

AN APPRAISAL OF THE RULES AND PROCEDURES  
OF BANK SUPERVISION, 1929-1939

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Rules and procedures of bank supervision may be appraised by reviewing their operations over the past ten years. From this standpoint the decade seems to fall into three distinct periods. From 1930 to the banking holiday in 1933 supervision was faced with panic, crisis and deposit contraction. After the holiday until roughly the middle of 1934, the supervisors fostered reorganization of weak banks, encouraged the sale of bank stock to the Reconstruction Finance Corporation, and in general reinstated classic supervisory rules and procedures. During the succeeding years supervisors have been faced with intermittent accusations that examiners were impeding recovery, and have consequently made some revision of the traditional rules and procedures.

The 1930-1933 Period

The role of supervision in the 1930-1933 period must be considered not only against a background of the abnormal conditions of those years, but also in light of the implicit principles of supervision in more normal years, and the condition of the banks and business in general at the end of the twenties. At the beginning of the depression, according to the unwritten law of long tradition, a leading function of the bank supervisor was to ascertain the extent of equity in banks by determining their liabilities and appraising their assets. Whenever the liabilities of a bank exceeded the appraised value of the assets, or capital was seriously impaired, it was his duty to take action to remedy

this situation. If stockholders' contributions or sales of stock did not yield sufficient new money, he brought pressure to achieve a re-organization or a merger, or, failing in this, urged the board of directors to close the bank. This traditional policy was defended upon the grounds that without it informed depositors might withdraw their funds between the time the impairment was determined and the suspension of payments. In this case the remaining depositors, as well as the new depositors would suffer much greater losses than if the bank had been closed at once.

Supervisors had also commonly been concerned with the volume of bank capital, even though it was not technically impaired, since capital was considered a cushion against asset depreciation. Accordingly, in cases of inadequacy they took steps to secure its increase. Another long-accepted function was the criticism of assets deemed to involve a high degree of risk. Supervisors in general endeavored to prohibit or discourage the acquisition of such assets and to urge or require their disposition.

#### Popular Cycle Theory as a Background

As the 1930-1933 depression developed serious proportions the theory became popular that it represented the inevitable reaction to unsound practices and situations of the days of prosperity. Similarly, as bank failures increased the doctrine spread that these failures were the inevitable result of unsound banking practices prevalent in the late twenties. Without wishing to make any pronouncements upon the causes of the depression I think it is fair to say that neither the

banks nor general business conditions of 1920 were unsound in the sense that they made inevitable either a depression of such magnitude or the catastrophic failure of banks.

To my mind, the critics who have blamed the banking crisis of 1930-1933 upon unwise policies of years preceding the depression completely misplaced their emphasis. Some banks, particularly in the agricultural districts, were in a weak condition prior to 1930, but their weakness was the result of the postwar depression in agriculture and was only a minor factor in the banking collapse of the early thirties. As the industrial depression developed, both rural and urban banks were victims not primarily of their own mistakes, but rather of the general deterioration in economic activity. Banks as a group previously were in a hazardous condition only in the sense that the banks of any fractional reserve system must inevitably be vulnerable. Once caught in the spiral of deflation individual banks and bankers could do nothing either to limit the deflation or to save themselves. Anything which they did do to improve their position only intensified the deflation and ruined other bankers.

In view of this background of the traditional duties of supervisors and the popular conceptions of the causes and inevitability of the depression, we need not wonder that the supervisors and examiners tended to continue and even intensify their traditional activities. To those who accepted the thesis that banks were failing because of their unsound condition and that the depression was at least in part due to that unsound condition, it seemed logical to believe that recovery

depended upon rehabilitation of the banks<sup>1/</sup>, liquidation of those beyond hope, and in general the vigorous enforcement of traditional supervisory rules and procedures.

#### Norms for Government Procedure

The continuation of customary supervisory practices during the depression, however, only intensified and accelerated the downswing. During such a period the only justification for any supervisory action was prevention of bank closings and resultant tying up of deposits. The prime immediate cause of bank failures was inability to meet the demands of depositors. Hence, the proper policy for the Government with respect to individual banks was to confine itself to supplying cash to meet the demands. The traditional supervisory policy of criticizing the risky assets of banks needed to be abandoned. Attempts to collect low grade loans and sell low grade securities would only intensify the depression. Prevention of new loans or purchases was economically undesirable. Similarly recapitalization requirements were undesirable. Except in those few cases in which new capital could come from hoarded deposits or cash subscribers would have to dump securities and other assets on already demoralized markets.

Enlightened supervisory policy demanded the studious avoidance of any action likely to result in bank closings. Reorganizations and mergers and the fanfare inevitably connected with them were on the whole only disturbing to public confidence. At such times the Govern-

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<sup>1/</sup> One of the supervisors stated in 1934 that it would have been a good idea to have had the banking holiday in 1930 or 1931. Stock Exchange Practices, Hearings before the Committee on Banking and Currency, United States Senate, 73rd Congress, 2d Sess., part 12,

ment's relation to individual banks should be confined to supplying them with all the cash necessary to ride out the storm and this was the function of the reserve authorities, not of the supervisors. All that the supervisors could usefully do was to continue their periodic visits to the banks, since the public would have been disturbed by any discontinuance of the practice, checking any gross self-dealing by bank managers, particularly <sup>in</sup> those cases in which the bank owners and managers believed the banks to be insolvent.

Supervisors carrying out their traditional functions must appraise the assets of the banks. Yet bank assets have a particularly indeterminate value in periods of crisis. Current market prices cannot be accepted because markets are demoralized and many classes of bank assets, e.g., most bank loans and real estate, cannot be sold at any price. Appraisals of assets at such a time depend largely upon the appraiser's forecast of the course of future business activity. There is great doubt whether the bank supervisors could have sufficient insight on this subject to give their appraisals any degree of reliability.

Even if meaningful appraisals could be made, however, the process of asset valuation would be worse than futile. As we have already noted, public policy calls for suspension during the depression of all supervisory functions dependent upon such valuations. Supervisors cannot help the situation by urging banks to sell securities or collect loans or shift from long term to short term securities. Any valuation of assets, therefore, merely encourages the continuation of practices dangerous both to the banks and to the economy at large.

The Actual Procedure

The evidence either is not available or has not been assembled to demonstrate conclusively what procedures actually were followed in the 1930-1933 period. While there was some propensity on the part of the examiners to continue old practices or even to tighten them, many supervisors issued instructions temporarily altering the rules. One examiner has testified that the rules were relaxed as early as 1930, and that otherwise the banking holiday would have come then instead of in 1933.<sup>1/</sup> Early in 1931 the Comptroller ordered some deviation from strict adherence to market value in the appraisal of bonds. Under an order of December 18, 1931, he instructed that no depreciation be charged off on non-defaulted bonds. However, one chief national bank examiner has testified that in all cases in which bond depreciation was so great as to result in a capital impairment, the procedure of valuing all bonds at market was continued. This means that the new procedure was followed only in cases in which it did not matter which procedure was used.<sup>2/</sup>

In October 1931 the Comptroller asked the chief national bank examiners to instruct all examiners "to exercise extraordinary discretion in their work, and to use every effort to encourage and sustain the morale in banks examined." He asked that leniency be extended "consistent with proper regard for public interest," and said that "present conditions demand sympathetic treatment".<sup>3/</sup> But it appears that even at

<sup>1/</sup> Ibid., part 10, p. 4646.

<sup>2/</sup> Ibid., p. 4643.

<sup>3/</sup> Ibid., pp. 4641-2.

this advanced stage of the depression many examiners continued rigorously to follow the customary rules. In July 1932 the Comptroller stated that "Reports of examination received by this office recently clearly indicate that some examiners have not fully grasped the meaning of previous instructions issued by this office during the past year with respect to examinations,...and it would also seem that some of the examiners may not fully appreciate the extremely abnormal business conditions and the weakened condition of the securities market at this time."1/ At the end of 1932 and 1933 the examiners still apparently thought that they were doing the right thing in valuing assets, urging charge-off of losses, pressing for increased capitalization, asking reduction or abandonment of dividend payments and effecting increases in liquidity.2/ The chief national bank examiner for the Seventh Federal Reserve District took considerable pride in the increase of liquidity of the Guardian National Bank of Commerce of Detroit from 20 to 40 percent between June and December 1932, pointing out that the increase was made possible by loan contraction. The evidence available seems to indicate that while the heads of the supervisory agencies adopted rather enlightened rules for supervision during the depression, the procedures of some examiners lagged considerably behind.

Indeed the supervisors seem to have been at least as willing to tide the banks over the period of stress as Congress and the monetary authorities. Banks failed during the depression because of inadequate

1/ From a letter sent to all chief national bank examiners; cf. ibid., part 12, p. 5836.

2/ Ibid., part 10, pp. 4619 to 4655; part 12, pp. 5838 to 5850.

cash to meet the demands of depositors. The scarcity of cash stemmed from the inability or unwillingness of the monetary authorities to relax the rules and procedures and from the defects of the basic law. Possibly the public opinion of the time would not have permitted supplying the banks with cash in completely adequate amounts. Whatever the reason, there was a reluctance to secure adequate legislative action extending the powers of the lender of last resort. The cumbersome act of February 27, 1932 did finally alleviate the situation somewhat but only a very limited volume of credit was advanced to the banks under its terms. Though the entire banking system collapsed, \$95 million was the maximum amount ever outstanding to the banks under the terms of the act.<sup>1/</sup> The substantial open market operations of the Federal Reserve System subsequent to passage of the act were of limited benefit under the circumstances prevailing at that time to banks which had few assets of the types purchased by the Federal Reserve banks.

After more than a year of heavy pressure on the banking system the Government took steps to supply the banks with needed cash by means of loans from the Reconstruction Finance Corporation. This was a laudable step, but it should have been taken earlier. Moreover, even though the Reconstruction Finance Corporation entered the field so late, complete collapse might have been averted if the needs of the banks for cash had been met more freely. A satisfactory explanation has never yet been forthcoming as to why the Federal Reserve System, the specialist in the field of advancing funds to commercial banks, would not have been

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<sup>1/</sup> Twentieth Annual Report of the Federal Reserve Board, 1933, p. 110.

the more logical agency for performing this function.<sup>1/</sup> It is significant that many member banks found that they were able to get credit accommodations more freely at their correspondent banks than at their Federal Reserve bank. This would seem to have called for revision of the rules and procedures of the Federal Reserve System rather than for delegation to a separate agency of the power to lend to banks.<sup>2/</sup>

#### The Post-Holiday Period

While in the 1931-1932 period supervisors gave some recognition to the fact that their duty was to keep banks open rather than to close them, after the holiday the doctrine of "cleaning up" situations became more important. A resurgence of the strict conservative point of view in bank supervision dates from the announcement of the policy that only sound banks would be reopened after the holiday. It may have been necessary to announce this policy in order to reestablish public confidence in the absence of a 100% guarantee. However, one does feel impelled at this date to question how the sound and the unsound banks could be distinguished in view of the indeterminate value of bank assets at that time.

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<sup>1/</sup> Neither has any rationale been developed for later giving to the Federal Reserve banks power to make loans directly to business rather than concentrating this function in the hands of the Reconstruction Finance Corporation.

<sup>2/</sup> The potentialities of bank borrowing as a means of limiting the depression were restricted by the reluctance of banks to remain in debt. This reluctance sprang in part from the adverse reaction of depositors to the appearance of substantial borrowing in the published statements required by the supervisors. Elimination of such a requirement might be impossible, or inexpedient in time of depression. It might well strengthen the banking system for any future crises to revise the form of the statement now in such a way as to withhold from the public the volume of bank borrowings.

A second aspect of the resurgence of the conservative approach was the program of investment by the Reconstruction Finance Corporation in the preferred stock of banks. I have never understood this policy, since it is impossible to see how it was likely to contribute either to business recovery or to the perpetuation of banking as a private business. In very few cases were the banks in need of cash at the time of the sale of preferred stock to the Reconstruction Finance Corporation. The chief function of the operation seems to have been for the Government to limit risk to one of its instrumentalities, the Federal Deposit Insurance Corporation, by increasing risk to another instrumentality, the Reconstruction Finance Corporation.

Another feature of this new phase was the announced policy of admitting only solvent banks to deposit insurance, though the practice in this connection may have been a liberal one since the methods of valuation used are not matters of public record. This period apparently marked the first serious entry by the Federal Reserve banks and the Federal Reserve Board into the field of bank examination and general bank supervision. Periodic examination and continuous supervision of insured nonmember banks by a Federal agency, the Federal Deposit Insurance Corporation, was likewise inaugurated. Programs for cleaning up the unsound banks were adopted. So-called "hospital divisions" were organized in the supervisory agencies and planned closings and mergers were instituted.

Some of these manifestations of the conservative point of view after the banking holiday may have limited unduly the resumption of recovery. Others may have contributed to confidence and consequently to

recovery. They are recounted here with no intent of either criticism or approbation.

#### The Period Since 1934.

In 1934 complaints were heard that banks were failing to extend the necessary credit for business expansion and that examination policy was in part responsible for this situation. If my impression is correct, although there was no substantial public opinion in 1930-1932 that bank examination was exercising a deflationary influence, such influence was really more significant at that time than in the 1934 period of public clamor. The 1934 discussion resulted in a credit survey conducted by the Treasury and a conference of Federal examining officials in Washington. The belief that examiners were preventing banks from making desirable credit extensions again resulted in conferences among examining agencies in the spring of 1938 and an agreement in June of that year. It will be noted that the agitation, research and conferences of 1934 and the conferences and agreements of 1938 coincided with periods of economic relapse. It is characteristic of public opinion in the post-1933 period that criticism of examination policy, whether anything is known of the real facts of examination policy or not, coincides very closely with business recession.

#### Government Loans to Business

Associated with criticism of the deflationary aspects of bank supervision and with movements to liberalize bank examination procedure have been provisions for Government loans to business. Since the summer of 1934,<sup>1/</sup> the Federal Reserve banks and the Reconstruction Finance

<sup>1/</sup> June 19, 1934, Public No. 417, 73d Congress.

Corporation have been empowered to make loans directly to business enterprises. As neither the bank supervisors nor these lending agencies have ever been able to be very precise in stating their standards it is difficult to say whether the Reserve banks and the Reconstruction Finance Corporation have stood ready to make loans of a quality or type which the supervisors would not permit the commercial banks to make. But insofar as this problem has been thought about at all there apparently has been a general presumption that these direct loans to business could be of a different type or of a lower quality than the supervisors would permit to be made by the commercial banks. If this is the case the validity of such Government policy is subject to question.

With deposit insurance operating in the manner which has characterized it during the past six years and which will probably characterize it in the future,<sup>1/</sup> the chief purpose of Government supervision and examination of banks seems to be to prevent undue risk from falling upon the Government and its agencies. But if this is true, why should supervisors prevent banks from making loans of a high degree of risk merely because a residuum of that risk would fall upon the Government, while other Federal agencies stand ready to make directly loans involving such a high degree of risk?

Since in the case of loans by banks only a residuum of risk falls upon the Government, while in the case of the direct loans all the risk falls upon the Government, there is a case for setting the

<sup>1/</sup> For a brief argument that the depositors in insured banks "have what is, in effect, 100 percent insurance at the present time", see Economic Journal, Vol. 48, December 1938, p. 700. See also the 1938 Annual Report of the Federal Deposit Insurance Corporation, pp. 11, 12.

supervisory standards somewhat lower than the standards for direct loans. On the other hand, it may be argued that despite 100 percent guarantee of deposits, bank failures are so economically disadvantageous as to justify higher Government standards for bank loans than for direct Government loans. In the absence of any conclusive evidence concerning the validity of these two arguments, there is a presumption that the minimum Government standards for bank loans and the minimum standards for direct Government loans should be identical.

#### The 1938 Agreement

The most publicized rules and procedures of bank supervision have been those agreed upon by the Federal agencies and by the Executive Committee of the National Association of Supervisors of State Banks in the summer of 1938. These agreements dealt with control of quality of bank loans and investments and with the valuation of bank loans and investments. As we have noted, these agreements were possibly inspired by the business recession of 1937-1938. Evidently its sponsors thought either that the recession had resulted in part from the nature of existing bank supervisory rules and procedures, or that recovery from the recession could be promoted by revision of those rules and procedures.

Probably the most notable aspect of the agreement was the abandonment of the word "slow" as a designation of a category of loans set up by the examiners. For more than two decades examiners had placed certain loans in a class so designated. The public was never apprised concerning the significance and purpose of the category. It is doubtful

if there was ever substantial agreement among examining officials themselves. However, at times some officials have undoubtedly tended to classify as "slow" all loans which they did not consider "proper" bank loans, irrespective of their chance of ultimate repayment. There has been a tendency to place in this category any loans considered not to conform to the self-liquidating loan theory of commercial banking.

The 1938 agreement provided that the category formerly designated as "slow" should henceforth have merely a numerical designation and should include only loans involving "a substantial and unreasonable degree of risk to the bank." No loan should be "so classified if ultimate payment seems reasonably assured." Thus, for better or for worse, the supervisory agencies formally renounced banking school doctrine. Since we do not know to what extent examiners were classifying sound loans as slow before the agreement, we cannot judge to what extent implementation of the agreement may have had a stimulating effect upon business. Examiners in the past may have tended to apply the self-liquidating loan doctrine in periods of depression while neglecting to apply it in times of prosperity. To the extent that this was true, adherence to this aspect of the 1938 agreement should lessen the adverse cyclical effects of bank supervision.

The other most significant aspect of the agreement was the provision that marketable bonds judged to be subject to no more than reasonable risk of default should always be valued at cost. This was the logical public announcement resulting from the evolution of policy in 1931-1932 which we have noted earlier. This public announcement in

1938 could not have had any substantial effect on recovery from the recession, but it does seem to represent a desirable statement of permanent policy designed to cope with any recurrence of the 1931-1932 situation. We may conclude, therefore, that in the main the 1938 agreement could not have only limited short-run effects but that from a longer range standpoint it is of substantial value.

The new policy still leaves much to be desired. One of the most conspicuous defects is in the valuation of low grade securities. Under the agreement bonds of a grade eligible for bank purchase are to be valued at cost and non-defaulted ineligible bonds at average market price for the last 18 months. Defaulted bonds are to be valued at market price as of date of examination. It is difficult to see why considerations which make market price an inappropriate basis for appraisal for high grade bonds do not apply equally to low grade bonds. There is no reason to suppose that the markets for low grade bonds more accurately reflect their worth than do the markets for high grades. Appraisal of low grade bonds would be no more difficult than appraisal of low grade loans, a traditional practice of the bank supervisory authorities. Since the supervisors do employ the classifications of rating agencies they should not hesitate to determine upon a valuation reserve to be required for each class of low grade

bonds.<sup>1/</sup>

Potentialities of Supervision

In the light of recent experience with supervision we may hazard a few remarks about its potentialities. How should supervision during prosperity differ from that of the past, and what procedures should be followed during depression? Even if it cannot be agreed that valuation of assets, supervisory pressure for increased liquidity, and capital increases during the 1930-1933 crisis were a mistake, surely the inauguration of deposit insurance changes the situation substantially. With this device in operation the justice to depositors argument loses its force and supervisors should feel free to refrain from closing banks or bringing pressure to bear upon them for reform at times when such action would have an undesirable effect upon the

1/ Securities judged not to involve an undue degree of risk (irrespective of whether the judgments of risk were based upon the decisions of the rating agencies or upon other bases) would be valued at cost less premium amortization or book whichever was lower. Securities judged to involve an undue degree of risk of loss would be valued at cost less premium amortization or book or market, whichever was lowest; except that if market were lower than a given percentage of par, a security would be valued at book or cost or that given percentage of par, whichever was lowest. The greater the degree of risk judged to inhere in a class of bonds the lower would be the given percentage of par adopted. For example, it has been suggested that the best grade of unduly risky bonds would be valued at book or cost less premium amortization or 90 percent of par, whichever was lowest. The same formula would apply to the second grade of unduly risky bonds, substituting 80 percent for 90 percent, to the third grade, substituting 70 percent, etc., 50 percent being substituted in the case of defaulted bonds. The percentages of par here suggested are quite arbitrary. Percentages ultimately decided upon should be a consensus among bank examiners, the rating agencies and other experts in corporation finance. Such percentages would certainly be no more arbitrary than the practice of valuing all Class III loans at 50 percent of face value.

general business situation. If it is thought that supervision can desirably do anything about increasing or maintaining the capital of banks the time to do this is during prosperity, not during depression or the initial phases of recovery. Generally speaking, the practice of the past has been quite the opposite.

Apparently supervisory control of bank assets has had little influence in time of prosperity but has been a depressing factor during periods of unemployment. Neither banking nor general business conditions can be helped by supervisory recommendations to liquidate any assets whatever during depression. The bankers of their own volition do more than enough liquidating during depression. Neither does it seem necessary or desirable that the supervisors should at such times exercise any influence over the assets purchased or loans made by the banks. If the bankers err at all at such times it is on the side of undue conservatism and this does not need to be supplemented by the inhibiting influence of the examiners.

Some may argue that positive steps should be taken to restrain banks from collecting loans and selling securities during depression and to require them to make loans and purchase securities. I am very skeptical that such a program has any great possibilities. If banking is to be a private business bankers cannot be forced to extend credit to other business men or prohibited from recalling such credit. The monetary authorities may properly make conditions attractive to induce banks to extend credit or stop contractions, but this has nothing to do with supervision.

On the other hand, it may be argued that the supervisors and examiners should restrain the banks in the making of loans and the purchase of securities in times of prosperity. Three aspects of such restraint may be distinguished, 1) prohibition or restriction of bank loans and investments involving a high degree of risk, 2) limitation of the total volume of the loans and discounts of the banks, and 3) control of the business purpose for which bank funds are used. If bank supervision were used as a device for enforcing the banking school theory, all three aspects of restraint would be involved. Bank funds could be used only for short-term self-liquidating business purposes. Under such a policy, according to the simplified version of the theory here employed, banks would take no undue risks and the amount of bank money would be the volume which was needed. It is indeed strange that the devotees of the banking school have not more often and more strongly advocated firm supervision as a means of causing the banking system to operate in accordance with their theories.

Apparently, however, a consensus exists that direct control of bank assets is not a very satisfactory means of controlling the volume of bank deposits. Other means of quantitative control are more effective, while no one has ever been able to project a plan for determination of quantity through direct asset control. In any case, such control would surely involve such strict supervision as to make banking a Government function.

There is some sentiment for the employment of bank supervision to control the business purposes for which bank funds are used. Advocates of such schemes wish restrictions placed upon the flow of bank funds into

over-expanding lines of business, or upon their flow into the stock market, etc. We cannot here discuss the possibility, desirability or necessity of Government control of the flow of investment. Control of the direction of bank investment, however, would be ineffective except as a part of general investment flow control. Control of bank loans and investments would have to be accompanied by control of investment of the undistributed profits of corporations, depreciation funds, new money stock issues, and by control of other financial institutions. Even control of the uses of bank funds for stock market purposes is surely completely successful only if accompanied by control of the funds flowing into the stock market from other sources. Control of the direction of flow of bank funds can be significant only as an incidental aspect of Government allocation of capital. Unless one advocates general Government direction of investment, he cannot enthusiastically support control of the direction of investment of bank funds through direct supervisory action.

The factors discussed seem to indicate that bank supervision can desirably play but a minor role in the field of social control of business. Bank examination and supervision are necessitated by the nature of the banking structure of the country, but they do not appear to be either useful or necessary for monetary or investment control unless incidental to some broader radical program of a type not currently the accepted program of the country. The lending powers acquired by the Federal Reserve System since the 1930-1933 period should enable that organization to operate in any future crisis along lines here indicated.

The bank supervisory agencies in the future should desist from certain practices in times of depression endeavoring rather to require banks to confine their loans and investments in times of prosperity to those involving no more than a reasonable degree of risk, and to increase bank capital sufficiently during such periods to withstand any probable losses.