

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

MADISON, WISCONSIN

AUGUST 29, 1952

TODAY'S CHALLENGE TO BANKING

That curious observer from Mars, looking through his telescope at the network of banks in the United States, would probably conclude that our banking system is in pretty good shape. Since 1933 banking has cleared its decks of the wreckage left by the devastating depression of 1930-1933 and is now in the soundest condition ever experienced. Bank assets and earnings have reached new all-time peaks. Bank failures have almost disappeared, and no depositor fears for the safety of his bank deposit. The legitimate financial needs of business and other borrowers are being met consistent with the fight against inflation. These are truly reassuring evidences of the stature and stability of our banking system.

Gratifying as these achievements are, it would be a mistake for us to rest on our oars. Recognition of our present short-comings is a necessary preface to continuation of this fine record. If our observer from Mars had an x-ray machine as well as a telescope he might amend his conclusions. Though matters appear on the surface to be in fine shape, a little probing into the internal condition of banks reveals several sources of potential difficulty.

As students of banking, most of you are familiar with the nature and extent of bank weaknesses. Many banks have neglected to maintain proper balance among the different types of assets they hold, exposing them unnecessarily to considerable risk. Serious questions have arisen concerning the capital position of many banks. Reserves for losses are only

nominal in many banks and non-existent in others. Lack of adequate accounting controls prevents many banks from operating as efficiently as they might and confronts bank employees with temptations which many of them are unable to resist. The human resource in banks has been woefully neglected, resulting in inefficient work methods, high rates of employee turnover, and increasing defalcations by employees. Without going further in listing bank weaknesses, let us turn to consideration of methods which would help to strengthen our banking system.

1. Careful selection of loans and investments. Safe banking requires that constant attention be given to the selection and supervision of a bank's earning assets. Our present prosperity with its accompanying increased demand for bank credit tempts many bankers to become careless in their lending practices. The long period of rising prices has made many marginal loans work out satisfactorily. To rely upon such uncertainties as rising prices, however, as the means of guaranteeing doubtful loans is one way of courting trouble. It is important that lending practices take into account the fact that prices can still go down as well as up.

Banks should be particularly cognizant of the risk they run in the field of real estate and consumer loans. The relatively small down-payment required in connection with real estate loans and the long-term nature of these loans make it especially important that individual risks in this field be carefully chosen. While consumer loans have been about the highest yielding and lowest risk type of loan, bank inexperience in handling defaults on this type of loan is both a financial and public relations hazard; therefore further extension of this profitable line of

credit should be carefully watched.

Bank investment in securities presents dangers of a different but no less definite nature. Not only may securities, like loans, incur the dishonor of default; they are also responsive to fluctuations in the market rate of interest. Large holdings of long-term securities may, in a period of rising interest rates, cause a bank considerable embarrassment. The maintenance of a well-balanced portfolio of securities both as to quality and maturity requires constant attention.

2. Provision of adequate bank capital. The growth during the last decade in bank assets and deposits has brought the capital ratio to a dangerously low level. From 1934 to 1951 the ratio of capital accounts to total assets declined from 13.2 percent to 6.7 percent. In other words, the equity of bankers in their banks is only about half what it was 18 years ago.

Sound banking requires that the capital structure of banks be strengthened as assets, and particular risk assets, are increased. Complacency with respect to the present capital structure plays into the hands of those who would like to see our entire banking industry brought under one central control. Ownership and control go hand in hand; it is sobering to realize that no other industry operates on such a thin margin of owner equity as does the banking industry. 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 advocates 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. Our persistent concern with strengthening the capital structure of banks has not been motivated by selfish reasons. Entirely aside from any consideration of the safety of the deposit insurance fund, it is our opinion that stock **holders** would find it to their own interest to work toward a stronger capital position. This conviction is reinforced by the consideration that whenever a bank becomes involved in financial difficulties, for whatever reason, it is the stockholders who must bear the initial losses.

There are three ways by which the capital structure of our banking system may be strengthened. First, newly organized banks should meet standards which reinforce rather than weaken the present capital structure; second, existing banks may sell new stock; and third, current earnings may be retained within the bank.

The Federal Deposit Insurance Corporation has followed the policy of requiring all newly insured banks to provide capital at least equal to the national average for all insured banks. In the case of proposed new banks, we try to estimate the deposit volume to be reached at the end of three years' operation and establish our dollar figure of required 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.

Banks already in operation may strengthen their capital structure either by sales of new stock or by retention of a larger portion of current

earnings. All insured banks which have capital ratios below the national average should try to improve their position. We realize, of course, that the national average is a standard which not all banks can attain simultaneously; but pursuit of this goal has already resulted in substantial progress. The average capital ratio of all insured commercial banks in the United States increased from 5.5 percent in 1945 to 6.7 percent in 1951. Encouraging as this movement is, there is still a long way to go.

Since many bank stocks are quoted in the market for less than book value, banks have been reluctant to enlarge their capital position by selling new stock. This is understandable, for the purchasers of such stock acquire advantages which would be particularly attractive if and when bank stocks improve marketwise. A few banks have recently floated issues of preferred stock; the Corporation is watching this type of financing with considerable interest.

The burden of capital improvement has for many years rested upon retention of earnings. Since 1943 the insured commercial banks of our nation have retained in their capital accounts between 54 and 70 percent of all net profits after taxes. This method of building up capital is, no doubt, the least painful. But it too has limits, both in recognition of stockholders who want dividends, and in deference to Government rulings which limit the proportion of earnings which may be retained. Even so, it is still the most promising source of new capital.

3. Establishment of adequate reserves against future losses.

Every banker knows that losses are inevitable no matter how carefully he manages his business. Accordingly, it is the part of wisdom and foresight

to build up adequate cushions against losses, and this can best be done during times of prosperity.

Banks are permitted to accumulate limited amounts of tax-free reserves for bad-debt losses on loans under terms of a December 8, 1947, ruling of the Commissioner of Internal Revenue. By permitting banks to charge off to current expenses some of the losses which are bound to occur, this ruling provided an incentive for the accumulation of greater reserves than most banks had theretofore acquired. In spite of the benefits to be derived from this ruling only 45 percent of all insured commercial banks had taken advantage of it by the end of 1951. At that time total reserves for this purpose amounted to \$716 million, or 1.23 percent of total loans. Unfortunately, these reserves are not always held by the banks which need them most. Many banks have by now accumulated all the reserves they may under this ruling; other banks which have so far ignored the ruling should certainly look into its possibilities.

4. Provision of better accounting controls. The large number of irregularities uncovered in our banks in recent years emphasizes the necessity of adequate internal and external controls. Between 1946 and the end of 1951 a total of 2,765 defalcations in insured banks were reported to the United States Department of Justice. Even more disturbing than the number is the year-by-year growth in irregularities. These defalcations were by far the major cause of banking trouble during this period, accounting for the difficulties of all but 3 of the 21 banks aided by the Federal Deposit Insurance Corporation since 1946. The methods of carrying on these peculations are varied and complex, and the

persons implicated range from bank janitors to bank presidents--more frequently presidents than janitors. To curb these irregularities a comprehensive system of accounting controls is one good place to start.

A well-organized audit control designed to discourage employees from taking chances should be in operation by every bank. It is the duty and responsibility of bank directors to provide for a continuous internal audit by a 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 made by the supervisory agencies. The agencies' reports do not pretend to be detailed audits and as a result often fail to uncover irregularities which may exist in a given bank.

A special survey made by the National Association of Bank Auditors and Comptrollers in 1950 found that only about 1,000 banks had full time auditors while another 500 banks had a partial audit program. This left approximately 13,000 or 90 percent of our nations' banks with no auditing program of any kind. Negligence of this sort no longer should be condoned.

Along with mechanical controls, employees should be spared opportunities which tend to compromise their integrity. For example, it is desirable to rotate bookkeepers and other key employees who have access to accounting records. In this way irregularities and other manipulations are more likely to be prevented as well as discovered. Similarly, 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 can not

get along without his services for that length of time. It is significant that many cases of stealing have been exposed during the vacation season.

Regardless of how good bank audits might be or what other precautions are taken, a number of employees will still find ways of appropriating bank funds. To protect against this eventuality every bank should have fidelity coverage in an amount at least equal to the scheduled recommendations of the American Bankers Association. Indeed, it would be wise to go beyond the minima recommended by the A.B.A. The 108 insured banks which have expired due to defalcations since 1933 had losses amounting to \$16 million; only \$3 million of this amount was covered by fidelity bond.

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 banks' deposit insurance assessments. So far 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 have been gratifying, but there are too many banks which are still carrying inadequate surety bonds, even at the reasonable rates prevailing today.

5. 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.

Bank directors occupy a key position. They are responsible for the overall policies and practices of a bank and should be chosen 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. Directors should be men of character, wisdom, and courage. It is they who are directly responsible for the selection of dependable 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 the deposits of customers; and it is they who are held legally responsible for supervising all bank policies and practices in a prudent manner. The ultimate success of any bank depends in large measure upon the selection of a good Board of Directors.

The executive officers and lay employees who are responsible for the day-by-day operations of a bank should also be chosen with great care. Top-notch officers and employees can be obtained and retained in a bank only by paying salaries comparable with those paid in other professions where the training, work, and responsibilities are somewhat similar. A banker is expected to make a good appearance 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 frequently a temptation "to borrow" funds from the bank to help balance the individual's budget. If and when a bank employee succumbs to this temptation he usually regards his "borrowing" as a temporary loan and has every intent of repaying the amount taken. These good intentions, however, are seldom realized; rather, chances are

that additional sums will be taken once the bars of personal conscience have been let down.

Higher bank salaries would not only help employees to resist temptation but would aid also in attracting a larger number of the better high-school and college graduates. Today most of the better graduates are going into professions or embarking upon careers other than banking. This presents a perilous 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 with respect to services of individuals.

Once a bank acquires good personnel, every effort should be made to encourage individual progress and contentment. Individual accomplishments should be recognized by adoption of equitable promotion plans. Furthermore, every bank should provide its employees with "shock absorbers" against the more common financial emergencies which are likely to overtake salaried people. I am thinking of such things as medical protection, life insurance and retirement plans. Protection against these eventualities should 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 employee and the bank.

A few dollars invested in the welfare of human beings will unquestionably prove to be the best investment which a bank can make. It is a well known fact that an employee can not do his most efficient work when he is troubled with financial problems or other problems connected with his job. Relief from these worries will not only improve the morale

and efficiency of employees, but will also remove one of the most common causes of defalcations and consequent bank failures.

6. Restrictions on the chartering of new banks. The prosperity and expansion of banking since the war 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 experience of the 1920's when excessive expansion in the number of new banks was accompanied by a rising tide of bank suspensions. 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.

A sound yet flexible guide to 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 should give consideration to these factors: (a) The adequacy of its capital structure; (b) its future earnings 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; and (f) the financial history and condition of the bank, if it is an existing bank applying for insurance.

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 the Currency, while charters

for State banks must be obtained from the respective State authorities. However, the ability of a prospective bank to qualify for deposit insurance is a consideration much respected by the chartering authorities. In most cases, proposals of new banks are investigated jointly by the Federal Deposit Insurance Corporation and the appropriate chartering authority. The chartering authority and the Corporation are each provided with all the facts, and each knows the importance of the various factors in the 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. It is our belief that the standards which new banks must meet provide a foundation which precludes many of the difficulties encountered in earlier periods.

7. Cooperation with other supervisory agencies in promoting 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 while at the same time minimizing the risks of so doing. This political tenet is embodied in our 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 the evolution of new ideas fostered by the dual system of banking. 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, some more successfully than others. No less than 150 bills were introduced in our Federal Congress between 1886 and 1933 providing for some form of deposit guaranty--a story chronicled in the 1950 report of our Corporation. Out of these various field tests and proposals the ground-work was laid for the establishment of the Federal plan of deposit insurance which we have today.

The freedom which nurtures such individual and local institutions must obtain its efficiency through cooperation rather than edict. Cooperation among the bank supervisory agencies is not merely a top-level matter, but extends to the grass-roots as representatives of the different agencies work jointly with individual banks. In about three-fourths of the states the Federal Deposit Insurance Corporation schedules joint or concurrent examinations with State supervisory authorities. This joint effort is made possible by use of a uniform examination report, a development of much more importance than it sounds to those unfamiliar with the multiplicity of accounting systems. Joint examinations not only achieve important savings for everyone concerned but also facilitate cooperation in bringing about corrective measures and needed improvements in the banks.

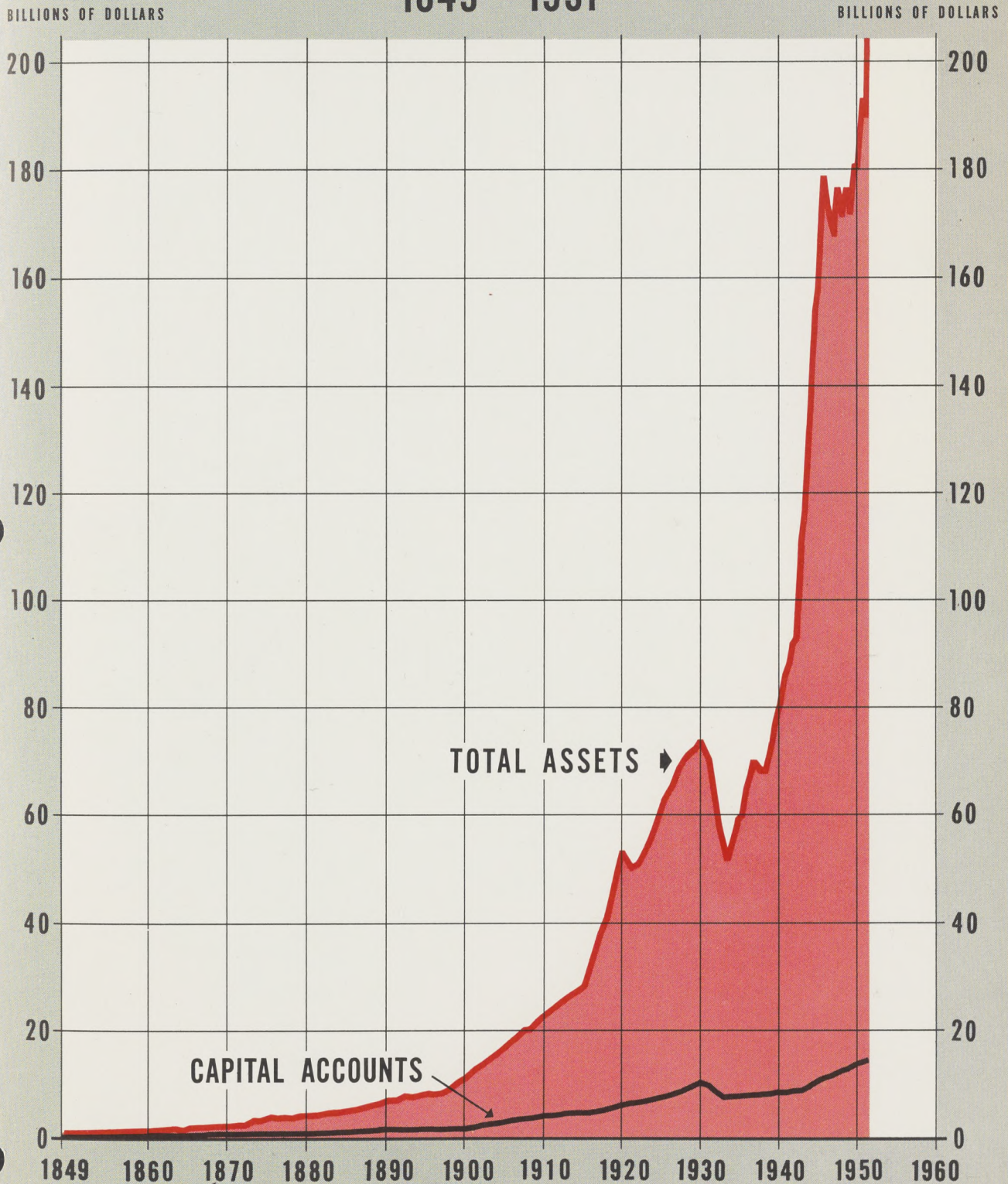
The slow and often painful ways of cooperation require constant cultivation. They do not get results as quickly as a dictator would like, but the decisions they reach and the structure they erect will be the more enduring, for they rest upon the wisdom and experience of the whole people.

8. Maintenance of a sound and stable national economy. So far no mention has been made of the necessity and importance of having a sound

and stable national economy within which the banks might operate. Actually, it is basic to all the others. Without a sound and stable national economy there could be no strong banks. The vitality of every bank depends greatly upon government monetary and credit policies. Government obligations and cash, both of which are issued and controlled by the government, constitute a large portion of bank assets. Some bank loans are guaranteed by the Federal government, and bank deposits are affected by governmental policies. A well-managed national economy means a strong and stable economy, which in turn provides the foundation for 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. Whatever affects the general development of the community, state, and nation affects also the banks. 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 which banks can properly play in keeping it on an even keel. More than that, we know that prosperity conceals and breeds weaknesses which, if left unattended, may later explode with devastating results. The self-analysis which enables us to see and remedy our faults is the best assurance that our present prosperity is no fly-by-night phantom, but promises a really new era in economic stability.

CAPITAL AND ASSETS OF ALL OPERATING BANKS U. S. AND POSSESSIONS 1849 - 1951

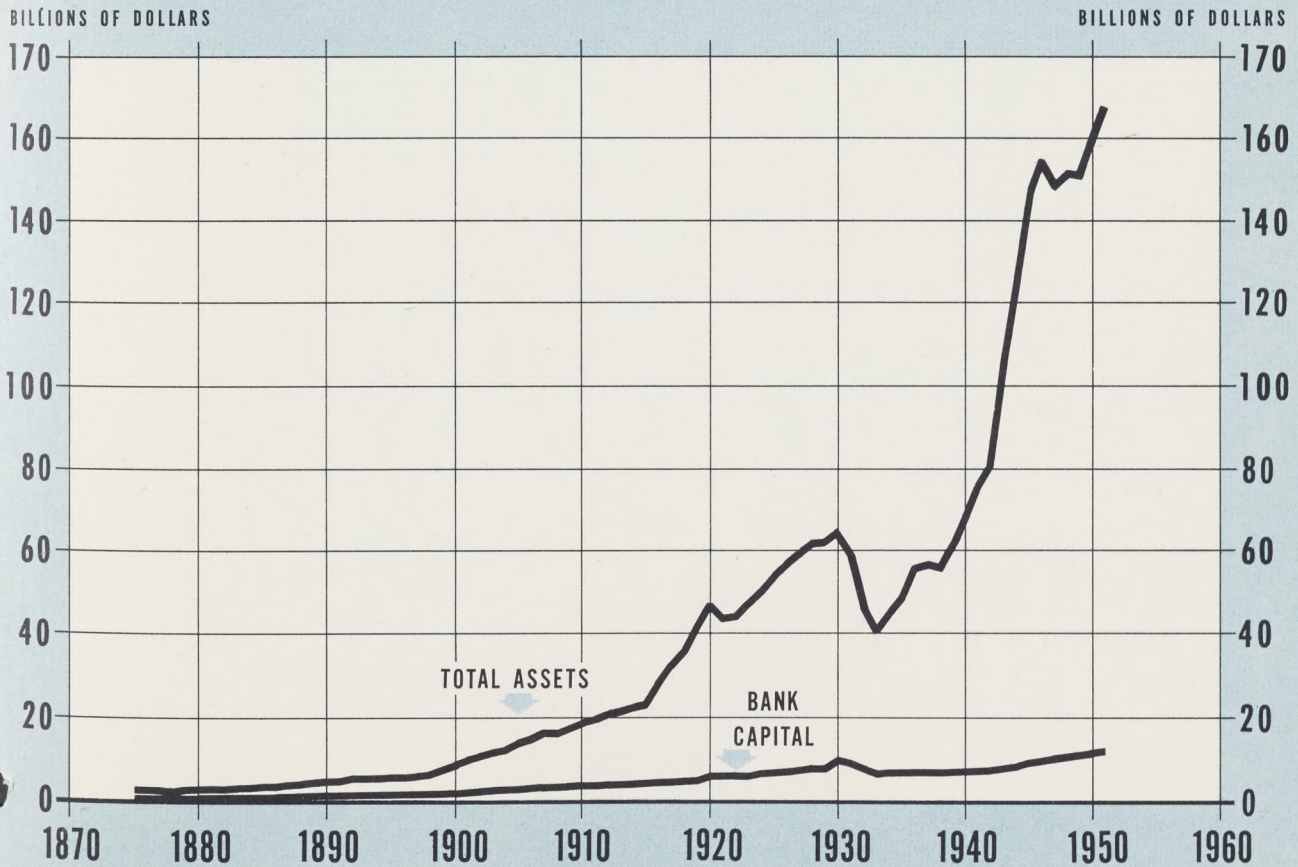
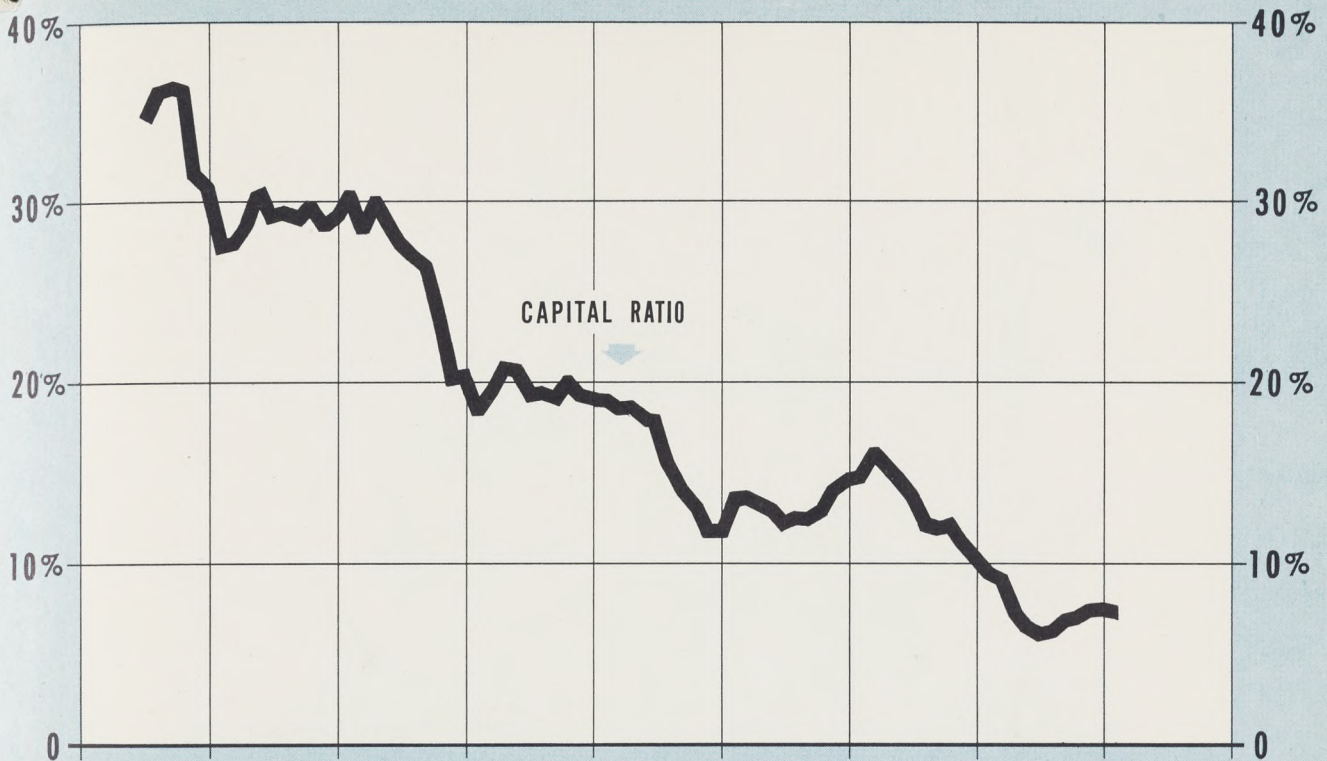


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CHART NO. 54

BANK CAPITAL RATIO

ALL COMMERCIAL BANKS, 1875-1951



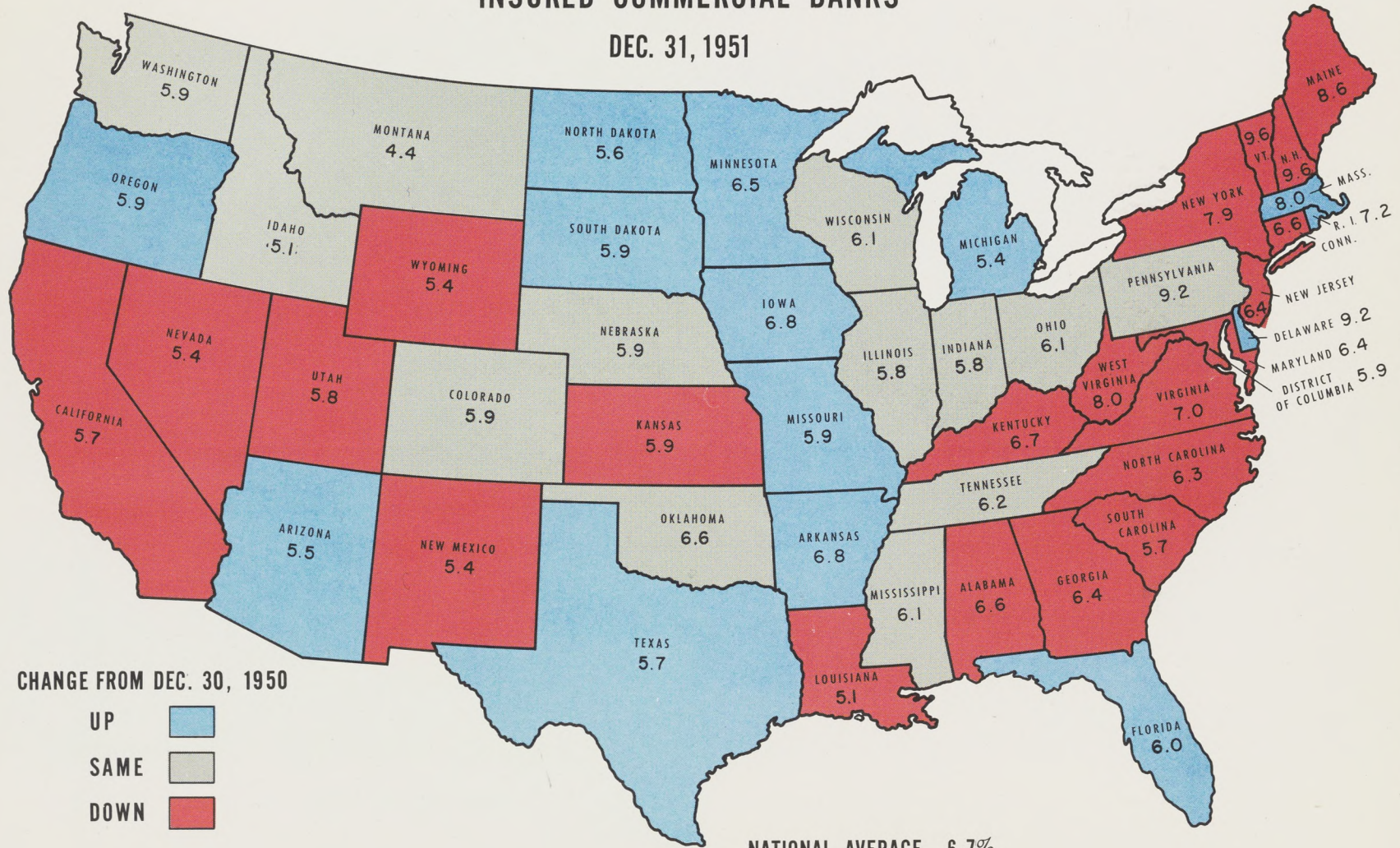
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CHART NO. 56

RATIO OF TOTAL CAPITAL ACCOUNTS TO TOTAL ASSETS

INSURED COMMERCIAL BANKS

DEC. 31, 1951

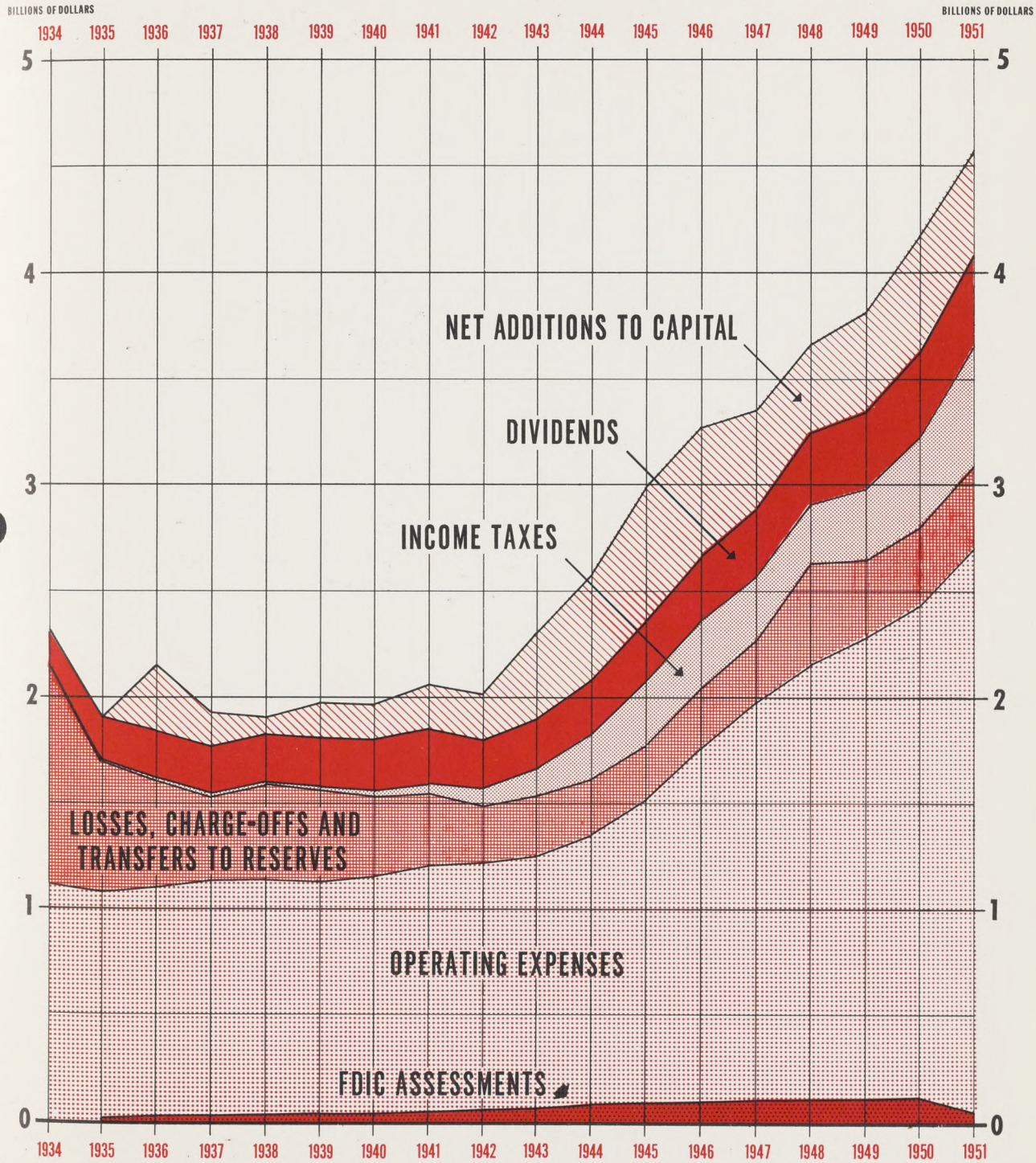


NATIONAL AVERAGE 6.7%

DISTRIBUTION OF INCOME BY INSURED COMMERCIAL BANKS

1934 - 1951

IN BILLIONS OF DOLLARS



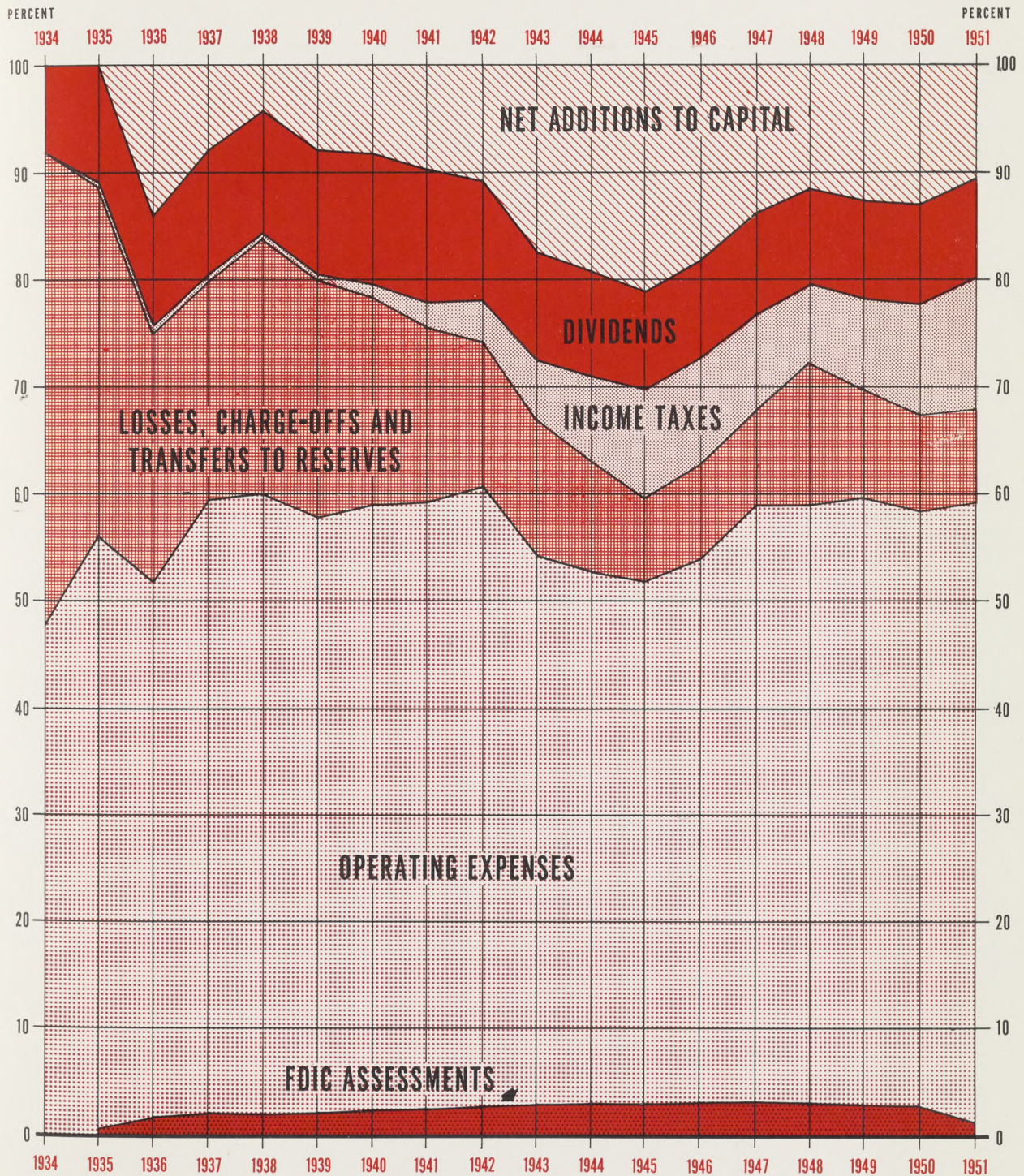
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CHART NO. 50

DISTRIBUTION OF INCOME BY INSURED COMMERCIAL BANKS

1934 - 1951

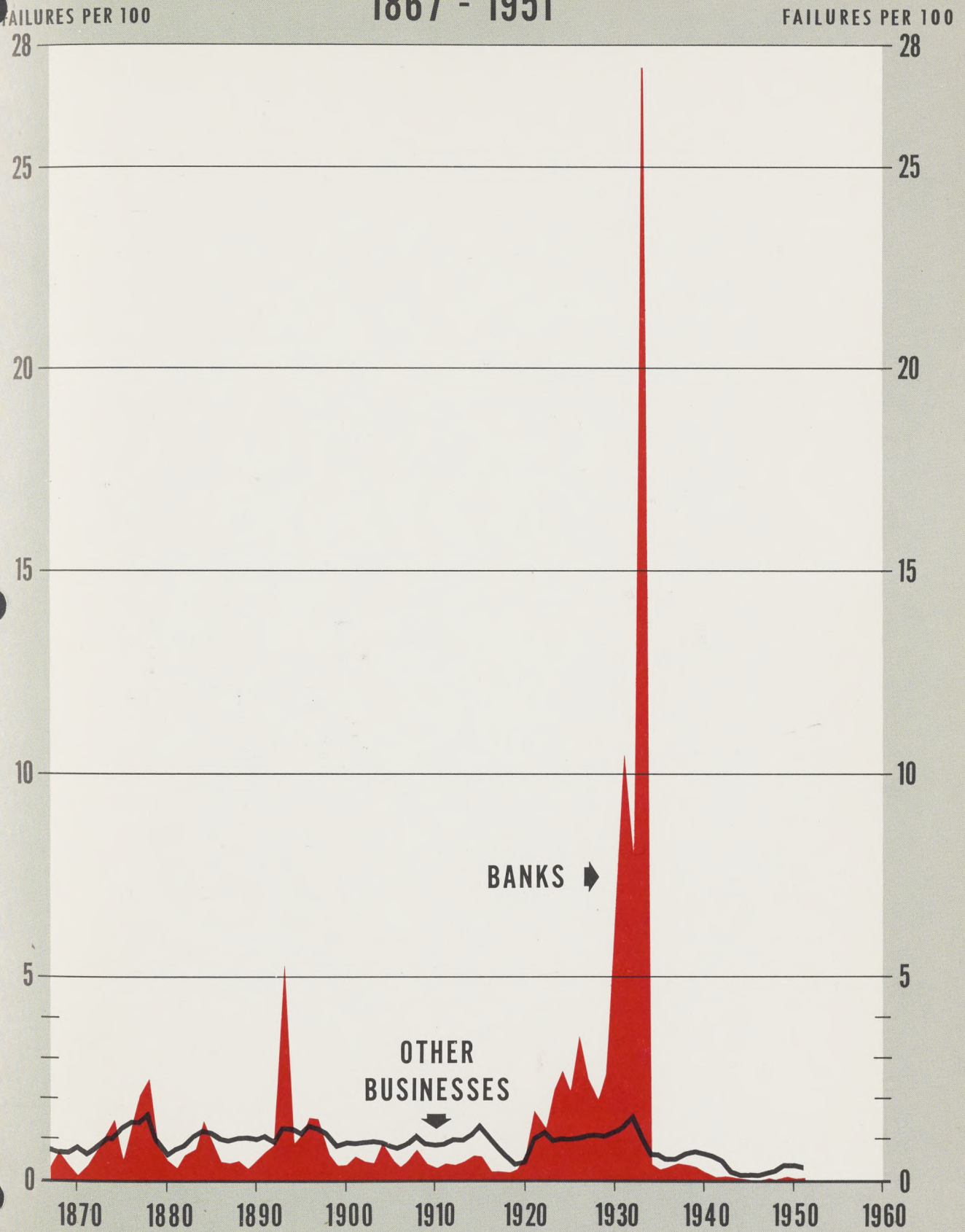
IN PERCENTAGES



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CHART NO. 51

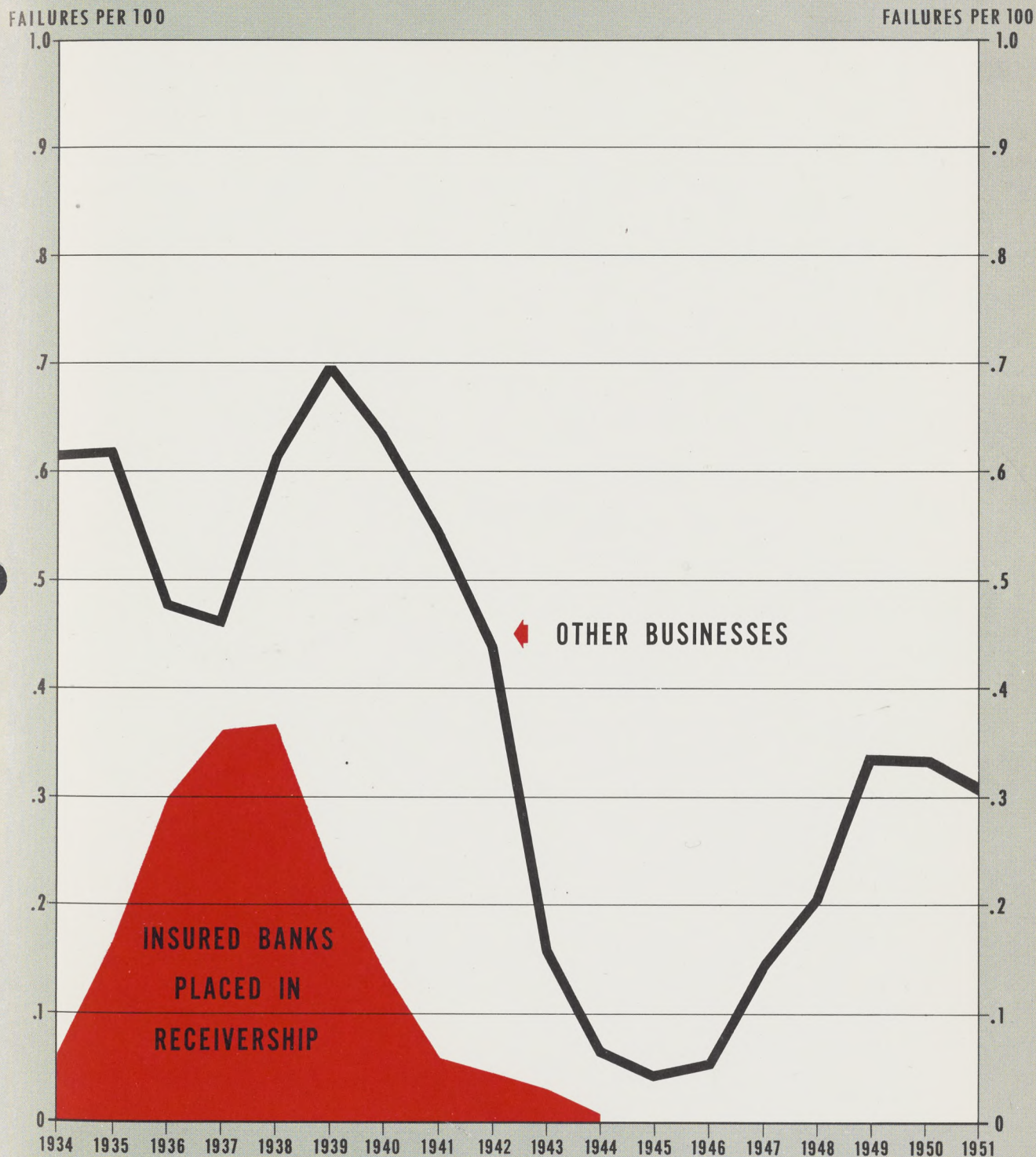
FAILURES IN BANKING AND BUSINESS 1867 - 1951



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CHART NO. 49

FAILURES IN BANKING AND BUSINESS

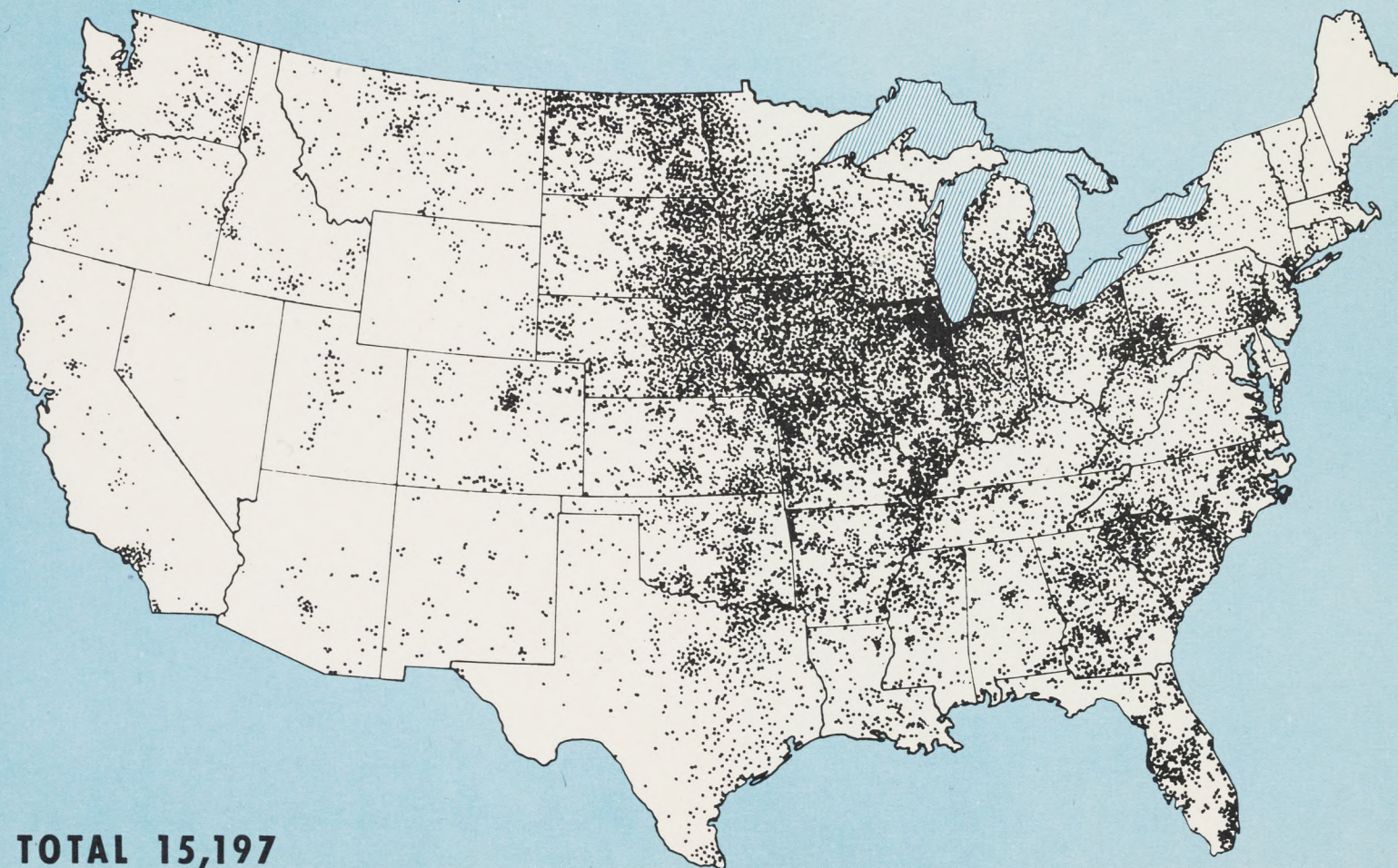
1934 - 1951



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CHART NO. 52

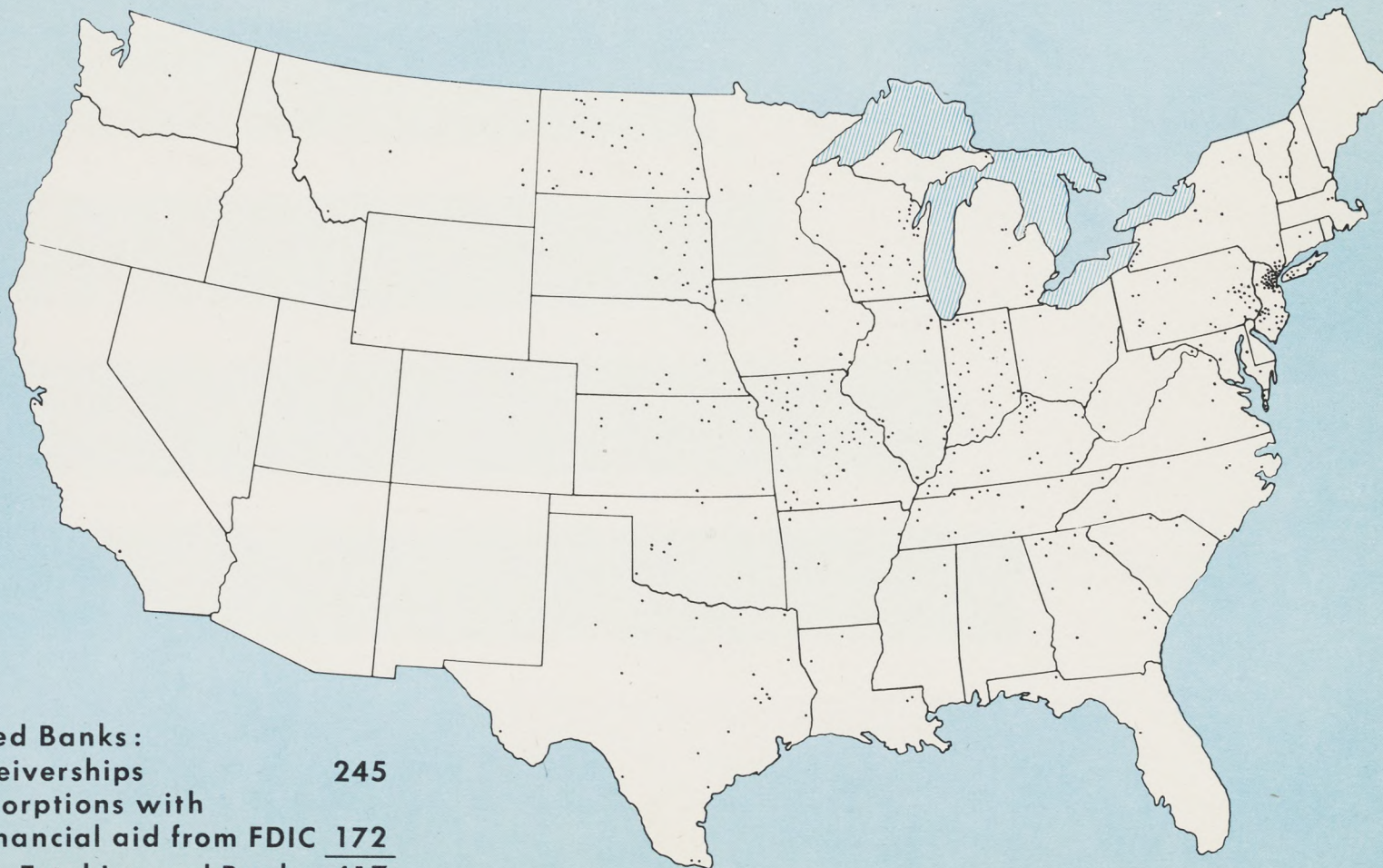
FAILURES IN BANKING 1916 to 1933



TOTAL 15,197

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CHART NO. 46

FAILURES IN BANKING 1934 to 1951



| | |
|---|------------|
| Insured Banks: | |
| Receiverships | 245 |
| Absorptions with financial aid from FDIC | <u>172</u> |
| Total Insured Banks | 417 |
| Noninsured Bank Suspensions | <u>99</u> |
| Grand Total | 516 |

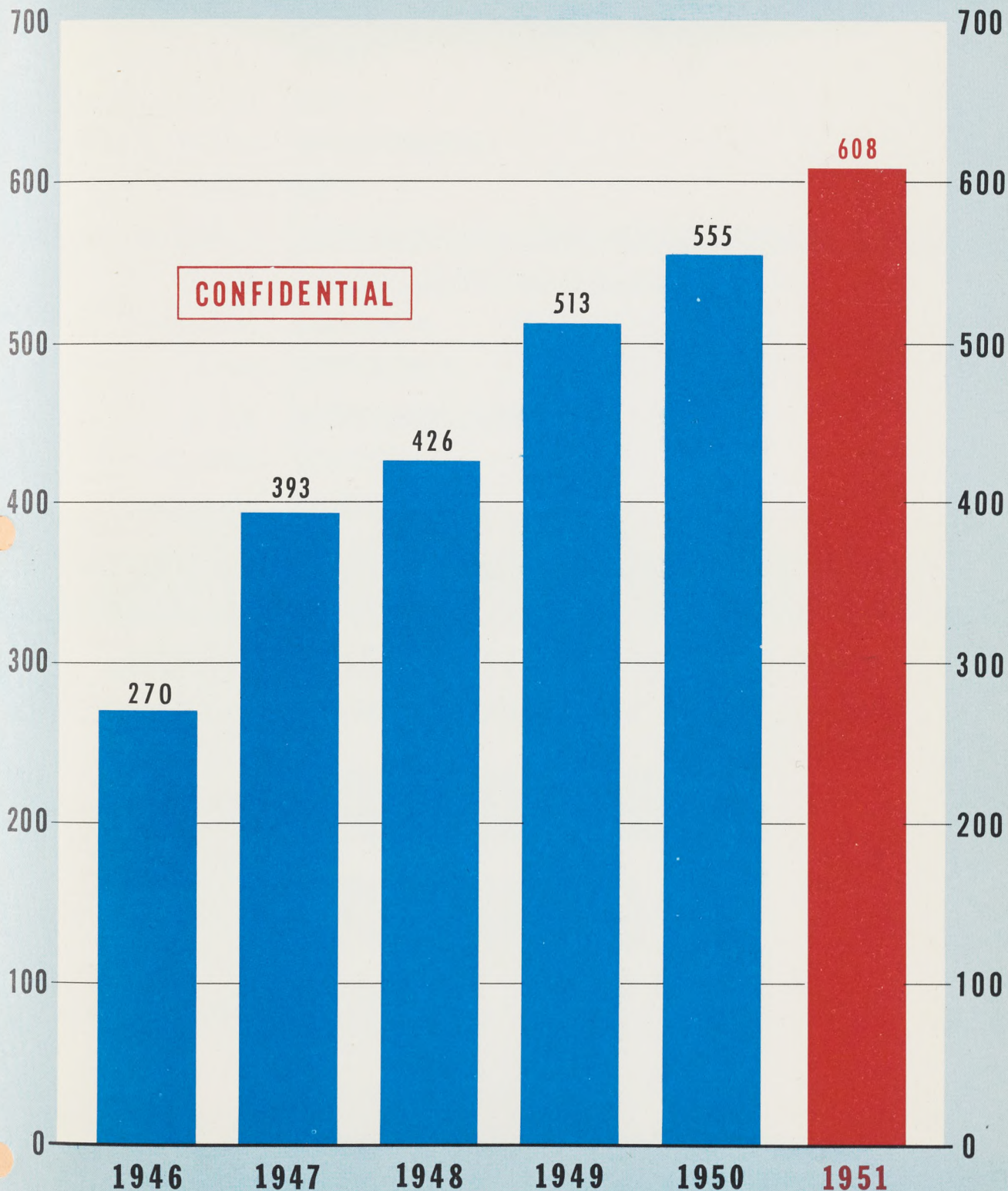
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CHART NO. 47

DEFALCATIONS

NUMBER REPORTED IN ALL INSURED BANKS

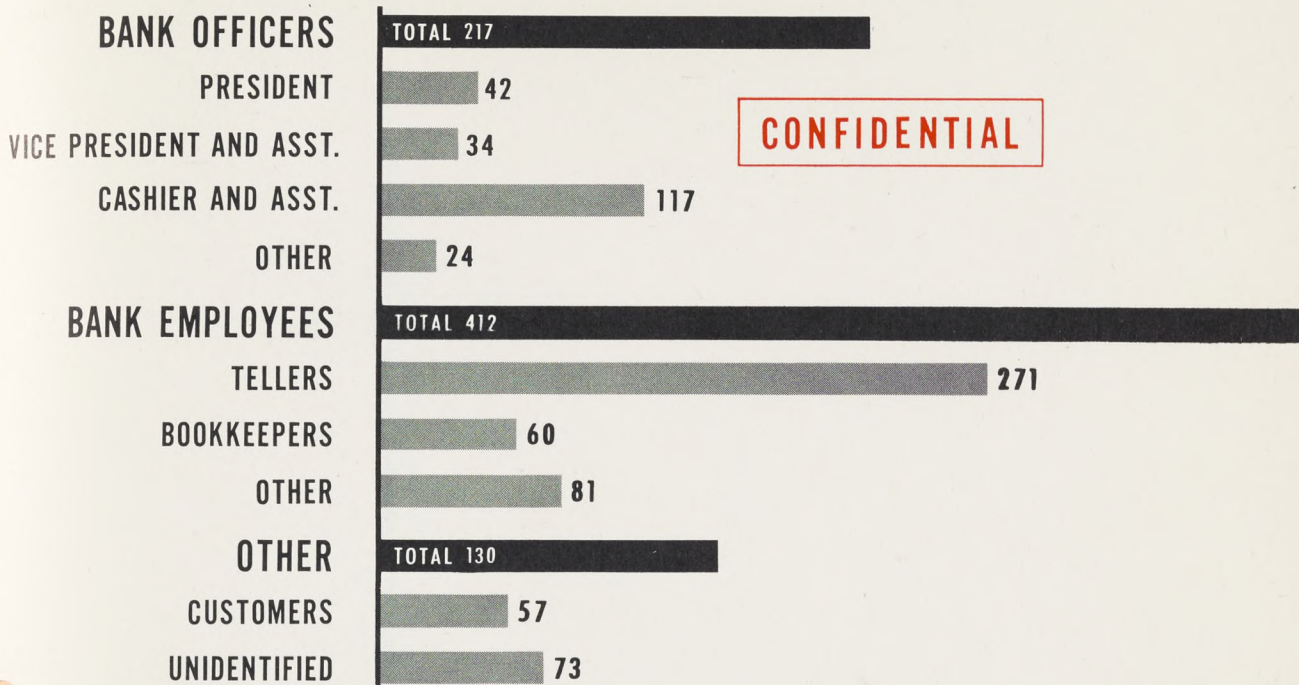
1946 - 1951



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CHART NO. 42

DEFALCATIONS

STATUS OF 759 PERSONS INVOLVED IN 608 REPORTS COVERING ALL INSURED BANKS • 1951



ANALYSIS OF IRREGULARITIES INVOLVED IN 608 REPORTS COVERING ALL INSURED BANKS • 1951

