Confidential February 10, 1941 Draft

A Plan To Improve Federal Banking Supervision.*

A consolidation of the functions and personnel of the multiple governmental agencies now attempting to supervise the commercial banking system is essential, not only for the banks but, more importantly, in the public interest. It is doubted if there is a single governmental undertaking in which there are more overlappings, duplications, and conflicting jurisdictions than will be found in the fantastic arrangement of agencies and authorities now charged with responsibilities over the banking system. Much of this could be corrected by reorganization and, while it is unnecessary to direct attention to all of the numerous reorganizations, consolidations, and transfers brought about among other governmental agencies during this Administration, "The Farm Credit Administration" and "The Home Loan Bank System" are typical examples of the improved structural organization which could be expected from action along similar lines in the case of the banking agencies.

The President has stated that "The Farm Credit Administration was organized to eliminate overlapping, prevent duplication, settle conflicting jurisdictions - in short, to provide a more efficient, logical and consolidated credit service for farmers at a low cost." The Executive Order creating it consolidated "the functions of all present Federal organizations which deal primarily with agricultural credit; namely the Federal Farm Board, the Federal Farm Loan Board, the functions of the Secretary of Agriculture with respect to loans in aid of agriculture, and those of the Reconstruction Finance Corporation pertaining to the management of the Regional Agricultural Credit Corporations."

* If, in extending the effective date of the Reorganization Act, Congress should see fit to eliminate some of the present exemptions, substantial changes in the proposed plan would be in order.

In the case of the Home Loan Bank System, the Home Owners' Loan Corporation, which did the salvage work in the home mortgage field, the Federal Home Loan Bank Board, which supervises the Federal Home Loan banks and their members, and the Federal Savings and Loan Insurance Corporation, which insures the shares of Federal Savings and Loan Associations and other members of the Federal Home Loan banks, all have been brought under common management.

In sharp contrast, the number of Government agencies dealing with the commercial banking system has increased. The salvage job in the banking field corresponding to that done by the Home Owners' Loan Corporation in the home mortgage field was done in the first instance by the Reconstruction Finance Corporation and the function is now divided between it and the Federal Deposit Insurance Corporation. The latter Corporation insures deposits. Monetary and credit powers are divided between the Federal Reserve System and the Treasury. Supervisory functions are even more widely scattered with a variety of powers in the hands of one or more of all of the aforementioned agencies and with the Federal Deposit Insurance Corporation in practice supervising nonmember insured banks, the Board of Governors Federal Reserve Banks and member State banks, and the Comptroller of the Currency national banks.

Nor is it believed possible to work out at this time any comprehensive and effective plan for consolidation through legislation. With the many different groups in the banking fraternity and Government and with as many panaceas as there are groups, nothing but conflict could come from an attempted solution by legislation. Therefore, with the expectation that the Congress will be asked to renew the power of the President to reorganize the administrative agencies of the Government and that the power will be renewed in the identical form in which it was last granted, it is suggested that the functions of the several bank supervisory agencies be consolidated in the manner and along the general lines which the following plan suggests.

The commercial banking system numbers about 14,500 banks of which 5,200 are Federally chartered national banking associations and 9,300 are State chartered institutions. All national banks are Federally supervised. In addition, Federal supervision extends to a great many State banks because of their membership in the Federal Reserve System, the insurance of their deposits by the Federal Deposit Insurance Corporation, or contractual relationships with the Reconstruction Finance Corporation. Furthermore, all State banks are subject to some Federal regulation such as imposed by the Securities Exchange Act of 1934 with respect to brokers' loans and loans for the purchase or carrying of registered stocks and by the Emergency Banking Act and Proclamations and Regulations thereunder. Of the 9,300 State chartered banks the deposits of all but about 1,000 are insured by the Federal Deposit Insurance Corporation and while only 1,200 of these 8,300 insured State banks are members of the Federal Reserve System, 85 per cent of total deposits at commercial banks are held by member banks of the System, that is to say by the 5,200 national associations and the 1,200 member State banks.

Including the Secretary of the Treasury and the Reconstruction Finance Corporation there are five Federal agencies which exercise supervision over the commercial banking system. The bank supervisory powers of the Secretary of the Treasury and the Reconstruction Finance Corporation are by no means minor but in relation to the other functions which they perform and in comparison with the supervisory functions of the three other agencies they occupy a relatively minor position. The other three agencies are (1) the Federal Deposit Insurance Corporation, a Government corporation, (2) the Board of Governors of the Federal Reserve System, an independent establishment of the Government, and (3) the Office of the Comptroller of the Currency. The last named office is a bureau of the Treasury but curiously enough the Comptroller is appointed by the President for a term of five years whereas the Deputy Comptrollers are appointed by the Secretary of the Treasury, who also exercises certain authority with respect to other personnel of the office.

National Banking Associations are chartered by the Comptroller of the Currency but they are obliged to become members of the Federal Reserve System and their deposits must be insured by the Federal Deposit Insurance Corporation. The deposits of State banks becoming members of the Federal Reserve System must be insured by the Federal Deposit Insurance Corporation and State banks whether or not members of the Federal Reserve System may have their deposits insured by the Federal Deposit Insurance Corporation. All banks are subject to the regulatory powers of the Secretary of the Treasury arising out of the Emergency Banking Act and the Proclamation of the President and all may have relations with the Reconstruction Finance Corporation arising out of loans from the Reconstruction Finance Corporation or sale to it of capital obligations. The result is Federal supervision of some sort over practically all banks with a complete absence of uniformity in the supervision to which the several different classes of banks are subjected.

Moreover, the present system is not the result of orderly development under a comprehensive plan but, on the contrary, is the consequence of unrelated actions taken during periods of emergency and of piecemeal development over a period of many years. It is not surprising, therefore, to find the final product to be a conglomeration of agencies with diffused responsibility, divided and conflicting powers and gaps and overlaps in authority. Such divided responsibility cannot but materially weaken if not finally break down efforts to supervise the banking system in any effective manner, all of which is developed in more detail in the Board's Annual Report of 1938, pages 1 to 12.

As each agency has been created or given new responsibilities appropriate personnel arrangements have followed, to the end that in each agency there are now divisions whose work is identical or parallel to the work carried on by corresponding divisions in the other agencies. Thus, supervision by the Federal Reserve System in the 12 Federal Reserve districts is carried on through the 12 Federal Reserve Banks and their 24 branches. At the same time, the Comptroller of the Currency operates through 12 chief national bank examiners each of whom is in charge of a district and the Federal Deposit Insurance Corporation operates through 12 supervising examiners. Each Federal Reserve Bank, each chief national bank examiner, and each supervising examiner of the Federal Deposit Insurance Corporation has a staff of examiners. In Washington each agency has its own corps of supervising examiners; its own corps of lawyers; its own divisions of research and statistics and its own secretarial staff. Simple and fundamental principles of good organization dictate the need for eliminating such wholly unnecessary duplications in the personnel and work of these agencies.

There are other compelling reasons why there should be consolidation. In addition to the impact of supervision upon the individual bank it has collective consequences which spread over the entire economy and directly affect national credit conditions.

An important function of bank supervision is the examination of banks. While there has been progress in the direction of improving examining methods (see Board's Annual Report for 1938, page 37), there is still room for improvement both in the methods under which examining policy is determined and in the methods under which examinations are made. Since it is the supervisor who has the authority and the responsibility, the examiner should be his agent to collect data and lay the facts before him from which he could make his findings and deliver his criticisms, recommendations or requests for corrective measures to the bank. In practice it usually happens that the first criticism of any banking practice or asset brought to the attention of the bank is set out in the copy of the examiner's report of examination which is furnished to it at about the same time that it is furnished to the supervisor. The supervisor then follows up the report with a letter to the bank, setting out any criticisms, recommendations and requests for corrective measures that he may wish to make. Obviously, the supervisor, under this procedure, is handicapped in raising objections which the examiner has not seen fit to raise. Conversely, failure to support the criticisms made by the examiner in his report may impair the effectiveness of the examiner with the bank. So it is that with respect to the individual bank the pattern for it to follow too often is cut by the subordinate examiner rather than by the responsible authority.

Of even greater importance is the influence which examining policy exerts collectively on the banking system as a whole. It is a fact that many examiners are inclined to look to market quotations to ascertain the allowed value of a security, yet the market quotation may be influenced by many factors besides the obligor's solvency. Indeed, there is the classic example of the bank being required to write down railroad equipment trust certificates which happened to be quoted below par because of the rate of interest which the issue bore in relation to the current market rate, when at the same time it was being permitted to carry the railroad's unsecured open obligation at par. Furthermore, constant pressure to liquidate because of market decline may in itself serve further to depress market quotations as was very well proven in the period from 1929 to 1933. And, as a not too happy commentary on the other side of the picture, it will be recalled that not a small part of the banking trouble during that period came from the so-called "secondary reserve" of bonds and securities built up during the hey-days of the '20's with the approval and encouragement of examiners.

The relation between supervisory and credit policies must have been known to the Congress because, in enacting the Federal Reserve Act, one of the declared purposes was "to establish a more effective supervision of banking in the United States." In these circumstances, it would appear only logical that control of examining functions now exercised by the Comptroller of the Currency be lodged in an agency charged also with the responsibility of national monetary and credit policies as well as with the solvency of the banking system and the interests of all depositors.

The Federal Deposit Insurance Corporation is not such an agency. It has no functions and no responsibility in the broad field of credit control. It was created to insure bank deposits - not to supervise banks and its interest properly should be that of an insurer. Furthermore, it insures only the first $5,000 of a deposit and while this coverage may include in number the great bulk of depositors it is not all inclusive. Indeed, its interest in the assets of a closed insured bank conflicts with the interest of a depositor having more than $5,000 on deposit. As an insurer it should be entitled to rates comparable with the risk and with means of protecting itself by relieving itself of an improper risk; but it should not be permitted to supervise its assured's business any more than the ordinary insurance company would attempt to supervise the business of one of its customers.

Since the Board of Governors is a body with responsibilities for national credit and monetary policies and also with responsibilities with respect to bank supervision, logically, it would seem that the control of examinations and the determination of examining policy should be in its hands. As was stated by Dr. Jacob Viner in an article entitled "Recent Legislation and the Banking Situation" appearing in the American Economic Review, Vol. XXVI, No. 1, Supplement, March 1936:

> "* * * The examiners, through the qualitative credit standards which they impose on banks, directly influence the quantity of bank credit. When business is prosperous and optimism prevails, examiners, like the bankers themselves, must tend to appraise credit risks in terms of the favorable conditions of the moment. The bankers, and especially the small bankers, confident that what is good enough to pass the scrutiny of the examiners should be good enough to meet their standards, persist on their career of credit expansion. Later, when the tide of business turns, when banks begin to fail and loans which were passed without criticism during the boom days have to be written off as bad debts, the examiners are blamed. Reacting in a perfectly natural manner, they become stricter and more exacting in the standards they apply, and they press the banks to liquidate loans and investments which the banks, if left to their own devices, would be happy to keep in their portfolios. The process of bank examination thus tends to encourage credit expansion during the upswing of the business cycle and, more seriously, to intensify credit contraction during the downswing.
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> "There is an obvious cure for this perverse effect of bank examination, requiring three innovations in the administration of the examinations; unified control of bank supervision and examination; coordination of examination policy with credit control policy; and systematic and continuous supervision and instruction of the examiners in terms of a uniform and flexible policy. Fully to attain all of these objectives would require the centralization of all bank examining functions under the direction of the Federal Reserve Board."

If under a new Reorganization Act present exemptions were eliminated, it would be possible, in addition to transferring the examining functions of the Comptroller of the Currency, also to transfer the present examining functions of the Federal Deposit Insurance Corporation to the Board, but under a simple reenactment or extension of the present Reorganization Act the latter step would not be possible. Nevertheless, it would still be possible substantially to unify the present system through an Executive Order accompanied by administrative rearrangements which together would result in the two agencies being operated substantially as one. Specifically it would:

1. Combine all of the statistical and research work of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Board of Governors, including the collection of reports of condition, etc. in one division; combine the supervising examiners of each agency into one group; combine in one legal department all legal work with appropriate sections for the various activities; and effect such other combinations as might prove to be desirable. Each division might have employees paid by the Board of Governors and employees paid by the Federal Deposit Insurance Corporation but the work of the division would be done as a unit. Determining the employees who should be on the Federal Deposit Insurance Corporation payroll and the employees who should be on the Board of Governors' payroll would be a matter of administrative judgment and could be worked out over a period of time.

2. Combine in the office of the vice president in charge of examinations in each Federal Reserve Bank, the duties now performed by such vice president, the chief national bank examiner, and the supervising examiner of the Federal Deposit Insurance Corporation and combine their respective staffs into one staff. These steps also could be worked out over a period of time to the end that eventually the duties of the vice president of the Federal Reserve Bank in charge of examinations and the duties of the Supervising Examiner of the Federal Deposit Insurance Corporation would be performed by one person with one staff and with the cost allocated between the Federal Reserve System and the Federal Deposit Insurance Corporation by administrative adjustment.

The purpose of the Executive Order would be to merge as nearly as possible the three principal Federal agencies into one authority.

Since both the Federal Deposit Insurance Corporation and the Board are exempt under the Reorganization Act it would be impossible to merge them technically - but inter-relationships could be established which, together with appropriate administrative rearrangements which could follow, would reasonably assure the cooperative conduct of the work of both agencies in substantially the same manner as if they were one. The Order would contemplate the elimination of the Office of the Comptroller of the Currency and the transfer of the functions of that office in such manner as best to accomplish the foregoing objective. Specifically it would:

1. Transfer to the Chairman of the Board of Governors, or to some other member of the Board of Governors, the function of the Comptroller of the Currency as an ex officio member of the board of directors of the Federal Deposit Insurance Corporation. The establishment of this inter-relationship would facilitate the necessary administrative rearrangements already mentioned. As an essential element in the plan, however, it would be necessary that one member of the board of the Federal Deposit Insurance Corporation in addition to the ex-officio member from the Board of Governors be a person completely in sympathy with the whole program.

2. Transfer to the Board of Governors the functions of the Comptroller of the Currency relating to the chartering of national banks, the approval of their branches and changes of their capital structure. These functions would then be combined with those relating to the admission of State member banks to the System, the approval of their branches, and changes in their capital structure.

3. Transfer the authority of the Comptroller of the Currency to call for reports of condition, etc. of national banks to the Board of Governors. These functions would then be combined with those of the Board of Governors relating to reports of condition of State member banks. Transfer personnel engaged in banking statistical matters to the Board of Governors.

4. Transfer to the Board of Governors the power of the Comptroller of the Currency to make regulations defining investment securities. Besides being closely related to national credit policies these regulations affect State member banks as well as national banks.

5. Transfer the function of the Comptroller of the Currency under section 30 of the Banking Act of 1933 to the Board of Governors to be performed in each Federal Reserve district by its agent. Under section 30 this function, with respect to member State banks, is performed by the Federal Reserve agent and this would combine the functions in one person.

6. Transfer all examining and other supervisory functions of the Comptroller of the Currency to the Board of Governors. Transfer the power to make assessments upon national banks to defray expenses of making examinations to the Board of Governors. Transfer all personnel of the office of the Comptroller of the Currency engaged in the performance of examining and other related functions to the Board of Governors with the understanding that such transfer would not prevent, by mutual agreement, transfer of any part of such personnel to the Federal Deposit Insurance Corporation. While this provision would give the control of these functions to the Board of Governors, it would not prohibit an arrangement whereby the physical work of examining could be done by employees of the Federal Deposit Insurance Corporation commissioned also as National Bank and Federal Reserve examiners, if that action appeared to be desirable.

7. Transfer the authority of the Comptroller of the Currency to appoint receivers or conservators to the Board of Governors.

8. Transfer all functions of the office of the Comptroller of the Currency in the liquidation of national banks to the Federal Deposit Insurance Corporation. These latter functions would be combined with the existing receivership functions in the Federal Deposit Insurance Corporation.

9. (a) Terminate the authority of the Secretary of the Treasury to license member banks or (b) transfer such authority to the Board of Governors.

10. (a) Transfer the authority of the Reconstruction Finance Corporation to subscribe to preferred stock, notes

and debentures of banks or make loans to banks to the Federal Deposit Insurance Corporation and (b) transfer the authority of the Secretary of the Treasury to request and the functions of the President to approve purchases of preferred stock by the Reconstruction Finance Corporation to the Federal Deposit Insurance Corporation so as to merge these functions completely in the Federal Deposit Insurance Corporation. Making this the responsibility of the authority charged with the responsibility for the liquidation or rehabilitation of the bank would serve the ends of good organization, promote greater flexibility in correlating retirements of preferred capital and payment of interest and dividends thereon with the capital needs of the individual banks, reduce the number of agencies with which the banks have to deal and should reduce administrative expenses. With respect to transferring authority to make loans to banks, it is to be noted that the Federal Deposit Insurance Corporation has power to make loans and to purchase assets to aid in rehabilitation of banks and it would not seem necessary for more than one agency to operate in this field.

11. Transfer the currency functions of the Comptroller of the Currency to the appropriate bureau of the Treasury.

12. Transfer the functions of the Comptroller of the Currency relating to the supervision of credit unions in the District of Columbia to the Farm Credit Administration.

13. Transfer the functions of the Comptroller of the Currency relating to the supervision of building and loan associations in the District of Columbia to the appropriate authority in the Home Loan Bank System.

14. Transfer any funds related specifically to a particular function to the agency to which the function is transferred.

15. Abolish the Bureau of the Comptroller of the Currency, the Office of the Comptroller of the Currency, and the Office of the Deputy Comptroller of the Currency and terminate all authority of the Secretary of the Treasury relating thereto except as to currency functions.

With an Order along the foregoing lines as a foundation the necessary administrative steps could follow in due course. Very few changes in personnel and salaries would be necessary at the beginning and the question of how much expense should continue to be borne by the Federal Reserve System and how much should continue to be borne by the Federal Deposit Insurance Corporation could be studied carefully before making any major change in the distribution of expenses. In short, the plan could be worked out as a long-term over-all program thereby avoiding the chaos and confusion which might result from making drastic and immediate changes under the mandate of an all-inclusive Executive Order. At the same time, the broad final purpose of merging and consolidating the personnel and work under common control could be fulfilled. Nominally the two agencies would continue as two separate entities, but practically they would be operated as one.

Further to implement the program, the Board of Governors could arrange for the erection of an addition to the Board's building, for the joint occupancy of the expanded quarters by the staffs of the two agencies, and for the occupancy of private offices in the quarters of the Board of Governors by the directors of the Federal Deposit Insurance Corporation. There is at present a vacancy in the membership of the Board of Governors which could be filled as an incident to the program.

As to the matter of savings to the Government, it is to be noted that the Federal Reserve System is supported by its investments, the Federal Deposit Insurance Corporation is supported by its investments and assessments upon insured banks, and the Comptroller of the Currency, with the exception of approximately $250,000 of appropriated money, is supported by assessments upon going and insolvent national banks. Consequently, the initial savings in dollars to the Government might seem negligible but it is quite obvious that ultimately reductions in general administrative expense would be very substantial. Furthermore, there would be substantial savings to the banking system but the real value of the program should be measured in terms of the increased efficiency and effectiveness of Federal banking supervision which would result.

Poor Management -

1. Bottlenecks - Will not delegate authority or responsibility. Wants all work of any importance to clear over his desk.

   (Examples: Memoranda circulated from time to time reminding lawyers to "keep him informed", last being about three weeks ago. Memo to division heads occasioned by Pollard asking Bauman to meet visitor in his office. Complaint to Dreibelbis about not being informed of Knoke's and Logan's visit for informal discussion with Treasury. Memo to Gov. Ransom about participation in conference on procedure to enforce Regulation W.)

2. Suspicious and jealous of men doing any work.

3. Unnecessary paper work.

4. Loses temper and is overbearing with employees.

   (Example: Envious when Regulation W was being rewritten. Also Pollard incident referred to above.)

5. Lodges unnecessary discretion in Miss Dyer, with result that her attitude toward men in office is bad.

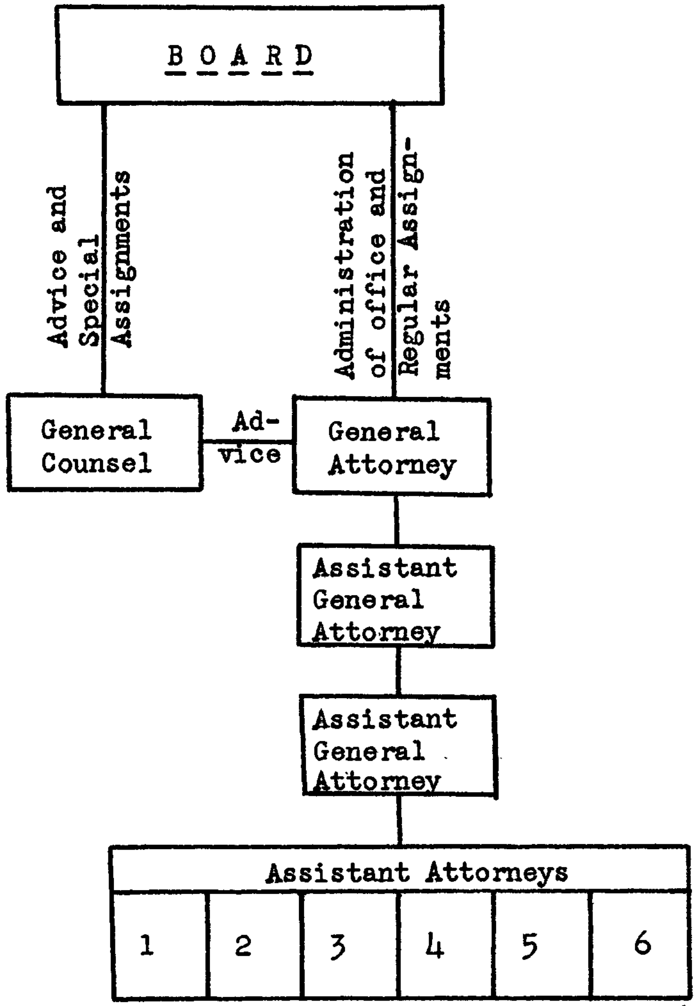
Poor Judgment -

1. Cannot appraise importance of question. Exaggerates importance of minor questions.

   (Example: "Rush" memos and "Urgent" memos.)

Poor Public Relations -

1. Offends representatives of other agencies.


BOARD
Advice and Special Assignments
Administration of office and Regular Assignments
General Counsel
Ad-vice
General Attorney
Assistant General Attorney
Assistant General Attorney
Assistant Attorneys
1
2
3
4
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