FEDERAL DEPOSIT INSURANCE CORPORATION
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Address of

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Before the

23rd ANNUAL CONVENTION OF THE NATIONAL ASSOCIATION OF BANK
AUDITORS AND COMPTROLLERS

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ADDRESS OF MR. H. EARL COOK, DIRECTOR, FEDERAL DEPOSIT INSURANCE CORPORATION, BEFORE THE NATIONAL ASSOCIATION OF BANK AUDITORS AND COMPTROLLERS

BALTIMORE, MARYLAND OCTOBER 23, 1947

"A CHALLENGE FOR THE BANKS"

Mr. Burbett, members of the association, and distinguished guests:

It is a distinct pleasure to be with you in Baltimore this morning and to see how splendidly your convention is getting under way. It is evident from a glance at your program that you are met for serious study and discussion, and not for a vacation. Your purpose is commendable and I am sure that your achievment will be profitable.

I was particularly happy at the invitation to address you because it reaffirmed the mutual interests of your association and Federal Deposit Insurance Corporation. Our relations and cooperative efforts have been responsible for some of the major improvements in bank accounting and supervisory techniques during the past thirteen years. Witness the development of uniform reports of condition and of earnings and dividends on the supervisory side and the writing and publication of your own NABAC manual in 1943. I can assure you that we value this relationship very much and that you may consider the facilities of Federal Deposit Insurance Corporation always at your disposal when they can be helpful in solution of our mutual problems.

In casting about for some description of the sort of group I would be addressing today, I was told by one of our Federal Deposit Insurance Corporation men who has worked closely with you since the Corporation was organized, "They are a swell gang—hard-working, intellectually curious, and able practitioners. But they haven't forgotten how to have a little fun when the day's work is done. In fact, theirs is the only bankers convention to which I would willingly pay my own travelling expenses."

That was a high tribute coming from one who had attended conventions of all segments of the banking industry in all sections of the country. But I was a little sceptical of his enthusiasm. I had read recently Elbert Hubbard's old definition of an auditor, and I didn't know which opinion I should give more credit. Mr. Hubbard, you may recall, said that "The typical auditor is a man past middle age, spare, wrinkled, intelligent, cold, passive, non-committal, with eyes like a codfish, polite in contact, but at the same time unresponsive, cold, calm, and damnably composed as a concrete post or a plaster of paris cast; a human petrification with a heart of feldspar and without charm of the friendly germ, minus bowels, passion, or a sense of humor. Happily, they never reproduce, and all of them finally go to Perdition."

After seeing you gentlemen at work and at play I am happy to report that I share my associate's judgment, and that I should like to be able to demonstrate to Mr. Hubbard that the breed has changed considerably since he wrote his definition.

We of the Federal Deposit Insurance Corporation like to think that a new era of banking was ushered in by the Banking Act of 1933. Today there are nearly 13,400 commercial banks and trust companies and 200 mutual savings banks whose deposits are insured by the Federal Deposit Insurance Corporation. These institutions constitute 92 percent of all the banks in the nation and hold 95 percent of all the deposits which, as of June 30, 1947, amounted to 155 billion dollars.

As you have heard, we are now well into the fourth year in which there has not been a bank receivership or a loss to a single depositor in this country. This marks an all-time record in the nation's history for bank solvency, stability, and safety.

The fine record of banking in recent years is gratifying to all of us, I am sure, but it would be a mistake for us to rest on our oars. Knowledge of past mistakes, alertness to new developments, and foresighted planning all are necessary if this fine record is to be extended on into the future. We in supervisory capacities are doing all we can in these respects, and we try constantly to encourage bankers to plan for the future and to provide against contingencies.

The nature of our problems is changing constantly, and it is the very fact of this constant change that makes research and planning so essential. Perhaps I can best illustrate my point by reviewing our own experience in Federal Deposit Insurance Corporation.

Since its inception, Federal Deposit Insurance Corporation has protected 1,319,000 depositors in 401 closed insured banks. Of their $509,000,000 of deposits, 98 percent were made available immediately without loss to the depositors.

In the nearly 14 years of its operation, the Corporation has promptly paid $87,000,000 in the 245 insured banks that have been placed in receivership. More than 330,000 depositors in those institutions were completely protected.

By authorization of the Banking Act of 1935, the Federal Deposit Insurance Corporation exerts every effort to forestall failures by aiding the merger of weak insured banks with stronger institutions. There have been

156 such mergers, with the Federal Deposit Insurance Corporation disbursing some $176,000,000. The advantages of this type of action are that all depositors are fully protected and that there is no interruption to banking service in the community. The successor, or absorbing bank takes over all sound assets of the weak bank. The difference between the amount of these sound assets and the deposit liabilities assumed by the continuing bank is paid promptly in cash by the Federal Deposit Insurance Corporation. The advantages of this latter technique, when it is made more flexible to care for situations where there is only one bank in a town or where existing competitors will not assume liabilities and assets are obvious. It is the logical vehicle for depositor and community protection, in our opinion, and will be used wherever possible.

In the early years of its operation, the Corporation was forced by circumstances to devote the major part of its attention to bank assets. Despite the more than one billion dollars of RFC capital poured into the banks and despite the millions of dollars that were absorbed through stockholders' assessments and deposit waivers in the early thirties, there were still on our bank's books hundreds of millions of dollars of assets that were worthless or substandard when Federal Deposit Insurance Corporation began operations. During the first two years of its existence, after calm appraisal became possible, the Corporation devoted its energies to locating and analyzing concentrations of these unsatisfactory assets throughout the banking system. As soon as authority was granted by the Banking Act of 1935, the Corporation moved immediately, in conjunction with State bank supervisors and the Comptroller of the Currency to clean up those concentrations of deadwood.

Meanwhile, and again in conjunction with supervisory authorities, we set about preventing deterioration in assets that were then acceptable or that subsequently were to be acquired. We began, as you will recall, with requirements that charge-offs or valuation allowances be taken care of out of current earnings before stockholders' dividends were declared. Then, in a series of conferences culminating in 1938, supervising authorities reached agreement on improved methods of asset appraisal and classification which were designed to reflect intrinsic worth and to minimize the effect of day-to-day market fluctuations. Theretofore, it was common practice for supervisors to characterize one category of assets as "slow". The revised standards called upon examiners to classify assets basically in terms of relative credit risk. In addition, a fundamental change was made in supervisory appraisal of bond investments. For issues of investment merit valuation at market was abandoned and cost, less proper amortization, was substituted. These changes may fall short of perfection, but they are advances in supervisory methods that will help to make our banking system work in an era of economic change.

Then came the war and its upward pressure on prices, which enabled many banks to salvage something from assets that previously had appeared to be worthless. Parenthetically, I must say that the wartime boost in prices, in addition to helping the banks, was a great factor in the recovery record of the Federal Deposit Insurance Corporation on its outlays for protection of depositors. I shall cite that record later.

So, through earnings and through asset appreciation, the banks were able to streamline and to modernize their pouches and their portfolios.

They benefitted and we at Federal Deposit Insurance Corporation drew a few deep breaths in the knowledge that another housecleaning had taken place.

There currently is a sharp uptrend in banks on the so-called risk assets. Real estate loans increased more than a billion dollars between December 31, 1946 and June 30, 1947. Commercial and industrial loans continued to rise, gaining $750,000,000 during the six months. Consumer loans grew 21 percent during the six months and the rate of growth will accelerate with the demise of Regulation W on November 1.

We at the Federal Deposit Insurance Corporation regard this trend as healthful, rather than ominous. We think it highly desirable that banks assume risks, so long as they charge rates commensurate with the risks and so long as they make adequate provision out of earnings for that portion of the risk which is likely to materialize. We have urged special care on the part of bankers in extending real estate loans at present inflated prices; we have urged that, even with the abandonment of Regulation W, banks continue to require high down-payments and shorter periods of amortization. Since bankers associations almost unanimously have echoed these sentiments, we have little fear of a sudden flight into the "Never-never Land" of uncontrolled inflation by our banks.

Those factors I mentioned before—knowledge of past mistakes, alertness to new developments, and foresighted planning—all are working against the excesses which characterized previous periods of banking difficulty. In addition, we have vigorous and united supervisory agencies working to detect and arrest the development of any dangerous trends in bank assets. Finally, we have in Federal Deposit Insurance Corporation both a record of achievment that makes depositors confident in their security and a potential four-billion dollar reservoir that should allay their fears about any mistakes of judgment you bankers or we in Government might make.

In short, the bank asset problem was brought to check ten years ago, and still is under control.

Mistakes in the judgment of bank lending officers have become less frequent, but there still is in plentiful supply that "glue on the fingers" aspect of human frailty that makes so important the work of you men in your banks.

It is not hard to see why we at Federal Deposit Insurance Corporation agree with your association's slogan "The better the auditor, the safer the bank". In many cases in which we have been called upon to help depositors in the past peculation by trusted officers and employees of the banks in amounts that exceeded the bank's capital and its surety coverage have been the direct cause of difficulty. With assets in good condition and under constant supervision, this source of loss will continue to be our greatest concern.

It is impracticable for a bank examiner, even in very small banks, to make anything like a complete audit during the course of a regular examination. A certain amount of audit procedure is followed and, as a rule, the smaller the bank and the less chance it has for introducing systems of internal audit control, the further the bank examiner's audit is carried. The examiner's chief concern, however, is to induce bank management to set up adequate internal controls and, in every case where the bank is large enough, to establish an independent auditing department, During the ten-year period following enactment of the Banking Act of 1935, more than 1200 irregularities were reported to prosecuting authorities by Federal Deposit Insurance Corporation examiners. These did not include irregularities found and reported by examiners of the other agencies. They ranged from nominal amounts to amounts big enough to bring about insolvency.

The two principal safeguards against these peculations are, of course, ample fidelity coverage and a well organized audit control designed to discourage employees from taking chances. The Federal Deposit Insurance Corporation is empowered by law to require all insured banks to maintain adequate fidelity coverage. The law gives the Corporation the right, in the case of a bank which refuses to provide adequate coverage, to purchase such coverage for the bank and to add its cost to the bank's Federal Deposit Insurance Corporation assessment. We have preferred so far, however, not to resort to this expedient but rather to rely upon the cooperative efforts of all State and Federal bank supervisory authorities to sell banks on the wisdom of full insurance protection against all types of losses. The results of these efforts during the past ten years have been gratifying, but there are too many banks that are carrying inadequate surety coverage, even at the reasonable rates prevailing today.

To further minimize the effects of "Human Frailty" I believe that every bank should provide its employees with "shock absorbers" against the more common financial emergencies that are likely to overtake salaried people. I am thinking of such things as group health, accident and life insurance and group hospitalization for employees and their families.

This sort of protection can be carried at very reasonable rates, especially when its cost is shared by the bank and its employees, and its use would certainly remove one of the most common causes for stealing.

I believe also in the establishment of retirement plans for bank employees. There are very few banks where such plans can not be financed without too great a drain on earnings. Equitable promotion plans are another safeguard against rebellious wrong-doing. If every employee feels that his chances of promotion are just as good as those of his co-workers, he will have much more incentive to make the bank his lifework and much less temptation to steal what he thinks he never will be able to get rightfully.

In this connection, I recommend to your attention the booklet "Safeguards Against Human Frailty", written by Vance Sailor, Chief of the Corporation's Division of Examination, sections of which I have paraphrased above. Colonel Sailor cites book, chapter, and verse on some of the cases that have caused the Corporation financial outlay during recent years and suggests remedies that you, as well as we, should urge upon the banks that have dealings with you and that come to you for advice.

Your association has done admirable and extremely valuable work in setting up standards of internal audit control for small banks that cannot afford a complete auditing department. You may be sure that we appreciate your efforts and that we shall do everything we can to help you spread the gospel.

In addition we must urge that fidelity and other insurance be provided in amounts sufficient to protect banks against all insurable hazards. In this connection, the "fair" coverage recommended by the

Insurance and Protective Committee of the American Bankers Association will be our goal.

May I congratulate your association, also, upon its steady and valuable interest in research on banking problems. Under your officers and Mr. Vogel your group has heeded well its slogan that "The biggest room in the world is the room for improvement." I urge that you continue and develop and encourage this interest in finding newer, better, and safer ways of doing things in the banking field. As I said earlier, any aid we can give you in your research activities will be given readily.

Now, lest you think me presumptuous to be telling bankers how to manage their businesses, I had better give you briefly a few facts about how Federal Deposit Insurance Corporation has been getting along. Since you are the fellows who have to fill out the rather complicated assessment reports twice a year, I am sure you will have more than an academic interest in where your money is going.

As I said earlier, the Corporation has been called upon so far to protect 1,319,000 depositors in 401 closed banks, holding $509,000,000 of deposits.

Of the $306,000,000 advanced by the Corporation in these cases, our ultimate losses are estimated to be not more than $26,000,000. That represents 8% of the advances, and 5% of the deposits that were protected.

Operating expenses of the Corporation for the entire thirteen and a half years of its operation amounted to only $49,000,000.

During those thirteen and a half years insured banks paid in as assessments $728,000,000. Our surplus (exclusive of capital) on June 30, 1947, was $844,000,000.

By authority of an Act of the last session of Congress we repaid to the United States Trueasury on September 9 this year more than 146,700,000, representing more than half of the original capital subscribed to the Corporation by the Treasury and the twelve Federal reserve banks. We anticipate that the remainder will be repaid during the next eighteen months in amounts that will not bring our net worth below one billion dollars.

With a net addition to surplus of nearly $120,000,000 over assessments and after expenses and deposit insurance losses during thirteen and a half years, I think it safe to say that the Corporation not only preaches good management, but practices it.

But I should not be talking too long about success in the abstract. Success to me is a personal attribute, well exemplified by you men here today and best defined, I believe, by Robert Louis Stevenson, who said, "The man is a success who has lived well, laughed often and loved much; who has gained the respect of intelligent men and the love of children; who has filled his niche and accomplished his task; who leaves the world better than he found it, whether by an improved poppy, a perfect poem, or a rescued soul; who never lacked appreciation of earth's beauty or failed to express it; who looked for the best in others and gave the best he had. His memory is a benediction".

Gentlemen, I salute you and thank you.

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