FEDERAL DEPOSIT INSURANCE CORPORATION
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ADDRESS OF

HONORABLE LEO T. CROWLEY,

CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

BEFORE THE

INDIANA BANKING CONFERENCE,

INDIANA UNIVERSITY

BLOOMINGTON, INDIANA OCTOBER 25, 1938

OUTLINE OF AN ADDRESS BY HONORABLE LEO T. CROWLEY, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION, BEFORE THE INDIANA BANKING CONFERENCE, INDIANA UNIVERSITY

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"Bank Regulation on the Part of FDIC"

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Mr. Chairman, President Wells, and Gentlemen:

I am happy that my first visit with a group of Indiana bankers should occur under such auspicious circumstances. I have long advocated the conference or seminar idea as a vehicle for keeping abreast of current developments in the field of banking. It is consequently a pleasure to help inaugurate in your State a banking seminar sponsored by the State Bankers Association, the Department of Financial Institutions, and the State University — three progressive organizations united in a common purpose. It is particularly pleasant to visit in the domain of President Wells, who worked so closely and so well with the Federal Deposit Insurance Corporation during his years as Secretary of the Department of Financial Institutions and Supervisor of Banks and Trust Companies. The State and the University are indeed fortunate to have a man of Dr. Wells' ability and accomplishments in their service.

FDIC Laws and Regulations Few

Your program committee asked that I speak today on FDIC's part in bank regulation. From the standpoint of regulation as most bankers think of it--as a body of statutes, rulings, opinions, and precedents--the Corporation's part is notable principally because its operations have been possible with so few statutory and administrative legal provisions.

Minimization of the Corporation's role as a "regulatory" body in the traditional sense follows from the fact that its regulatory powers supplement, to a large extent, those of other supervisory agencies, namely, the several State supervisors and the Office of the Comptroller of the Currency. This situation has some disadvantages. On the whole, however, our position encourages a practical rather than a legalistic approach by the Corporation to the problems of supervision and permits us to coordinate activities of other agencies into a unified attack on those problems.

Importance of Bank Examinations to Supervisors

Complete and current knowledge of how insured banks are conducting themselves is essential to proper administration of deposit insurance. The Corporation has been charged not only with responsibility for paying the insured claims of depositors in banks which close, but also with the duty of strengthening insured banks so that losses to the Corporation will be kept at a minimum. Curative and preventive action is difficult, if not impossible, in the absence of adequate diagnosis. The Corporation therefore relies greatly upon that excellent fact-finding instrument, the most valuable tool of supervision, the bank examination.

The bank examination is designed to ascertain whether banks are being operated with the safety of depositors' funds as a primary consideration. Each examination attempts to determine whether depositors' funds are safe insofar as the bank's liabilities are backed by true values; whether depositors' funds are safe insofar as operations are concerned; and whether depositors' funds are safe insofar as future prospects are concerned.

In line with its function as a fact-finding instrument, the examination is necessary more frequently in some institutions than in others. Annual examinations are sufficient check upon the condition and operations of institutions which are properly operated and whose assets are sound. This group includes the vast majority of banks in the country. In banks which are or show signs of becoming problem cases, however, more frequent examination and the constructive visits of conference examiner are necessary to develop programs for correction and to determine that hazardous conditions and practices are remedied.

Importance of Bank Examinations to Directors

Not only is the examination the most valuable tool of supervision; it is likewise one of the best aids to bank directors for effective exercise of their duties. I should like to emphasize the importance of detailed review by each bank's board of directors of each report of examination of that bank. It is the board of directors that is primarily responsible for formulating and directing the policies of a bank. The executive officers are intended merely to put into effect the board's decisions. Examiners' comments on a bank's policies should be of immediate concern to its directors, since it is to them that supervisors will look for correction of the bank's criticized aspects. All agencies should address a copy of each report of examination to directors of the subject institution and require that directors review the report in detail at their following meeting, spreading both the report and their deliberations in the minutes of that meeting. Delegation of a certain amount of authority and latitude to executive officers by a bank's directors is intended under our commercial banking set-up. It is unfair both to depositors and to executive officers, however, for directors to shirk or to disregard their duty to review periodically the officers' exercise of their delegated authority as well as examiners' reports of officers' performance. All credit extension involves risk. It is a prime responsibility for directors to recognize and to control the degree of risk assumed by their institution in its extensions of credit.

Some insured banks have adopted a simple procedure which has considerable merit as a complement of supervisory examinations. The procedure calls for a semi-annual independent appraisal of the bank's assets by the officers who acquired the assets. These analyses are primarily for the information of directors, but are also made available to examiners when an examination begins. The advantages of this plan are apparent. It keeps the officers familiar with the assets for which they are responsible, gives the bank's directors additional opinion concerning the condition of their institution, and furnishes a basis for negotiation which has practically eliminated disagreement with examiners in banks which have tried it.

The recently announced standardization of examination policies and procedures materialized from months of study and conferences between the Corporation and State Supervisors and among the Federal agencies under the leadership of Secretary Morgenthau. The new standards are notable because through them all banks are subjected for the first time to the same set of rules and standards, and because they represent a restatement of supervisory aims and objectives on a basis designed to work without substantial alteration equally well in every bank at every stage of the business cycle. The new basis adopted for asset valuation permits a bank to be viewed as a "going" concern.

To bankers the chief advantages of the uniform standards are that now all assets of bank quality will be valued by examiners on the basis of their intrinsic soundness, without regard for temporary market conditions, and that bankers now can know definitely in what light assets they acquire will be judged by examiners.

Examination No Substitute for Management

Important as the examination is to supervisors, it is essentially a post facto instrument. The actual building of individual institutions and the shaping of a sound banking system are primarily the banker's function. It is true that laws and regulations prescribe broad limits to the activities of bank managers. It remains the banker's function, however, to decide upon each of the loans and investments which go to make up his bank's earning assets. The bank examiner serves only as a check upon the banker's judgment and as a consultant who can lend the experience of many institutions to the solution of each banker's problems.

Indiana bankers are to be congratulated upon their conscientious efforts to analyze problems of bank management and to work out solutions for those problems. The results of your collective activities are of distinct value not only to your own group but also to banks throughout the nation.

The Research Committee of the Indiana Bankers Association pioneered in the study of banking trends, and the Committee's annual reports furnish valuable guide-posts for policy determination. The Bureau of Investment Research operated by the State University and the Department of Financial Institutions is potentially an excellent device for investment education.

National developments in the field of banking likewise owe much to the participation of Indiana men. Uniform call and earnings reports were developed under the leadership of President Wells, who was also responsible in large measure for revivifying the National Association of Supervisors of State Banks, a body which now works constantly and aggressively for cooperative improvement of the banks under the charge of its members. Mr. Batton, Mr. Wallace, and Mr. Dehority of your Department of Financial Institutions were active in all stages of the recent development of uniform examining standards, and the Department was among the first to put basic features of the program into practice.

Changes Proposed in FDIC Assessment Plan

The Corporation has had considerable correspondence recently with officers of the Indiana Bankers Association concerning the State's plan for insuring deposits of public funds. It has been suggested that the Corporation take steps to have removed from the base used in computing insurance assessments, deposits of public funds which have protection in addition to Federal deposit insurance.

I have not been able to give much encouragement to those seeking such a change. Indiana's situation is not unique. Wisconsin, my own State, has a similar fund for the protection of public deposits. Its income, like that of the Indiana Fund, has, so far, been almost entirely devoted to repaying losses incurred prior to Federal deposit insurance. The revenue our Corporation receives is intended to prevent losses in the future.

If we begin to make exemptions and exceptions in each case which appears on its face to merit special treatment, the Corporation's income will be greatly reduced. There is no more reason for acceding to the Association's proposal than there would be for exempting from assessment all deposits secured by pledged assets. Where conflicts occur between the Corporation's assessment plan and conditions occurring in only one or a few States it seems to me that remedy should be sought within the State rather than on a nationwide basis.

Banking System in Excellent Condition

The banking system as a whole is currently in excellent condition. The banks are sound and they enjoy and deserve the confidence of their depositors. I have stressed in previous addresses, however, that depositors' confidence will be enjoyed only so long as depositors can be certain that their banks are capably and safely managed as well as properly supervised. Supervisors will not shirk their share of the responsibility for sound banks. We urge that every banker make his decisions in the light of his own responsibility to build and maintain a strong institution and so to contribute his share toward a permanently sound banking system.

Objectives of Supervision and Management

The principal objective of both bankers and supervisors must be to prevent a repetition of what happened to the banks and to depositors' funds during the years between 1921 and 1933. Bank failures throughout the country for that period averaged more than 900 a year, involving an annual average of more than $400,000,000 of deposits. For Indiana alone the annual average bank mortality during the period was 44 banks and about $22,000,000 of deposits. Assuming that the recovery ratio which applied for the country as a whole was experienced also in Indiana, these figures mean that between sixty and seventy million dollars of funds on deposit in Indiana banks which failed between 1921 and 1933 have never been recovered by the depositors.

Deposit insurance came into being because the millions of depositors whose funds disappeared in failed banks were determined that they should have to bear no more losses. Their funds were not put in banks for speculation, and they properly rebelled at being called upon to bear losses proportionately as great as though they had used the money for blind fliers in equities, commodities, or real estate.

Supervision of banks and their operations by governmental bodies has always been supposed to protect depositors from the loss of their funds. I believe that when government assumes responsibility for this supervision depositors have a right to expect that their funds shall be safe. I also believe that history shows few more shameful records of the betrayal of a trust than the story of bank supervision during the years prior to 1933. The Corporation's study of banks that failed during those years shows that in hundreds of cases failure could have been averted, or at least losses considerably minimized, had supervisors acted promptly and with courage to remedy dangerous situations as they developed. What justification could there have been in any instance for permitting assets to be carried at values far in excess of their true worth, and for permitting dividends to be paid time after time without requiring as a prerequisite revaluation of assets on a fair basis.

Some qualifications to this blanket indictment of pre-banking-holiday supervision are naturally in order.

In the first place, as I have already pointed out, supervision is essentially post facto by nature, and bankers must accept primary responsibility for the acquisition and retention of unsound assets. That banker judgment is the most important factor is demonstrated by the ease with which many well-run institutions were able to withstand economic shocks that were fatal to hundreds of other banks.

Secondly, I believe present-day bank supervision to be effective and supervisors to be generally men of character, ability, and courage. Further, there exists today a unanimity of supervisory opinion and a spirit of cooperation between

Federal and State agencies that will make for an increasingly effective type of supervision.

It is our hope that the combination of better supervision, better bank management, and Federal deposit insurance will soon eliminate losses to depositors as a social menace. Proper supervision and enlightened management will reduce to a minimum the number of banks that fail during the years to come. The Corporation's $290 million capital, the $125 million surplus we have built so far, and our $45 million to $50 million annual income are probably sufficient to permit caring for the depositors of all insured banks that it is found necessary or desirable to close. By far the most indispensable items on the Corporation's balance sheet and income statement, however, are and will always be those intangibles, good management and good supervision.

The thousands of smaller banks are not likely to cause the Corporation serious trouble. It will, of course, always be necessary to subject large banks to especially thorough supervision, since the Corporation is no less vulnerable than most insurance funds to the effects of a large and simultaneous concentration of claims.

FDIC Powers Permit Prompt Action and Minimize Losses

Our power to make loans and to purchase assets makes it possible for us to step into institutions with poor prospects before deterioration has progressed too far. Our policy is definitely to meet problem situations as they arise, taking our losses at the earliest practicable moment, so that whatever unforeseen economic development may occur, the banking system will be in good health, depositors can continue confident in the safety of their funds, and there will be no necessity for forced liquidation of bank assets to meet panic demands at the cost of drastically depressing markets. Our experience in the some 240 loan and pay-off cases so far bears witness to the wisdom of this course of action. As a result of prompt action in closing or consolidating these banks, and owing to the orderly manner in which the Corporation is able to liquidate their assets, recoveries on amounts we have expended in connection with deposit insurance activities will approximate 75 percent.

Development of Uniform State Banking Codes Desirable

To return to a point I have already briefly mentioned, I should like to emphasize the desirability of developing minimum uniform provisions for inclusion in all State banking codes. The existing variety of statutory requirements creates a disturbing and an unnecessary amount of confusion. It likewise makes for differences in the competitive status of banks of various classes that encourage indulgence in hazardous practices. There can be no justification for continuance of this confusion, since, despite necessary allowances for regional differences, not all of the many legal provisions covering a single point of bank operation can be the optimum provision for that point. I do not suggest that clarification of this situation can be accomplished overnight. On the contrary, it is a project which demands considerable study. Neither do I wish to give the impression that regional differences should be ignored and the codes of all States made absolutely identical. I do believe, however, that many of the basic provisions covering the organization and operations of State banks are not subject to any influence by the location of the banks, and that the lot of all State banks and of the whole banking system could be materially benefited by standardization of these provisions. As examples, I cite the factors to be considered in chartering new institutions, the regulation of absolute and relative capital for beginning and going banks, limitations to the acquisition of assets of certain types, and directions for the disposition of profits. The development of proper standards is a work of sufficient importance to enlist the talents of the best theoretical and practical banking minds in the country. It is my earnest hope that the several States will realize the advantages of the step I suggest, that a cooperative committee of experts will be formed to study the situation and to recommend corrections, and that on points of basic importance, at least, some degree of uniformity can be obtained.

Bankers Problem Scarcity of Income

The nub of the banker's problem lies in the difficulty of reconciling the need for safety and a fair degree of liquidity and the need for profitability. For the problem of risky assets, which was formerly of paramount importance, there has been substituted in most cases a problem of earnings. Yields on assets of bank quality have found and are staying at new low levels. Increases in some expense classifications have accompanied this decline in income. Finally, changes in corporate organization and financing habits have greatly reduced the demand for traditional types of bank credit.

Are Term Loans Acceptable As Bank Assets?

This situation has led banks to turn to new types of assets as a source of income. Currently the most talked-about new type is the term loan. The interest of bankers is encouraged by business, which finds it difficult to obtain long-term capital through security markets at a reasonable cost, and by government, which sees in such loans a means of promoting economic recovery.

Much confusion and cloudy thinking have characterized public discussion of the propriety of term loans as bank assets. I hope that an exposition of the Corporation's attitude on the subject will serve to clarify the issue rather than to add to the befuddlement.

Remote maturity alone is definitely not sufficient reason to rule a credit instrument ineligible for investment by banks. The fundamental consideration in judging debt of whatever term is the ability of the obligor to pay interest currently during the life of the instrument and to redeem the instrument at par. Bankers as a general rule have been quite insistent about current payment of interest. They have, however, almost entirely neglected to insist upon amortization or sinking-fund provisions to insure repayment of principal. I think it likely that a properly written term loan, carrying provisions for serial repayment, is superior as a bank asset to the continually renewed short-term instruments, the familiar "sleeper" loans, with which banks heretofore have engaged in capital financing.

Being new to most bankers, this type of financing should be approached carefully in the light of the deposit structure and the character of other earning assets of each bank. Bankers who decide that their institutions can properly acquire sound loans of relatively long maturity should equip themselves to properly analyze what applications they receive. The Association of Reserve City Bankers has in preparation a booklet entitled "Term Loans for Commerical Banks" which outlines fundamental considerations for this type of credit extension and which I recommend to the attention of each of you who contemplates investigating the possibilities of the field.

It should not be necessary to reiterate that soundness must be the ultimate criterion in passing upon loans of this type, just as upon any other bank asset, and that profitability must be measured from the long-range point of view, in terms of income less losses that may occur.

It has been suggested that Chairman Jesse Jones of the Reconstruction Finance Corporation and I do not entirely agree with respect to the types of loans commercial banks can make properly. From the vantage point of one who has worked very closely with Mr. Jones for nearly five years, I can assure you that his objectives are identical with mine; that he, even as I, would never advocate that any bank loan be made at the sacrifice of safety for deposits.

Mr. Jones has urged that banks actively seek out sound opportunities for credit extension in their communities. With this recommendation I am sure we all agree. Far too little is actually known about the legitimate demand for long-term credit for small business. I believe, however, that there are, in many communities, business loans that could advantageously be made by banks and that bankers should carefully survey conditions in their respective communities. Banks would be better able to reply to critics if they were armed with the factual data such surveys would make available.

Need For Conservative Dividend Policies

One phase of bank management which seems during the years to have been approached in a ruinously haphazard manner is that of distribution of profits. As in any enterprise, investors in bank stocks should receive a return on their investment, provided the return is legitimately available for distribution. Accepted corporate practice is to consider as available for dividends over the long run some part of that portion of earnings which remains after deduction of expenses, depreciation on building and equipment, provision for current losses, and segregation of amounts to care for emergency expenses and losses--in other words, some portion of net profits.

Available data indicate that many banks have strayed far from accepted practice. In occasional years, the payment of dividends in excess of net profits can be condoned, provided that the bank is in sound condition and provided that the dividend is paid from net worth that represents an accumulation of earnings. During a period of years, however, payment of dividends in excess of net profits is suicidal. The dividends of thousands of banks are known to have been greater than their net profits during the years prior to the banking holiday, and this despite the fact that net profits did not reflect the write-off of huge volumes of losses that were allowed to accumulate during those years.

It is certainly not too early to consider remedies for an abuse which contributed so greatly to the banking system's collapse. A return to fundamentals and to accepted practice is all that is required, but this particular bit of "gittin' religion" must be immediate and unanimous. Banks should establish as a permanent policy thorough consideration of the bank's assets, its capital position, its earnings trends, and its net profits as a prerequisite to the declaration of any and every dividend.

It is important that banks which have been off dividends for the past several years move cautiously in re-establishing dividend payments. Return to a dividend paying basis should not be contemplated until assets are beyond criticism and until ample provision has been made for contingencies. It is likewise desirable that resumption of dividends begin on a conservative basis and that the rate be low enough to make continuity of dividend payments likely. There was a time when a dividend could be passed only at the risk of a "run". Deposit insurance has, I believe, ended that era by establishing a degree of public confidence that should substitute for the timidity bankers formerly felt, the courage to give the public the facts of bank operations. Continuity is, however, still a desirable feature of dividend policy.

Elimination of the double liability feature attaching to bank stocks makes it especially necessary that the dividend policies of all the banks be established on a conservative basis. The Federal Deposit Insurance Corporation now assumes the risk that bank stockholders formerly assumed. It is logical that a smaller return to stockholders and the plowing back of a greater portion of earnings into the bank's assets should follow from the reduction of stockholders' risks.

I thank you for your attention this afternoon. It is my earnest wish that by discussions such as this bankers everywhere may come to know the Corporation's program and to cooperate in its fulfillment; that differences of class, of region, and of background may be sublimated in the interest of the whole banking system; and that through the joint efforts of capable bankers and conscientious supervisors there may grow and prosper in this country a financial structure of unassailable integrity and soundness, contributing its share to the growth of our economy and, above all, worthy of the trust of our people.

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