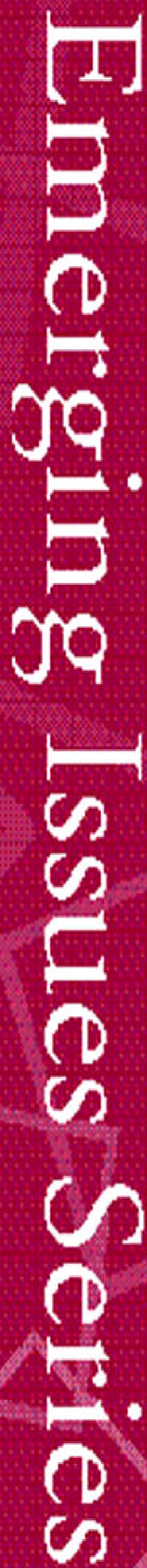

CONGLOMERATES, CONNECTED LENDING AND PRUDENTIAL STANDARDS: LESSONS LEARNED

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CONGLOMERATES, CONNECTED LENDING AND PRUDENTIAL STANDARDS: LESSONS LEARNED

Catharine M. Lemieux*

The United States regulatory system has evolved over time with financial crises and other historical and political events providing the impetus for this change. The US system has not had the benefit of a central architect or a set of core principles to guide the design of our regulatory system. However, various financial crises and economic jolts have taught banking supervisors much about the incentives that influence bank management, the risks posed by extending credit based on reasons other than sound credit underwriting practices, and the risks of failing to control insider abuse.

Connected lending is a particularly important aspect of prudential standards and is receiving more attention as the US considers relaxing the traditional barriers between banking and other financial services. Financial conglomerates provide opportunities for individuals in control to use the resources of the company for their own personal benefit. Complicated structures can increase the difficulty in determining both who is in a position of influence over the regulated entity and who benefits from various transactions. International operations further complicate the problem.

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Understanding of the problems associated with insider abuse and the importance of controlling these activities is essential to promote a safe and sound international financial economy. Below are presented eleven lessons learned from the US experience.

LESSONS LEARNED

1. There are powerful incentives for people with questionable reputations to control banks.

Supervisors need to have the authority to evaluate the competence, integrity and qualifications of proposed management, including the board of directors. The "Fit and Proper" test requires that bank insiders have both the technical qualifications and personal qualifications to effectively manage and oversee the activities of an insured depository institution. While such qualifications are important for any business, the special role of banks in the economy makes this particularly important. Banks' access to the payment system and insured deposits provide opportunities for unscrupulous people to use the bank for their own gain, for example to launder receipts from illegal operations, to provide financial assistance to their own related interests or those of their friends, or to provide financial assistance to further political or social objectives. The Basle Committee recommends evaluating individually and collectively the banking experience, other business experience, personal integrity and relevant skills of bank management and board members.[1] In addition, they recommend background checks to determine whether previous activities raise doubt concerning the competence, sound judgment and honesty of these individuals.[2] It is also important to recognize the ongoing nature of this responsibility. Supervisors should have the authority to require notification of subsequent changes in directors and senior management, and the authority to prevent appointments, if they are found to have a potential negative impact on the interests of depositors.

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[1] *Core Principles for Effective Banking Supervision*, Basle Committee on Banking Supervision, September 1997, 17.
[2] *Id.* at 17.

In the US, no individual or group acting in concert can increase ownership to 25 % or more of the voting shares of an insured bank or bank holding company without prior notification to the primary federal supervisor.[3] In addition, an individual or group that will hold 10 % or more of an institution's voting stock must file a change of control notice if the institution has issued registered securities or has no stockholders with greater holdings.[4] Regulators review personal history, financial data, the terms of the transaction, and the source of funds to finance the control change.[5] Any plans the acquiring party has to sell, merge, liquidate, or change the structure of management of the bank must also be disclosed. Regulators also request a list of people hired to help in the acquisition, the terms of their employment, and a copy of all public or private offers.[6] A person filing a change in control notice must also publish an announcement of the change in a local newspaper.[7] Grounds for disapproving a proposed acquisition include: creation of a monopoly, public interest considerations, the financial condition of the acquiring party, unwillingness of the acquirer to provide requested information, and any adverse impact of the proposed transaction on the federal deposit insurance fund.[8]

At a World Bank conference on preventing bank crises held in Chicago during 1997, several presenters discussed the importance of reviewing the qualifications of bank owners and managers for expertise as well as integrity. Thomas Glaessner, from the World Bank, in discussing the Mexican financial crisis, listed allowing new owners from the securities industry to

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[3] 12 USC 1817 (j)

[4] Kenneth Spong, *Banking Regulation, Its Purposes, Implementation, and Effects,* 1994 FED. RESERVE BANK OF KA. CITY, 129.

[5] *Id* .at 129.

[6] *Id.* at 129.

[7] *Id.* at 129.

[8] *Id.* at 130.

takeover banks as a contributing factor. These individuals found that managing liquidity in a bank was very different from managing liquidity in a securities firm.[9] Danny Leipziger, from the World Bank, identified poor management at Argentine provincial banks as a leading factor in the rise in non-performing loans that undermined the confidence and increased the fiscal burden of financially strapped provinces.[10] Donald Billings, from the US Treasury and the American Embassy in London, pointed out that recapitalizing banks in Central and Eastern Europe had just given inexperienced bank managers more capital to manage, resulting in the need for multiple recapitalizations.[11] As organizations become engaged in more diverse activities, the quality and experience of management will be even more critical, as is demonstrated in these examples from various countries.

2. ***Lending on criteria other than sound credit underwriting principles increases credit risk and can cause economic distortions.***

Favored classes of borrowers should not exist. All extensions of credit should be subject to similar underwriting standards that are based on an analysis of the risks associated with the request. In the US, regulations cover extensions of credit by an insured depository institution to those who are deemed to have a significant influence over the management of the institution (Regulation O) and with affiliates of the insured institution.[12] The Appendix reviews

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[9] Thomas Glassner, and Ignacio Mas, *Incentives and the Resolution of Bank Distress*, THE WORLD BANK RESEARCH OBSERVER, Feb. 1995, 55.

[10] Dan Leipziger, *The Argentine Banking Crisis: Observations and Lessons,* PREVENTING BANK CRISES: LESSONS FROM RECENT GLOBAL BANK FAILURES, proceedings from a conference sponsored by the Federal Reserve Bank of Chicago and the Economic Development Institute of the World Bank, edited by G. Caprio, Jr., et al, EDI Development Studies, 1998, 38 (on file with author).

[11] Donald Billings, Transitional Economies, (presentation at the symposium on Preventing Bank Crises: Lessons from Recent Global Bank Failures, *supra*, note 2) (on file with author).

[12] Training Materials from the Federal Reserve Bank of Kansas City. *Project Best, Sections 23A and 23B* (May 1, 1997) [hereinafter *Project Best*].

some of the main aspects of these regulations.

Often, it is an economic jolt that provides the catalyst that exposes the losses inherent in the loan portfolio as a result of connected lending. As long as businesses in the economy are not under stress, repayment is not threatened. The problems come when companies enjoying "special" privileges suddenly are faced with macroeconomic changes that their "special" privileges can no longer mitigate. History has shown the pitfalls associated with credit allocation are based on social policy or politics. The US, Japan, and Korea present some interesting recent evidence. In the US, changes in monetary policy that led to changes in the volatility of interest rates, a declining real estate market and changes in tax laws had a profound impact of insured depository institutions in the 1980s. Those institutions with the largest losses often were found to have significant violations of laws and regulations designed to control insider abuse.[13] In Southeast Asia, the jolt came from changes in foreign exchange rates. Here too, not all financial institutions became insolvent, but for those that did, insider abuse was evident.[14] In Korea, *Chaebols*, or financial conglomerates, lent money to industries identified by bureaucrats. Lack of credit analysis and political influence has resulted in one of the most highly indebted corporate sectors in the world. Many Korean companies have leverage of 400 % or more. In Japan, bank and industrial *keiretsu* groups targeted financing based on five-year plans drawn up by the Ministry of Finance and the Ministry of International Trade & Industry. These plans focused on export, growth and inflation targets, not on profitability. Majority ownership of the stock of the individual companies was also controlled by these groups, limiting the possibility of

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[13] U.S. GENERAL ACCOUNTING OFFICE, BANK INSIDER ACTIVITIES, INSIDER PROBLEMS AND VIOLATIONS INDICATE BROADER MANAGEMENT DEFICIENCIES (1994) [hereinafter GAO (1994)], 3.
[14] Maggie Ford, *Now Comes the Crisis*, EUROMONEY, Dec. 1997, 44-47.

any discipline from principal shareholders. These practices have led to excess capacity in electronic components, semiconductors, computers, steel, shipbuilding and petrochemicals.[15] These examples from Southeast Asia illustrate how lending based on factors other than repayment ability causes economic distortions that have serious repercussions, particularly during an economic downturn.

Lending relationships based on personal gain are also another recipe for trouble. News reports from Southeast Asia indicate that some of the principals involved in troubled banks are relatives or friends of those running the government. Shareholders of the 16 insolvent banks scheduled to be closed in December in Indonesia included several members of the former Royal family, relatives of the President, the brother of an industrialist convicted of bank fraud, and the former head of the state oil company, Pertamina, who was dismissed for unauthorized borrowing of $10 billion.[16] Bambang Trihatmodjo, second son of Suharto, the President of Indonesia, admitted that his bank had broken the legal lending limit with loans to the Chandra Asri petrochemical plant, which he and other shareholders owned. He said: "We admit we broke the legal lending limit . . . . But to be fair 90 % of other Indonesian banks did the same." [17]

Principle 10 of the Basle Committee's Core Principles requires that transactions between banks and related companies and individuals should be on an arm's length basis, be effectively monitored, and appropriate steps should be taken to mitigate risks.[18] Lending is still

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[15] Ed von Leffern & K.Y. Cheng, *The Asian Economic Crisis: Causes and Impact*, THE J. OF LENDING & CREDIT RISK MGMT., Mar. 1998, 53.
[16] Ford, *supra*, note 14, at 44.
[17] *Id. a*t 44.
[18] Basle Committee on Banking Supervision, *supra*, note 1, at 17.

one of the riskiest of all the activities banks undertake. It is also one of the most difficult to value. Connected lending introduces other variables into the equation that impact the likelihood of repayment. Unless this risk is controlled, experience has shown that it can severely impair the solvency of a financial institution.

3. Inventive people can find ways to subvert rules and regulations.

Individuals intent on operating depository institutions for their financial gain will scrutinize laws and regulations for potential loopholes. They will construct convoluted corporate structures to make the trail of funds difficult to follow. Over time regulatory agencies have had to issue increasingly detailed definitions of exactly what constitutes an extension of credit to an insider, who is an insider, how to deal with their "related interests," and what constitutes control.[19]

The savings and loan crisis offers many examples of this, but perhaps the best known involves Charles Keating, former owner of the now defunct $5 billion Lincoln Savings and Loan. Keating sold uninsured bonds issued by Lincoln's holding company American Continental Corporation (ACC), to Lincoln's customers without proper notifications and disclosures that these investment products were not insured deposits. In court, Keating did not deny that the sales violated the conditions of qualification set up by the State of California or that he was aware of the illegal practices of the holding company and thrift employees. He argued that selling qualified securities in violation of the conditions in the authorizing qualification was not a crime. The court rejected this argument. In further proceedings against Keating the judge

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[19] Training Materials from the Federal Reserve Bank of Kansas City. *Project Best, Basic Regulation O* (May 1, 1997) [hereinafter *Project Best Reg O*].

stated:

> "It is abundantly clear that ACC officials abused their positions with respect to Lincoln Savings and Loan. Bluntly speaking their actions amounted to the looting of Lincoln. This was not done crudely. Indeed, it was with a great deal of sophistication. The trades were all made to have an aura of legality about them. They even entered into a so-called formal tax-sharing agreement in order to claim they had the approval of the regulatory authorities for this phase of their illicit activities. '[20]

This case illustrates how easy it is to misrepresent products of uninsured affiliates as being covered by the safety net. In the US, there are anti-tying rules which limit the ways in which a financial organization can tie the marketing of various products.[21] Customers must not feel that to acquire one product, for example a mortgage, they must purchase another product, such as mortgage insurance, from that same company. Therefore, there are restrictions on when the same employees can market different products and when sales literature can be distributed (in the previous example it would be after loan approval). As organizations offer an expanded array of financial services, it becomes increasingly important for customers to be able to distinguish which products carry the backing of the federal safety net and which products are more risky.

Financial conglomerates present greater opportunities for risk shifting and regulatory gaming. In the US, different products are subject to different regulations and different

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[20] 62 Banking Rep. (BNA) 71 (Jan. 10, 1994).
[21] Spong, *supra*, note 4, at 90.

supervisors. For instance, while the distinction between certain insurance products and certain bank products is becoming increasingly blurred, these similar products are regulated by different supervisors depending on the institution offering them.[22] One of the risks that has been identified when institutions can choose their regulators by choosing where to book assets is "competition in laxity." This occurs when the regulators compete for "clients" by promising less onerous regulatory oversight. Regulatory coordination and sharing of information are important ways to minimize this risk. This problem is even greater when companies must choose between booking assets in regulated or unregulated entities or in a more or less regulated country. Controlling this risk requires an umbrella regulator and the ability to "wall-off" the regulated entity. Umbrella regulation is necessary because in the US, there is evidence that regulation is a significant factor in the decision to place certain activities at the bank or bank holding company level. When asked why they might prefer conducting non-bank activities in a bank, one of the three primary reasons banking organizations typically cite was elimination of Section 23A and B restrictions.[23] Unless there is one supervisor charged with evaluating the risk of the entire organization, it would be possible for organizations to conduct the riskiest activities outside the regulator's scrutiny. US experience with the ability of firewalls to insulate insured entities from the activities of their affiliates is less than successful. Reputational risk has caused banks to come to the aid of their affiliates even in cases where they were not legally liable for the actions of the affiliate

[22] For example, both banks and life insurance companies can offer annuities. Insurance companies are regulated by the state insurance commissioners for each state in which they operate. Depending on the type of charter, a bank could be regulated by one or more federal regulators which include the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Federal Reserve System. If the bank has a state charter, in addition to a federal regulator, the bank would also be regulated by the state banking commissioner in the state where its head office is located.
[23] Myron L. Kwast & S. Wayne Passmore, The Subsidy Provided by the Federal Safety Net: Theory, Measurement, and Containment, Finance and Economics Discussion, 34.

even if the company is not wholly owned. An example of this is the case of First Chicago's support of a Brazilian investment bank, Banco Denasa, a bank in which it maintained a minority interest. When Denasa experienced financial difficulties and the majority owner could not inject additional capital, First Chicago elected to take control and provide the necessary support. First Chicago ultimately experienced a $131 million loss.[24] These risks point to the importance of concise definitions, regulatory coordination and cooperation, and umbrella oversight.

4. Insider abuse can lead to large losses and is frequently a factor in bank failures.

The US Government Accounting Office report published in 1994 reviewed information from banks that failed in 1990 and 1991. Out of the 286 cases investigated, 175 had identifiable insider problems. Of these, 74, or 26 %, had *major* insider problems. Fraud was the most often cited form of insider abuse, found in 104 of the 175 banks with any insider problems. Insider abuse was found in 117 of the sample, and loan losses to insiders were found in 81 banks in the sample.

The study looked at the frequency of Regulation O and 23A and B violations in the 175 banks that had identifiable insider problems. Insider loans exceeding the lending limit were noted in 82 banks for a total of 148 violations. Loans to insiders with preferential terms were noted in 70 banks for a total of 103 violations. Failure to maintain required records, failure to obtain prior board approval, and overdraft payments exceeding limits were noted in 52 to 61 banks. Improper transactions with affiliates were noted in 49 banks for a total of 78 violations. Most of these violations were noted in more than one exam. In one of the most expensive

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[24] Gary Whalen, *Bank Organizational Form and the Risks of Expanded Activities,* COMPTROLLER OF THE CURRENCY, Jan. 1997, 30.

savings and loan failures (HomeFed), top executives gave themselves nearly $20 million in golden parachute severance packages as a declining real estate market eroded the thrift's capital. Regulators canceled these packages.

5. ***Insider abuse is not an isolated deficiency.***

Economic theory predicts that insolvent firms have significant incentives to engage in go-for-broke risk-taking. For insured institutions some have called this, "Heads I win, tails you lose," because if the gamble pays off, the owners reap the profits, and if it does not pay off, the insurance fund is stuck with the losses. Insider abuse is often one of the gambles financially stressed, insured institutions undertake. But it is seldom the only one. The 1994 GAO study looked at the factors that were most commonly associated with specific violations.[25] They found that when loans to insiders exceeding loan limits were found, the examiners were 4 times more likely to criticize management for dominant board members. When examiners cited a bank for failure to maintain required records, they were 2.7 times more likely to also criticize the bank for poor and/or negligent management of other areas of the bank. When the bank was cited for failure to obtain prior approval for extension of credit, examiners were nearly 7 times more likely to also criticize the board for lack of expertise. The more likely owners and managers are to have Regulation O or Section 23A and B violations, the more likely they are to disregard other risk controls.

6. ***Control requires knowledge. Regulators must review board actions, related interests of insiders, and internal controls at the bank. Regular regulatory reporting is a must.***

The supervisors need to be able to monitor institutions for compliance with these

regulatory requirements. Given the incentives to engage in self-dealing that exist for those that have an influence on the institution's management, violations of the laws and regulations instituted to control this behavior will be difficult to detect. On-site examinations are sometimes the only way to detect these problems. Examiners must determine which individuals participate or have the authority to participate in major policymaking functions of the company. This may or may not be the executive officers of the institution. Principal shareholders' relationships should also be monitored. Here, it is particularly important to monitor control of shares rather than ownership per se. Once the identity of the insiders is determined, examiners must determine the full extent of their related interests. It may not be apparent that a loan to a particular business actually benefits an insider of the bank. It is also important to investigate all possible sources of income or benefit that an insider may garner through his ability to influence decisions at the bank. US regulations define an extension of credit to include more than just loans. Such transactions as repurchase agreements, overdrafts, stand-by letters of credit, advances of unearned salary, and any other similar transactions which obligates an insider to pay money to a bank are covered.

US regulations covering insider transactions limit the amount of the transactions as a function of the bank's unimpaired capital and surplus and require the approval of the board of directors for all transactions over a certain amount. Examiners need to determine that the board of directors is properly informed of all insider activity and has granted the proper approval for significant extensions of credit. Internal control processes are very important and all insider activity should be an integral part of board reports.

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[25] GAO (1994), *supra*, note 13, at 53.

Regulatory reporting can alert supervisors to questionable activities in between on-site visits. Examiners need to verify the accuracy of regulatory reports as well as conduct independent investigations of compliance with these statutes. In the US, as part of the quarterly Report of Condition, banks must report the total amount of credit extended to insiders; the number of insiders having loans which exceed the lesser of 5 % of the bank's unimpaired capital and surplus or $500,000; and the number, dollar amount and range of interest rates charge on loans made to executive officers since the previous reporting date.[26]

The Basle Committee calls for both on-site and off-site supervision in Principle 16 of the Core Principles, emphasizes the importance of regular contact with bank management in Principle 17, and calls for prudential and statistical reports from banks on a solo and consolidated basis in Principle 18.[27]

7. *Education can help.*

The GAO's 1994 analysis of failed banks found that management and board deficiencies were the most significant factors in the failure of banks.[28] The most common management problems identified were a passive and/or negligent board, loan losses due to lax lending practices, and poor and/or negligent management. The study concluded that insider fraud and abuse were symptomatic of broader management and board failures. A knowledgeable and active board of directors is the first line of defense against insider abuse. The GAO study reported that in some cases directors at failed institutions had little knowledge of their duties and responsibilities and had received little training about their corporate

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[26] This last item is not treated as a part of the actual call report.
[27] Basle Committee on Banking Supervision, *supra*, note 1.
[28] GAO (1994), *supra*, note 13, at 3.

governance responsibilities. In the US, board approval is required for significant insider loans, and examiners review information submitted to the board and assess how well they are informed concerning insider activities.

In the US, there have been regulatory initiatives to provide training to outside directors of banks so they can better fulfill their fiduciary duties and responsibilities. In addition, meetings with the board of directors and bank management ensure that the board is not receiving a report of the on-site examination findings that has been filtered through bank management.

8. ***Where economic systems are weak (lack transparency, lack accounting and legal systems), supervisors must fill the gap.***

An independent audit is an additional tool that aids bank supervisors in controlling connected lending. Auditors can provide an independent assurance that the accounts are a true and fair view of the financial position of the company and can go a long way in assuring the public that the institution is being operated in a safe and sound manner. However, unless auditors are held accountable for their work, there is the potential that a conflict of interest could develop between the bank and the auditor, because the auditor is paid by the bank. There were instances during the 1980s when the most recent audits of failed financial institutions failed to indicate any problems.

Transparency is another important aspect of bank supervision that can help deter connected lending. Corporate separateness can aid transparency. In the US, corporate separateness demands that corporations maintain sufficient distance from their affiliates to prevent the corporation from being responsible for the affiliate's liabilities. This requires limits on the interconnectedness of affiliates and is often achieved through separate accounting

records, board meetings, directors, officers, employees and facilities. Transparency is also needed so that investors and supervisors can accurately identify those individuals that are responsible for the sound operations of the bank and to ensure that these individuals have the autonomy within the organization to respond quickly to supervisory recommendations and requirements.

The Basle Committee's Core Principles emphasizes the importance of independent audits and appropriate controls in Principle 14.[29] In the US, FDICIA mandates that all banks with total assets greater than $500 million must submit audited annual reports to the appropriate federal regulator and be made available to the public. The reports must contain audited financial statements, the independent public accountant's report on this statement, a report and assessment by bank management on the effectiveness of the bank's internal controls and its procedures for complying with safety and soundness regulations, and the accountants evaluation of the bank's internal control structure and assertions made by management. In addition to the audit, FDICIA requires that all insured banks establish an audit committee comprised of outside directors who are independent of the bank's management. This committee is charged with the responsibility of reviewing the annual reports with bank management and the independent accountant. For institutions over $3 billion in assets, at least two individuals on the audit committee must have banking or related financial management expertise, and the committee must have access to its own legal counsel.[30]

It may not always be possible to enlist independent accountants in the effort to ensure a

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[29] *Id.*
[30] Spong, *supra*, note 4, at 121.

safe and sound banking system. In Japan, GAAP accounting policies are not required, and tax policy does not encourage prompt recognition of losses. One factor limiting the likelihood that Japan can quickly incorporate GAAP accounting policies is the lack of trained accountants. There are only 8,000 accountants in Japan compared to 250,000 in the US. There are also very few attorneys or judges and no strong court system that enforces contract law.[31] At the World Bank Conference on Preventing Banking Crises, Donald Billings, from the US Treasury and the American Embassy in London, pointed out that in most transitional economies, there is no accounting system in place.[32] Without an accounting system, it is impossible to make lending decisions based on repayment ability or asset values or to determine the value of the bank's loan portfolio. Problems have also surfaced in Southeast Asia. The head of the Malaysian Securities Commission, Munir Majid, told investors in November that needed improvements included an end to "unhealthy practices" in corporate governance, such as the shifting of assets, conflicts of interest, lack of shareholder participation at annual company meetings, lack of transparency in accounting practices, and inadequate investor protection.[33]

When accounting and legal systems are not sufficiently developed, bank regulators must fill the gap. Through on-site examinations, regulators can ascertain the loss inherent in the loan portfolio and verify that the bank has realistically valued its assets and liabilities. Through moral persuasion, supervisors can also encourage banks to get their customers to adopt standard accounting procedures.

9. *Capital is a symptom not a cause.*

[31] von Leffern & Cheng, *supra*, note 15, at 54.
[32] Billings, *supra*, note 11.
[33] Ford, *supra*, note 17, at 44.

Capital provides a backstop to help an organization weather periods of financial stress. The Basle Capital standards, in effect since 1988, have proved effective in getting institutions to increase their capital levels and have helped achieve a more coordinated approach to supervision internationally.[34] In the US, FDICIA instituted a regulatory system, which necessitates prompt corrective action. It calls for progressively more stringent supervisory actions as an organization approaches various capital tripwires. While supervisors closely monitor bank capital, declining capital should only be viewed as a symptom of a problem, not as the problem itself. There is always a reason why capital levels decline, whether this is due to losses in the loan portfolio, losses on investments, or fraud. It is the reason for these losses that is at the core of the bank's problems, not the decline in capital per se. That is not to say that bank supervisors should reduce their scrutiny of bank capital, but in dealing with troubled institutions it is important to remember to look beyond declining capital for the root cause of the problem. Recapitalizing a troubled institution that has major problems with such things as loan underwriting, insider lending, internal controls, or risk management only gives bank management and owners more money to lose.

10. Bank structure matters.

The organizational structure needs to minimize the risk to depositors of contagion from activities conducted by other entities within the larger organization. The organization needs to have appropriate corporate governance in place, including a management with clear accountability, a board of directors with the ability to provide an independent check on

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[34] Kevin Jacques and Peter Nigro, *Risk-Based Capital, Portfolio Risk, and Bank Capital: A Simultaneous Equations Approach*, JOURNAL OF ECONOMICS AND BUSINESS, Volume 49 Number 6, 1997, 535.

management, and independent external and internal audit and compliance functions. The organizational structure should not inhibit the ability of the supervisor to obtain adequate access to management and information. Herring, from the University of Pennsylvania, in his examination of the BCCI failure, concluded that the opaque corporate structure severely hindered supervision of the bank's activities.[35] The Basle Committee particularly mentioned the importance of understanding the nature of the conglomerate's intra-group and related affiliate transactions and exposures, indications of the volume of such transactions, and the size of material intra-group financial exposures.[36] Supervisors need to understand the channels through which the holding company, subsidiaries and affiliates of a regulated legal entity can influence the financial health of the entity. This includes arrangements such as servicing agreements.

Supervisors need to decide which activities should be covered by the safety net. There are costs associated with a safety net. Appropriate safeguards are needed to prevent leakage of any subsidy to uninsured activities. In setting regulations, bank supervisors must be cognizant of the trade-off between the synergies of joint operations and the necessity of protections aimed at maintaining a safe and sound banking system. Many of the safeguards, such as limitations on intra-group transfers, also limit the synergies an organization can achieve through joint operations. Often, it is where the assets are booked that creates the potential risk, while cross-selling presents few safety and soundness concerns.

Connected lending becomes increasingly important as the complexity of the organization increases. The problem is compounded when there is a mixture of supervised and unsupervised

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[35] Richard J. Herring, *The Collapse of BCCI*: *Implications for the Supervision of International Banks*, *in* REFORMING FINANCIAL INSTITUTIONS AND MARKETS IN THE U.S. 121, 134 (George G. Kaufman, ed. 1994).
[36] Basle Committee on Banking Supervision, *supra*, note 1, at 67.

entities and different bank supervisors, with potentially different objectives, controlling the various entities. The objective of supervisors is to prevent the bank from becoming a captive source of finance for its owners. While insider abuse is a concern in all companies, it is a particular concern when there is a government safety net. Money is fungible. Funds raised with the enhancement of a government guarantee can easily migrate to be used in the financing of activities not intended to benefit from government backing without monitoring and controls. Access to lower cost funds could lead to over investment in activities and hinder those who do not have access to these funds from entering the market, thus limiting competition.

In Principle 20 of the Core Principles, the Basle Committee states that, "an essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis."[37] However, in the US, in addition to limits on the type of activities that can be conducted in an insured depository institution, there are firewalls between affiliates that aid in transparency and those that help maintain corporate separateness. One of these is Section 23B of the Federal Reserve Act, which applies to certain affiliates within a holding company.[38] Currently covered transactions must be on terms and under circumstances that are the same, or at least as favorable to the bank, as comparable transactions with other parties (see Appendix). The intent of these restrictions is to contain the subsidy provided by the federal safety net. Otherwise, it would, for example, be possible for the uninsured entity to transfer bad assets to the insured affiliate at inflated prices, thus shifting the risk to the deposit insurance fund. There is also a potential problem when different affiliates are regulated by different agencies. In

[37] *Id.* at 67.
[38] *Project Best, supra*, note 12.

addition to making it more difficult to determine the identity of the insiders and their related interests, and who is ultimately benefiting from a transaction, affiliates may engage in asset shifting to make whichever affiliate is being examined look good. An additional restriction contained in Section 23B prohibits a bank or affiliate from suggesting that the bank is in any way responsible for the obligations of its affiliates.[39]

11. The independence of bank supervisors and their ability to enforce regulations is critical.

Supervisors need to have a system of progressive interventions with which to enforce compliance. Some studies have shown that supervisors can be reluctant to use overly harsh punitive measures.[40] Having a list of supervisory responses that become progressively harsher according to the severity of the infraction make for more effective supervision. While it is important to act promptly on all supervisory problems, connected lending requires particular attention. Prompt corrective action can prevent single infractions from multiplying. It is also important that the progressive intervention includes closure before capital completely erodes. The time between capital levels of 2 % and zero capital allows bank management more time to engage in go-for-broke behavior.

Kane, from Boston University, describes the direct and indirect incompatibility that exists between taxpayers and politicians, insurance-fund managers, bank stockholders, and

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[39] *Id.*

[40] Edward J. Kane, THE GATHERING CRISIS IN FEDERAL DEPOSIT INSURANCE, Cambridge, MA: The MIT Press, 1985; James R. Barth, Philip F. Bartholomew, and Michael G. Bradley, *Determinants of Thrift Institution Resolution Costs*, *in* THE JOURNAL OF FINANCE, July 1990; Lawrence J. White, *The Reform of Federal Deposit Insurance, in* Journal of Economic Perspectives, Fall 1989; R. Alton Gilbert, *Supervision of Undercapitalized Banks: Is There a Case for Change?,* FEDERAL RESERVE BANK OF ST. LOUIS, May/June 1991.

bank managers.[41] Information asymmetries between bank regulators and the institutions they regulate cause time lags. Because of the periodic nature of exams, time can elapse before regulators become aware of the extent to which an institution's reliance on risky activities threatens the solvency of the insurance funds they administer or protect. Even when fund administrators recognize the risk, the absence of takeover discipline makes them slow to control the funds' exposure. This permits aggressive banks to extract subsidies from the safety net. When these risks produce losses that impact the solvency of the insurance fund, political pressure on fund administrators makes it possible for officials to tolerate gambling that failing banks can recover if only they had more time.

Recent events in Asia illustrate the problems that can exist when these incentives are not controlled. One Indonesian banking analyst stated, "It is not that Bank Indonesia is incapable of supervising banks, but the 'x factor', ownership of banks by politically-connected figures, makes it difficult to supervise effectively or impose sanctions."[42] In Thailand, the central bank propped up Bangkok Bank of Commerce despite the fact that the Bank had nearly $3 billion in bad debt, gave a third of total loans out to shareholders, made unsecured loans to politicians for speculation, and had issued false statements to regulatory authorities.[43]

The US has not been immune to accusations concerning regulatory forbearance and political meddling. Several large failures have uncovered a trail of political contributions to legislators who had the power to intervene on behalf of the regulated institutions. In fact, when

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[41] Edward J. Kane, *The Incentive Incompatibility of Government-Sponsored Deposit Insurance Funds, in* THE REFORM OF FEDERAL DEPOSIT INSURANCE: DISCIPLINING THE GOVERNMENT AND PROTECTING TAXPAYERS, (James R. Barth & Dan Brumbaugh, Jr. eds., 1992).
[42] Ford, *supra*, note 14, at 45.
[43] *Id.*

asked whether his financial support had influenced political figures to intervene with the Federal Home Loan Bank System regulators on behalf of his troubled firm, Charles Keating of Lincoln Savings and Loan, quipped, "I want to say in the most forceful way I can: I certainly hope so." [44]

Kane discussed the failure of the Ohio Deposit Guarantee Fund, a state run insurance fund that collapsed in 1985 largely due to the failure of Home State Savings.[45] The president of Home State Savings made substantial contributions to both political parties, and was indicted for loans to leaders of the two political parties that were characterized as a "willful misapplication" of funds.[46] The head of the ODGF was accused of approving several Home State requests for branch offices in return for promises of post-government consulting work. He was hired as a consultant by Home State three weeks after leaving office. In addition, the Governor met with the owner of the thrift on 32 different dates between November 1982 and its failure in April 1985.

In the national arena, there is also evidence of political interference on behalf of thrifts. Kane has documented the pattern of contributions to political action committees by thrifts and their trade associations.[47] Former House Banking Committee Chairman Fernand St. Germain was using a credit card bearing the name of a savings and loan lobbyist.[48] Finally, the report of the Special Outside Council to the House Ethics Committee clearly developed evidence of

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[44] Kane, *supra*, note 41, at 163.
[45] *Id.* at,163.
[46] Kane, *supra*, note 41, at 158.
[47] *Id.* at 163-164.
[48] *Id*. at 163.

threats made by Speaker of the House, James Wright.[49] These charges were never prosecuted. In the Senate, five senators met with the head of the Federal Home Loan Bank to express concern over allegations of unfair regulatory treatment, at a time when the FHLB was closing in on Lincoln Savings. It may be coincidental, but the head of the FHLB replaced the examination team at Lincoln and began a new exam, delaying closure and costing the insurance fund an estimated $1 billion.[50]

One way to limit the effectiveness of politically motivated meddling is to have clearly specified mandatory actions on the part of bank supervisors. A 1991 GAO study of seventy-two banks that were undercapitalized as of January 1, 1988 concluded that regulators did not always use the most forceful actions available to correct unsafe and unsound banking practices.[51] Mandating specific enforcement actions helps eliminate capricious enforcement and provides regulators with justification for their actions if questioned by others that may be politically motivated. The savings and loan crisis in the US provided ample evidence that forbearance can be costly. Estimates of the cost to resolve insolvent thrifts in 1986 were $15 billion, yet by 1990, Dotsey and Kuprianov reported that the cost to resolve the thrift industry crisis exceeded $100 billion.[52] Early resolution can also limit political interference by serving as alternative to forbearance. When economic conditions are threatening the soundness of multiple institutions, the government may not have the resources to resolve multiple failures if they are required to wait until capital has been completely dissipated before closure. In this case,

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[49] *Id.* at 163.
[50] *Id.* at 164.
[51] U.S. GENERAL ACCOUNTING OFFICE, BANK SUPERVISION PROMPT AND FORCEFUL REGULATORY ACTIONS NEEDED, (April 1991), 3.
[52] Michael Dotsey and Anatoli Kuprianov, *Reforming Deposit Insurance: Lessons from the Savings and*

forbearance or gambling that conditions will improve may be the only viable alternative. Finally, increasing the separation between the government and the regulators is another way to improve the independence of bank regulators.

CONCLUSION

Connected lending presents significant risks to the credit quality of an institution. This paper has discussed several notable cases involving insider lending. These cases have in common a breakdown in good corporate governance processes and controls: the failures of boards of directors to act upon their fiduciary responsibilities, the operation of institutions as captive sources of finance, and the failure to correct deficiencies noted by supervisors. Many of these cases are associated with economic jolts. Stressful economic conditions exacerbate existing risks causing large losses. In the US, each episode has led to a refinement in the regulatory tools in place to deal with this problem. While every country has its own unique culture and history which influence the development of its financial, accounting and legal systems, the lessons outlined here should provide some guidance for countries considering their supervisory system. The Basle Committee's Core Principles provide an excellent framework for dealing with these problems and these "lessons" supplement that framework.

It is important to carefully consider the full implications of the Basle Committee's recommendations on bank supervision. Many countries have recently made or are considering significant changes in the way their banking system and the bank supervisory system is organized. The US is considering financial modernization legislation that will expand the products and services banks can offer, while England has restructured its bank supervisory and

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Loan Crisis, in ECONOMIC REVIEW, March – April 1990, 3.

monetary functions and granted each greater autonomy. The last two decades have provided ample examples of what not to do when it comes to bank supervision and regulation.

While most of the world is currently enjoying a healthy economy, there are clouds on the horizon that may again provide the macroeconomic jolts that will again reveal unsuspected losses in loan portfolios. Economic shocks in one country have the potential to disrupt banking systems in other countries. The impact of the Asian crisis on the US stock market is a recent example of the links that exist in global financial markets. Europe's conversion to the Euro and financial institutions' efforts to deal with the Year 2000 computer problem are two examples of upcoming economic events that could impact financial systems in many countries.

International payment systems are only as strong as their weakest link. The inability of a major international bank to meet its obligations could have international implications. Settlement delays as a result of systems failure would reverberate around the world. International supervision must be prepared to cope with the resulting stress this would cause on our financial institutions. These lessons have shown that supervisors who know their institutions are protected from political pressure and are able to take prompt corrective action, both to help contain risk and to prevent the systemic implications of bank failure.

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APPENDIX
US Regulations

The primary regulations used in the US to control connected lending are Section 23A and B of the Federal Reserve Act and Regulation O. The information in this appendix comes from the regulations, Federal Reserve training material, and *Banking Regulation* by Kenneth Spong.

Regulation O

In the aftermath of the banking crisis in the 1930s, Congress identified bank loans to insiders as a threat to a safe and sound banking system.[53] Sections 22(g) and (h) of the Federal Reserve Act prevent those in charge of the bank from obtaining bank credit on preferential rates and terms. Subsequent episodes of bank failures have pointed to this type of connected lending as a continuing threat to bank soundness. In 1978, growing public concern over the relationship between insider abuse and bank failures resulted in Congress passing The Financial Institutions Regulatory and Interest Rate Control Act of 1978.[54] This act extended insider lending restrictions to executive officers, directors and principal shareholders as well as limited the borrowings of these individuals from correspondent banks.[55] In the aftermath of the banking problems in the 1980s, The Federal Deposit Insurance Corporation Improvement Act of 1991 further restricted extensions of credit to insiders and included increased reporting requirements.[56] Additional revisions from 1992 through 1997 have refined ambiguous definitions, allowed small banks to lend an increased amount of unimpaired capital and surplus to insiders, reduced the prior approvals needed for first mortgage loans to executive officers,

[53] *Project Best Reg O supra,* note 19, 3.
[54] *Id.* at 3.
[55] *Id.* at. 3.
[56] *Id.* at 3.

and allowed certain exemptions for executive officers and directors of bank affiliates.[57]

The statutory provisions which comprise Regulation O are contained in Section 5200 of the Revised Statutes for national banks; Section 22 of the Federal Reserve Act; Section 106 of the Bank Holding Company Act Amendments of 1970; Section 7 of the Federal Deposit Insurance Act of September 21, 1950; Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 as amended by the Garn-St. Germain Depository Institutions Act of 1982; Section 306 of the Federal Deposit Insurance Corporation Improvement Act of 1991; Housing and Community and Development Act of 1992; and Economic Growth and Regulatory Paperwork Reduction Act of 1996. Many states have passed similar restrictions, so a violation of Regulation O may also constitute a violation of state law for state banks.[58]

Regulation O prevents insiders from using their positions and leveraging a bank or company to procure loans on more preferential terms or conditions than would otherwise be available to other customers of the bank.[59] Restrictions are also extended to the related interests of insiders and the indebtedness of insiders to correspondent banks. Insiders are considered to be executive officers, directors, or principal shareholders. Executive officers are defined as people that participate or have the authority to participate in major policymaking functions of the company or bank, while principal shareholders are defined as people that directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has the power to vote more than 10 % of any class of voting securities of a member bank or

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[57] *Id.* at 3.
[58] *Id.* at 4.
[59] *Id.* at 4.

company.[60]

Extensions of credit to insiders must comply with the limit on loans to a single borrower applicable to national banks. This limit is currently 15 % of the bank's unimpaired capital and surplus for loans not fully secured and an additional 10 % of unimpaired capital and surplus for loans fully secured by readily marketable collateral.[61] The bank's total lending to insiders may not exceed its unimpaired capital and surplus.[62] However, there is an exception for small banks with deposits of less than $100 million to help them attract directors and avoid restricting credit in small communities. These banks may establish a limit of up to 200 percent of unimpaired capital and surplus for insider lending. However, this exemption is only available to banks having a satisfactory supervisory rating and adopting a board resolution certifying the necessity of a higher limit.

Any extension of credit to an insider that exceeds the higher of $25,000 or 5 % of the bank's unimpaired capital and surplus must receive prior approval by a majority of the board of directors. All extensions of credit to the individual or their related interests must be aggregated when applying this limit. Aggregated extensions of credit in excess of $500,000 require prior board approval regardless of the amount of the bank's unimpaired capital and surplus.[63]

Regulation O also places limitations on overdrafts by executive officers and directors and imposes additional restrictions on borrowing by executive officers. Overdrafts from executive officers or directors can only be paid in accordance with a written, pre-authorized,

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[60] *Id.* at 6-7.
[61] *Id.* at 17. Unimpaired capital and unimpaired surplus is the sum of the bank's tier 1 and tier 2 capital based on the bank's most recent report of condition and the balance of the bank's allowance for loan and lease losses not included in tier 2 capital for the purposes of calculating risk-based capital.
[62] *Id.* at 17.

interest-bearing extension of credit or a written, pre-authorized transfer of funds from another account.[64] Additional restrictions on borrowing by executive officers limit extensions of credit to the higher of 2.5 % of unimpaired capital and surplus or $25,000, unless the loan is to finance an officer's residence or children's education.[65]

A combination of onsite examinations and regulatory reporting are used to enforce insider lending restrictions. In the quarterly Report of Condition, banks must report:

- the total amount of credit extended to executive officers, directors, principal shareholders, and their related interests;
- the number of insiders having loans which exceed the lesser of 5 percent of the bank's unimpaired capital and surplus or $500,000; and
- the number of loans made to executive officers since the previous reporting date, the total of these dollar amount of these loans, and the range of interest rates charged.[66]

Banks are also required to disclose to the public, upon written request, the names of any executive officers and principal shareholders whose loans are reported on the Report of Condition, provided the loans to a particular related individual and their related interests exceed $25,000. Compliance with this regulation and a review of the lending records are conducted during regular onsite examinations.[67]

Violations of Regulation O are subject to civil money penalties of an initial maximum of $5,000 per day for each day during which the violation continues. These penalties may escalate

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[63] *Id.* at 16-17.
[64] *Id.* at 20.
[65] *Id.* at 22.
[66] Spong, *supra*, note 4, at 66-67. These items are not treated as a part of the actual call report.
[67] *Id.* at 66-67.

to $25,000 a day if a pattern of misconduct is apparent, the institution suffers more than minimal loss, or the party experiences pecuniary gains or other benefits. A maximum penalty of $1 million a day or 1 % of the bank's assets, whichever is less, applies to violations or actions done knowingly and which knowingly or recklessly cause a substantial loss to the institution or substantial gain to the individual.[68]

Section 23A and B of the Federal Reserve Act

As with Regulation O, the aftermath of bank failures in the 1930s pointed to the relationship between banks and their affiliates as a source of instability for insured institutions.[69] Section 23A of the Federal Reserve Act restricts covered transactions. Covered transactions are defined as extensions of credit, purchases of assets or investments, acceptance of securities issued by an affiliate as collateral, or issuance of a guarantee on behalf of an affiliate.[70] When passed in 1933, the act only applied to member banks of the Federal Reserve System. In 1966 the Federal Deposit Insurance Act extended 23A to cover all institutions insured by the Federal Deposit Insurance Corporation.[71] The current form of 23A is the result of 1982 amendments contained in the Garn-St. Germain Act.[72] In 1989, the Financial Institutions Reform, Recovery, and Enforcement Act extended these provisions to thrift institutions in response to the savings and loan crisis.[73] The Federal Deposit Insurance Corporation Improvement Act of 1991 added additional restrictions that prohibit a critically undercapitalized bank from engaging in any

[68] *Project Best Reg O, supra,* note 19, at 34.
[69] *Project Best, supra,* note 12, at 1.
[70] *Id.* at 11.
[71] 12 U.S.C.A. §§ 1811-1835a (West 1998).
[72] *Project Best, supra,* note 12, at 5.
[73] *Id.* at 5.

covered transaction without prior written approval from the FDIC.[74] Section 23B of the Federal Reserve Act was added in 1987 through enactment of the competitive Equality Banking Act. This section provides additional restrictions on bank transactions with non-bank affiliates.

Just as Regulation O restricts loans to insiders, Section 23A and B of the Federal Reserve Act restrict the ability of bank affiliates to obtain preferential treatment from insured banks. Section 23A limits the dollar amount of covered transactions between a bank and its affiliates and requires special collateral protection for any extensions of credit to an affiliate. Covered transactions to a single affiliate are limited to 10 % of the bank's capital stock and surplus. The aggregate amount of covered transactions with all affiliates is limited to 20 percent of the bank's capital stock and surplus.

Any covered transaction with affiliates must be on terms and under circumstances that are the same, or at least as favorable to the bank, as comparable transactions with other parties. Credit extensions or guarantees must be fully secured at all times. Low quality assets and securities issued by an affiliate cannot be used as collateral. Purchase of low quality assets from an affiliate are not permitted unless the bank or its subsidiary performs an independent credit evaluation and committed to purchase such an asset prior to the time it was acquired by the affiliate. Low quality assets are defined as assets that were classified or specially mentioned in the latest examination or inspection report, assets in non-accrual status, assets 30 days or more past due, or assets that have been renegotiated or extended due to the deteriorating condition of the obligor.[75]

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[74] *Id.* at 5.
[75] Spong, *supra*, note 4, at 89-90.

Exceptions to Section 23A are granted for transactions between subsidiary banks of a holding company, provided the company owns 80 percent or more of the voting stock of each bank, the terms and conditions are consistent with safe and sound banking practices, and the transaction is NOT for the purchase of low quality assets.[76] Also excluded are non-bank subsidiaries of a bank (except for operating subsidiaries approved under the Office of the Comptroller of the Currency's Part 5 rule); companies engaged solely in holding bank premises; companies engaged solely in conducting a safe deposit business; companies engaged solely in holding obligations of the US Treasury, its agencies, or other securities guaranteed by same as to principal and interest; or companies where control results from a debt previously contracted.

Section 23B provides additional restrictions on banks in regards to transactions with non-bank affiliates. It requires that any transaction between a bank and an affiliate must be on terms and under comparable rates as transactions with or involving nonaffiliated companies. Contrary to Section 23A, 23B defines affiliate to exclude other banks.[77] Additional transactions are also added to the definition of covered transactions. These include the sale of securities or other assets to an affiliate, including assets subject to a repurchase agreement; the payment of money from or the furnishing of services to an affiliate under contract, lease or otherwise; any transaction in which an affiliate acts as an agent or broker or receives a fee from the bank for its services to the bank or any other person; any transaction or series of transactions with a third party if an affiliate has a financial interest in the third party or an affiliate is a participant in such a transaction or series of transactions. Section 23B extends a covered transaction to an individual

[76] FDICIA gives a bank's primary federal regulator the authority to revoke this exemption for any bank which is significantly undercaptialized or any undercapitalized bank which fails to submit and a implement a capital restoration plan. 12 U.S.C.A. § 371 c (d) (West 1998).

or non-affiliated entity if any of the proceeds of the transaction are used to benefit or are transferred to an affiliate. It also contains an advertising restriction that prohibits a bank or any subsidiary or affiliate from publishing an advertisement or entering into an agreement that states or suggests that the bank is in any way responsible for the obligations of its affiliates. Violations of Section 23A or B are subject to civil money penalties of up to $5,000 per day.[78]

The Office of the Comptroller of the Currency recently altered its regulations to permit banks to have operating subsidiaries to conduct non-bank activities.[79] These subsidiaries are subject to Section 23A and B.

Other Regulations

Additional restrictions concern certain tie-in arrangements between a bank, its holding company parent, and any subsidiaries of the holding company. These are contained in the Bank Holding Company Act Amendments of 1970.[80] Additionally, examiners scrutinize management contracts, services, personnel use and other relationships between a bank and its holding company. Finally Section 5199 and 5204 of Federal statutes prevent the bank from upstreaming funds to the holding company in amounts that would impact the safety and soundness of the insured bank.[81]

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[77] *Project Best, supra,* note 12, at 29.
[78] *Id.* at 5.
[79] OCC News Release Part 5 Fact Sheet 96-128 November 20, 1996.
http://www.occ.treas.gov/ftp/release/96-128.txt.
[80] 12 U.S.C.A. §§ 1850, 197-1978 (West 1998).
[81] 12 U.S.C.A. §§ 39, 60 (West 1998).

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