FEDERAL DEPOSIT INSURANCE CORPORATION
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ADDRESS OF

HONORABLE LEO T. CROWLEY

CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

BEFORE THE

MEMBERS OF THE KENTUCKY BANKERS ASSOCIATION

LOUISVILLE, KENTUCKY   SEPTEMBER 23, 1937

ADDRESS OF HON. LEO T. CROWLEY, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION, BEFORE THE MEMBERS OF THE KENTUCKY BANKERS ASSOCIATION AT THEIR ANNUAL CONVENTION

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GOVERNMENTAL SUPERVISION OF BANKS AND BANKING

Mr. Chairman, Ladies and Gentlemen:

It is pleasant to be able to meet with you today. I appreciate the courtesy of your invitation. It is my belief that bank supervisors have erred in failing to keep bankers informed of supervisory policies and procedures, and that bankers, in their turn, have shown a curious lack of interest in the why and the how of bank supervision. Certainly bankers should be interested in the agencies which regulate their businesses. Likewise, attempts at supervision are fruitless unless supervisors enjoy the confidence and respect of bankers and unless bankers know and sympathize with the ends supervisors are trying to achieve. I feel, therefore, that opportunities such as this to discuss some of the policies and problems of bank supervision are mutually advantageous.

The Necessity For Supervision

Before we begin to evaluate bank supervision it might be wise to ask why such an elaborate system of bank supervision is necessary in the United States and to attempt a brief answer to that question. In this connection let us take a look at the banking structure to which this supervision applies. We know that no other banking system in the world is subject to such stringent regulation; there must, therefore, be something quite unique about the American system.

Our banking system, unlike those of other countries, today consists for the most part of thousands of unit banks, each independently managed. It can be said that this structure grew naturally in response to the peculiar demands of our rapid and gigantic economic development during the nineteenth century.

It was not entirely happenstance that free unit banking should have continued to flourish in the United States while amalgamation was combining the units in other countries into what we know today as Britain's "Big Five", Italy's "Big Three", and France's "Big Four". The fear of monopoly on the part of the American people has been evident in every stage of the evolution of our banking structure. Our desire to have banking facilities available has always been tempered by a fear that the control of money and credit might become concentrated in too few hands. Popular opinion has always supported continuation of the unit system, and that system was firmly established by passage in 1863 of the National Bank Act. There is no reason to believe that, without this unique popular pressure, our system would differ today in any essential respects from the more common monopolistic systems of the world.

Public opinion, then, has endorsed and perpetuated the unit system, and factors inherent in the system have necessitated an ever-growing body of law and regulations. The relative smallness and omnipresence of the units engender competitive factors which lead to unsound practices. If the system is to be preserved, supervision of its structure and of its activities must continue.

The Objectives of Supervision

To understand the growth of our system of supervision of the banking business, we must also recognize the quasi-public nature of the banking function. If a bank is chartered to render financial service to the people of a community, the chartering authority has the right and duty of assuring the faithful performance of that service. In this capacity the supervisor undertakes to assure that the service is rendered at a fair cost, to keep its quality adequate, to assist chartered institutions to receive a fair rate of return on the investment of private capital which they represent, and to discourage unforeseen interruptions in service. He also undertakes to maintain a financial structure adequate to satisfy the thrift, credit, and general banking needs of the people he serves. The primary purpose of our banking supervision, however, has always been to protect the creditors of banks from pecuniary loss. The importance of this responsibility has not changed, in spite of fundamental shifts in the relative importance of various types of bank obligations.

You will recall that prior to about 1860 the circulating medium in this country was composed chiefly of the circulating notes issued by banks. The importance of the privilege of issue during this period is forcefully demonstrated by the virtual extinction of State banks through that provision of the National Bank Act which levied a ten percent tax upon the notes of other than national banks. A minimum of bank supervision was sufficient to assure the maintenance at par of their circulating notes by banks in view of the 100 percent reserves.

The gradual change in our national economy from local or regional self-sufficiency toward national and international trade brought about an attendant shift from circulating notes to demand deposits as the important circulating medium. The effects of this shift were: first, to revive State banking systems and so to gainsay those who believed the National Bank Act had created a single banking system; and second, to substitute depositors for noteholders as the chief creditors of our banks and as the persons supposed to benefit from Governmental supervision of the banking system, hence the beginning of bank supervision as we now know it.

The Tools of Supervision

You are all familiar with the traditional tools of bank supervision, the instruments through which supervisors work to protect depositors from loss. Governmental regulation of banking is built upon a statutory outline of privileges and limitations. This outline is filled in with supplementary and explanatory rules, interpretations, and regulations, promulgated under authority of law as the need arises. Finally, the supervisor is presumably granted powers of enforcement through the bank examination and other visitorial privileges and through such authority as he may have to charter or to terminate the affairs of banks under his jurisdiction.

A significant development during recent years has been the tendency of banks to supplement governmental supervision with an increasing amount of self-regulation through the medium of clearing house associations and similar professional groups.

Beyond a brief mention of the bank examination I do not propose to burden you with a detailed discussion of these supervisory implements. The purpose of the bank examination is to discover and bring to the attention of supervisory authorities and bank directors the true bank which lies back of book figures. Examiners also attempt to appraise the banking practices and the management which motivate the activity going on behind the desks and in the cages of our banking institutions. It is upon the findings of examiners that supervisory decisions concerning individual banks must be made. The bank examination should afford an equally valuable guide for the administrative and policy decisions of bank directors.

I doubt that most bank officers and directors realize what a good thing they are passing up when they give only a cursory reading to the official reports of examination of their banks. In the examination report the banker is offered an appraisal of all aspects of his institution representing the best opinion of a disinterested person who could have no reason to be biased in his analysis. If bankers would realize that the men who are sent to examine their institutions have a background based upon contact with the operations and problems of hundreds of banks they would agree that the examiner's opinion on most matters should be not only sound but frequently superior to the more localized point of view of the banker himself.

Has Supervision Succeeded?

The extent to which supervision has protected depositors from the loss of their funds is debatable. I need not remind you that bank failures by the thousand occurred as recently as the period from 1920 to

1933. Complete eradication of bank failures in this country will probably always be prevented by a few factors which cannot be legislated away. There is no reason to believe that the business cycle will vanish in the near future from the list of economic phenomena, and the business cycle always carries with it a hazard which is unpredictable. The personal element is uncertain and often unreliable and this factor affects our banking structure not only through bank management but perhaps equally through bank supervisors, whose judgment certainly has not in every case been infallible.

If I may be permitted an analogy in this connection I should like to point to the parallel of bank supervision with respect to the failure hazard and building inspection in connection with fire hazard. The end in view in each case is to limit the hazard. There can be no thought of eliminating the risk entirely. The best we can hope for in either case is the constant improvement of standards. In each of these cases supervision is primarily for the benefit of the general public. The building inspection protects the occupants of your banking house; the enforcement of banking regulations protects the creditors of your bank. It is quite possible that your particular building is completely fire-proof and that the inspection is superfluous; it is equally possible that your institution represents the ideal bank from the point of view of sound capital, sound assets, and the other standards by which creditor protection is measured. But even if the standards in each case were not constantly changing--and they are--it would be imperative that all buildings be inspected and that all banks be examined in order that standards might be established by which to gauge the safety of other buildings or of other banks. Further, there is no building so fire-proof and no bank so sound that it is not affected by general conflagration or catastrophe. It is the function of inspection and of supervision to minimize the possibility for growth into conflagration or catastrophe of isolated fires or failures.

Banks are not exempt from the failure hazard which must be faced by investors in any business. It is to be expected that local economic catastrophes or competition will react just as unfavorably upon the banker as upon the hardware merchant or the automobile dealer. Supervisory authorities can hardly be indicted, therefore, simply because institutions under their jurisdiction are forced by circumstances to suspend operations and to liquidate.

In any recitation of the bank mortality statistics of the 70-year period from 1865 to 1934, the fact that 20,000 commercial banks suspended operations is of secondary importance. The really significant statistic is that which reveals that depositors in those banks lost about three and a half billion dollars of their funds. This loss reflects a variety of factors which may be grouped under three heads: (1) Economic or general factors which lie outside the control of individual bankers or bank supervisors: (2) unwise or improper policies or practices on the part of bankers; (3) inadequate or ineffective supervision. I believe the first two groups of factors represent the most important causes of bank failure. I am convinced, however, that proper supervision would have lessened materially the losses to depositors as such. Bank supervisors in the past have not been as forthright and vigorous as they should have been in insisting on having at all times a true picture of the condition of each of the banks under their supervision. Too often they have temporized with situations and altered their standards in individual cases because of some expediency. The result has been self-deception and failure to take action in time to protect properly the depositors' interests. As a consequence, losses accumulated and banks became so involved as to make it impossible for them to meet the shock of adverse business conditions. Above all else it is essential that bank supervisors have an accurate picture of the state of affairs in each bank.

Factors Affecting the Efficacy of Supervision

In retrospect, the failure of bank supervision better to accomplish its purpose seems to have resulted from the interplay and cumulative effect of many complex economic and political factors. First in importance among these factors I would list the failure to maintain sound bank supervisory pollicies unremittingly regardless of fluctuating economic conditions. The most impressive display of the disastrous possibilities of such a short-coming occurred during the 20's and the early 30's. During and prior to the 20's banks accumulated a large volume of assets of a substandard character. Such assets were undesirable to have in the portfolios and were the first to become worthless under the pressure of adverse economic circumstances. While the supervisors' authority to exercise some control over the character of assets has been considerably less in the past than the public has generally believed, it is none the less true that supervisors in general were not sufficiently firm in insisting that the banks eliminate their losses and their criticized assets during prosperous times.

Had the banks possessed a better class of assets in the early 30's they would not have had to accentuate the already declining prices by calling questionable loans and dumping low grade securities on the market. On the other hand, they would have been able to stand by as a stabilizing influence.

Inadequate control over banking practices is a second factor which has impaired the efficacy of bank supervision. The actual police powers of bank supervisory officials have always been somewhat less than is commonly believed. For the most part, the only statutory weapon granted supervisors to enforce observance by banks of legal requirements has been to place an offending bank in liquidation. Naturally authorities hesitate to apply so drastic a measure. In the more nebulous but equally important field of controlling banking practices not defined by law supervisors have until recently been absolutely powerless, having to rely for correction of unsound practices entirely upon moral suasion. Each of you knows that judgment exercised in the broad field left to the initiative of bank managers can make or break a bank. We all have come in contact with cases where unscrupulous bankers, living within the letter of the law, have brought ruin to the depositors who trusted them and to soundly run neighboring institutions, thus damaging beyond repair the good name of the banking profession. Yet, even when supervisors have known of the existence of such dangerous situations in time to accomplish some correction and rehabilitation they have been powerless to act.

Inadequate control over expansion in the banking system, likewise, has greatly hampered supervisors' efforts to minimize losses to depositors. So long as supervisors are required by law to grant charters to all who apply and so long as supervisors' decisions with respect to the advisability of new banking facilities can be overruled by some person or by some body not familiar with supervisory policies, banks will fail unnecessarily and depositors will suffer. It is necessary, too, that the chartering and control of financial institutions other than banks be coördinated with supervision of banks. The development of a uniform and effective financial program requires that banks, building and loan associations, credit unions, and all similar thrift and loan institutions shall work toward the same end, under uniform supervision.

It is likely that the failure to recognize the essential similarity between circulating notes and bank deposit currency contributed to the loss record of the last seventy years. At any rate, it would be interesting to know what line of reasoning led to the conclusion that circulating notes of banks need be fully secured by cash or immediately convertible securities and that a cash reserve of seven or ten percent offered commensurate protection for demand deposits in banks.

Another intangible but undoubtedly important factor contributing to the unsatisfactory record of bank supervision has been the primacy of political and personal considerations in supervisory decisions. How illogical it is that the supervision of financial institutions, a task calling for infinite ability and for long-range planning and consistent and impartial execution of policies, should continue in these enlightened times to be little more than a poorly paid political plum. Kentucky is fortunate in having so capable a man as Hiram Wilhoit supervising its banks. Fortunately for you bankers and for depositors, men of ability are making the same personal sacrifice in most other States. But I say let the renumeration of these men be commensurate with their responsibility. Let matters be arranged so that their tenure of office does not depend on political vagaries. Get good men in these key positions and keep them there.

Finally, I attach particular importance to the fact that banking reforms in this country have always waited until periods of financial and economic crisis made further delay impossible. The reforms have been almost invariably curative rather than preventive--specific rather than fundamental. The story of the development of our bank supervision is a story of repeatedly plugging the holes in our dike without seeming to realize that its foundation rested on quicksand. I quite realize the lazy attraction of "status quo" and the tremendous force of human inertia against change of any kind. However, one would expect bankers, as leaders in the business life of their communities, to see and to admit shortcomings in the banking process as these shortcomings become evident. It is natural to assume that bankers would realize that the purpose of proposed reforms is to achieve results, not merely to undertake "change for change's sake." Yet bankers, on the whole, have opposed vigorously--sometimes even bitterly--every important reform that has been introduced in this country. How much more valuable would this expenditure of effort have been if bankers had faced the facts, subordinated their vested interests, and waded in themselves to achieve a solution of their problems. And how much misery and economic waste would have been spared if bankers, supervisors, and legislators had taken the time to work out together a sound operating basis for the banking system instead of waiting for economic catastrophes to hold up the weaknesses of that system to the shriveling heat of trail by fire and to the bitter gaze of a disillusioned and impoverished people.

These, then, are some of the major problems which have confronted bank supervisors. As continuing problems, for the most part, they still occupy our attention and will continue to do so, probably, short of Utopia. In previous addresses before bankers' associations I have dealt at length with the progress that has been made in recent years and with current efforts to improve the quality of banking and of bank supervision.

Recent Steps Toward Improvement

Recent banking legislation has been correlated with a broad legislative program aimed at levelling extremes of the business cycle. Broadened credit and rediscount facilities have been provided to ease banks through periods of stress. The Corporation has been granted broad power to curtail indulgence in unsafe and unsound practices. Not only has a more reasonable attitude towards the chartering of new banking institutions come into favor, but supervisors are also attacking the problem of unprofitable existing institutions through the medium of surveys of the banking needs of each State. As a result of these surveys it is hoped we will be able to consolidate or to relocate institutions with an uncertain outlook. Frank discussion of the problems of banking and bank supervision is removing these activities from the realm of mystery and so lessening the chances for political abuse. Through constant and whole-hearted cooperation among the State supervisors and between State and Federal supervisory agencies supervision has lost its haphazard air and has assumed an attitude of concerted and determined attack on the forces which hitherto have hampered its efforts.

Most auspicious of the recent developments affecting bank supervision I consider to be the creation of the Federal Deposit Insurance Corporation. By insuring depositors against loss the Corporation substitutes itself--a compact, single-minded driving force--for the inarticulate and disorganized millions of depositors who insist that we shall have a sound banking structure and that deposits shall not be dissipated. The Corporation's tremendous potential liabilities in its role as insurer make the quality and effectiveness of bank supervision a vital concern of the Corporation's directors.

In its role as bank supervisor the Corporation is in a position to make a unique contribution to the banking system and to the record of supervision. In the Federal Deposit Insurance Corporation bankers have for the first time an agency concerned with the soundness of the entire banking system and without special interests in any class or segment of the membership of that system. The Corporation offers bankers an unprecedented opportunity to develop a much needed uniformity of practices and standards without imperilling their traditional structural set-up.

Our experience under this new order is not yet sufficient to test the adequacy of existing banking legislation or to permit promises for the future. I find cause for rejoicing, however, in the fact that the tone of supervision has become forward-looking rather than retrospective and I can assure you that supervisory authorities generally feel their responsibility for intelligent application of the enlarged powers they have been granted.

Bankers Determine Extent of Supervision

I might say further that the goal of present day bank supervision is not the complete regimentation of the banking profession which so many bankers seem to fear. Supervisors clearly realize the dangers of an autocratic application of arbitrary standards to every transaction of every banking institution. Likewise, they realize that a completely unregulated, and individualized pursuit of the banking business would end disastrously. Somewhere between those extremes exists a middle road which leads to a sound and prosperous banking system and to safety for depositors. It is that road we must find and follow.

In the last analysis, bankers themselves determine the extent to which their activities must be supervised. It is to the distinct advantage of all concerned that the supervisory system should be as simple as possible. I visualize our supervisory system as comparable to a fence surrounding a playing field and defining the boundaries of that field. Within the enclosure of law and regulation bankers are free to exercise their initiative and to conduct their business to the best of their judgment. The results of this exercise of initiative and judgment, as reflected in the soundness of your institutions and the safety of your depositors' funds, will determine the boundaries of the field.

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