



**Shadow Financial
Regulatory Committee**

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Statement of the
Shadow Financial Regulatory Committee

on

The Federal Reserve Board's
"Source-of-Strength" Policy

May 18, 1987

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On April 24, 1987, the Federal Reserve Board issued a policy statement declaring that it would generally consider it to be an unsafe or unsound banking practice for a bank holding company to fail to act as a "source of strength" by assisting a troubled or failing bank subsidiary where the holding company is in a position to provide financial support. The statement is an outgrowth of concerns that some federal bank regulators have had where a multibank holding company having available financial resources has permitted or threatened to permit a subsidiary bank to fail. The Board's policy would be implemented in particular cases through the institution of cease-and-desist proceedings aimed at forcing financial support.

The Board's "source-of-strength" policy appears to be intended to force bank holding companies to be guarantors of the capital adequacy of their subsidiary banks. Viewed as such it is tantamount to a rule making bank stock assessable. The Shadow Committee believes that the Board's policy statement is defective in several respects:

1. The policy runs counter to what the Committee believes to be sound bank closure policy. Bank owners should not be required to inject financial resources into insolvent banks; nor should they be deprived of the right to place solvent institutions into voluntary liquidation in order to prevent further erosion of their investment. The interests of depositors and the FDIC could be better protected by an improved closure policy that permits and encourages the closing of troubled banks prior to real insolvency. The threat of early closure would present owners with the choice of

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infusing additional resources to protect their investment or leaving the salvage of their investment to the regulators. A rule that would deprive owners of the ability to close troubled institutions serves only to promote socially inefficient investment.

2. In its present form the policy statement is exceptionally vague. It does not define specific circumstances under which financial support will be demanded from holding companies; it does not specify in what amounts it will require support; and it does not specify how it will determine whether a holding company "is in a position to provide the support." Because of this vagueness, and because the policy can only be enforced through case-by-case litigation, it creates the potential for an overly broad and arbitrary application of the policy, which could have an adverse impact on the value of bank holding company stocks and on the willingness of holding companies to acquire banks -- particularly troubled banks.
3. The policy discriminates among different types of owners of banks, imposing liabilities on corporate owners that would not be imposed upon individual owners or upon chain banking organizations that do not operate in a holding company format. The Committee believes that if bank owners are to be assessable, the need for assessment should be addressed by the regulators having responsibility for determining the adequacy of bank capital, rather than by the regulator of bank holding companies.
4. The Board's legal authority to enforce the policy is open to question. Congress has not given the Board power to issue capital directives to bank holding companies, while it has given such power to the regulators of banks, and it is far from clear that the Board can use its cease-and-desist authority over holding companies to compel capital contributions to subsidiary banks.