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Federal Regulation of Bank Loans to Bank Executives: An Amendment to the Federal Reserve Act

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CURRENT LEGISLATION

FEDERAL REGULATION OF BANK LOANS TO BANK EXECUTIVES: AN AMENDMENT TO THE FEDERAL RESERVE ACT

On July 3, 1967, President Johnson approved a bill amending Section 22(g) of the Federal Reserve Act and easing restrictions on loans by member banks in the Federal Reserve System to their executive officers.[1] This bill is intended to increase the amount which a member bank may lend to its executive officers.[2] The former provision, enacted in 1935, prohibited any member bank from lending more than $2500 to each of its executive officers and required that all such loans be approved in advance by the bank's board of directors.[3] The new statute allows officers to borrow up to $45,000, but divides their borrowings into three categories. An officer may obtain: (1) a first mortgage loan, up to $30,000, on his home with specific prior approval of the board of directors;[4] (2) extensions of credit, up to $10,000, for the purpose of financing the education of his children;[5] and (3) unsecured credit, up to $5000, for general purposes.[6] Extensions of credit may be made only on terms not more favorable than those extended to other borrowers.[7] The new act restricts loans to partnerships in which one or more officers of a member bank are partners, if the officers own, either individually or jointly, a majority interest in the partnership.[8] The full amount of a loan to such a partnership will be considered to have been extended to each officer who owns an interest in the partnership. No loan may be granted to a member bank executive officer unless the officer submits a detailed current financial statement to the bank.[9] Any extension of credit from a member bank to an executive officer under the new act must promptly be reported to the board of directors of the bank.[10] All loans made under the Act must be included by each bank with the report of condition it must file with the appropriate federal supervisory authorities and the Federal Reserve Board.[11]

For each day that any extension of credit in violation of the Act persists, the violation will continue for the purposes of Section 8 of the Federal Deposit Insurance Act.[12] Section 8[13] authorizes the appropriate federal banking

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1 12 U.S.C.A. § 375a (Supp. 1967).

2 H.R. Rep. No. 262, 90th Cong., 1st Sess. (1967) (1967 U.S. Code Cong. & Ad. News 1529).

3 Banking Act of 1935, ch. 614, § 326(c), 49 Stat. 716.

4 12 U.S.C.A. § 375a(2) (Supp. 1967).

5 Id. § 375a(3).

6 Id. § 375a(4).

7 Id. § 375a(1)(B).

8 Id. § 375a(5).

9 Id. § 375a(1)(C).

10 Id. § 375a(1).

11 Id. § 375a(9).

12 Id. § 375a(8).

13 12 U.S.C. § 1818 (Supp. II 1965-66).

agency[14] to issue a cease-and-desist order against any member bank that it has reasonable cause to believe is violating the law. It also provides for the suspension or removal of directors or officers, who, in the opinion of the appropriate federal banking agency, have, through their personal dishonesty, breached their fiduciary duty and threatened the welfare of the bank.

This comment will first discuss the history of federal regulation of bank loans to officers. The strengths and weaknesses of the new statute will then be analyzed and suggestions made as to how the Act can be improved and strengthened. Third, the breadth of coverage of the Act will be discussed.

I. Historical Background

Prior to 1933, there were no express restrictions on the right of any officer of a member bank in the Federal Reserve System to borrow from the bank of which he was an officer.[15] In the mid-1930's excessive loans to bank officers and directors came to be regarded by Federal Reserve officials[16] and by officials in the office of the Comptroller of the Currency[17] as an important cause of the bank failures during that period. The danger of excessive loans prompted Congress, in 1933, to amend the Federal Reserve Act to prohibit completely loans to executive officers of all member banks and subject any individual violator—the lender or the borrower—to imprisonment and fine.[18]

The complete prohibition on loans to officers was ended by the Banking Act of 1935[19] which permitted loans up to $2500 with the prior approval of a majority of the entire board of directors. The complete prohibition was felt to be unnecessarily rigid and conducive to abuses which were difficult to regulate. Just as it would have seemed absurd to force an officer of one bank to maintain his deposit with a competing bank, so it appeared unwise to prohibit an officer from borrowing from his own bank, when the loan would readily be approved on its merits under sound banking practice.[20] Some regulation was thought to be necessary, however, to prevent an officer from taking advantage of his position of trust by granting unwarranted loans to himself and thereby breaching his fiduciary duty.

The Banking Act of 1935 provided that violation of the statute was punishable by removal from office and a possible $5000 fine for repeated offenses.[21] The removal sanction was used primarily as a threat since the procedure for implementation was very cumbersome. Any proceeding under

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14 Id. § 1813(q). This section states:

> The term "appropriate Federal banking agency" shall mean (1) the Comptroller of the Currency in the case of a national banking association or a District bank, (2) the Board of Governors of the Federal Reserve System in the case of a State member insured bank (except a District bank), and (3) the Federal Deposit Insurance Corporation in the case of a State nonmember insured bank (except a District bank).

15 Trefftzs, The Regulation of Loans to Executive Officers of Commercial Banks, 50 J. Pol. Econ. 377 (1942).

16 Id. at 378 n.8.

17 Id. at 378 n.9.

18 Banking Act of 1933, ch. 89, § 12, 48 Stat. 182.

19 Banking Act of 1935, ch. 614, § 326(c), 49 Stat. 716.

20 Trefftzs, supra note 15, at 382.

21 Banking Act of 1935, ch. 614, § 326(c), 49 Stat. 716.

the removal sanction involved many conferences and many hearings before any final conclusion could be reached. Thus removal proceedings were undertaken by the banking agencies with great reluctance because banking regulation is basically supervisory in nature.[22] Banking agencies did not want to put banks out of business and would exhaust every supervisory possibility before formal proceedings would be instigated. Between 1933 and 1940, when bank failures were much more common than today, formal proceedings were brought in only two instances.[23] In 1966, Congress added the power to issue cease-and-desist orders to the enforcement techniques available to the banking agencies.[24]

The infrequency of bank failures today[25] might indicate that the regulation of loans to bank officers has lost its purpose. This reduction in bank failures and the increase in stability of the banking industry has, however, been largely a result of such regulation. Just as federal securities regulation has protected the average investor, banking regulation has protected the average depositor. The fact that dishonesty of bank officers can have great effect on a bank is illustrated by the failure of the San Francisco National Bank in 1965 which was attributed to the gross dishonesty of its president.[26] The problem of dishonesty in bank management has been serious enough for the Senate Permanent Subcommittee on Investigations to conduct a running probe into the banking industry.[27] Therefore, banking regulations such as restricting loans to executive officers are vital to insure the continued protection of the bank depositor.

II. ANALYSIS OF THE ACT

The new act, like the old one before it, authorizes the Federal Reserve Board to "prescribe such rules and regulations, including definitions of terms, as it deems necessary to effectuate the purposes and to prevent evasions"[28] of the Act. Acting under this authorization, the Board of Governors of the Federal Reserve System has proposed a change in its regulations to make them conform to the policy of the 1967 statute.[29] This power to change regulations and define terms gives the Board of Governors great power to determine the scope and coverage of the Act. The effect of the power of definition is shown by the change in the definition of "executive officer."

Under the old regulations, an executive officer was defined as one who "participates in or has authority to participate in the operating management

22 See 1 K. Davis, Administrative Law § 4.04 (1958).

23 Monograph, Fed. Res. System, Attorney General's Comm. on Administrative Procedure, Sen. Doc. No. 186, 76th Cong., 2d Sess. 31 (1940) (W. Gellhorn & C. Byse, Administrative Law 642 (1960)) (hereinafter referred to as Sen. Doc. No. 186).

24 12 U.S.C. § 1818 (Supp. II 1965-66).

25 Rep. No. 1482, 89th Cong., 2d Sess. (1966). (1966 U.S. Code Cong. & Ad. News 3536). Since the beginning of 1962, of 14,000 commercial banks, 500 mutual savings banks and 6000 saving and loan associations, there have been only 26 involuntary closings.

26 Time, Mar. 26, 1965, at 79.

27 See Meyers, The Bank that Never Should Have Opened, Fortune, July, 1965, at 126.

28 12 U.S.C.A. § 375a(10) (Supp. 1967).

29 32 Fed. Reg. 12,758 (1967).

of the bank or any branch thereof . . . ."[30] This definition was meant to include any officer who took an active part in the management of the bank's daily affairs regardless of whether the officer had an official title, a title of assistant, or whether he served without compensation. The new regulation limits the definition of the term "executive officer" to any officer who "participates or has authority to participate, otherwise than in the capacity of a director, in major policy-making functions of the bank . . . ."[31] The distinction between these definitions is very important. An officer who participates in the "operating management" of a bank does not necessarily take part in the "major policy-making functions." For instance, an officer who decides whether Mr. Jones is an acceptable risk for a loan participates in the "operating management" of the bank, but most likely he would not participate in "major policy-making functions" such as determining whether a certain type of loan should be offered. The new definition excludes persons who may have official titles and may exercise a certain amount of discretion in the performance of their duties but whose decisions are circumscribed by policy standards fixed by the top management of the bank.

The new definition, however, assumes that certain titled officers are "executive officers"[32] unless they are specifically excluded by a resolution of the bank's board of directors from participation in major policy-making functions. This power of excluding officers from the definition by resolution gives the bank great leeway to define what officers are to be included in the term "executive officer."[33] Banks may use this flexibility to exclude junior officers who have the greatest need of borrowing. The power given to the banks to select their "executive officers" indicates, however, that the Federal Reserve is considering the interests of bank officers ahead of protection for the banking public. A much more inclusive definition of "executive officer" is necessary to protect the banking public from the dangers of excessive loans to bank officers. The statute will be a mockery if a dishonest officer and a compliant board of directors may evade the statute by a simple resolution excluding the officer from the category of "executive officer."

The new regulation carries over the old definition of the term "extension of credit" with one exception.[34] The definition is all-inclusive since it covers extension of credit "in any manner whatsoever." The one exception provides that an officer may borrow up to $1000 on a bank-credit-card or similar plan without having to report it as an extension of credit within the terms of the statute.[35] This exemption allows an officer to take advantage of his bank's modern lending devices and get small loans without the formalities necessary

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30 Federal Reserve Reg. O, 12 C.F.R. § 215.1(b) (1939).

31 Proposed Reg. O, § 215.2(b), 32 Fed. Reg. 12,758 (1967).

32 Id. Such "assumed" officers include the chairman of the board, president, every vice-president, cashier, secretary, treasurer, and trust officer.

33 For example, one of the large banks in Boston with over 400 officers has, by resolution, included only 50 in the category of "executive officer." Interview with Lee J. Aubrey, Assistant Vice-President of the Federal Reserve Bank, Boston, Massachusetts, Oct. 13, 1967.

34 Proposed Reg. O, § 215.2(c), 32 Fed. Reg. 12,758 (1967).

35 Id. § 215.2(c)(IV).

to obtain a loan under the statute. Certainly the small sums which would be exempted pose little threat to bank security.

Turning to the substantive provisions of the new statute, one of its most important aspects is the attempt to put the bank officer on equal terms with any other borrower. The statute tries to insure that no officer, merely because of his position, can get better terms on a loan than any other borrower. This intent is manifested by the sections which provide that an extension of credit may be made only if "(A) the bank would be authorized to make it to borrowers other than its officers" and "(B) it is on terms not more favorable than those afforded other borrowers."[36] Section (B) has raised the greatest protest from member banks since they are no longer able to give their officers the preferential interest rate that could be given under the old act.[37]

Although it may be desirable to insure that all borrowers get equal treatment, the new statute may not effectively accomplish its purpose. First, it may be evaded by interbank borrowing, that is, an arrangement whereby the officers of bank *A* grant favorable terms to the officers of bank *B* if bank *B* will reciprocate. A second potential weakness in this section involves the "other borrowers" over whom the officers cannot get more favorable terms. The question might be raised as to whether an officer could get the prime interest rate a large corporation could get. The term "other borrowers" has not been clarified by Congress or the Board of Governors of the Federal Reserve System. The problem of evasion of the requirement of equality by interbank borrowing could be eliminated by prohibiting such arrangements between banks. The term "other borrowers" could be clarified by amending the regulations to include only borrowers whose financial status is comparable to that of the officer applying for the loan.

Effective regulation of loans to officers requires that the loan be approved by a disinterested party, preferably the board of directors. Under the old statute, prior approval by the board of directors was required for every loan to an officer. The old requirement of prior approval for each loan was liberalized by a ruling of the Federal Reserve Board,[38] providing that a board of directors could issue a blanket resolution authorizing the bank to extend credit to a particular officer for any amount within the statutory limit at any time for a period of up to one year, without consideration of any particular loan. This continuing authority meant that the board of directors only had to approve the time period within which any number of loans up to the statutory limit could be granted. The regulation was criticized because it allowed bank boards of directors to abdicate one of their most fundamental functions, that is, keeping themselves informed of the officers' outside interests.[39] The one year period was considered too lax.

Under the new statute, specific prior approval of a loan is required only on the $30,000 mortgage loan.[40] The granting of the $5000 general loan and

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36 12 U.S.C.A. §§ 375a(1)(A), (B) (Supp. 1967).

37 Interview with Lee J. Aubrey, supra note 33.

38 1937 Fed. Res. Bull. 1074.

39 Trefftzs, supra note 15, at 392.

40 12 U.S.C.A. § 375a(2) (Supp. 1967).

the $10,000 loan for education need only be reported after the loan is made.[41] Elimination of the prior approval requirement is unwise. A desirable provision would be one which demands prior approval of all loans; for in its absence, a loan which the directors feel is unwise may already be made before they are given an opportunity to act on it. The bank's funds thus receive little tangible protection when there is no prior approval provision. A good compromise solution between approval of every individual loan and approval once a year is demonstrated by a Washington statute which provides that the resolution authorizing the loan must be adopted "within 30 days . . . prior to the making of such loan . . . ."[42] With such a regulation, a resolution could be extended from month to month, thus giving the borrower sufficient assurance that his loan will be granted but at the same time protecting the bank's funds through a periodic review by the board of directors of the potential borrower's financial position. Another alternative which might achieve the desired result of protecting the bank while at the same time not being overly burdensome could require prior approval by the board of directors after the officer has borrowed some aggregate amount, perhaps $1000. This would lessen the inconvenience of having to convene the board of directors to consider every request by an officer for a loan.

The need for keeping the board of directors better informed of their officers' financial interest is alleviated somewhat by the requirement in the 1967 amendment of a detailed current financial statement from the officer before he can get a loan.[43] This statement must include, but is not limited to, all data usually associated with a personal financial statement, such as the officer's income and bank accounts, and any obligations for which he is personally liable. The requirement of a financial statement when added to the 30-day prior approval provision suggested above for all loans over $1000 would give a bank adequate knowledge of its officers' outside interests and give the bank the ability to correct any abuse of borrowing power by officers before serious damage is done. Furthermore, these requirements for obtaining a loan do not appear to be so cumbersome that an officer seeking a loan will most likely go elsewhere to borrow.

One of the most difficult tasks in formulating a statute regulating bank loans to officers is to set a fair limit on the amount of a loan an individual officer may obtain. The new limits certainly provide a fairer representation of a typical officer's financial needs than the very arbitrary $2500 limit imposed by the old statute, but the new limits are just as arbitrary in their own way.

The act provides that an officer may obtain a first mortgage loan on his residence up to $30,000. There is no reason, however, why, if the officer desires to buy a $70,000 house, he should not be able to obtain a mortgage for that amount from his bank. He should not be forced to go out and get a second mortgage for the $40,000 over the statutory limit. So long as the whole sum is adequately secured, a limitation seems completely unnecessary. In addition, if the officer takes a mortgage for $40,000 from another bank in addition to the $30,000 first mortgage given by his own bank, his loan for $30,000 from

[41] Id. §§ 375a(1), (3), (4).
[42] Wash. Rev. Code Ann. § 30.12.060 (1961).
[43] 12 U.S.C.A. § 375a(1)(C) (Supp. 1967).

his own bank would become immediately due and payable on demand of the bank.[44] This consideration effectively encourages an officer considering a $70,000 house to refrain from borrowing the balance of his requirements from another bank, a result which removes the major source of mortgage money available to other buyers. Finally, with the rising costs of housing, the $30,000 limit may be woefully inadequate for homebuying purposes in a very short time. In fact, the limited number of officers presently affected by the statute are those who would most likely, even at present price levels, be able to afford a home over the $30,000 limit.

The House Report on the new bill states that an officer may not obtain mortgages on two different homes even though both together do not exceed the $30,000 limit.[45] Thus, an officer may not be able to borrow $18,000 from his bank for a year-round residence and another $12,000 for a vacation home. There is absolutely no reason to make it this difficult for an officer to own more than one residence. The arbitrariness of the $30,000 limit is not reduced by the House Report's assurance that it in no way precludes a member bank officer from repaying the mortgage loan and at a later date securing another mortgage loan from the same bank.[46] Here again, the fact that a mortgage loan is secured reduces the necessity for any limit on the amount which can be borrowed. If equality among borrowers is to be the goal of the 1967 act, an officer should be allowed to get the same mortgage terms obtainable by any other borrower of comparable financial status.

The $10,000 limit on educational loans suffers from the same type of arbitrariness. In just a few years, the spiraling costs of higher education will make this limit unrealistic. It is especially unfair to the officer with many children in college at the same time. In addition, the limit is unfair to the officer with many children in a large city who feels compelled because of inadequate public schools to send his children to private schools, and possibly finance college educations at the same time. Granted, education loans must be limited by sound banking practice, but there is no reason why these limitations could not take account of the rising cost of education and the needs of an officer with many children to educate.

The $5000 limit on unsecured general loans to officers is also arbitrary and inflexible. It makes no provision, for example, for a large emergency medical expense or any other such emergency expense. Aside from emergency situations, an officer who wishes to obtain a loan to purchase an expensive automobile might not borrow the whole of the needed capital from his own bank. Again, the loan should be regulated by sound banking practice.

The arbitrariness of these loan limits could be greatly reduced by providing that the amount of the loan over the limit be adequately secured. Such a policy is followed in Pennsylvania[47] where loans of all types over $5000 are

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[44] Id. § 375a(1)(D). An officer's loan from his own bank becomes payable on demand when he borrows from another bank in an amount greater than he could borrow from his own bank.

[45] H.R. Rep. No. 262, 90th Cong., 1st Sess. (1967) (1967 U.S. Code Cong. & Ad. News 1530).

[46] Id.

[47] Pa. Stat. Ann. tit. 7 § 1415 (1967). It is interesting to note that the former

permitted, if secured by deposits in the bank, the cash surrender value of life insurance in an amount equal to that of the loan, or by other collateral with a market value of at least twenty percent more than the amount of the loan. The loan may also be secured by a mortgage or it may be insured. This type of system minimizes the effects of the loan limits but still affords the bank and its customers sufficient protection from large loans to officers by requiring that a loan in excess of $5000 be secured.

While the 1967 statute deals specifically with limiting loans to individual officers, it places no limit on the aggregate amount a member bank may loan to all its officers. Such an aggregate limitation is imposed in many states in the form of percentages of capital and surplus.[48] This type of limitation would be ineffective in the case of a large city bank with huge capital and surplus. If the limitation on the aggregate amount were fifty percent of capital and surplus, two banks with the same number of officers but different amounts of capital and surplus would have different amounts available for loans to their officers. For example, Bank *A* with capital and surplus of $1,000,000 would have $500,000 available for loan, while bank *B* with capital and surplus of $4,000,000 would have $2,000,000 available for loan. Assuming a state with an aggregate and individual limitation, Bank *B*, with greater loan funds for officers, could conceivably grant up to the maximum to each of its officers and still not exhaust its aggregate loan allowance, while bank *A* might not even be able to loan each of its officers a maximum individual loan.

One of the largest problems in regulating loans to bank officers is providing adequate protection against the circuitous methods a dishonest officer may devise to evade the statute. An officer who wishes to exceed the statutory limits on loans may often resort to some type of indirect borrowing through a third person or a "dummy" corporation. Such practices fill the pages of court records involving failed banks,[49] and there is no protection in the 1967 act against the officer who wishes to hide his loan by diverting it through a "straw man" or a corporation in which the executive officer has a controlling interest. This type of indirect borrowing could be reduced if all loans to corporations in which bank executive officers have managerial discretion or own a controlling interest are subjected to review by the bank's board of directors. Such a review would not only help the board to keep informed of the outside interests of an officer but would also make the fraudulent use of dummy corporations more difficult. In New Jersey, protection against such indirect borrowing is afforded by requiring corporations in which a director or an officer or a group of directors or officers have a controlling interest to offer "security having an ascertainable market value at least 20% greater than the

Pennsylvania banking statute, (Pa. Stat. tit. 7, § 819-1007 (1936)) spoke in terms of "readily marketable collateral" rather than just "collateral." It is hard to understand why the terms "readily marketable" were deleted since it would seem desirable to require collateral that is quickly salable.

48 See, e.g., Kan. Gen. Stat. Ann. § 9-1104 (Supp. 1961).

49 E.g., Jones Nat'l Bank v. Yates, 240 U.S. 541 (1916). In that case, a bank with about $300,000 in capital had among its worthless assets a loan of $235,000 to a company with no assets and no active business, which was a front for the president of the bank who also had a personal loan of $85,000. There were also loans of $54,000 to the cashier and $107,000 to a relative of the president.

amount of the proposed liability . . . ."[50] In an effort to make such a rule effective, an officer should be required to make full disclosure of his interest in such a corporation when it applies for a loan. Although such indirect loans may be very hard to detect because of the many possible ways to hide the loans themselves and the officer's interest within the corporate structure, this is no reason to deny protection against such loans when they are detectable.

The 1967 statute does attempt to prevent some types of indirect borrowing in its provision dealing with partnerships.[51] Under that provision, the full amount of any credit extended to a partnership is considered to have been extended to each officer who is a member of the partnership, if the officer or group of officers have, either directly or indirectly, a majority interest. For instance, a $5000 loan to such a partnership would be considered as a $5000 loan to each member of the partnership who was an officer of a member bank. This provision, which was carried over from the preceding act, has been criticized as being far too limited in scope, that is, in view of the unlimited liability of partners, all such partnership loans, regardless of the degree of interest of the officer, should be subject to review by the board of directors.[52]

One of the most difficult problems encountered in restricting bank loans to executive officers is the problem of whether to require an officer to report his outside borrowings. The primary reason for requiring reports of outside loans is to inform the bank as to officers whose excessive debts could induce them to breach their fiduciary duty and to give the bank time to take corrective measures before irreparable damage can be done. The 1967 act provides that when an executive officer of a member bank borrows from other banks in a total amount greater than the amount of credit which he could borrow from his own bank, he must make a written report to the board of directors of his bank, stating the date and amount of each such loan, the security therefore, and the purposes for which the proceeds have been or are to be used.[53] This provision liberalizes the old statute's reporting requirement that the officer report *all* loans from other banks, regardless of size of such loans, to the board of directors. The new provision makes it much more difficult for a bank to keep track of its officers' outside loans by allowing an executive officer to borrow from another bank or banks up to the limit in each category without having to report the borrowing to his board of directors. It is hard to understand the intent of Congress in giving executive officers so much leeway before requiring reports of their outside loans. A reporting requirement does not appear to impose too great a burden on borrowing officers, and since more effective protection for the bank and its depositors can be provided by a reporting requirement, a reversion to the old rule requiring all loans from other banks to be reported is suggested.

Another defect in the outside-loan-reporting provision was carried over from the old act. This defect in the Banking Act of 1933 was pointed out in a statement made before the subcommittee of the Senate Committee on Banking and Currency in 1933. The statement noted:

50 N.J. Stat. Ann. 17.9A-72B(3) (Supp. 1966).
51 12 U.S.C.A. § 375a(5) (Supp. 1967).
52 Trefftzs, supra note 15, at 386.
53 12 U.S.C.A. § 375a(6) (Supp. 1967).

> The important point is that the Act refers to borrowing only from another bank. An officer may borrow from any other source without making a report. There is no provision covering borrowing from brokers, private bankers, or others. It would seem that the rule should be that all executive officers of a member bank should report to the Board of Directors all of their borrowings above say, some nominal minimum, related to the size of their salaries. Thus the Board will be informed of the obligations such officers may be under to all those who are lending them money.[54]

This "loophole" has never been closed. A bank has no way of knowing if an officer is burdening himself with great financial obligations to nonbank sources. One of the most dangerous types of borrowing engaged in by officers would seem to be loans from a broker. The amount of the officer's indebtedness could greatly increase if he buys stock on margin and purchases very speculative stocks. Borrowing from a broker could become even more inimical to the interest of the officer's bank if the broker was himself a borrower from the bank. In such a situation, the officer is not only engaged in speculative borrowing, which could induce him to misappropriate bank funds, but he may also be in a position where a conflict could arise between his need for an extension of broker credit and his duty to the bank of giving close scrutiny to the amount and security of the broker's bank loans.[55] A similar conflict could arise where loans to an officer from a business are extended to influence the officer to recommend to his bank a line of credit in excess of that which the facts would justify. It is not uncommon in the business world for money to be lent to officers of corporations as a means of currying favor. This is a serious business problem, but where the corporation is a bank, it touches a matter affecting the public interest.

Under the new act, any loan to an executive officer from his own bank becomes due and payable on demand of his bank when he is indebted to any other bank or banks in an amount in excess of the statutory limits in any of the three categories stated in the act.[56] This allows a bank to call any loans to an officer when the officer's borrowing from other banks has exceeded the statutory limits. The power to call loans would be more effective if an officer had to report loans from all sources, because the bank would have power to act when an officer becomes over-extended to any source. Under the act as it is presently worded, this provision will not be available unless the outside borrowing is from another bank. Depositors are entitled to this extra protection to insure the most judicious investment of their funds.

Responsibility for enforcement of the 1967 act is in the federal banking agencies. The original act was criticized as being worse than no regulation at all because it instilled in the public a false feeling of security from an inadequate and poorly administered law.[57] The inadequacy of the statute is quite evident, but the allegation of poor administration is questionable.

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54 137 Com. & Fin. Chron. 3925, 3927 (Oct.-Dec., 1933).

55 J. Goodbar, Managing the People's Money 394 (1935).

56 12 U.S.C.A. § 375a(1)(D) (Supp. 1967).

57 Trefftzs, supra note 15, at 392-93.

The effectiveness of the statute's enforcement is very difficult to determine because of the very nature of federal banking regulation which is often cited as the outstanding example of federal regulation of an entire industry.[58] Banking agencies use methods of informal supervision, almost always without formal adjudication, even for the determination of controversies. They are very reluctant to bring formal proceedings and use them only after every other supervisory possibility has been exhausted and the situation threatens to become critical. Only two formal proceedings have been brought under the Banking Act of 1933 to remove directors and officers of member banks for continued violations of law or unsafe or unsound practices.[59] Banks naturally try to avoid such drastic penalties, and supervision thus becomes a more effective administrative tool. In the twenty years prior to 1956, the Federal Deposit Insurance Corporation, for example, took action against 177 banks, of which only 43 were suspended. These figures are indeed impressive considering that in a single year, 1956, the FDIC conducted over 10,000 examinations and investigations.[60] The extremely small number of formal proceedings and the present rarity of bank failures make it extremely difficult to question the administration of the federal banking laws in general and this law in particular.

III. Coverage of the Act

In addition to the weaknesses in the language of the statutory provisions, there are other weaknesses that are caused by the limited coverage of the statute. The most important weakness is a result of the restriction of coverage to member banks in the Federal Reserve System. As of 1965, there were 13,804 commercial banks in the United States with assets of 377.3 billion dollars. The 1967 act covers 4815 national banks with assets of 219.7 billion and 1406 state member banks with assets of 93.6 billion.[61] It has been suggested that the federal regulation of bank loans to officers be extended to all federally insured banks.[62] Such an extension would put 7320 insured nonmember banks with assets of 60.7 billion under federal regulation. The depositors of nonmember banks should be afforded the same protection as depositors in member banks. The urgency for federal regulation of loans to officers of insured nonmember banks should be lessened to some extent, however, by the fact that all but a handful of states regulate loans to officers. But the effectiveness of state regulation appears to be extremely lax, if the number of state banks cited to supervisory authorities by the FDIC for unsafe or unsound practices is any indication of state regulation.[63] The laxity of the states plus a desire for uniform financial laws which would guarantee the same protection to depositors in all states is a strong argument in favor of expanding coverage along this line. That Congress has the power "to enact such regulatory legis-

[58] 1 K. Davis, supra note 22, at § 4.04.

[59] Banking Act of 1933, ch. 89, § 30, 48 Stat. 193.

[60] 1 K. Davis, supra note 22, at § 4.04.

[61] U.S. Bureau of the Census, Statistical Abstract of the United States: 1966, at 456.

[62] Trefftzs, supra note 15, at 381.

[63] Id. at 382.

lation as is deemed necessary to protect and make effective this government agency [FDIC]"[64] must be conceded.

Another example of the limited nature of the 1967 act is that it makes no provision for regulating loans to bank directors. The main argument against such regulation is that directors of the highest calibre would be harder to obtain if they knew their borrowing power was to be restricted. This is especially true since directors receive only nominal compensation for their services, and must necessarily be chosen from an intelligent and prosperous class of citizens. Men who are competent to serve as directors may refuse to serve if deprived of the unlimited privilege of obtaining legitimate bank credit for themselves and for the business firms in which they are interested.

This argument is countered by the fact that a great number of states regulate loans to bank directors,[65] yet those state banks seem to have no trouble in obtaining directors of a high quality. Perhaps, no limit should be placed on the amount a director may borrow, other than the ten percent of capital and unimpaired surplus limit placed on every borrower by the National Bank Act.[66] But there is no reason why a director should not have to receive approval of his loan by the board of directors. In Rhode Island, for example, no loan can be made to any bank director unless he submits to the board of directors or the executive committee of the board in writing, an application for the loan, giving "the amount, terms, and security, if any, offered therefor," and unless the application be accepted "by the vote of a majority of those present constituting a quorum . . . ."[67] This requirement of prior approval would provide the same protection against unwise loans to directors as it would against unwise loans to officers.

IV. CONCLUSION

The new law is inadequate because of loopholes in the law itself and its narrow coverage. The 1967 statute has failed in that it has perpetuated most of the weaknesses of the old statute and has added a few new loopholes, e.g., the provision that no loans from other banks have to be reported until they exceed the statutory limits.

The failure of the 1967 act was unintentionally pointed out by Congressman Multer of New York, while remarking on the new statute: "The reporting procedures and other safeguards against self-dealing contained in H.R. 9682 [the 1967 act] will only be as effective as these agencies make them. If they do not do the job *then we will have to write more specific provisions into the law.*"[68] (Emphasis added.) The Congressman's emphasis on the activities of the regulatory agencies appears misdirected for it is not the job of the banking agencies to strengthen a weak law; that is the responsibility of Congress. A stronger law with many of the provisions previously suggested to close the loopholes in the present law would strike a better balance between allowing

64 Doherty v. United States, 94 F.2d 495, 497 (8th Cir. 1938).

65 See, e.g., Cal. Fin. Code § 3371 (West Supp. 1966); Ind. Ann. Stat. § 18-1306 (1964); Pa. Stat. Ann. tit. 7, § 1415 (1967); Tex. Rev. Civ. Stat. art. 342-509 (1959).

66 12 U.S.C. § 84 (1964).

67 R.I. Gen. Laws Ann. § 19-10-5 (1956).

68 113 Cong. Rec. 6634 (daily ed. June 5, 1967) (remarks of Congressman Multer).

the member bank executive officers adequate sources of credit and protecting the banking public.

The inadequacy of the past and present law has forced the responsibility for regulating loans to bank officers almost exclusively on the banks themselves. Certainly the major responsibility for controlling the conduct of bank officers should be on the banks. The problem is that the 1967 act does not provide the needed protection when a bank does not fulfill this responsibility. The present law offers little protection against those who would willfully violate it while it impedes the flow of credit to those officers who would obey the law. The possibilities of evading the provisions without violence to the letter of the law are apparent. There is no real restraint on the very type of bank officers and board of directors that most need restraint. Those who might borrow without abusing their positions will seek loans elsewhere if they need more money than the law permits. But those whose borrowings are unwarranted, whose borrowings are against the best interests of their institutions will know how to evade the provisions.

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