supra* note 100, at 115.

116. *Id.* at 169.

117. *Id.* Wyndham Robertson reports that

[i]n May, with many banks still resisting the revolving credit agreement, Jack Courshon, wealthy founder and trustee of F.M.I. and a principal owner of its advisory company, decided to carry his plea for help to the top. Through Congressman Claude Pepper, an old friend and part owner of the advisory company, he arranged a private audience with Arthur Burns. On May 21, Courshon, Burns, Pepper, and Marx Leva, a Washington lawyer who is a former Assistant Defense Secretary and a trustee of F.M.I., met, according to Courshon, for "a good hour."

Id.

118. *Id.*

119. *Id.*

120. *Id.* at 168.

The banks' response to the recent collapse of the REIT industry has been to renegotiate their bank loans on more lenient terms rather than to declare defaults and attempt to foreclose on real estate owned by the troubled REITs.¹²¹ As a direct result of pressure by the Federal Reserve Board, banks found themselves doubling their loans and risk at the very time they should have been liquidating their REIT loans and reorganizing the REITs in bankruptcy. Instead, by 1975 bankers had an exposure in the \$22 billion REIT industry of \$11 billion.¹²²

Although it is understandable that banks which have created REITs under their own names should wish to protect their reputations by bailing out their REITs, the extension of additional credit in such a situation merely aggravates the problem. The tremendous outflow of assets (*i.e.*, depositors' funds) which is required to keep most REITs out of bankruptcy has placed an almost insurmountable drain on the banks' assets. Before the situation becomes more serious, REIT activity must be restricted and banks must be forced to put their REITs into default. Without such action, the banks' efforts to save face in the REIT market may cause the collapse of the entire banking system.

B. Foreign Loans

The exposure of American commercial banks to default in loan arrangements with less developed countries is undoubtedly the most critical problem facing the American banking system today. While the Federal Reserve has prime responsibility for a bank's foreign operations, the Fed's regulatory philosophy has been "rather liberal in the sense that it has permitted United States banks to engage in a much broader range of operations overseas than are authorized in the United States."¹²³ As late as 1964, there were only eleven United States banks with overseas branches.¹²⁴ By 1974, there were 125 banks with 732 overseas branches;¹²⁵ branch assets grew from \$6.9 billion in 1964 to \$155 billion in 1974.¹²⁶ Each of the five largest United States banks makes more than forty percent of its profits from foreign operations, with Chase Manhattan now earning sixty-four percent of its profits abroad in 1975 as compared with

121. See Nader & Brown, *supra* note 57, at 35.

122. See Robertson, *supra* note 100, at 113.

123. Debs, *International Banking*, MONTHLY REV., FED. RES. BANK OF N.Y. (June 1975) at 122.

124. HOUSE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS FINANCIAL INSTITUTIONS AND THE NATION'S ECONOMY (FINE) 93d Cong., 2d Sess. (1975).

125. *Id.*

126. *Id.*

only twenty-two percent in 1970.¹²⁷ Foreign earnings account for sixty-two percent of Citibank's profits; of this sixty-two percent, however, forty percent of Citibank's profits come from the under-developed world.¹²⁸

It has been difficult to ascertain the amounts United States banks have loaned abroad. A New York Times report broke down United States loans to nine countries as follows:

*Bank Lending Abroad*¹²⁹

(Loans by banks in the United States and their major foreign branches to governments, banks and corporations in the designated countries as of June 30, 1976, in millions of dollars.)

	Loans by banks in U.S.	Loans by branches abroad
Argentina	1,348	856
Brazil	3,931	7,101
Great Britain	5,822	35,837
Indonesia	288	1,694
Italy	624	5,033
Mexico	4,695	6,876
Peru	853	817
Philippines	693	1,365
South Korea	1,939	1,081

The report indicates that, as of July 1, 1976, "banks in the United States and their major foreign branches had some \$32.6 billion in loans outstanding to five developing nations — Argentina, Brazil, Mexico, Peru and Indonesia, all of which have been deserted as heavy international borrowers with real or potential repayment problems."¹³⁰

The bonanza of bank lending to foreign governments began in 1970. During the boom, American banks furnished capital to the world from their deposits or from money they hoped to buy at a lower price than they were lending. Since the rates of interest were higher in London than in the United States, these Eurodollar loans

127. See Rothschild, *Banks: The Coming Crisis*, NEW YORK REVIEW OF BOOKS, May 27, 1976, at 17.

128. See Rose, *Why They Call It 'Fat City'*, 91 FORTUNE 106, 107-08 (March 1975). A more recent report states that Citibank receives more than 70% of its profits from foreign earnings. Bennett, *Mountains of Debt Pile Up as Banks Push Foreign Loans*, N.Y. Times, May 15, 1977, § 3 (Bus. & Finance), at 1, col. 3.

129. Crittenden, *Loans to Developing Lands By U.S. Banks on Increase*, N.Y. Times, November 10, 1976, § D (Bus. & Finance) at 1, col. 5.

130. *Id.*

to foreign countries were attractive investments. Experience in more recent years has shown, however, that there are both advantages and disadvantages to foreign financial operations. First, the prospect of default on loan arrangements, especially with respect to loans to less developed countries, is almost certain to materialize. For example, for the past eighteen months, Zaire has been in default on payment of principal and interest on its estimated \$800 million of outstanding bank indebtedness.¹³¹ Recent efforts by government creditors to stretch maturities and reduce repayments have collapsed.¹³² Similar difficulties have arisen in connection with United States bank loans to Peru, although an additional \$210 million loan was recently loaned to Peru in response to its request for aid in paying off \$318 million due on its foreign debt of reportedly \$135 billion.¹³³

In the case of the Franklin National Bank, Franklin had bought \$14.5 million of Peru loans, one million from Wells Fargo's syndicate, and \$5 and \$8.5 million from similar syndicates headed by Manufacturers Hanover Trust and Morgan Guaranty, respectively.¹³⁴ To date, the Federal Deposit Insurance Corporation has been unable to liquidate Franklin's total purchases of foreign loans which approximated \$500 million.¹³⁵

Secondly, while American banks operating in foreign money markets are comparatively free from regulation and reserve requirements, deposits in overseas branches are not insured by the Federal Deposit Insurance Corporation.¹³⁶ In the Franklin case, the Federal Reserve, as lender of last resort, was forced to come to

131. Barron's, August 16, 1976.

132. *Id.* An agreement has reportedly been reached, however, in London between Zaire and 13 agent banks representing over 100 lenders to put Zaire's debt and interest payments on a current basis. The plan has four parts: payment of all interest arrears (about \$40 million); payment into a special fund of between \$40 and \$50 million to pay all principal arrears by February 1977; negotiation by Zaire of a stand-by credit from the International Monetary Fund; and fourth, a new \$250 million loan from the private banks. Stabler, Wall St. J., November 9, 1976, at 8, col. 2.

Another development in the Zaire situation is that both Citibank and Bankers Trust Company have sued the Export-Import Bank in the United States District Court for the Southern District of New York to prevent its setting up a preferential facility under which Zaire would pay off its Export-Import Bank debts before loans by its commercial bank creditors. *Attacking the Ex-Im Bank: Who Should Get Paid First?*, INSTITUTIONAL INVESTOR (October 1976), at 48.

133. See Crittenden, N.Y. Times, July 24, 1976, at 29, col. 4; Oberdorfer, Washington Post, August 29 and November 3, 1976.

134. Interview with Mr. Charles A. Holm, associate supervising liquidator with the Federal Deposit Insurance Corporation, in New York City (Aug. 8, 1975).

135. *Id.*

136. Generally speaking, overseas deposits are not insured by the FDIC. *But see* 12 U.S.C. § 1813(l)(5) (1970).

Franklin's aid by advancing Franklin over \$1.7 billion to enable it to pay off these foreign depositors and approximately 500 million of federal funds.¹³⁷

The loans of United States banks to foreign countries now exceed \$32.6 billion and are increasing.¹³⁸ These loans involve considerable risk and are properly within the province of investment bankers or governments; commercial banks using depositor's funds have no place in the area of foreign lending, especially loan arrangements with politically and financially unstable governments. Furthermore, the practice of making loans to foreign countries by private banks inevitably involves them in the determination of international economic policy which is properly the responsibility of governments, not banks or multinational corporations. Most significantly, the invasion of the long-term lending market by commercial banks has destroyed the traditional sources of capital for companies and governments. It has weakened the American banking system by draining it of money that should never have been frozen in such risky long-term ventures. Clearly, the time has come for Congress to study the implications of these loans and establish a national policy designed to restrict further loans to less developed countries and to establish procedures for rescheduling and eventual repayment.

CONCLUSION

The problems which confront the American banking system today are many and serious. Some of the most pressing problems —

137. 121 CONG. REC. H6370-71 (daily ed. July 8, 1975) (remarks of Rep. Wright Patman).

138. Another aspect of the problem of foreign loans concerns the amount of money which Middle Eastern oil exporting nations, including Iran, have on deposit in American banks. These countries had \$11 billion in deposits in American foreign branches as of June 30, 1976, presumably in long-term certificates of deposit and \$7.3 billion in short-term deposits in banks in the United States, totalling roughly \$18.3 billion. Crittenden, *Loans to Developing Lands By U.S. Banks on Increase*, N.Y. Times, November 10, 1976, § D (Bus. & Finance) at 1, col. 5. Testimony released by the Subcommittee on Multinational Corporations of the Senate Foreign Relations Committee indicates that the major banks, supported by the Federal Reserve, are even more sensitive about releasing information on these deposits than on their foreign loans. *Hearings Before the Subcomm. on Multinational Corporations of the Senate Foreign Relations Comm.*, 94th Cong., 1st Sess., pt. 15 (1975). The ten largest banks have successfully refused to comply with the Committee's request for information on the loans and the deposits of their foreign branches, apparently fearing that these countries will withdraw their massive deposits from the American banking system should the banks release the information. The high degree of concentration of the OPEC nations' funds in a handful of banks is cause for concern on the part of the American banking community since the few American institutions handling these massive loans and deposits would be totally vulnerable to a "sudden decision by the Arabs to shift their funds." *Id.*

abuses in the exercise of monetary controls by the Federal Reserve System, the lack of effective bank regulation, the virtually unrestricted expansion of the bank holding company structure, the collapse of the REIT industry, and most critical of all, the vast exposure of United States banks to defaults on foreign loans — have been summarized above. These problems are intimately related; nearly all of them have occurred previously in our economic history, have gone unchecked and have produced disastrous results. Yet there is another connection, perhaps a more significant one for modern purposes. All of these problems have developed to the crisis stage as a result of the failure of the Federal Reserve System to hold a tight rein on the American banking community's desire for profits — whether bank holding company, REIT, or foreign loan — at any expense, even the collapse of the banking system. With members of the Federal Open Market Committee dependent on local banking interests for their positions, it is not surprising that national monetary policy-making, conducted in the secrecy of the Open Market Committee, has favored these interests. Therefore, before any effective reforms can be implemented to deal with bank holding company activity, the REIT industry, or foreign loans, the structure of the Federal Reserve System must be altered to eliminate the conflict of interest inherent in the presence of the regional Bank Presidents on the Federal Open Market Committee. The restructuring of the Fed should follow the proposals suggested earlier in this paper with regard to reducing the terms of office of Board members; making the term of the Chairman coterminous with that of the President; redemption by the United States of stock held by local banks in their regional Federal Reserve Bank; authorizing the appointment of the Bank Presidents by the President of the United States; compelling full disclosure on the part of the Federal Open Market Committee; and the formation of a single bank regulatory agency with power to examine all banks. Only when these changes have been made can the implementation of other reforms such as the abolition of the bank holding company structure and the restriction of REIT and foreign loan activity be effective in preventing any further jeopardizing of the stability of the American banking system.