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"BANKERS ARE MEETING THE CHALLENGE"

ADDRESS OF HONORABLE H. EARL COOK

DIRECTOR, FEDERAL DEPOSIT INSURANCE CORPORATION

BEFORE THE

EASTERN REGIONAL CONFERENCE

NATIONAL ASSOCIATION OF BANK AUDITORS AND COMPTROLLERS

BALTIMORE, MARYLAND
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FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON 25

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Mr. Chairman, Gentlemen of the Association, and distinguished guests:

It was my privilege some five and a half years ago, in October of 1947, to address the National convention of your association here in Baltimore. My interest in you and in the progressive activities of your association has grown increasingly throughout those years. There is no professional group, to my knowledge, that has contributed more to improved methods of bank controls and internal audits than NABAC.

Your regional and national meetings are workshops in the truest sense of the word. What social activities there are lend but slight leavening to the very serious purpose and the very important accomplishments of your gatherings. The imposing shelf of texts, of bulletins and of special studies that have been published under the association's imprint add up to the most comprehensive encyclopedia that I have seen on an extremely technical phase of a technical subject.

Then there is the Auditgram. No month's reading in our office would be complete without it. Its constant balance of facts, findings, opinions, information and personalities contributes to its reputation as the most readable of trade publications.

You may have gathered by now that I think you fellows are doing a pretty good job. I do. But, as is always the case with us from Washington, I have a few suggestions as to how it could be improved.

On that October day in 1947 -- the occasion of what was practically my maiden address as a member of the board of directors of Federal Deposit Insurance Corporation -- I chose as my topic "A Challenge for the Banks". Today, five and a half years later, I should like to discuss steps banks have taken to meet the challenge. The ultimate success of these steps depends upon the understanding, the wisdom and the initiative of you men as well as upon the constant vigilance of supervisory authorities and the Federal Deposit Insurance Corporation.

Prior to 1946 difficulties in most of the banks which required aid from Federal Deposit Insruance Corporation to protect depositors arose from progressive and accumulative deterioration in assets. It took several years after creation of the Corporation to clean up the debris which went by the name of "assets" in many insured banks.

This improvement on the balance sheet was accomplished in many and various ways:

First: Insured banks with incurable asset problems were put in receivership or merged with sounder banks, with Federal Deposit Insurance Corporation making up the difference;

Second: Examination procedures were improved to prevent any general deterioration of assets or any sudden shift in their valuation;

Third: An intensive program for the betterment of bank management was inaugurated both by the banks and by the supervisory agencies;

Fourth: A continuing high level of production and prices helped to "rehabilitate" some assets and held at steady levels those that had been acquired more recently.

As a consequence of these and other influences, asset problems in insured banks diminished substantially. But another little ogre reared its ugly head and it has continued to plague us constantly. Of the 22 cases in which the Corporation has been called upon for financial aid to protect insured depositors since January 1, 1946, 19 have been the direct or indirect result of defalcations.

In 1947 I mentioned that Vance Sailor, Chief of our Division of Examination, had written an essay on "Human Frailty" which, I believe, was reprinted in your Auditgram. After a study of the cases which have occurred during the intervening years and after a review of those which occurred earlier, both Vance and I have come to the conclusion that the primary fault lies not with those who do the misfeasance, but rather with those who permit it to happen.

Not that I agree with the judge who recently set free a defaulter and excoriated the board of directors of his bank for the low salary they paid him. "To each his hire" has been an admirable admonition from time immemorial and it should prevail today.

It is time, however, for those who claim the title of bank director to start directing. It is time, as Vance says, for them to start "knowing their Marys and Joes". It is time for them to realize that attending a casual meeting irregularly is not enough to justify their title and that such indifference may be enough to jeopardize not only their standing in the community but their pocketbooks. Those are the two factors that got them the jobs in the first place and they are the two places where it could hurt most if they fail to fulfill their responsibilities.

Defalcations in banks, just as in most other businesses, don't just happen. There has to be an underlying cause. Let me say at the outset that the banking profession, statistically, is a profession of the highest integrity in this respect. Unfortunately, the public expects its bankers to be flawless, and the news of a peculation that is discovered in a bank rates banner heads on page one, while if a tailor runs off with a clothier's receipts, the news will appear in a four-line box next to the obituary column. What is sauce for the tailor is certainly not sauce for the teller!

Vance Sailor likes to point out frequently that the active, operating personnel in banks is like Ivory soap and is 99.44% pure. The other 0.56%, however, is sufficient to give the banking system a black eye.

What can be done about eliminating this annoying fraction of one percent? Well, in the first place, we in the supervisory and insuring fields have been introducing new techniques and improving our examining procedures, with the idea of doing the best possible job on our side. We have long been aware of the hazards that are involved and we are working constantly to close what gaps exist, within the limitations of our functions and our capabilities.

On the other side of the picture, the bankers are doing a fine job. There has been general acceptance of our suggestions for improved internal controls. Furthermore, our examiners are instructed to be constantly on the alert for techniques which they find employed in one insured bank that may be beneficial in other institutions.

You men gathered here today are thoroughly familiar with the many simple steps that can be taken to minimize the danger of defalcations. It would be presumptuous to preach to you about them. But I shall take the liberty of reviewing a few of the fundamental safety factors in the hope that you, who govern the internal operations of larger institutions and who command such respect among your smaller correspondents and associates, will spread the gospel among the smaller banks which cannot afford to employ men of your training and talent.

It is significant that of the 19 banks requiring financial aid from Federal Deposit Insurance Corporation as the result of fidelity losses from January 1, 1946 through the end of 1952, all but one held deposits of less than $3.5 million. That is not to say that irregularities do not occur in larger institutions, but the banks that were destroyed through breaches of trust -- those in which fidelity bonds and capital accounts could not equal the depredations of trusted officers and employees -- fell among the smaller size groupings.

What we hope, therefore, is that you who have the knowledge, you who have the practice, you who have the welfare of the whole American banking system so close to your hearts, will spread the gospel among the smaller banks of your acquaintance. Not all of the technical aspects of protection against fraud -- just the fundamentals. Don't prescribe a two-ton vault door in a $200,000 bank, but at least suggest procedures that can't be cracked with a skeleton key.

Our purpose in making this request is selfish only to the extent that we, too, share pride in the record of integrity of the American banking system. Financial losses that the Corporation has been required to assume because of infidelity have been relatively small. Remember that the surety coverage and the capital funds all must be dissipated before the Corporation is called upon to put up a single dime.

The two major selling points you should use in your campaign among the smaller banks would seem to me to be these:

First: The directors and the stockholders should protect themselves against personal loss and disgrace.

Second: What happens by way of dishonesty in the smallest bank reflects upon the integrity of the largest bank and so breeds distrust of our whole banking structure.

We in Federal Deposit Insurance Corporation are not convinced that there is an increasing incidence of defalcations. We believe that better internal controls and improved examination procedures are responsible for turning up many that have been dormant for several years. It is true that the number of cases reported to the U.S. District attorneys has grown from 270 in 1946, to 621 in 1952, but the rate of increase has been slowing down rapidly, and we hope to see a sharp decline when the figures for 1953 are in. With your help, we shall have started to descend the ladder.

Now, with your permission, I shall mention just a few of the fundamental safeguards which we hope you will urge upon your friends in the smaller banks.

The first, of course, is compulsory vacations for all employees. In some of the shortages mentioned above the offender had not taken a vacation for years and in many cases he was complimented because of his devotion to duty. We had one case within the last few years where directors inaugurated a policy of compulsory vacations. One of the officers, who thought his manipulations were pretty well covered up decided to take ten days in Canada. When a long-absent depositor called to make a withdrawal and the ledger sheet was found missing, subsequent study found the vacationer to be short about $80,000.

Another safeguard is rotation of employees. In smaller banks, this is rarely possible, but you should urge adoption of the practice in every case where it is humanly possible. The rotation, of course, should not be on any fixed schedule. Its value lies in the element of surprise.

No matter how small the bank, there should be a complete separation of the teller and bookkeeping functions. Even in banks as large as $5 and $6 million we have found appalling laxity in observing this basic rule. Allowing one officer or employee to perform both functions is like sending a rabbit to the store for a head of lettuce. The temptation is just too great and the opportunities for wrong-doing too many.

Every time a defalcation is uncovered the hue and cry is heard: "Where were the examiners while this was going on?" Now you know and I know that bank examinations are not and cannot be audits in the true sense of the word. The function of examiners is to verify and appraise assets shown on the books of the banks, to assay the quality and efficiency of bank management and to make recommendations for improvements where they seem necessary.

The audit function is definitely and entirely the responsibility of the board of directors in each bank. In only very rare instances are the directors themselves competent enough as accountants to make by themselves the examinations and audits required by statute. For this reason, we urge that they make provision either through their correspondent banks or through private certified public accountants to have adequate audits made. If the directors can be made to understand that the step is primarily for their own protection, then they could have no valid excuse for neglecting their responsibilities in this supremely important phase of bank operations. In many cases, smaller banks have grouped together on a county-wide basis to employ auditors to inspect all their institutions periodically. This not only has fulfilled the intent of the statute, but it has reduced costs to an absolute minimum for participating institutions.

It is true that not all outside accountants are skilled in the complexities of bank auditing. But significant progress is being made to improve that condition. In Iowa, for example, the Iowa State Bankers Association and the Iowa Society of Certified Public Accountants are planning a joint seminar to acquaint CPA's with the pecularities of bank auditing. Similar cooperative discussions are being held in other States.

Let it be noted, however, that the directors' responsibility does not end when he has established adequate internal controls and provided for periodic audits by qualified accountants. The human factor must always be uppermost in their considerations and deliberations.

As a general rule, the directors are considered to have discharged this part of their responsibility when they select skilled and competent management to operate the bank. Yet they would be wise to review from time to time the personnel policies being followed by the officers they select. Believe me, these are just as important as the lending policies and the new machines, and the shiny fixtures.

I am convinced that the greatest safeguard against losses is <u>management's</u>

continuing personal interest in employees of the bank. A bank has no greater liability than a discontented or neglected employee. It could have no more valuable asset than an employee who is given the feeling of "belonging" and the knowledge that he has someone to turn to in time of trouble or stress.

The morale situation in a bank should be of continuing concern to senior officers and to directors. Here are a few suggestions that have been demonstrated to be healthy boosters of morale in many institutions:

An impartial promotion program should be adopted in every bank. An employee who feels that his chance will come is not likely to get discouraged, even if his salary increases are very slow. But the fellow who feels that he is standing still and will be held down forever is not only a bad producer but also a bad risk. It often becomes necessary in any business to bring in an outsider with specialized skills to fill a vital spot in the organization. Whenever such action becomes necessary in a bank, management should make the reasons clear to any employee who might feel that he is being by-passed. The mere fact that the boss is willing to confide in him will take most of the sting out of any imagined slight that he may feel.

We have found, too, that health insurance, paid for either by the bank or jointly by the bank and the employee is a great morale booster. If a teller's wife has to undergo an operation he is going to see that the hospital and the doctors are paid in some way. If there is a health insurance policy, that takes care of it. Otherwise, he is very likely to "borrow" a little money from the till and repayment in those cases is extremely rare.

The management of every bank -- and that includes directors as well as officers -- should know more about their employees, what they think and what they are doing. They should know how employees spend their time when they are not in the bank -- what their hobbies and habits are; who their associates are. One doesn't have to be a pry or a spy to find out these things. In many of our defalcation cases the offenders have been notorious for spending a lot of time in night clubs, race tracks, or casinos; and everybody in town seemed to know about it except the officers and directors of the bank. In one instance, the directors had to pay substantial amounts at the time of liquidation for failure to discharge their duties in this respect.

It is essential that an employee should have the feeling that if he has a problem he can take it to one of his superiors, sit down and talk it over in a friendly way and expect sound advice and help. If bank management would take greater pains to cultivate that feeling of security, most of their employee problems would be solved.

Well, I have rambled on quite at length, but I did want to review what management has done to meet the challenge since I spoke to you in 1947 and I did want to suggest what more can be done to bring us closer to our goal.

In brief summary, the gospel which we preach and the gospel which we hope you as devoted disciples will spread thoughout the land falls into three categories: 1. Improved internal controls. 2. Wider and more effective use of bank audits, and 3. An awakening to the need for improved human relations between top management and employees. Given your support in promoting these worthy aims, I am sure that when next I report to you I can say authoritatively that "Banking Has Met the Challenge". Thank you.

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