

Dr. Cramer substituted.

ADDRESS BY THE HONORABLE H. EARL COOK, DIRECTOR, FEDERAL DEPOSIT INSURANCE CORPORATION, WASHINGTON, D. C., BEFORE THE BANKING SCHOOL, UNIVERSITY OF VERMONT, BURLINGTON, VERMONT

BURLINGTON, VERMONT

SEPTEMBER 12, 1951

STRENGTHENING THE BANKING SYSTEM

In times of peace, prepare for war. In times of prosperity, prepare for adversity. These admonitions might well serve as the keynote of my discussion.

Viewed as a whole, the banking system of our Nation does not appear to be confronted with any serious problems at this time. Since 1933 banking has cleared its decks of the wreckage left by the devastating depression-born storm of 1930-33 and is now in the soundest condition ever experienced. Bank assets and earnings have reached new all-time peaks and there has not been a single receivership of an insured bank since May 1944. From 1944 to June 30, 1951, only 16 banks required the financial assistance of the Federal Deposit Insurance Corporation. In each of these cases the banks which became involved in financial difficulties were absorbed by other banks in the neighborhood without the loss of one penny to any of the depositors. Truly this is a remarkable achievement and marks a new chapter in bank stability for our Nation.

This 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 our past errors, recognition of our present shortcomings, alertness to new developments, and farsighted planning are all necessary if this fine record is to be extended into the future.

If our banks are subjected to the same careful scrutiny that an inspector gives when grading a bushel of apples the findings are likely to be somewhat analogous. While most of the apples are expected to be in good condition, some will have soft spots, bruises, or scars on them;

others will have a few decayed spots that are visible to any observer; but the apples that are really difficult to classify are those which have rotten spots or worm holes hidden beneath a beautiful exterior surface. Defects of this sort may not be discovered until it is too late to salvage any of the good parts whatsoever.

The external bruises, scars, or soft spots in our banking system are sometimes caused by forces outside the control of individual bankers. A long severe depression, restrictive government legislation, or a change in demand for the product of a one-industry community, all tend to create financial pressures which ultimately lead to severe complications. Internal defects, on the other hand, are more likely to be the direct result of poor management or human frailties of one sort or another. It is not my intention to elaborate to any great extent on the external factors; rather, I shall concentrate largely on those internal disturbances for which management and other bank employees are solely responsible.

From the establishment of the Federal Deposit Insurance Corporation through June 30, 1951, a total of 416 insured banks required the financial aid of the Corporation. Of these, 245 were receivership cases which involved the outright liquidation of the banks, and 171 were absorption cases where the banks which became involved in financial difficulties were absorbed by other banks with the financial assistance of the Corporation. A large percentage of these failures or near failures is directly traceable either to bad management or other shortcomings associated with the personnel of banks.

Evidence of bad management is found in various unsafe and unsound banking practices, such as poor loan and investment policies, inadequate provision for capital and reserves, selection of incompetent personnel, and failure to use the banking facilities and manpower in the most efficient

manner. Evidence of human frailties, on the other hand, is measured in the sizeable number of defalcation or peculation cases currently being uncovered.

Time will not permit a detailed analysis of each of the weaknesses enumerated above, but I should like briefly to comment on the extent of bank holdings of substandard assets as well as the prevalence of defalcations and other irregularities.

Each year since 1939, the volume of substandard assets in the insured commercial banks of our Nation has ranged from about \$1 billion to \$3 billion. Nearly two-thirds of the assets included in this classification consist of loans and about one-third of securities. At the end of 1950, about 1.0 percent of the appraised value of loans in insured commercial banks was classified substandard and substandard securities amounted to 1.9 percent of the appraised value of all securities other than United States Government obligations.

While the overall proportion of assets classified as substandard in 1950 was at a historically low level, the amount of such assets present incipient problems to certain regions and to individual banks. For example, in 1950 it was found that the proportion of substandard loans to total loans varied from a low of 0.36 percent in the State of Rhode Island to 5.27 percent in your own State of Vermont. Differences among individual banks were even greater. Thus for certain particular banks, substandard assets might constitute a real or potential problem.

Although substandard assets present a very challenging problem to certain banks and regions, they fail to attract the same degree of attention and concern that usually attend the discovery of cases involving defalcations or other irregularities. Moreover, I hasten to add that defalcations or irregularities in one form or another are not uncommon occurrences. New cases are uncovered almost every day and without doubt many remain yet to

be uncovered. Of the 416 banks which became involved in financial difficulties from 1933 through mid-1951, 29 percent of the failures was attributable directly to defalcations, and defalcations were a contributing cause of failure in many other instances. Of the 26 banks which required the financial assistance of the Corporation during the past eight years, 20 of them were forced into difficulties directly because of defalcations. In several of the remaining banks, defalcations were discovered when the books were thoroughly examined.

Another measure of the extent of human frailty is contained in examiners' reports of irregularities found in banks. From the enactment of the Banking Act of 1935 through December 1950, the Legal Department of the Federal Deposit Insurance Corporation forwarded to United States attorneys a total of 2,017 reports on irregularities in insured nonmember banks which were thought to constitute violations of Federal criminal statutes. These irregularities embraced embezzlements, abstractions, willful misapplications of the bank's moneys, funds or credits, false entries, larceny, check kiting, and other similar acts.

Time does not permit any further enumeration of weaknesses in our banking structure. It is more important that we turn now to a consideration of the devices or methods that might be used for strengthening our banking system.

1. Selection and retention of efficient bank personnel. It has been said that a chain is no stronger than its weakest link. Likewise it might be said that a bank is no stronger than the individuals who man the various positions in a bank. Every employee makes his contribution, good or bad, to the success or failure of each bank. Accordingly, it is essential that every precaution be taken in the selection and follow-up of all bank employees - whether they be directors, executive officers, tellers, or bookkeepers.

Bank directors are responsible for the overall policies and practices of a bank and must be selected with great care. Their selection should be based on their ability and qualifications for the position rather than their social or financial standing in the community. If they are to assume their rightful duties and responsibilities they must be men of character, wisdom, and strength. They must have the courage to make whatever changes are necessary in order to strengthen the position of the bank. It is they who are directly responsible for the selection of dependable, efficient, and progressive officers; it is they who formulate the general lending and investment policies of the bank; it is they who are expected to protect and preserve the deposits of customers; and it is they who are held legally responsible for supervising all bank policies and practices in an intelligent, prudent manner. Thus it is evident that the ultimate success of any bank must depend in a large measure upon the selection of a good board of directors.

But the board of directors is not expected to handle or supervise the detailed operations of a bank. These functions must be delegated to executive officers and lay employees who likewise should be chosen with extreme care.

Top-level officers and employees can be obtained, and retained, in a bank only by paying salaries competitive with those paid in other professions where the training, work, and responsibilities are somewhat comparable. A banker is expected to dress well and to associate with the better elements in the community. It is often difficult, if not impossible, to do this on the low salaries paid by many of our banks. Where this situation prevails there is always the temptation "to borrow" funds from the bank to help balance the individual's budget. At first these "borrowings" are viewed as temporary loans and the individual involved usually

intends to repay the amount taken. These good intentions, however, are seldom realized. Rather, the likelihood is that additional sums will be taken once the bars of personal conscience have been let down.

Higher bank salaries would also help to attract a larger number of the better high school and college graduates. Today most of the better graduates are going into professions other than banking. This presents a dangerous prospect for the future of banking and it is high time that the banks started doing something about this problem. Let us all remember that if we want quality products, we must be willing to pay the price; the same truism prevails as far as the services of individuals are concerned.

Once a bank acquires good personnel, every effort must be made to encourage individual progress and contentment. Individual accomplishments must be recognized by adoption of equitable promotion plans. If each 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 life's work, and much less temptation to steal what he thinks he never will be able to get rightfully. A contented employee is the best safeguard against rebellious wrongdoing.

To minimize further 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; group hospitalization; and retirement plans. Health, accident, and hospitalization protection must be provided not only for the employee, but for his entire family. This sort of protection can be carried at very reasonable rates, especially when its cost is shared by the bank and its employees.

A few dollars invested in the welfare of human beings will unquestionably prove to be the best investment that a bank can make. It is a well-known fact that an employee cannot do his most efficient work when he is troubled or worried about financial problems or any other problem connected with his job. Relief from these worries not only will improve the efficiency and morale of employees, but will also remove some of the most common causes of stealing.

2. Careful selection and evaluation of loans and investments.

Safe banking requires that constant attention be devoted to the selection and supervision of the earning assets of a bank. There is always the danger that our current prosperity with its accompanying increased demand for bank credit might lead to loose lending practices. We have experienced a long period of rising prices during which loans once classified as marginal have since proved to be sound. It is unlikely that such favorable circumstances will continue indefinitely. Therefore, it is important that we prepare for the day when prices may fall below their present level. Two fields which appear to be particularly vulnerable are real estate loans and consumer loans. The recent increase in these loans has been tremendous. Because of the small down payment, and the long-term nature of real estate loans, it is especially important that careful consideration be given to the selection of individual risks in this field. Consumer loans, on the other hand, may not run for such long periods of time, but there is always the danger that banks may be tempted to liberalize their terms in an attempt to meet the competition of other consumer lending agencies. At the present time Regulation "W" prevents any such liberalization, but as soon as there is any relaxation of these terms the competition may return. The possibility of such a development requires constant vigilance on the part of every banker.

A similar situation is present with respect to bank investment in securities. Any rise in the market rate of interest tends to bring a decline in the prices of securities, particularly of long-term securities. The maintenance of a well-balanced distribution of bank security portfolios both as to quality and maturity requires constant attention to forestall serious difficulties in the future.

3. Establishment of adequate cushions against future losses.

Every banker knows that some losses are to be expected even in prosperous times. Accordingly, it is most important that adequate cushions against these expected losses be built up during times of prosperity.

The December 8, 1947 ruling of the Commissioner of Internal Revenue permits banks to accumulate limited amounts of tax-free reserves for bad-debt losses on loans. This ruling is a move in the right direction since it permits a bank to anticipate and charge-off to current expenses some of the losses which are bound to occur in the future. Despite the advantages of this ruling only 43 percent of all insured commercial banks had taken advantage of it by the end of 1950. At that time, total reserves for this purpose amounted to \$595 million, or 1.15 percent of total loans. Unfortunately, these reserves are not always held by those banks which need them most.

Provision for losses not only requires the establishment of valuation allowances against bank assets, but it also requires provision of adequate bank capital. The recent expansion in bank assets and deposits has brought the capital ratio of banks to a dangerously low level. From 1934 to 1950 the ratio of capital accounts to total assets declined from 13.2 percent to 6.8 percent. The ratio of capital accounts to assets other than cash and United States Government obligations declined from 26 percent in 1934 to 17 percent in 1950. This ratio, which is sometimes

called the risk asset ratio, is now at the lowest level ever reached since the Federal Deposit Insurance Corporation was organized. In fact, it is necessary to go back as far as 1928 to find a year when the risk asset ratio for all commercial banks was as low as at the end of 1950.

Sound banking requires that the capital structure of banks be increased as assets, and particularly the risk assets, are increased. If this is not done our banks will be operating with such narrow margins of owner equities that certain segments of our population might use this condition as an excuse to seek nationalization of the entire banking industry. No other industry operates on such a thin margin of owner equities. It is my firm conviction that the only way to preserve the dual system of free enterprise banking is to make our banks so strong that the proponents of government operation and control will find few supporters.

The position of the Federal Deposit Insurance Corporation with respect to a bank's capital needs has sometimes been misunderstood. While it is true that we have consistently advocated a strengthening of our banks' capital structure, yet it should be emphasized that this has not been done solely for selfish reasons. Entirely aside from any consideration of the safety of the deposit insurance fund, it is our opinion that stockholders themselves should work toward a stronger capital position. This conviction is reinforced by the fact that whenever a bank becomes involved in financial difficulties, it is the stockholder who must bear the initial losses.

There are three ways by which the capital structure of our banking system may be strengthened; they are: first, preventing the organization of unneeded new banking units with inadequate capital; second, selling new stock to local citizens; and third, retaining a substantial portion of current earnings within the bank.

In an attempt to establish a capitalization standard, the Federal Deposit Insurance Corporation has followed a policy of requiring all new members to provide capital at least equal to the national average for all insured banks. In the case of proposed new banks, we endeavor to estimate the deposit volume to be attained at the end of three years' operations and establish our dollar figure as to the adequacy of capital on that basis. We feel that this is a reasonable basis upon which to determine adequacy of capital, even though it often results in a dollar figure greater than the statutory requirements of the law under which the bank is being chartered.

Operating insured banks which have capital ratios below the national average are urged to strengthen their capital structure either by sale of new stock or by retention of a larger portion of current earnings. By using both of these devices substantial progress has been made since 1945. Chart No. 33 shows that the capital ratios of all insured commercial banks in the United States increased from an average of 5.5 percent in 1945 to 6.8 percent in 1950. At the end of 1950, banks in 43 states had average capital ratios at or above the 1945 national average, while banks in only 13 states had capital ratios above the 1950 national average.

Since 1943 the insured commercial banks of our Nation have followed a policy of retaining in their capital accounts between 56 and 70 percent of all net profits after taxes. In 1950, 58 percent of such profits was retained. This method of building up capital is, no doubt, the least painful and accordingly is the one used by most banks.

A number of banks still retain a legacy from the banking crisis during the last depression in the form of preferred stock of capital notes and debentures held by the Reconstruction Finance Corporation and

other agencies. Although most of this type of capital has been retired, there still remains a small amount which should be eliminated as rapidly as possible whenever an adequate capital cushion can be substituted therefor.

4. Providing better internal and external controls. The large number of irregularities and peculations uncovered in our banks in recent years emphasizes the necessity of adequate internal and external controls. The two principal safeguards against these irregularities and peculations are: first, a well organized audit control designed to discourage employees from taking chances and second, ample fidelity coverage to take care of possible losses. In addition, it is desirable occasionally to rotate bookkeepers and other key employees who have access to the accounting records. In this way irregularities and other manipulations are more likely to be prevented as well as discovered. As a final precaution, every individual in a bank should be required to take an annual vacation of at least two weeks. No employee is so indispensable that the bank cannot get along without his services for that length of time. Moreover, I hasten to add that many cases of stealing have been exposed during the vacation season. Be alert to those bank officers or other employees who cannot possibly leave the bank for even a short vacation. Their motives may require explanations other than those actually given.

It is the duty and responsibility of bank directors to provide for a continuous internal audit by some qualified person within the bank as well as to provide for periodic audits by well qualified outside auditing firms. It is not sufficient to depend simply upon the examination reports submitted by the supervisory agency. The agency's reports do not pretend to be detailed audits and as a result often fail to uncover any irregularities which may exist in a given bank.

In a special survey made by the National Association of Bank Auditors and Comptrollers in 1950, it was found that only about 1,000 banks had full-time auditors, while another 500 banks had a partial auditing program. 1/ This left approximately 13,000 or 90 percent of our Nation's banks with no auditing program of any kind. Negligence of this sort no longer should be condoned. It is the responsibility of management to see that every precaution is taken in the prevention and elimination of opportunities for manipulation or embezzlement.

Regardless of what precautions are taken or how good bank audits might be, however, there will still be a certain number of employees who will invent ingenious ways of appropriating bank funds. To guard against this possibility it is strongly recommended that every bank provide fidelity coverage in an amount at least equal to the scheduled recommendations of the American Bankers Association.

The Federal Deposit Insurance Corporation is empowered by law to require all insured banks to maintain adequate fidelity coverage. In those cases where a bank refuses to provide such coverage, the Corporation is authorized under the law to purchase this insurance for the bank and add its cost to the bank's deposit insurance assessments. So far, however, we have preferred not to use this authority. Instead we have cooperated with State and Federal bank supervisory authorities in an attempt to convince banks of 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 still carrying inadequate surety coverage, even at the reasonable rates prevailing today.

1/ National Association of Bank Auditors and Comptrollers, Duties and Responsibilities of a Bank Auditor and/or Comptroller, p. 1.

5. Restrictions on the chartering of unneeded new banks. The prosperity and expansion of banking in recent years has been accompanied by a substantial increase in applications for bank charters and for admission to deposit insurance. Wholesome competition by new banks organized on a sound basis, where there is need in the community for additional banking facilities, is essential under our free enterprise system. But we must not repeat the experiences of the twenties, when excessive expansion in the number of new banks was accompanied by a rising tide of bank suspensions.

Being an insurance agency, the Federal Deposit Insurance Corporation has no chartering powers. If a national charter is desired application must be made to the Comptroller of Currency, while charters for state banks must be obtained from the respective state authorities. A method of chartering banks that has worked well in actual practice is the joint examination of the proposed organization and management of new banks by the Federal Deposit Insurance Corporation and State banking authorities prior to chartering and admission to insurance. This method provides economies of time and money for both supervisory agencies and the bank. The State supervisors and the Corporation are each provided with all the facts on which to base the final decision. They know each other's attitude, and the importance of the various factors in each other's considerations. Under this method it is extremely difficult for a marginal institution to organize and become insured by playing off one agency against the other. In view of the gratifying results of joint examinations of proposals for new banks in the few states in which this method is used, we should like to see its use extended to other states.

A sound and flexible guide in chartering and admitting new banks to insurance is provided by the principles set forth in the Banking

Act of 1935. This Act provides that before a bank may be admitted to insurance the Board of Directors of the Federal Deposit Insurance Corporation shall give consideration to these factors:

- a. The adequacy of its capital structure.
- b. Its future earning prospects.
- c. The general character of its management.
- d. The convenience and needs of the community to be served by the bank.
- e. The adequacy of its corporate powers, and where applicable.
- f. The financial history and condition of the bank, if it is an existing bank applying for insurance.

It is unwise to charter or admit to insurance any new bank which is unlikely to succeed. Such a policy can only lead to trouble when the going gets tough. It is much more desirable to adopt a chartering policy that seeks to prevent overbanking and resultant bank failures, than attempt to cure the difficulties after they have reached the crucial stage.

6. Cooperation with other supervisory agencies in the preservation of the dual system of free enterprise banking. Students of political science observed long ago that the American system of government maximizes the opportunity for testing new ideas and policies while at the same time minimizing the risks of so doing. Many new ideas were introduced and first tested by a city, county, State, or Federal governmental unit. Those ideas that proved to be worthwhile were later adopted by part or all of the other governmental units while those that proved to be unsound were discarded.

The same general observations might be made regarding the dual system of free enterprise banking. Under this system each state is free

to sponsor banking legislation and regulate its own system of state-wide banking. New ideas in banking methods and controls can be initiated and tested on a small scale; those ideas which are worthwhile soon tend to permeate the entire banking system while the others wither away with few harmful effects. Deposit insurance provides a good illustration of this point. The deposit insurance idea was originated and given its first laboratory test in the State of New York as early as 1829. Other states later experimented with variations of the New York plan. Out of these various field tests the ground work was laid for the establishment of the Federal plan of deposit insurance.

The dual system of free enterprise banking works best when there is full cooperation between Federal and State supervisory authorities. Both authorities must cooperate wholeheartedly in the establishment and enforcement of rules and standards which encourage wholesome competition; both must also stand ready to adopt any change which will result in improved banking methods or operating results. By working together in a spirit of understanding the American banking system can be strengthened to the point where it has no peer throughout the entire world.

The development of a uniform examination report for banks is one of the major steps in the direction of closer cooperation between Federal and State supervisory authorities, a step which has been taken since the advent of the Federal Deposit Insurance Corporation. With slight modification, this form is used by all of the Federal agencies and a majority of the states. Moreover, in almost three-fourths of the states, joint or concurrent examinations are scheduled with State supervisory authorities. Not only does this arrangement achieve important savings for both the supervisory authorities and the institutions under examination, but it facilitates cooperation among all of the interested parties in

bringing about corrective measures and needed improvements in the banks of our Nation.

7. Maintenance of a sound and stable national economy. So far our attention has been focused largely upon the internal methods of strengthening the banking system. No mention has been made of the necessity and importance of having a sound and stable national economy under which the banks might operate. My omission of this factor up to this point should not be interpreted as implying that it is relatively unimportant. Actually, it is basic to all the others. Without a sound and stable national economy there could be no strong banks. The very life-blood of every bank is dependent upon government monetary and credit policies. A large portion of bank assets consists of government obligations and cash, both of which are issued and controlled by the government. Bank loans are subject to government credit controls and bank deposits are affected by governmental policies. Thus, the very existence of each bank depends upon what the government does and how well it manages its affairs. A well managed national economy will mean a strong and stable economy, which in turn will set the stage for a system of sound banks.

The relationship between our banks and the government, however, does not end here. The banks of our Nation have responsibilities which go far beyond those of self-preservation and individual gain. Being institutions of public trust, they have a vital interest in the economic and general development of the community, state, and nation.

When inflation threatens to diminish the worth of the dollar and create upheavals throughout the entire economy, our banks must be prepared to do everything within their power to attack this insidious

force. This may require certain sacrifices on their part, but in the long run such sacrifices will redound to the benefit of the banks themselves as well as to the people for whose welfare the banks have a unique responsibility.

At the present time American business concerns are spending record sums for the enlargement and modernization of their facilities. Outlays for new plants and equipment during the current year are expected to reach a total of \$25 billion, which is nearly one-fourth greater than the peak expenditure of any previous year. This large outlay, when coupled with heavy buying of goods and equipment by the armed services, creates inflationary pressures which are difficult to restrain.

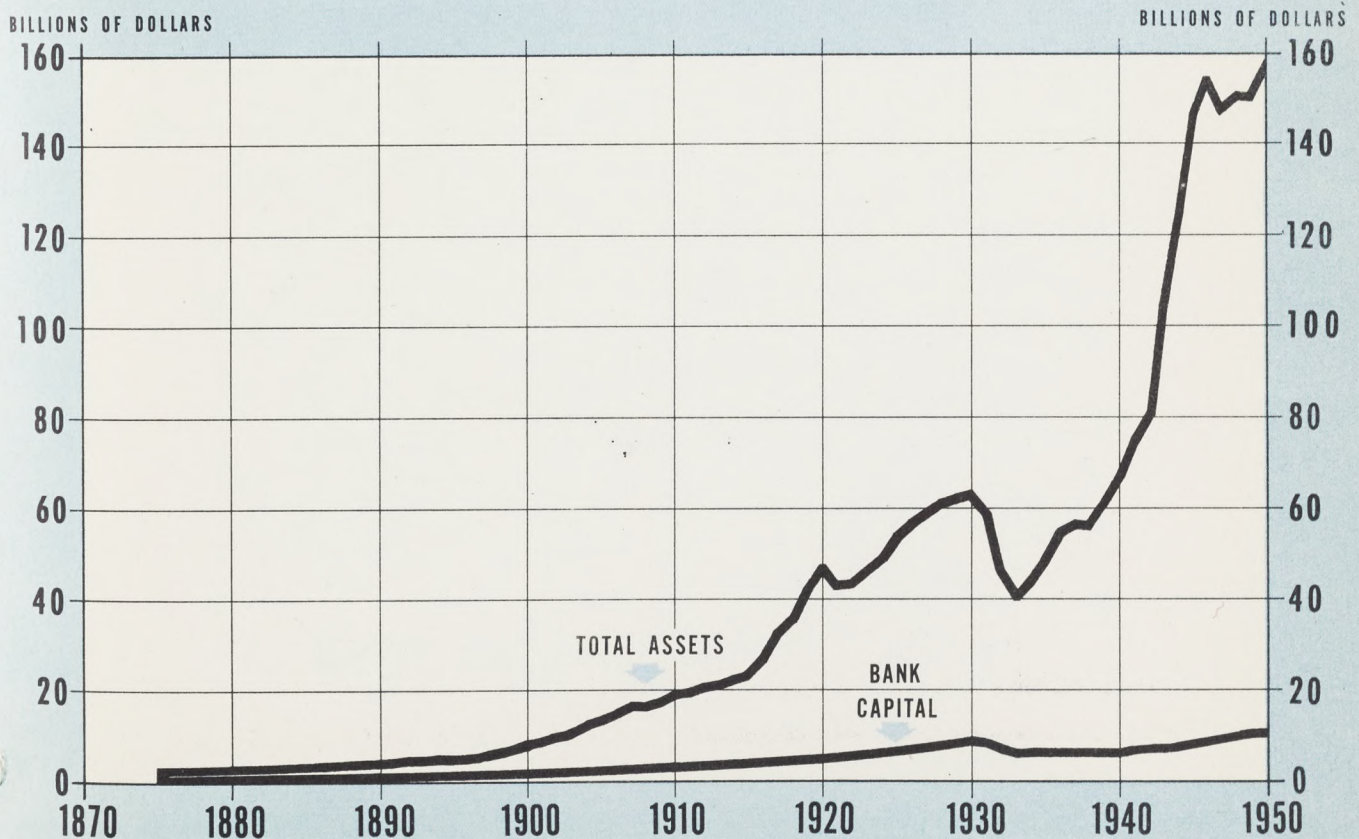
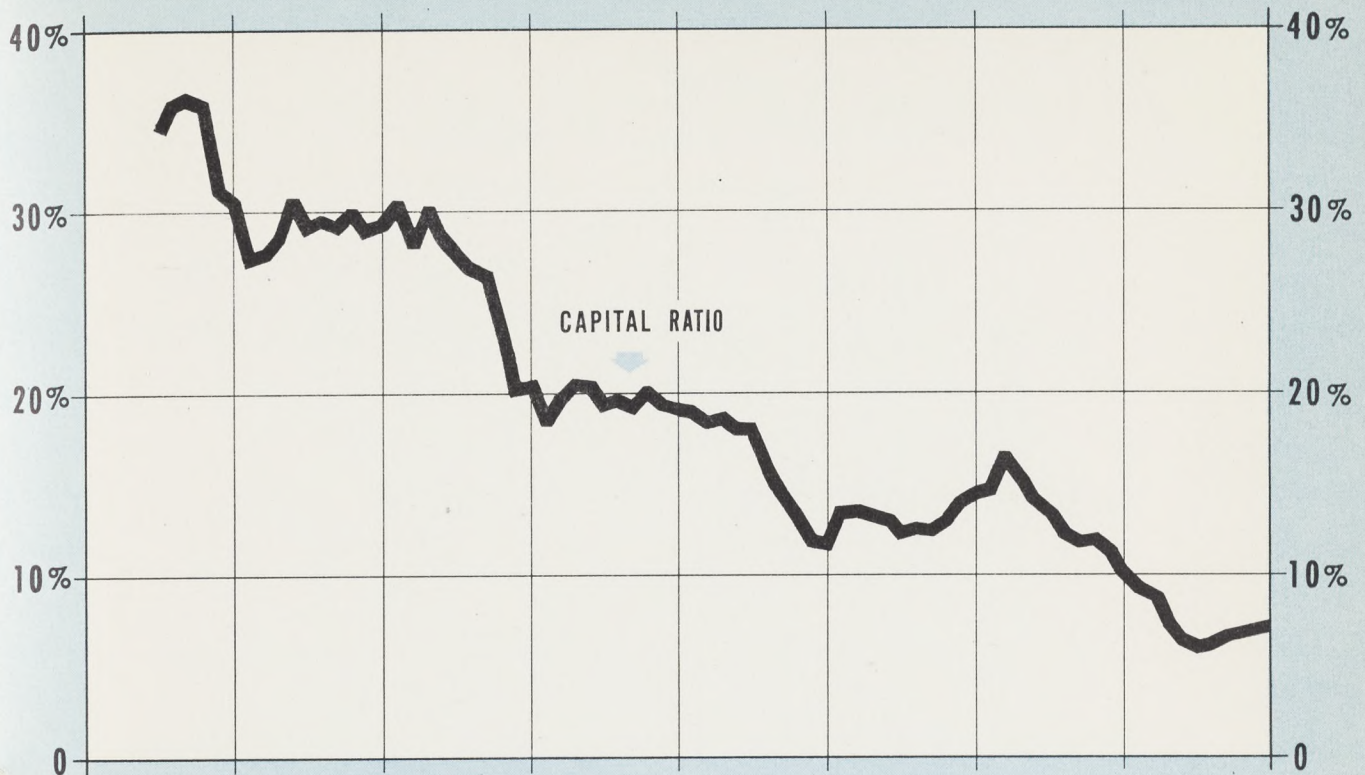
To help combat the inflationary pressures, the financial institutions of our Nation have been called upon to support a program of voluntary credit restraint. Banks have been asked to make only those loans which are necessary to finance the defense program and maintain production of essential goods and services. Voluntary restraint requires a degree of denial and self-discipline which runs counter to the American tradition of always pushing onward to bigger and bigger things. Yet it is the kind of restraint which promises most nearly to permit adaptation within the overall limits of our capacities.

Twenty-five years ago bankers did not understand the responsibilities which were theirs in the achievement and preservation of prosperity. Today we have a better appreciation of what makes the economy "tick", and know more about the role that banks can properly play in keeping it on an even keel. More than that, we know that prosperity no less than depression has its pitfalls. The self-discipline with which

bankers are meeting our present inflationary situation is symptomatic of their response to the temptations of prosperity. The self-analysis which enables us to see our faults more clearly is our best assurance that the prosperity we now know will not fade away.

BANK CAPITAL RATIO

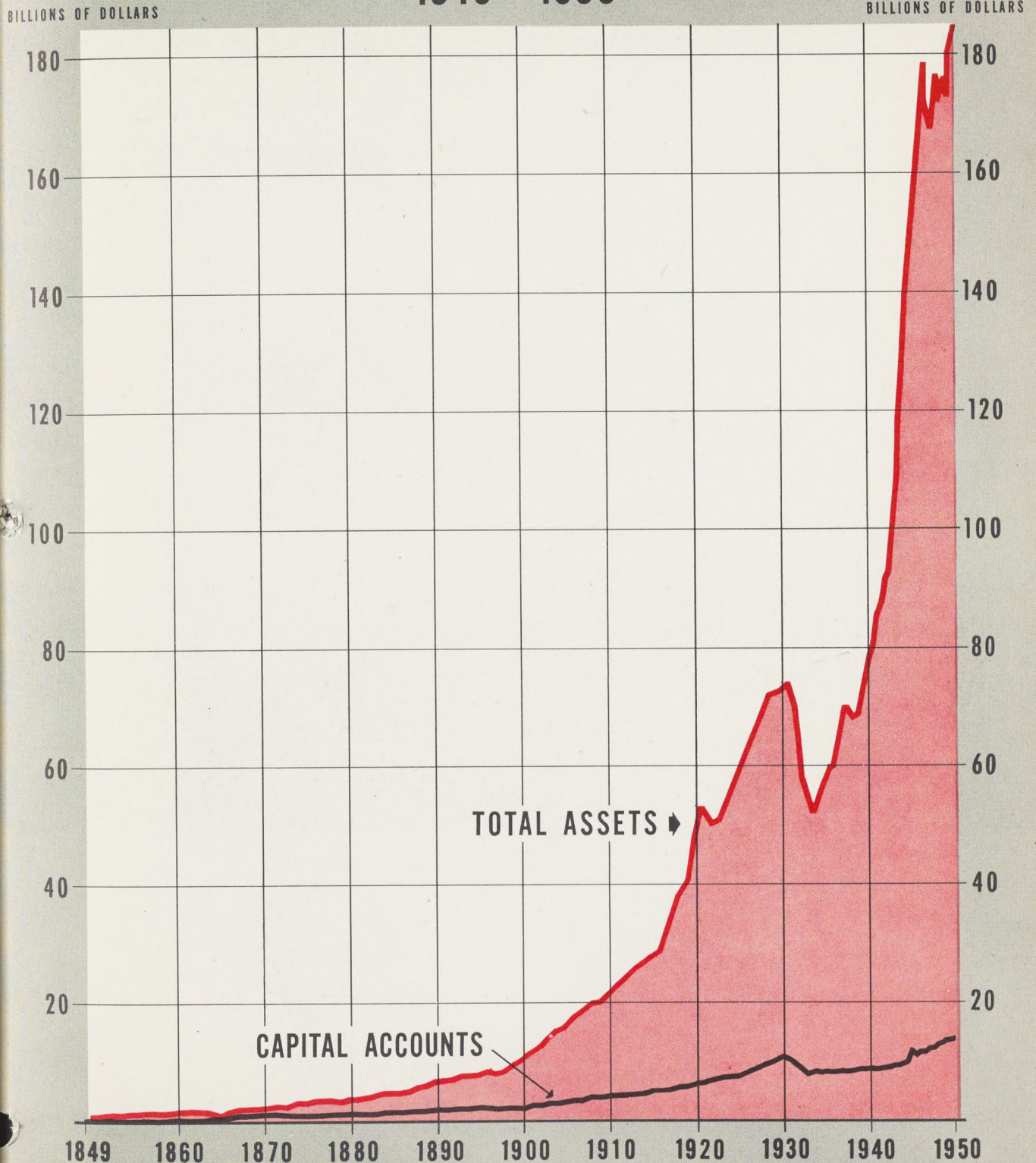
ALL COMMERCIAL BANKS , 1875-1950



Division of Research and Statistics
FEDERAL DEPOSIT INSURANCE CORPORATION

CHART NO. 23

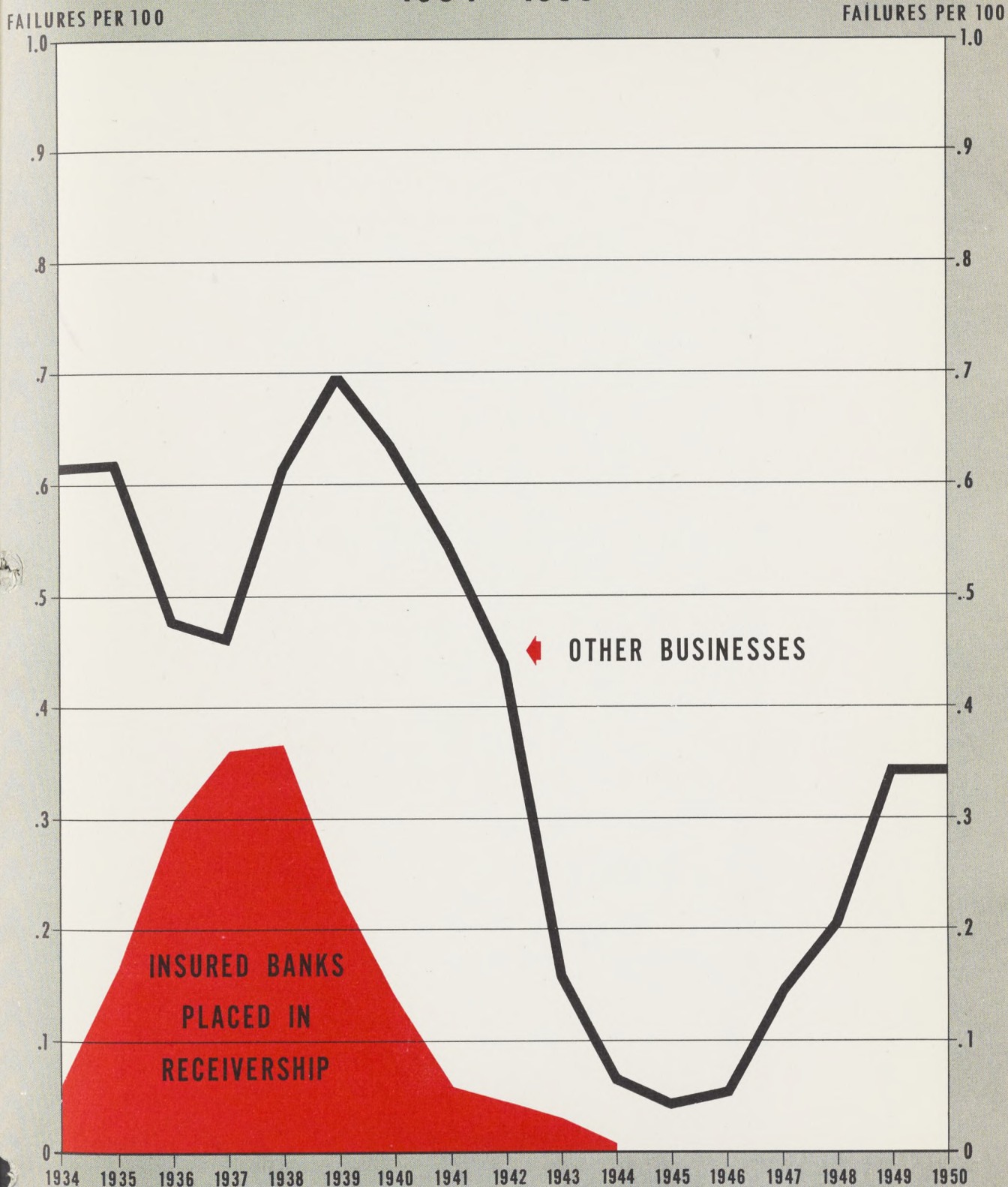
CAPITAL AND ASSETS OF ALL OPERATING BANKS U. S. AND POSSESSIONS 1849 - 1950



Division of Research and Statistics
FEDERAL DEPOSIT INSURANCE CORPORATION
CHART NO. 24

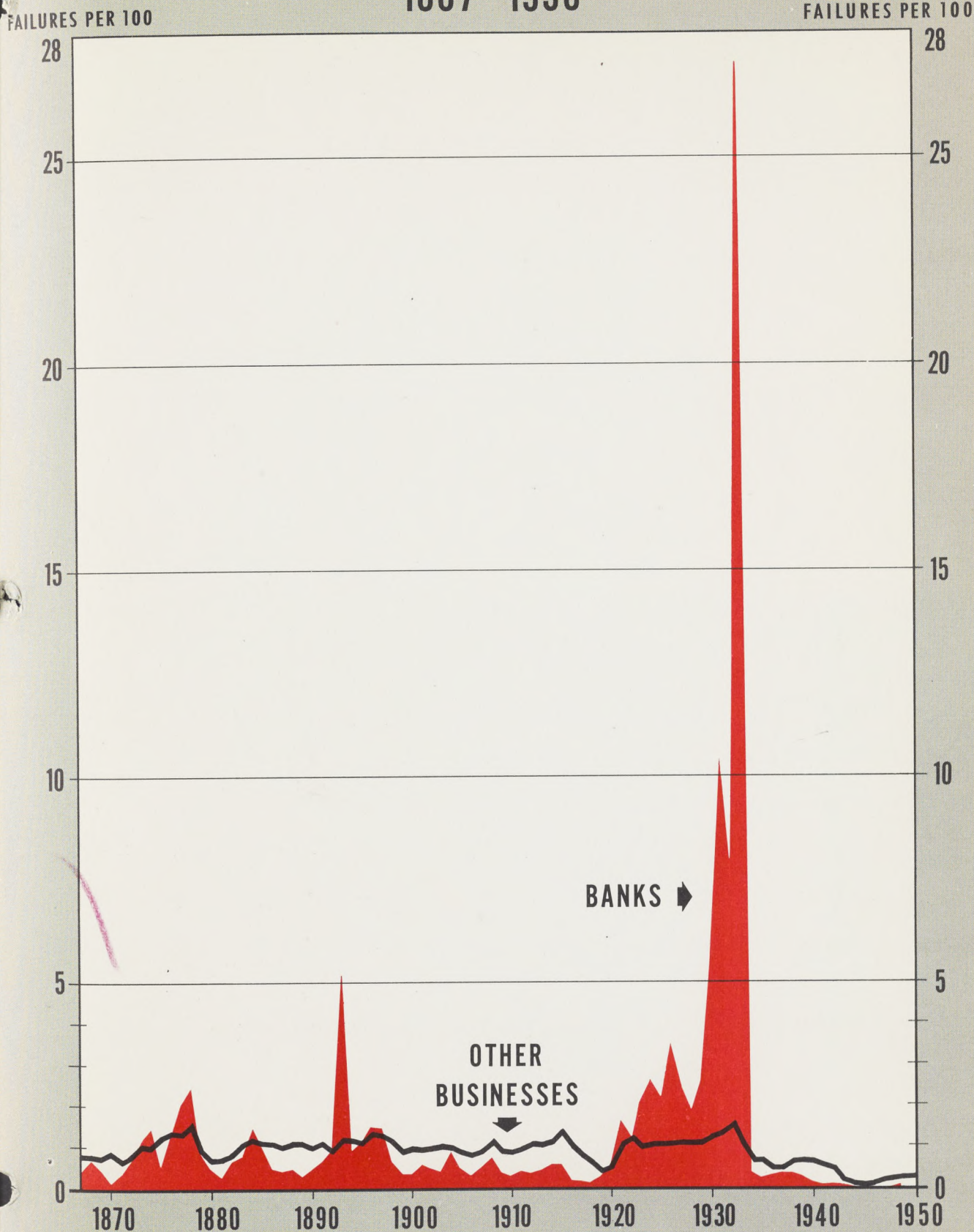
FAILURES IN BANKING AND BUSINESS

1934 - 1950



Division of Research and Statistics
FEDERAL DEPOSIT INSURANCE CORPORATION
CHART NO. 27

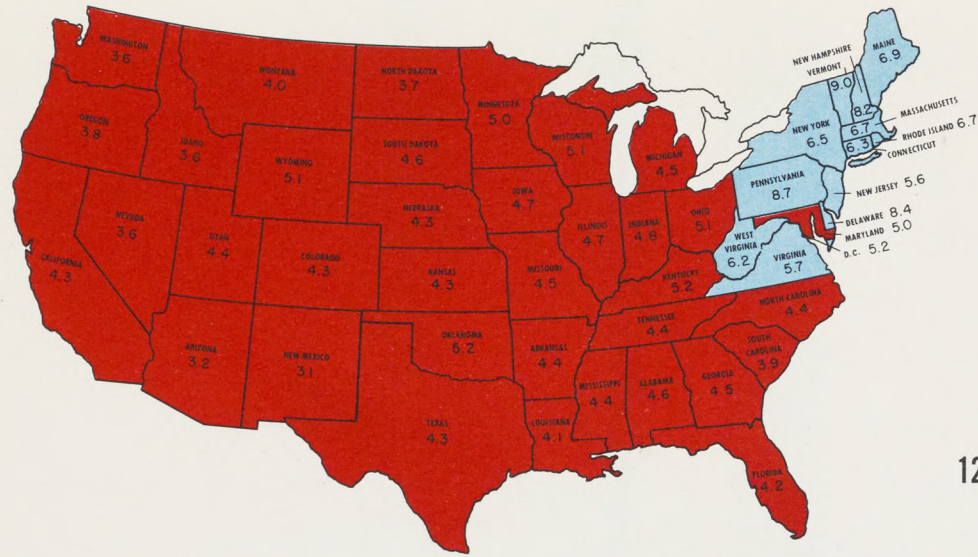
FAILURES IN BANKING AND BUSINESS 1867 - 1950



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CHART NO. 29

COMPARISON OF CAPITAL RATIOS 1945 and 1950

INSURED COMMERCIAL BANKS



December 30, 1950

CAPITAL RATIOS

1950 NATIONAL AVERAGE 6.8%

6.8% and above (light blue)

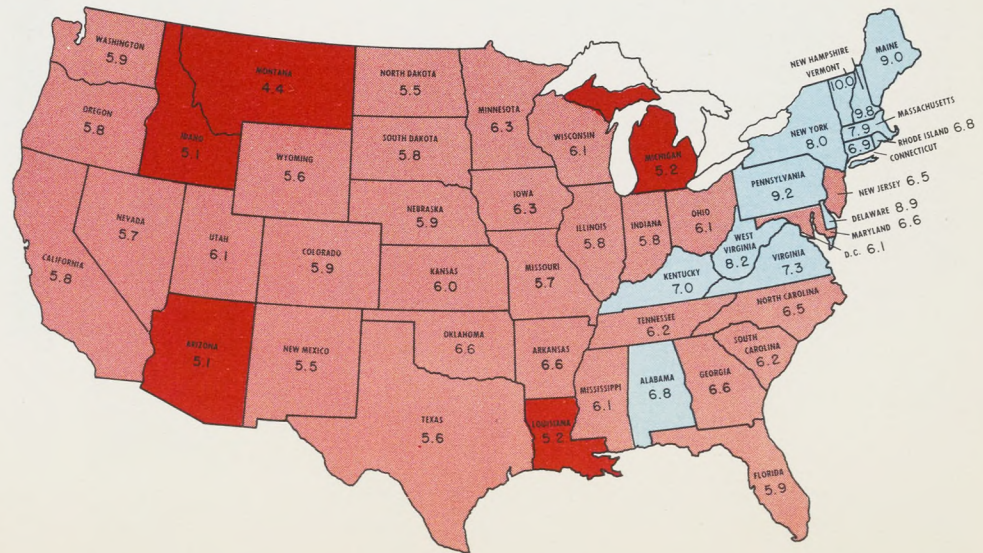
Below 1950 average:

5.5% to 6.7% (pink)

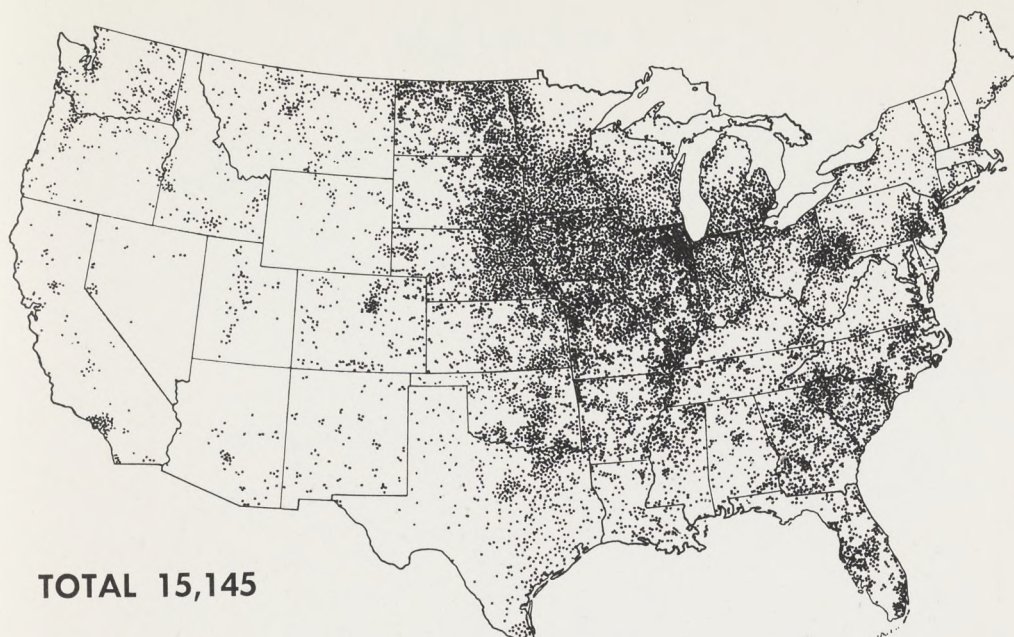
Below 1945 average of 5.5% (red)

43 States at or above the 1945 National average

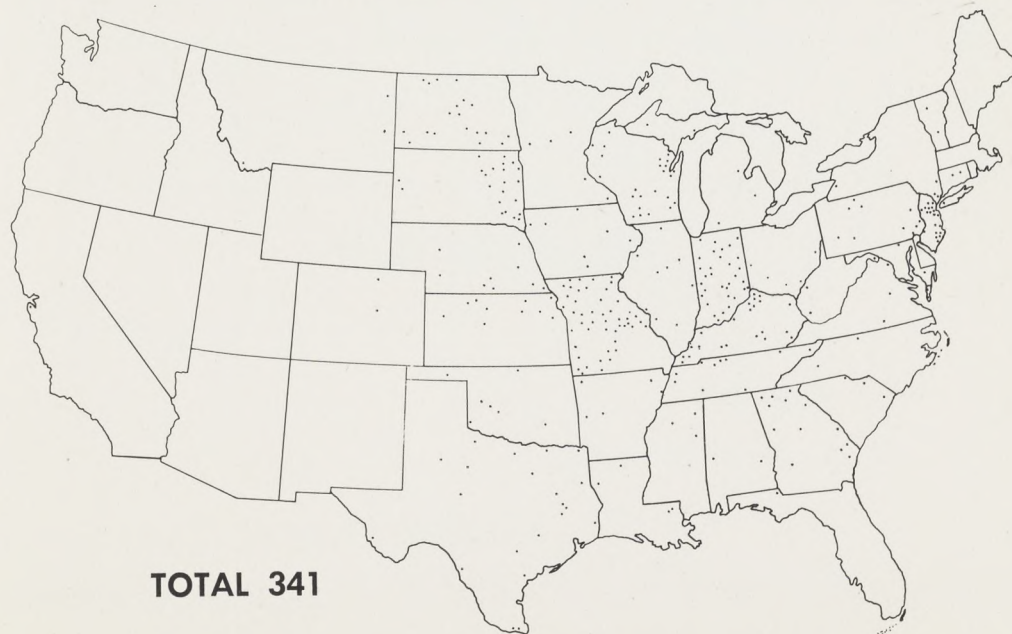
13 States at or above the 1950 National average



BANK SUSPENSIONS 1917 to 1933

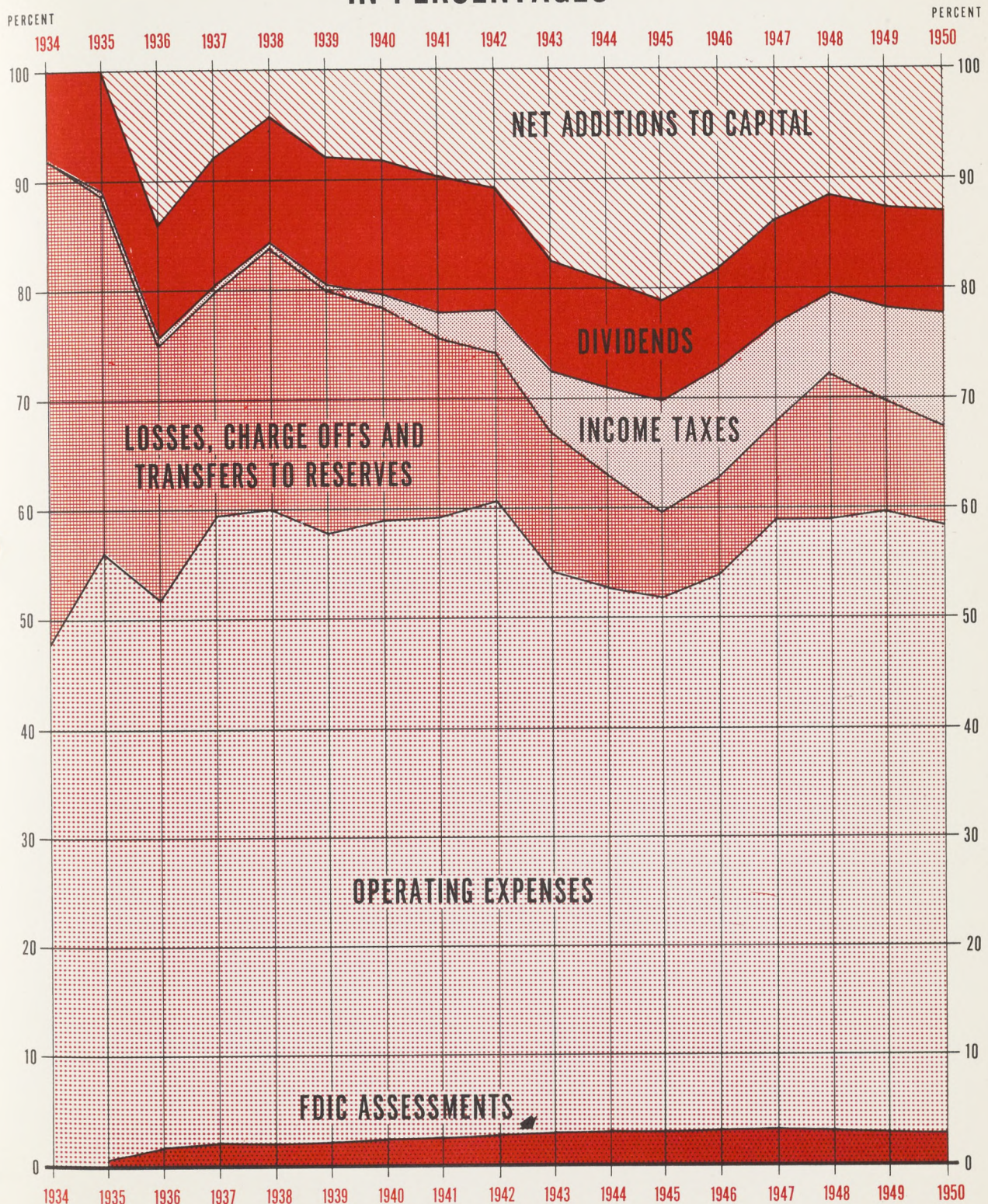


BANKS PLACED IN RECEIVERSHIP 1934 to 1950



Banks Insured by FDIC • NO RECEIVERSHIPS since MAY 1944

DISTRIBUTION OF INCOME BY INSURED COMMERCIAL BANKS 1934 - 1950 IN PERCENTAGES



Division of Research and Statistics
FEDERAL DEPOSIT INSURANCE CORPORATION

CHART NO. 36