NEWS RELEASE

FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON 25, D. C.

Telephone: EXecutive 3-8400
Extension 226

FOR RELEASE TUESDAY A.M.
September 18, 1962

BANK SUPERVISION AND EXAMINATION AT THE FEDERAL LEVEL: ISSUES AND POLICY PROBLEMS

Address of

ERLE COCKE, SR., CHAIRMAN

FEDERAL DEPOSIT INSURANCE CORPORATION
Washington, D. C.

at the

ANNUAL CONVENTION

of the

NATIONAL ASSOCIATION OF SUPERVISORS OF STATE BANKS

at

Bretton Woods, New Hampshire

September 18, 1962

In the beginning, I wish to state that the comments which I will make are my individual thinking. This talk has not been discussed with either of the other members of the Board of Directors of the Federal Deposit Insurance Corporation.

BANK SUPERVISION AND EXAMINATION AT THE FEDERAL LEVEL: ISSUES AND POLICY PROBLEMS

Supervision of banking today is vested in three federal agencies and authorities in 50 States as well as two other areas (Puerto Rico and the Virgin Islands). The much heralded and highly regarded dual banking system is, in reality, a plural banking system, for each State, along with the chartering authority for national banks, has its own laws, regulations, procedures and standards. Partisans of tidy structural patterns take delight in criticizing the differences and conflicts inherent in such a system of multiple authorship and authority; and I am not among those who hold that no improvements can be made. However, in our discussion of possibilities for change, we must never overlook what I take to be axiomatic; namely, that in the nearly hundred years of its existence, our plural banking system has convincingly proven its genius, and changes in our banking laws must proceed from the premise of the inviolability of this system.

Diffusion of Authority

Problems stemming from the diffusion of bank supervisory authority between State and federal agencies are admittedly difficult. Attempts to cope with them have so far been voluntary and extra-legal in nature. For example, a report on bank examinations made to the Secretary of the Treasury in 1934 recommended that, "Immediate steps should be taken to consult with the bank supervisory authorities in each of the States with a view to obtaining their cooperation in coordinating Federal and State supervision of banks through the adoption of uniform policies

(more)

and forms and elimination of duplication in examination."

From the time of its establishment the Federal Deposit Insurance Corporation has steadfastly adhered to a policy of cooperation with the other bank supervisory authorities in attempting to solve problems of mutual concern. Drafts of bills formulated by the Corporation to provide for cooperation between State banking authorities and the Corporation in making examinations and in exchanging information with regard to insured institutions were included among the proposals submitted for consideration by State legislatures in 1934 and 1935. By the close of 1935 the objectives of these proposals were achieved by State legislation or other arrangements in a total of 32 States. Subsequently there has been a continuing effort to improve and add to these arrangements.

Another significant cooperative effort by the Federal Deposit Insurance Corporation, together with the other federal agencies and the representatives of the State bank supervisors, was the Procedural Agreement as regards guiding principles to be observed in bank examination work. Designed to implement some of the important lessons of the early 1930's, this Procedural Agreement, formalized in 1938, and still quoted frequently in financial publications, covered questions of asset valuation and classification, as well as determinations with respect to capital and the establishment and maintenance of reserves for losses. Revised in 1949, the Agreement now would benefit from further consideration by the supervisory authorities because of recent and prospective developments in banking.

Experience with State-federal cooperative efforts has taught that coordination of bank supervision has many facets and demands a continuing effort by all of the participants. For example, there is a gunuine need for agreement

(more)

among the State and federal authorities on the essential elements of a uniform banking code as well as a persistent effort to keep such a code up-to-date. Needed also is some permanent machinery for consultation that will facilitate the adoption of uniform policies, procedures, report forms and practices, on a national basis, for a regional group of States, or an individual State.

Problems resulting from the diffusion of authority among the federal agencies are likewise amenable to treatment and do not require wholesale surgery. The bank supervisory powers and duties of the three agencies, viz., the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation, can be reorganized and integrated into a structure that is better adapted to the current situation. Proposals to centralize supervisory authority in a single agency have certain weaknesses, but deserve serious consideration along with other plans. A clear-cut decision concerning the structure that will best serve the public interest is needed to clarify the atmosphere of supervision.

Examination as a Tool of Supervision

The examination of banks and investigations by examiners with respect to proposed changes or additions in banking facilities constitute the principal means for implementing bank supervision. Bank examining activities include both visitation by representatives of the supervisory authority, who prepare a report of their finding and recommendations, and reporting by the bank--without visitation--on a standard information form.

Up to now, reports based on visitation have been the major tool of bank supervision. However, reports obtained without visitation offer great hope of adding substantially to the benefits already available from the use of these

(more)

fact-gathering devices. Properly designed reports may be expected to secure data which could be matched with information obtained on a visitorial basis, and processed by modern-day computers. Such an approach to bank supervision could reduce substantially the volume of costly field work and office review, and at the same time provide information not heretofore obtainable.

Recent developments in banking call for both new approaches and new methods in regard to the examination problem. For example, the size of banks and the complexity of their operations have increased tremendously over the past three decades. These changes in size and complexity impose a special obligation on the supervisory authorities to be vigilant for practices that may affect adversely the effectiveness of the traditional examination. The precise nature of the limitations on the value of the usual examination, and the consequences for bank supervision, are unknown. However, it seems doubtful that examination techniques designed for a banking system comprising many small units with few opportunities for specialization of work assignments are entirely suitable for giant banking organizations which can make effective use of highly skilled technicians. This is one of the many aspects of bank examination work that deserves further serious consideration.

Rapid change in the structure of banking is now being stimulated by a complex of forces. Among the many diverse elements included in this complex, one might mention the accelerated rate of population growth since the 1930's; the rural-urban migration, and the migration of city dwellers to nearby suburbs; the shift of population from the North and East to certain areas in the South and West; the tremendous expansion of industrial activity; and the related

(more)

increase in business volume. In addition to these environmental changes, it now appears that the automation of clerical tasks made possible by a host of recent electronic inventions will stimulate changes in banking organization and structure necessary to take advantage of cost-saving opportunities. For instance, legislation is now under consideration by the Congress of the United States that would enable banks to benefit from automated facilities through stock ownership in service corporations. These developments will have an important bearing on bank examination work as well as present insistent questions concerning branches, mergers and holding companies.

It is within this developing framework that the responsibilities of the different bank supervisory agencies may be reassessed. What do these changes imply for the traditional roles performed by the different agencies?

Supervision by the Federal Reserve

No one questions that the Federal Reserve System is chiefly concerned with monetary policy. Supervision of banking, including the examination of individual banks, is subordinate to this major responsibility. Accordingly, attention at the Fed is focused on pertinent information obtained from call reports and other special financial and business reporting programs regarding conditions in the entire banking industry or in its major segments.

Supervision by the Chartering Authorities

All of the States and the Office of the Comptroller of the Currency have the legal authority to charter banks, pursuant respectively to State and Federal laws. The power to approve or reject an application for entrance to this type of business, in accordance with varied and frequently rather general standards, represents the initial function of the chartering authority. In order to

(more)

evaluate charter applications, and to maintain compliance with laws and regulations, examinations are a necessary tool of the chartering authority. For example, a finding of noncompliance under law or regulation may require a decision to close a bank in financial difficulties, to require additional capital, or to strengthen management so that the bank will not drift into a position of weakness as a prelude to failure.

Supervision by Insurer

Like the chartering authority, the insurer is concerned with the condition of individual banks. The right of the insurer to select or reject a risk, and its right of inspection and examination whenever necessary, are essential ingredients of a successful insurance operation. Accordingly, the Federal Deposit Insurance Corporation should continue to periodically inspect its risks so that the hazards of deposit insurance may be contained within the limits of reasonable calculation. Mere technical authority to examine is not sufficient; the inspection and examination of the insured banks by the Corporation is a duty it owes to the depositors and to the public.

Lest it be forgotten, the catastrophe hazard inherent in deposit insurance is worthy of emphasis. To be sure, the banking community and the federal and State governments have taken many steps to reduce this hazard by such means as improving the skills of bank management and personnel, the banking legislation of the 1930's, the Employment Act of 1946, and improvements in the extent and quality of bank supervision. Moreover, the Federal Deposit Insurance Corporation has sizable resources to validate its obligation to depositors in the insured banks. It is true that when the financial troubles of business generally,

(more)

as well as individual banks, reach the dimensions of serious monetary problems that are nationwide in scope and character, the responsibility rests with the Federal Reserve rather than the Corporation; should the situation be such as to affect the security of the nation, "all government" must become involved. But short of such catastrophe, the integrity of Federal deposit insurance is vital to a viable banking system.

Failure of an insured bank to meet its obligation to depositors in the ordinary course of business is the event that triggers action by the Federal Deposit Insurance Corporation to protect these depositors. The Corporation does not have control over the time or the occasion when it may be called upon to furnish this protection, since the power to close a bank is in the hands of its directors and the chartering agency. Thus the call for performance on the insurance obligation may sound at any time and without warning. Like any other insurer, the Corporation is entitled to safeguards. For the Corporation, this means the authority to determine, without hindrance or limitations, the risk with respect to each insured bank by periodic examination, including the investigation of proposals as to banking management and facilities.

Owing to the need for inspection by the deposit insuring agency as well as the bank chartering authority, alternating examinations by each agency would seem to be the best way to satisfy their respective needs. Moreover, the experience of the Corporation shows that a maximum of one examination each year is sufficient for its purposes, except in unusual or emergency circumstances. The advantages of alternating bank examinations have been demonstrated by the Corporation's experience in cooperating with State examining authorities. Such a procedure brings fresh eyes and new minds to the task of inspecting

(more)

and examining the activities of each bank. In virtually all cases, alternating examinations have proved to be better than joint or concurrent ones.

Suggested Changes in Supervisory Structure

Taking into account the considerations and developments mentioned so far, certain improvements in the existing structure of federal bank supervision may be suggested. Experience with deposit insurance has emphasized the importance of maintaining a spearation between the chartering and the insuring agencies. Likewise, the diffusion of supervisory authority has emphasized the need for coordinate but separate inspection of banks. Alternate examinations would entail minimum changes in long-established arrangements and at the same time correct serious defects. So viewed, they are consistent with the history of bank supervision; they recognize both the lessons of experience and the obstacles to change in a real world.

Adoption of alternate examinations would not greatly disturb the alignment of responsibilities of the three Federal bank supervisory agencies. The Federal Deposit Insurance Corporation would examine each insured bank at least once each year, and would investigate, concurrently with the chartering authority, all proposals as regards banking facilities and personnel. Some reduction in work load appears realizable if the Corporation were to alternate its examination with the State examining authorities in the case of State banks, and the Comptroller with respect to national banks. The examining authorities could exchange copies of each examination report. Furthermore, reports would be available to the Federal Reserve for informational purposes both on individual banks and in the form of aggregate data.

With respect to national banks, the Office of the Comptroller of the Currency in the United States Treasury Department would continue its powers

(more)

and responsibilities as the bank supervisory and chartering authority. The Comptroller is now required by law to make two examinations in each calendar year. One of these examinations, however, may be waived in a two-year period. This requirement could be modified by authorizing one regular national bank visitorial examination annually. Such an examination together with a regular examination each year by the Federal Deposit Insurance Corporation would give the desired examination coverage. Thus, representatives of both the chartering and the insuring agency would have a recurring opportunity to inspect and report on each bank's condition and performance under the applicable laws.

Given the orientation of the Federal Reserve, which is chiefly concerned with problems of broad national interest regarding money and credit and related matters, that agency does not need to engage in such operations as bank examination work. At various times officials of the Federal Reserve System have indicated their desire to be relieved of all duties extraneous to their fundamental responsibility of performing the functions of a Central Bank. In at least one instance an outstanding official of the System has stated that transfer of the examination and supervisory functions of the System to another agency "would relieve the Federal Reserve System of a great deal of work, which, while important, is not essentially interrelated with its primary function of regulating the supply of money and credit." However, each of the 12 Federal Reserve Banks requires a limited number of qualified examination personnel to review reports and--if needed in specific or emergency circumstances--to exercise visitorial powers.

Since the cost of examination work is an operating expense chargeable

(more)

against income from assessments for deposit insurance--not a proper expenditure of funds appropriated by the Congress for purposes of government--the Federal Deposit Insurance Corporation would defray the expense of one examination each year for both national and State banks. A saving of at least one-third and possibly more of the work load would result if the Office of the Comptroller of the Currency examined each national bank annually and received the Corporation's report in place of a second examination. This saving would make possible a reduction in statutory examination fees levied on national banks. Furthermore, in many States such an arrangement would tend to place national and State chartered banks on the same basis with respect to charges for examinations, and when entirely coordinated, would bring about savings in examination costs for State banks, realizable perhaps during the first full year of operation under the plan. As heretofore, each bank would carry the cost of the examination as provided by the law applicable to the chartering authority--either the State supervisor or the Comptroller of the Currency.

If it were to undertake the task of examining insured banks chartered by the Comptroller of the Currency, the Federal Deposit Insurance Corporation could draw upon its background of successful experience in working with State chartering authorities in bank examining activities. Certainly there should be no more basis for conflict resulting from the examination of national banks by an insuring agency than has been experienced with the States that are likewise chartering authorities. Already the FDIC examines regularly all insured nonmember State banks (a majority of all banks), and without cost to the respective States or banks.

(more)

Proposals to centralize federal bank supervisory authority in one agency are designed to achieve operating economies and standardization of examination procedures. Reasonable men may disagree concerning the effects which centralization of bank supervisory authority might have on the dual banking system. It seems to me likely that many of the presumed advantages, including operating economies, could not be realized. Such proposals also ignore the fact that the chartering authorities and the Federal Deposit Insurance Corporation as an insurer of bank deposits should have separate bank examination powers. Safeguards against the improper use of supervisory authority or the adoption of unwise policies could be weakened by too much centralization. Changes in our banking structure are now overdue; but let us not be too drastic in our pursuit of the dramatic, nor reckless of our priceless heritage.

####