INTEGRITY, ARE YOU PROTECTING THIS RISK ASSET?

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Address by Dr. Edison H. Cramer, Chief of the Division of Research and Statistics, Federal Deposit Insurance Corporation, before the Seventeenth Annual Convention of the Independent Bankers Association, Mobile, Alabama, April 10, 1951.

When Mr. DuBois asked me to speak to this Seventeenth Convention of the Independent Bankers Association, he did not specify the topic he wanted discussed. But having been an officer in a small bank, which is a member of this Association, I know the interest you take in every serious threat to the independent, unit banks of America. Consequently, I chose a topic that in my judgment constitutes such a threat. The menace to which I refer is dishonesty on the part of bank officers and other employees. I framed the title of this talk in the form of a question with the hope and expectation that each one of you will ask yourself if you are doing your best to protect the integrity of your employees--the most important risk asset in your bank.

My remarks this morning will be in the nature of a preliminary report of a study of defalcations in insured banks, which is being carried on under my supervision.

Dishonesty on the part of bank employees is a problem that many of us are reluctant to acknowledge, and that we hesitate to discuss. It is a topic we dislike seeing reported in the press or broadcast over radio or television. Reporters and the public are likely to forget that for every dishonest bank employee, there are hundreds who do not yield to temptation. Nevertheless, it is a real problem, and one that cannot be solved by pretending it does not exist. The National Association of Bank Auditors and Comptrollers recognizes this and states in its Manual, "the greatest risk to banks is that of fidelity."

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We in the Federal Deposit Insurance Corporation also have good reason to be aware of the importance of this problem. Defalcations have been the largest single cause of insured bank failures. Of the 415 banks requiring the financial aid of the Corporation since its inception 17 years ago, 120--more than one out of four--were wrecked by dishonest employees.

The seriousness of this problem is also brought to the attention of the officials of the Corporation at the semi-weekly meetings of the Board of Review. Among other things this standing committee considers reports by our examiners of irregularities in insured banks not members of the Federal Reserve System--those we regularly examine. During the first quarter of this year, this committee met twenty-six times, and at all but six meetings irregularities were reported. The largest number for any one meeting was five, and the total for the three months was forty. Twenty-eight states were represented. These widespread irregularities by bank employees are not new to the banking business, but our study shows that they are increasing at an alarming rate.

Growth in defalcations. Table 1 shows the steady year-by-year increase in irregularities. It includes only those cases reported to the United States District Attorneys. The amounts vary all the way from eight dollars to one million and a half dollars. As you can see, the number has more than doubled in the last five years, and in 1950 reached a total of 555. We are undertaking, in this study to which I referred, a detailed analysis of these 555 cases, and hope to enlarge our understanding of the methods used in defalcations, the means by which they are discovered, their incidence among

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TABLE 1. NUMBER OF DEFALCATIONS
IN ALL INSURED BANKS, 1946-1950

Year	All insured banks	National banks	State banks member F.R. System	Banks not members F.R. System
1946	270	173	30	67
1947	393	225	52	116
1948	426	233	56	137
1949	513	290	67	156
1950	555	309	67	179

different types of employees and, of course, methods of prevention. Our study has not yet progressed beyond the point of assembling and making a preliminary classification of certain facts present in defalcations. But I believe you will find some of these facts interesting.

Persons involved. Of the 555 defalcations reported in 1950 we have made detailed summaries of 300 cases involving bank employees. These 300 cases involved 356 persons--131 officers and 225 other employees. Who were these individuals? What positions did they occupy? The positions ranged from president and vice president, where we found ten percent of the violators, to a negligible number of janitors and messengers. However, as you would expect, the most frequent offender was the teller. One hundred and sixty-three persons in that position were involved in defalcations; six of that number also had duties as bookkeeper, and four had the title of assistant cashier along with that of teller. The next most frequent offenders were the cashiers, numbering 76 persons, including a few who combined cashier duties with other responsibilities.

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OFFICERS AND EMPLOYEES INVOLVED IN 300 IDENTIFIED IRREGULARITIES IN INSURED BANKS DURING 1950

Position	Number
Total employees	356
Officers:	131
Directors	3
Presidents	20
Vice presidents	15
Cashiers	30
Cashiers-presidents	2
Cashiers-vice presidents	5
Cashier-directors	2
Assistant cashiers	36
Assistant cashiers-branch managers	1
Branch managers	11
Assistant cashiers-tellers	4
Assistant treasurers	2
Other employees:	225
Bookkeepers	39
Tellers	153
Tellers-bookkeepers	6
Clerks, miscellaneous	10
Collection department employees	6
Other (Auditor, administrative assistant, stenographer, accounting department, messenger, hanitor, porter, guard)	11

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Methods used. As much as we are interested in the positions which most easily permit defalcations, it is the methods used that present the greatest challenge. Perhaps the most frequent method is that of withholding deposit tickets and falsifying records. In one case we investigated, the cashier went to all the trouble to prepare special statement sheets for the customers with whose accounts he had tampered, substituting these for the ones prepared by the bookkeepers. Only discrepancies in dates of deposits led to his discovery.

Methods of misappropriating funds vary widely. One of the simplest was used by a teller who found a check on the floor of the bank, and cashed it. But most of the embezzlements have been devised with the utmost attention to detail. In one case small charges against checking accounts of individual depositors were made by the cashier by tipping back the carriage of the posting machine so that the charge would not show on the ledger or statement sheets, but the balance would be reduced. In similar manner, a credit for the same amount was made to the cashier's own account. Of course, a few depositors checked their accounts and the irregularity was discovered.

One of the most original methods encountered in these cases involved manipulation of the bank's income account. The president of the bank did not credit interest on 27 notes, but instead held the money in cash to be paid as bonuses to his sons who were officers of the bank. He managed to hold out over $2,000 in this manner in just two months, before he was caught.

The bond portfolio of a bank sometimes comes under suspicion. In one small bank $25,000 in bonds were purchased at a price in excess of the market price. This raised an immediate question: Who benefitted by the

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premium price, the president of the bank, or the bond dealer, or both?

Many of the cases which have been uncovered are rich in drama and human interest. One of the most tragic was that of a man who some 20 years earlier had committed an indiscretion with his wife's sister. For all the ensuing years he had been blackmailed by this sister-in-law, who ran a road-house, apparently financed with the bank's money. The bank officer had lived below his legitimate income during all those years, and was a respected citizen of the community. He could perhaps have continued his embezzlements indefinitel except for an illness which hospitalized him, and proved fatal. Ironically, it was his own son, called in from a neighboring bank to help out during his father's absence, who discovered the irregularities.

Family banks offer unique opportunities for misappropriation of funds. The chance of discovery is perhaps lessened when ownership, control, and management are concentrated in a few trusting hands. However, when an officer embezzles from his family's bank, the family itself suffers when things go wrong. A striking case was that of a vice president who was a practicing attorney and the real estate loan officer, son of the Chairman of the board, and brother of the president. He managed in a few years to embezzle $650,000 through spurious real estate mortgages, wrecking the bank and dissolving most of his family's holdings of stock. Fortunately, none of the bank's creditors suffered any loss, but the family, including those members not implicated in the misdeeds, sustained substantial financial losses.

Another set-up that has facilitated irregularities is that of an employee of a bank with an outside business, especially if this business has an account with the bank which employes him. Year before last, a defalcation

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provided a good illustration of this weakness. In this case the long-time cashier of the bank had an ownership interest in a mill. He also was influenced by a cousin who had an interest in an oil-refining company. The bank could not lend the money needed by these two firms, so the cashier let them have it anyway by taking it out of large accounts. His manipulations were usually confined to accounts with active balances sufficient to withstand substantial charges. Looked at retrospectively, the abnormal activity in the savings accounts and the trend of total deposits counter to those in neighboring banks offered clues that something might be wrong. But the bank did not have adequate internal controls and the irregularities were not discovered until too late to save the bank from insolvency.

Somewhat similar to employee interest in outside concerns is that of bankers holding public positions of trust. It is the most natural thing in the world for people to think that a banker is trained in finance and therefore would make a good treasurer of the city or school district or church or club. In one case, a banker who was town treasurer sold the town's bonds that had been called for redemption and put the money in his pocket. He avoided detection for several years by paying interest on the coupons, but when the bonds came due and were presented for payment he had to give up. In another case, the banker was hired as town auditor and in this dual capacity managed to conceal his manipulation of the town's account for several years. As cashier of the bank he certified to himself as town auditor incorrect bank balances.

The postwar record. During the past five years, the Federal Deposit Insurance Corporation has had to aid depositors in 17 insured banks. These banks were merged with other insured banks with the financial aid of the Corporation. It is interesting to note that in fourteen of these seventeen

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cases, large defalcations were the direct cause of the difficulty. In another case, that appeared to be in trouble because of losses on loans, a large defalcation was discovered as soon as our examiners had an opportunity to scrutinize carefully the records. In other words, in this postwar period of five years, fifteen banks have closed because of large defalcations.

As shown in Table 3, these 15 defalcations were in banks having a total of $27 million in deposits. To protect depositors the Federal Deposit

TABLE 3

DEFALCATIONS IN INSURED BANKS RECEIVING FINANCIAL AID FROM THE FEDERAL DEPOSIT INSURANCE CORPORATION, 1946 - 1950

Year	Number of banks	Location of banks	Amount of deposits	Amount of defalcation	Amount of bond	ABA bond coverage	Amount of FDIC disburseme
1946	1	Churchville, Va.	$ 316,000	$ 30,420	$ 15,000	$ 20,000	$ 265,000
1947	3	Evanston, Wyoming	1,991,000	227,058	50,000	80,000	202,000
		Lemont, Illinois	1,749,000	250,994	50,000	75,000	479,000
		Central City, Pa.	1,709,000	128,371	20,000	75,000	93,000
1948	3	Newark, New Jersey	7,921,000	657,000	200,000	155,000	1,515,000
		Pryor Creek, Okla.	1,925,000	731,628	100,000	80,000	1,925,000
		Franklin, Texas	609,000	81,253	35,000	35,000	249,000
1949	4	Dyer, Indiana	3,090,000	438,686	150,000	100,000	1,282,000
		Martinsdale, Mont.	709,000	203,672	40,000	40,000	426,000
		Weston, Ohio	742,000	143,935	50,000	40,000	258,000
		Spencerville, Ind.	436,000	273,481	35,000	30,000	586,000
1950	4	Cecil, Pa.	2,246,000	1,549,615	50,000	40,000	1,730,000
		Westphalia, Mich.	1,126,000	455,071	45,000	50,000	968,000
		Minooka, Illinois	1,711,000	197,026	50,000	65,000	245,000
		Aurora, N. C.	991,000	90,065	75,000	50,000	939,000
5 years	15	12 States	$27,271,000	$5,458,275	$965,000	$935,000	$11,162,000

Note: Deposits and disbursements have been rounded as indicated. ABA bond coverage is based on known deposits, not the finally determined amount, which latter is presented on this table.

All data for 1950 are estimated except bond amounts. Disbursements include those made during 1951 as well as 1950.

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Insurance Corporation was forced to disburse over one-third of that amount. The actual amount of the defalcations was about a half of that, or $5.5 million. Bond coverage of $965,000 was wholly inadequate to meet this loss. And it is interesting to note that the amount of bond coverage slightly exceeded the standard suggested by the Insurance and Protective Committee of the American Bankers Association. In other words, the amount of bond coverage recommended by the ABA as a minimum standard is just that. It does not pretend to afford adequate protection but is only a suggested minimum.

Bankers blanket bond. No one, of course, maintains that fidelity insurance should take care of all losses due to defalcations. At best, the standards suggested by the American Bankers Association afford a yardstick only of the average experience with defalcation losses sustained by banks in different sized groups. It is not intended that fidelity insurance should take care of the extreme cases in dishonesty losses. Table 4 was prepared to show the extent to which insured commercial banks are following the recommended standards. In using these tables, it must be borne in mind that the standards were raised by the Insurance and Protective Committee of the ABA in June of 1950. About half of the banks used as a basis for the percentages in Table 4 were examined before the standards were raised. Therefore, it follows that some of the banks classified as below the new standard were at or above the old standard when they were examined early in 1950. Moreover, reports from the banks examined near the end of the year were not available when the tabulation was made.

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TABLE 4

FIDELITY BOND COVERAGE OF INSURED COMMERCIAL BANKS
EXAMINED DURING 1950

(Preliminary data)

	Below A.B.A. Standard %	At or Above A.B.A. Standard %
All banks	32	68
Nationals	54	46
State Members F.R.S.	44	56
State Nonmembers	13	87

With the foregoing qualification in mind, it is interesting to see that over two-thirds, in fact 68 percent, of the insured commercial banks examined in 1950 equaled or exceeded the ABA standards. Or, stating the same fact in the negative, 32 percent were below the standards. As you will note from this table, there was considerable variation among the different classes of banks in the degree to which they met ABA standards. Over half, or 54 percent, of the national banks were below the suggested minimum; at the other extreme, only 13 percent of the State nonmember banks were below the ABA standards.

It would be illusory, however, to place too much confidence in fidelity coverage. No individual in his right mind takes liberties with his health simply because he has a life insurance policy. Similarly, no bank can afford to ignore those practices and safeguards whose observance reduces the need for fidelity insurance.

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Internal controls. The first line of defense against defalcations lies in the rigid and regular internal controls of management. This is a subject I will only mention, for a discussion of accounting controls would take far more time than I have. Suffice it to say an air-tight system of record controls, if any system can be air-tight, is a strong discouragement to dishonesty.

Vacations. Bordering on this field is a matter I should like particularly to mention; namely, the matter of employee vacations. Looking back over the history of defalcations, it is at first surprising, and then significant, that many of them were engineered by employees who were regarded as so indispensable that they seldom if ever took leave of their job. Of course, after their misdeeds were revealed, the reason for their continuous and loyal service took on a new meaning. No employee should be encouraged to substitute a kind of personal accounting for the bank's records; and that is what a bank does when it keeps an employee constantly on the job. For its own safety, as well as part of an enlightened employee program, a bank should provide for paid vacations, and insist that they be taken regularly. Fortunately, more and more banks are doing this, and are thus greatly reducing the opportunity for concealing dishonesty.

Bank salaries. Bank salaries are another phase of the defalcation problem. What are the motives behind the dishonest acts of bank officials and employees, and how strong are the moral restraints against dishonesty? First of all, one must recognize the unusual temptations placed before bank employees. They deal in money, the universal means to material satisfaction. They come to have a kind of contempt for it and at the same time see in it the solution to

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pressing personal problems. After dealing in six figures five days a week, it must come as a letdown to take home a few dollars in the pay envelope. This combination of temptation and of salaries that are often inadequate, in terms of parity with jobs of comparable responsibility, is more than some employees can resist.

In many cases the first offense is not stealing in the eyes of the offender, but only a little borrowing to tide over an emergency. Sometimes it may be prompted by pique and undertaken as a means of redressing felt wrongs or injustices. Or it may be a flat attempt to obtain more of the good things of life without working for them. If one gets away with it the first time, he is tempted to try again and again, until his peculations get beyond the point where retreat is possible. As concealment becomes progressively more burdensome, more ingenious methods have to be used to prevent detection, and the chances of discovery increase. Most defalcations eventually collapse of their own weight.

Lie detectors. If the first penetration of the offender's moral standard could be prevented, the problem of defalcations would be solved. This is where rigid internal controls do their most effective job. Knowledge that the slightest dishonesty will be quickly and surely discovered will keep most of those that are tempted from taking the first fatal step. Several banks have fortified their internal controls with the lie detector technique. They begin this program by getting a specialist in this field to give every employee--officers and all--a lie detector test. Subsequently, every new employee is tested as part of the employment routine, and the whole staff is tested periodically.

Better selection of employees. There is one remaining suggestion I would like to propose for your consideration. We have recently been hearing a

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great deal about the results of psychological tests. If it is possible for aptitude tests to show whether a person will be a good salesman or a good mechanic or a good bookkeeper, why would it not be possible to design a test that would show a job applicant's ability to withstand temptation? Perhaps this has already been done, I do not know. But surely this is one approach to the problem that should not be overlooked.

In closing I want to recommend to the Independent Bankers Association that it help fight this plague that has afflicted so many banks. If we can mitigate this evil, we will not only reduce the greatest single cause of bank failure and its consequent loss to stockholders, but will help preserve the traditional American banking system. If we safeguard our greatest asset--the integrity of our bank officers and employees--we will not only save money for ourselves, but save them and their families from shame and disgrace. Perhaps it would even be appropriate to close by quoting a well known slogan, "Remember the life you save may be your own."

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