

BANKING AND BANK SUPERVISION

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You are, I am sure, fully aware of my topic, but for emphasis I shall repeat it: "Banking and Bank Supervision." Not, "Banking versus Bank Supervision," or vice versa, which is apparently too generally the concept of not only bankers but of the public.

Our form of bank examination and bank supervision is peculiar to this country. This is quite natural, since it has grown out of our unique system of banking. Whether you prefer to call it the dual banking system or the free-enterprise-banking-system is not important. We like to think of it as both.

Only in recent years have other countries shown an interest in our bank examining processes. You might be interested to know that about four years ago an official of The Reserve Bank of India visited the United States to study the practices and procedures of our bank supervisory agencies. We were somewhat amazed to learn that there were more than 1400 independent banking units in India. This gentleman visited all of the Federal banking agencies as well as some of the State banking departments and took back to India with him many original ideas that he discovered here.

About two years ago Japan took steps to set up a system of bank examination and supervision and copied our pattern. The chief examiner of the Inspection Division, Ministry of Finance of Japan spent two months

in the United States this year studying the operation of our bank examining machinery. This gentleman made extensive visits to the Division of Examination of each of the three Federal banking agencies.

I mention this only for the purpose of emphasizing the fact that we were the first to recognize the wisdom and necessity for a system of bank examination and supervision to aid and promote our system of banking.

In the early days of our Republic each bank was chartered by special legislative enactment. Late in 1781 the Continental Congress of the 13 original States chartered the Bank of North America the main purpose of which was to furnish fiscal assistance for the conduct of the Revolutionary War. Subsequent to the adoption of the Constitution the Federal government - in 1791 - by a special act of Congress, granted its first bank charter to The First Bank of the United States. The life of the Charter was 20 years. In 1816 the Congress granted a 20-year charter to the Second Bank of the United States.

During this same period, of course, the several states were granting charters for the operation of banks. Each charter required a special act of the legislature. The advantage of a bank charter, naturally was the limited financial responsibility imposed upon each of the individual stockholders as compared to the unlimited liability involved in the operation of a private banking firm.

All of these early charters carried some provision for supervisory control by the chartering authority. The actual exercise of supervision, however, was for the most part non-existent or very loose. At the same time, the idea always prevailed that the chartering authority should have

the right to exercise certain controls.

Finally, in 1837, the State of Michigan set the pattern for our present day chartering practices for banks. A general bank chartering statute was enacted whereby a group of individuals desiring to establish a bank could do so by complying with the statutory requirements and receiving administrative approval. In other words, it was no longer necessary to lobby a bill through the legislature in order to secure the privilege of operating a chartered bank. The following year New York passed a similar law and other states followed in rapid succession. All of these laws provided for some form of supervisory control.

Following President Jackson's successful campaign to prevent the extension of the charter of The Second Bank of the United States, the Federal government remained out of the picture in bank chartering until 1863 when the National Bank Act became law. This Act, which was amended and improved in 1865, provided for the "free" chartering of banks by the Federal government and a definite program of supervision, including periodic examinations of National banks. This was the real beginning of bank examination and supervision as we know it today.

This brief review is intended to emphasize the fact that some form of supervision by the bank chartering authorities has been an integral part of our bank chartering system from its very beginnings. While the idea has persisted throughout the years, the concepts of supervision have undergone a gradual change from the original idea of a strictly policing job to the generally accepted concept of bank supervisors today that their most effective contribution to banking lies in the field of counsel and cooperation.

For several decades, however, the purposes of bank examination were regarded as being fully served by having an examiner visit each bank and determine from an inspection of the records that the bank was operating within the limitations imposed by law. In most instances, little or no attempt was made to appraise the quality of individual assets. In other words, if a loan came within the legal limits it was usually not questioned unless it was delinquent, perhaps to the extent of being subject to a classification as a statutory bad debt. There was very little coordination between the work of the individual examiners, and little or no follow up by the department head between examinations.

The original concept of bank supervision, therefore, was that an individual examiner should visit an individual bank for the purpose of policing it for violations of law - and little else.

It is interesting to observe the several steps in the evolution from that very primitive concept of bank supervision to the broader, more complicated, but undoubtedly more constructive concept that exists today. Generally speaking, some broadening - or tightening up, if you prefer to call it that - of the application of supervisory controls followed each major financial or general economic crisis. The most notable legislative example of this, since the enactment of the National Banking Act, are the Federal Reserve Act of 1913 and the Banking Act of 1933 as amended by the Act of 1935.

The last mentioned legislation has, of course, had the most profound effect on the present day thinking of bank supervisors as to their duties and responsibilities, the sphere within which each supervisory agency must operate, and the limitations imposed thereby.

The banking difficulties of the 1920's which culminated in the debacle of 1929 to '33 presented a challenge to bankers and bank supervisors alike. They had to prove to the public that our own unique independent, dual banking system could and should survive. State and nationally chartered banks realized that they perforce must dwell together in amity. Likewise, the various state and federal supervisory authorities recognized that without in any way surrendering their independent prerogatives, they must work closely together, if they were to make any constructive contribution to the future soundness of our banking system.

So out of all of this has come what I believe to be the consensus today of bank supervisors as to their duties and responsibilities both to the public and to the bankers. Perhaps I can summarize this in a few punch paragraphs, as follows:

(1) While it is universally recognized by the statutes, both state and federal, that the supervisor's primary responsibility is the protection of the interests of the depositors, he must necessarily be interested in the welfare of the bank and in its entirety because of

- (a) The economic disruption to the community as the result of a bank failure;
- (b) The loss to minority stockholders who have no real voice in the management and therefore are the innocent victims of misfeasance or malfeasance on the part of active management;
- (c) The reflection on the banking system as a whole and resulting loss of public confidence which is the aftermath of any bank failure.

(2) Bank supervision falls short of the mark when it limits its activities to the periodic examination of banks with no interim follow-up to obtain corrections of recognized unsatisfactory situations.

(3) Bank supervision oversteps its authority as well as the bounds of propriety when it attempts to usurp normal managerial functions.

(4) In seeking to obtain necessary or desirable corrections the supervisor should employ the techniques of reason and salesmanship and avoid wherever possible the exercise of police powers.

(5) The supervisor should strive to the utmost to discharge the responsibilities of his office in a fair and impartial manner, never lacking in courage to maintain the integrity of his office while at the same time studiously avoiding the imposition of arbitrary requirements not contemplated by law.

I believe this summarizes fairly the accepted concept of present day supervision. Being mere humans, and therefore subject to all of the accompanying frailties, we may frequently fall short of the ideals to which we subscribe, but I can assure you that all of the supervisors who come within my purview are genuinely trying to abide by these principles.

The second phase of my subject, namely, practical application of these supervisory concepts, very readily divides itself into two parts -

(1) The development of uniform examination procedures and supervisory policies since 1933; and

(2) The present day application of those procedures and policies.

In discussing present day standards of bank supervision, I

take 1933 as the beginning point because prior to that date there was very little coordination in supervisory practices as between the various supervisory authorities. As a matter of fact, we could very well take 1935 as the beginning date because no real progress was made until after the enactment of the legislation popularly referred to as the Banking Act of 1935, which became effective on August 16 of that year.

It is true that in 1934 the Secretary of the Treasury attempted to get the three Federal banking agencies together in their thinking on the appraisal of bank assets but very little immediate progress was made in the direction of uniformity. The Banking Act of 1935, therefore, was the actual jump-off point from which we have progressed to our present state of cooperation and high degree of uniformity in the field of bank supervision.

The Banking Act of 1935 prescribed the first statutory conditions to be met by banks desiring to participate in any Federal banking program - other than capital requirements based upon population as prescribed by the National Bank Act. The Federal Reserve Act of 1913 imposed on State banks desiring to join the Federal Reserve System capital requirements similar to those of the National Bank Act.

Notwithstanding the lack of specific statutory authority on any factor except capital, the Comptroller of the Currency had for a good many years exercised his general discretionary authority to grant or refuse a National bank charter by requiring a proper showing as to (1) the needs of the community for the banking facilities being sought, (2) the acceptable character of the people who were promoting the organization and (3) the adequacy of the proposed capital in

relation to the expected volume of business - the latter without regard to the basic population requirements. Many of the states had similar requirements written into their banking statutes prior to 1935.

The Congress, in recognition of the evils that had beset the banking system as the result of the free competitive chartering of banks as between the several states and the National bank department, followed the lead of the Comptroller of the Currency and laid down certain specific requirements which must be considered by the FDIC in admitting a State nonmember to the benefits of deposit insurance. It required both the Comptroller of the Currency and the Federal Reserve System to observe the same requirements in granting a charter to a proposed new national bank, or in admitting a State bank into membership in the System.

Another provision of the Banking Act of 1935 of equal or perhaps greater importance than the admission standards, is that which gives the FDIC the right to cite any insured bank, State or National, for continued unsafe or unsound practices or continued violations of law and to require their correction within 120 days. If the bank fails to make the required corrections within the specified period, further action may be taken by the Corporation leading to the termination of the bank's insured status. As I said before, this action may be taken against any insured bank, whether it be a National, State Federal Reserve member, or non-member insured bank.

The primary purpose of this provision of the law, is to bring about the correction of unsafe or unsound practices and/or violations of law and thereby restore the bank to a normal state of healthy

operation. In only a few of the most stubborn and recalcitrant cases has it been found necessary to carry the termination proceedings through to a conclusion. Furthermore, the FDIC and the appropriate State or Federal supervisory authority, through their joint efforts will have exhausted all corrective alternatives before recourse to this action. This is as it should be, because the very essence of the Federal Deposit Insurance Law is to keep banks open and the banking system healthy.

While there are several other provisions of the Banking Act of 1935 that are calculated to bring about higher supervisory standards and a higher degree of uniformity in the application of those standards, the three provisions I have just described are, in my opinion, the most important. This Act is my second Bible, and the more I read and study it, the more aware I am that, in its enactment, the Congress intended that bankers and bank supervisors should work together to prevent a recurrence of the dismal history of bank failures prior to the Banking Holiday of 1933.

The law, however, can only lay down general standards of behavior. No matter how well conceived a particular piece of legislation may have been, or how well it may have been drafted, in the final analysis, its effectiveness is dependent upon the degree of competence and honesty with which it is administered and the manner in which the bankers observe its spirit. So I shall turn now to the administrative and policy actions which have been taken since 1935 to implement the law.

The Corporation examines, in collaboration with the State banking departments, the 6,700 odd insured State banks which are not

members of the Federal Reserve System. Taking advantage of that provision of the law which gives the Corporation right of access to the reports of examinations made by the Federal Reserve and National Bank examiners, the Corporation has consistently reviewed the condition of all insured banks as reflected by their examination reports almost since the beginning of deposit insurance. Incidentally, but very importantly, we have also had the benefit of reviewing the reports of the State examiners, and in turn, have made copies of our reports available to the respective State authorities.

There is no point in reviewing an examination report just to see how well or how poorly the banker is conducting himself as of any one given date. Except in those situations where a single review discloses the bank to be in serious difficulty, no real value accrues from such reviews except by comparison with past performance. You bankers have long recognized that fact through the use of your comparative analysis cards on your principal borrowing clients. The FDIC decided in 1934 that what was good for the banker, could be of equal or more benefit to the Corporation in keeping up with its insurance hazard in some 14,000 banks. Our first comparative analysis card was hastily conceived and therefore somewhat crude. By 1937, we had developed our present card, Form 96, which has required little change since then.

In attempting to set up comparative analysis cards in the early days we encountered considerable difficulty because of the divergent methods of reporting by the Federal Reserve, National bank, and our own examiners. The divergence between the several States and

the three Federal agencies was even greater. In order to correct this situation, the Corporation, in 1936, undertook a plan to get the three Federal agencies together on a uniform examination report. After a number of conferences covering a period of several weeks the three Federal agencies agreed on a form of report that was uniform and mutually acceptable to the three agencies.

The next step was to solicit the cooperation of the State bank supervisors to adopt examination report forms similar to ours. We had a very ready response from the Executive Committee of the National Association of Supervisors of State Banks. Practically all of the State supervisors recognized, as we in the Federal banking agencies had, that there was need for change in the manner of reporting the findings made in examinations of banks. They welcomed our suggestions, and contributed many of their own which have proven to be of value. As a result, slightly more than half of the states are now using examination report forms identical in all practical aspects with those used by the Federal banking agencies. The report in its present form has been changed from time to time, but no change has been made without first consulting and receiving the approval of the State bank supervisors.

After adopting uniform examination report forms it followed logically that there should be an agreement on uniform standards for bank examiners to use in their appraisal of bank assets. A number of joint meetings looking to the attainment of this objective were held by the bank supervisory agencies during 1937 and 1938 and finally an agreement was adopted by the Federal agencies and the Executive Committee of the

National Association of Supervisors of State Banks which came to be known as "the uniform valuation method of appraisal of assets". Those of you who are interested in the details of the agreement will find it fully set forth in the FDIC Annual Report of 1938 as well as in the Federal Reserve Bulletin.

This agreement embodied two major changes in the then existing classification procedures. Both were designed to bring about the appraisal of bank assets on "continuing business" value, rather than on estimated liquidating values as of the date of a given examination. The economic set-back in 1937 had left many banks with substantial depreciation in their bond portfolios, both in investment grade and substandard issues. It was therefore agreed that investment grade issues should be appraised at amortized cost or book value, whichever was the lower and that the current market value yard stick would not be applied to such issues. Substandard bonds (below investment grade and above defaults) would be appraised at the average monthly market quotations for the past eighteen months, and one-half of any depreciation on that basis would be set up as doubtful - or III. Defaulted securities and stocks would be appraised at current market and any resulting depreciation would be treated as loss and charged off.

The second change resulted from a feeling in certain quarters that bank examiners were inclined to overclassify loans to intrinsically solvent borrowers when times became a little tough, either locally or nationally, and thereby accentuate the difficulties of both the bank and the borrowers. The old fashioned classifications of slow, doubtful and loss took it on the chin as being primarily responsible for these alleged

aberrations of judgment on the part of the examiners and were therefore replaced by the Roman numeral captions of II, III and IV, the purpose being to base the classification more on the intrinsic worth of the asset than on its liquidity.

There is no doubt that much good came from these discussions and the adoption of this agreement. First, it made all of us in the bank supervisory field conscious of the fact that each of us could not proceed blithely in his own jolly direction, but that we must pool our thinking and attempt to chart a common course. Second, it emphasized in our minds the fact that we must not necessarily regard the assets of a properly run bank as doubtful just because they had taken on a slightly jaundiced appearance as the result of a more or less temporary economic disturbance.

Many of us in the supervisory field were never enthusiastic about the Roman numeral captions. Classification II was particularly difficult for the banker to understand, but more importantly to us, definition of the caption was difficult for our examiners to interpret. Captions III and IV meant Doubtful and Loss, so why not just call names names? At the same time there was a reluctance to go back to the adjective caption of Slow. After a considerable period of negotiations, the Roman numeral captions were replaced in 1949 by the adjective captions - Substandard, Doubtful and Loss.

Another recent but minor change in the 1938 uniform agreement was the discontinuance of the practice of appraising group 2 securities on the basis of the 18-months average of market value. Such securities are now appraised at current market value. There has been no change with respect to evaluation of U. S. Government and other group I (investment

quality) securities at the lower of book value or amortized cost.

These revisions represent no fundamental change in the procedure followed since 1938 nor do they signify any intention on the part of the supervisory authorities to become more or less severe in the classification of bank assets. Their purpose is clarification and simplification of procedure in the interest of more uniform application. The use of the 18-months average price for group 2 securities is no longer of practical significance since the banks of the country have only a nominal investment in such securities. As to classifications I am sure you bankers now have a much clearer idea of what the examiner is driving at when he talks in the language of "substandard, doubtful and loss."

The Corporation, like other supervisory agencies, is fully aware that its examinations are only as informative and effective as its personnel and is striving constantly to develop its manpower material. It is conducting a rather comprehensive educational program for examiners and assistants. This program, which began in 1946, is designed to fit the particular needs of each participant and to supplement the training he receives on the job. Usually the program consists of correspondence study in courses given by the American Institute of Banking. In other cases, examiners or assistants are enrolled in residence courses offered through a college or university or by a local chapter of the AIB. In the latter group are included enrollees in the Graduate School of Banking at Rutgers University, and in Central States School of Banking at the University of Wisconsin. Approximately 75 percent of the examining staff were either enrolled in or had completed courses under the program by the end of 1949. The entire cost of the program is paid by the Corporation,

but all participants take the courses on their own time, frequently devoting their vacations to weeks of hard work.

In conclusion I am sure you will agree that The Concept and Standards of Bank Supervision have developed materially since the Banking Holiday and the Banking Act of 1933. Bank supervisors have grown greatly in stature; they have moved definitely away from the old idea of coercive police powers. Now it is universally recognized that the superior supervision is exemplified by the best salesmanship.

Permit me to emphasize that the well-run bank has nothing to fear from the bank examiner or his superior. We may have friendly and open discussions of controversial matters but never acrimonious differences of opinion. The banker who is at continual odds with the bank examiner should have a moving picture made of himself. Perhaps he will see that he is the only man in his company who is out of step!