"History + Objectives of F.D.I.C."

ADDRESS OF MR. H. EARL COOK, DIRECTOR, FEDERAL DEPOSIT INSURANCE CORPORATION BEFORE GROUP VI, PENNSYLVANIA BANKERS ASSOCIATION

ALTOONA, PENNSYLVANIA FEBRUARY 12, 1948

Mr. Chairman, Ladies and Gentlemen:

It is ever a pleasure for a man from Ohio to come knocking on the door of its neighbor State, Pennsylvania, and find so cordial a welcome. I appreciate your kindness, and I am happy that Mr. Harl and I could be here today to share in your discussions of the problems that currently confront us in the business of banking and its corollary, bank supervision.

There could be no more timely or germane gatherings than this. So much is happening these days that affects the business of bankers that we have difficulty in keeping up with the news, to say nothing of the task of trying to anticipate and to plan for what contingencies tomorrow might bring.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

In this day of change and uncertainty, it is a pleasure to come to you as representative of an agency of the United States Government that for over fourteen years has been the symbol of stability and security. We in Federal Deposit Insurance Corporation are proud of our affiliation. We feel that the banks of the Nation, the business world, and--above all--the bank depositors have, at least partially through our efforts, come to know and to enjoy some confidence that savings and working capital will not be tied up to their detriment and that of the whole economy.

With your indulgence, ~~I should like to~~ quote an editorial that appeared recently in a New England newspaper. Headed "Your money is Safe", it goes on to say, "It is reported that about $75,000 is missing from a nearby bank, and yet depositors are calm and collected. If worst comes

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

to worst, they know they will collect from the Federal Deposit Insurance Corporation.

"One remembers the doubts expressed when the FDIC was created. It was a departure from previous concepts and, as such, to be viewed with misgiving. The viewers with alarm were half right. It was a radical step but a step in the right direction. Its only effect has been its intended one--to make people's money safe. There may be a lesson in this for people who believe on principle that all new ideas are necessarily bad."

As an operating banker, and as Superintendent of Banks in Ohio, I had ample opportunity to become acquainted with the operations and the philosophy of Federal Deposit Insurance during its formative years. It was a real honor when President Truman asked me to serve on the Board of Directors

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

of the Federal Deposit Insurance Corporation. During my tenure--brief as it has been--I have become an enthusiast both for the job that the Corporation is doing and for the people it has assembled to do that job. Mr. Harl's long experience in banking and in bank supervision fit him admirably for his post as Chairman of our Board. Mr. Delano, Comptroller of the Currency and third member of our board, is likewise a man of long experience in finance and in supervision of financial institutions.

"History and Objectives" may be a trite title to give to one's remarks, but I shall try to give the history in brief form and to compress the objectives.

We of the Federal Deposit Insurance Corporation like to think that a new era of banking was brought in by the Banking Act of 1933. Today there are nearly 13,400

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

commercial banks and trust companies and 200 mutual savings banks whose deposits are insured by the Corporation. These institutions comprise 92 percent of all the banks in the Nation, and they hold 95 percent of all the deposits which, as of June 30, 1947, amounted to 155 billion dollars.

In the more than 14 years of its operation, the Corporation has promptly advanced $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 159 such mergers, with the Federal Deposit Insurance Corporation

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

disbursing some $176,000,000 to protect an additional 1,000,000 depositors. 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.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

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 banks' books hundreds of millions of dollars of assets that were worthless or substandard when the 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

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

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

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

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

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

for protection of depositors. I shall cite that record later.

So, through earnings and through asset appreciation, the banks were able to greatly improve the quality of their assets. 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 accelerated with the demise of Regulation W on November 1.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

We think it highly desirable that banks care for legitimate credit needs of their customers 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 regard as absolutely essential, for protection of both lender and borrower 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 are hopeful that uncontrolled inflation will be discouraged by our banks.

Knowledge of past mistakes, alertness to new developments, and foresighted planning--all are working

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

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 achievement that makes depositors confident in their security and a potential four-billion dollar reservoir that should allay their financial worries.

In short, the bank asset problem was brought to check ten years ago and we hope to keep it under control.

Errors in judgment by 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 impracticable for a bank examiner, even in very small banks, to make anything like a complete audit

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

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. Responsibility for internal safety lies squarely with bank management, and it cannot be ignored.

W. Hannegan - comment

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

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

agencies. They ranged from nominal amounts to amounts large 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 chosen 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

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

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. Comment here - protection to stockholders equity

To further minimize the effects of "Human Frailty" many banks have provided their 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.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Retirement plans for bank employees also have been established by many institutions. There are very few banks where such plans can not be financed without too great a drain on earnings. Equitable promotion plans are likewise a safeguard against rebellious wrong-doing. If every employee feels that his chances of promotion are just as good as those of his co-workers, based on industry, integrity and loyalty, he will have much more incentive to make the bank his life-work and much less temptation to steal what he thinks he never will be able to get rightfully.

I congratulate your association, upon its steady and valuable interest in research on banking problems. Under your officers 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

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

encourage this interest in finding newer, better, and safer ways of doing things in the banking field. 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 the progress of the Federal Deposit Insurance Corporation.

As I said earlier, the Corporation has been called upon so far to protect 1,324,000 depositors in 404 closed banks, holding $512,000,000 of deposits.

Of the $307,000,000 advanced by the Corporation in these cases, our ultimate losses are estimated to be not more than $25,000,000. That represents 8% of the advances, and 5% of the deposits that were protected.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Operating expenses of the Corporation for the entire fourteen years of its operation amounted to only $53,000,000.

During those fourteen years insured banks paid in as assessments $785,000,000. Our surplus (exclusive of capital) on December 31, 1947 was more than $900,000,000.

By authority of an Act of the last session of Congress we have repaid to the United States Treasury more than $~~196~~ 70,000,000 of the $289,000,000 original capital ~~original capital~~ subscribed to the Corporation by the Treasury and the twelve Federal reserve banks. We anticipate that the remainder will be repaid during 1948 in amounts that will not reduce our net worth below one billion dollars.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

With a net addition to surplus of approximately $115,000,000 over assessments and after expenses and deposit insurance losses during fourteen years, I think it safe to say that the Corporation not only preaches good management, but practices it.

The Board of Directors of the Corporation recommended to the Congress that it be permitted to repay the capital subscriptions of the Treasury and the Federal Reserve banks in order that any vestige of Government subsidy would be removed from the banking system of the Nation. We feel that the idea of deposit insurance requires the prestige of Federal creation and management to make it fully effective as a stabilizing influence. We are convinced, however, that the banking system is now sufficiently of age to carry its own financial load for

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

the protection of its depositors' funds except in case of extreme emergency. The function of the Corporation, as we see it, will be to act as trustee for a fund built up by all insured banks for the protection of all their depositors. Like any insurance company, we rely upon the right to examine our risks to minimize demands upon the insurance fund. We rely also upon improved bank supervision and enlightened bank management to keep losses at a minimum.

In furtherance of our objective of ending Government subsidy of the banking system, we have urged retirement of ~~bank~~ Preferred stock and debentures held by the Reconstruction Finance Corporation in every instance where this can be accomplished without lowering the ratio of capital to total assets.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The commercial banks emerged from World War II with assets over twice the pre-war total, while capital accounts were only about 25 percent larger. As a consequence, the ratio of capital to total assets declined sharply during the war period and the average now is substantially below the level which in former years was considered to be a safe minimum. The question of adequate capital did not receive much attention during the war, since it was felt that the banks should be free to purchase as many United States government bonds as might be necessary to finance our war effort. However, that condition no longer applies, and both bankers and bank supervisors must reexamine the entire question of the adequacy of bank capital.

Large scale reduction of the Federal debt and a rapid increase in the rate and amount of bank lending during

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

the past two years have altered the composition of banks' total assets in great degree, the net result being that there has been a sizable gain in the ratio of the so-called "risk assets" to total assets in most institutions. It is axiomatic that an increase in risk calls for an increase in the protection against risk--in this case steady and considerable augmentation of bank capital accounts is indicated.

In some instances the sale of new issues of bank capital stock is difficult these days. Sound banking and supervisory policy, therefore, must call for the establishment of adequate reserves against risk assets and for the steady plowing back of bank earnings into capital accounts. The time to save money is when we are making money. The banks are making money, and I urge that they set an example of

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

thrift and husbandry by judicious use of their earnings.

In conclusion, I cannot overemphasize the importance of the role that you bankers must play if we are to win the battle against inflation.

At the risk of oversimplifying a really complex problem, I should like to state as my fundamental belief that the banker can do two things that will retard inflation materially and that will contribute to earlier stability of our economy. These are: First, Bankers must lend only when the credit will increase available supplies of basic raw materials, increase plant capacity, or otherwise help production of needed goods. Second, Bankers must intensify their efforts to encourage savings on the part of their customers to absorb as much as possible of the increased purchasing power that is bidding for the goods and services

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

in short supply. These may seem small thumbs in the dike, but they are steps that will serve effectively as brakes until the full might and resources of the nation can be thrown behind a truly effective anti-inflation program.

The program outlined early this month by Joe Dodge, President of the American Bankers Association, and currently being elaborated through a series of meetings such as this, has the unqualified approval of the Federal Deposit Insurance Corporation, and I feel safe in saying that the federal and state supervisory agencies share this view.

Comment - market declines - may recur.

The soundness of our whole economy depends upon the soundness of its financial and monetary systems, and you men are the guardians of those systems, charged with responsibility for their health and their proper functioning. Sound bank management is never a simple task. Today it

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

requires more vision, more unselfish service, and more courage than ever before. The financial fate of our Nation rests in the hands of you men and your colleagues. I hope you will meet the challenge of inflation squarely and fight it with every weapon at your command. I am confident we can win the battle.

****

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis