FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

NEWS RELEASE

ETHICS IN BANKING

Address by

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before the

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Nearly five years ago I was sworn in as a member of the Board of Directors of the Federal Deposit Insurance Corporation. Almost immediately I was immersed in discussion involving the then imminent failure of United States National Bank of San Diego -- soon to become the first billion dollar bank failure in our Nation's history. As most of you know, the cause of that failure was what has been termed a "riot of self dealing" by the controlling stockholder and Chairman of the Board, C. Arnholt Smith. To the best of our knowledge, Mr. Smith managed to funnel between $400 to $450 million through more than 200 corporate entities to related or affiliated enterprises.

Since that time the banking agencies and the banking industry have been the focus of public attention and Congressional scrutiny more extensively than at any time since the Depression -- caused by other large bank failures, most notably that of Franklin National Bank in New York, the economic trauma of 1974-75, and resultant concern about the soundness of the banking system and the adequacy of the regulatory aparatus. In my opinion, these disturbing events were in many respects beneficial to the banking system. Its stability and resiliency were tested and found adequate. Moreover, the stresses of the period highlighted certain shortcomings that bankers and bank regulators alike have moved to remedy.

Since August of last year, public attention has been directed again to the banking industry and bank supervisors -- this time because of the various inquiries relating to the banking practices of Bert Lance. Suddenly "overdraft" and "compensating balances" have become household words. As a result, debate revived in the halls of Congress, within the agencies, and within the banking industry as to how law and public policy should best deal with conflicts of interest in banking.

Actually, concern over business ethics is nearly as old as time itself. For example, the Bible cautions against usury. The present concern about ethics in banking is not unique to the industry. Ethics seems to be a general phenomenon, perhaps associated with the new morality of the post-Watergate era. Politicians, government officials, industry leaders, and others have all been subjected to increased scrutiny concerning their ethical and moral conduct. However, this increased concern about ethics should not be taken as an indication of a deterioration in the overall moral fabric of American society. I would like to quote from an editorial in a recent issue of the American Banker:

> In a sense, it is unfortunate that the cases of abuse get the attention, and the efforts of bankers to promote the highest ethical standards are unsung. Yet in another sense, if instances of massive overdrafts, insider lending and other abuses become so common as no longer to warrant notice in the press, then banking -- indeed, the nation as a whole -- would have sunk into a morass of immorality. They are news because they are uncommon.

Although I believe that unethical acts are the exception rather than the rule in banking, I believe it is important for the industry, banks, and individual bankers to take all possible measures to guarantee the highest standards of ethical and moral conduct in business matters. Perhaps the most essential ingredients necessary to individual ethical conduct are character and integrity. Both the banker and the bank customer must possess them. An experienced loan officer would tell you that it is not sound banking policy to make a loan to a person whose character is unreliable -- no matter how good or valuable the security for the loan is. And, the customer does not want to be dependent on a banker whose word cannot be relied on, who does not maintain confidences, or who is dishonest.

The importance bank customers attach to character and ethical standards is illustrated by three recent polls. Each included honesty, integrity, or ethical standards among the most desirable attributes by which the public judges

businesses and professions. For example, in a recent Gallup poll bankers were ranked fifth out of twenty occupational groups in the category of honesty and ethical standards. Only clergymen, medical doctors, engineers, and college teachers ranked higher. In a poll conducted by the Unidex Corp., which was related only to financial institutions, individuals were asked to rank eight characteristics deemed most important in choosing a financial institution. Honesty and confidentiality were the second and third most important attributes. Commercial banks were rated highest on both of these characteristics among the five types of financial institutions covered in the survey.

A third poll conducted for the U. S. News and World Report related to business in general. Banks were rated thrid in a list of 31 industries on the basis of the quality of their performance as perceived by the public. Honesty was one of the characteristics on which the ratings were based.

This concern by the public with ethics, as highlighted in these polls, suggests that bank codes of ehtics are desirable on both pragmatic and moral grounds. We need not spend much time on the pragmatics of the need for honesty, integrity, and reliability in individual banks. Unless a customer believes these attributes are present, the customer will seek another bank. I am not saying that honesty, integrity, and reliability are the only requisites for a successful bank, but I am saying that they are a prerequisite for a successful bank.

The next step, from the individual bank to the banking system, follows the same thread. Honesty, integrity, and reliability are prerequisites here also. If they were not present, the banking system would not work as efficiently as it does. Bankers conduct business with each other, as they do with customers, on the basis of commitments, many of them oral. When feasible, conversations are reduced to writing, of course, as a safeguard against faulty memories rather

than for enforcement of contractual obligations. In some cases, as with the code of ethics for the exchange of credit information drafted by Robert Morris Associates, there may be a written code, but many business dealings take place within the framework of unwritten customs of trade.

The private enterprise system depends on the existence and the observance of recognized, though not necessarily written, codes of conduct. Banking codes themselves are important because banking is such an important element in the entire system. Other codes or recognized standards keep transactions flowing among the various elements in our complex, interrelated, private enterprise system. Were it not so we would lose much of the advantage of specialization and of large scale production.

This brings me to one of the main, pragmatic reasons for you and for me to be interested in formulating and adopting codes of ethics for banks. The influence of banking activities on the money supply, on the allocation of scarce resources among alternative uses, and on the overall economic welfare is so great that it is generally accepted that the banking business should be regulated. Perhaps because of this fundamental need for regulation, there has been a tendency in our political democracy to enact a new law or to add to an old one whenever a problem arises in banking. And, as I mentioned at the outset, a number of such problems has arisen in the past few years. All too frequently ill-advised actions of a few banks are imputed to the large number of banks that has not indulged in similar actions. Yet, the solution is applied universally and, as a consequence, all must comply with the laws and regulations designed to meet problems created by only a few.

When existing institutional mechanisms for self-discipline can be made to function properly and effectively, the need for governmental intervention is minimized, if not totally eliminated. Such regulation is not only less costly

to the regulated institution and the regulator but, in my judgment, is far more effective.

Approximately 200 years ago in his Wealth of Nations Adam Smith spoke of bank control in this fashion:

> Though the principles of the banking trade may appear somewhat abstruse, the practice is capable of being reduced to strict rules. To depart upon any occasion from these rules, in consequence of some flattering speculation of extraordinary gain, is almost always extremely dangerous, and frequently fatal to the banking company which attempts it.

The rules to which Smith referred were the prudential rules that banks impose on themselves -- self-regulation, if you will. It is self-regulation that becomes one of the cornerstones of free enterprise, a basis to be supplemented by official supervision not an outworn tradition to be supplanted by such supervision.

In short, I believe that effective mechanisms of self-regulation are the best hope that we have for reducing, or at least checking, governmental intervention in the affairs of private institutions. For this hope to become reality, individuals and institutions in the private sector must squarely acknowledge the existence of problems and seek creative approaches to their resolution. The only alternative, it seems to me, is evermore onerous strategies of governmental intervention in the private sector.

This is where a code of ethics becomes so important to you. Widespread adoption of and adherence to codes of conduct and ethical principles can play a key role in the process of self-regulation in banking. And this in turn can reduce significantly the number of problem situations that might call for legislative or regulatory actions. It is my belief that self-regulation can not only reduce the number of problems but can lead to a more efficient, profitable banking system.

Over the past two years the FDIC has taken the initiative to strengthen the system of self-regulation that is inherent in the structure of American law. The FDIC's efforts to come to grips with the problem of insider abuse illustrates my point. Some have argued that the best way to deal with conflicts of interest is to simply prohibit the conflict. However, it is my view that most bank transactions with insiders and related interests are usually in the bank's best interest as well as in the best interest of the communities that they serve and involve no abusive or preferential treatment. Accordingly, in devising its approach to insider transactions the FDIC rejected prohibition.

A second approach considered was that of public disclosure of insider transactions. This is the approach that is proposed in the current version of the Safe Banking Act which is pending in the Congress. In effect, a public disclosure approach would extend to banks the type of periodic reporting requirements with respect to insider relationships that now exists under the securities laws for registered banks. However, a definition of insider and interests related to an insider sufficiently broad to address the problem would involve relatively massive disclosure for small institutions with limited resources. Also, in the opinion of some, public disclosure requirements sufficiently broad to be effective constitute an unwarranted invasion of privacy at variance with traditional supervisory approaches. Although the latter reason alone may not warrant rejection of the strategy, it did encourage the search for an alternative.

Periodic reporting of insider relationships to the regulator was a third approach that was considered and rejected. It was our view that meaningful reporting requirements in this area would be complicated and burdensome and that they would impose undue costs on the banks without achieving commensurate benefits.

In lieu of prohibition, disclosure, or extensive reporting requirements, the FDIC chose an approach that focused on the existing institutional mechanisms -- the board of directors and the examination process. The regulation, which became effective May 1, 1976, and which reflects this approach, establishes procedures that require bank boards of directors to supervise insider transactions in a meaningful fashion. The board of directors of each insured nonmember commercial bank is required to review and approve each insider transaction involving assets or services having a fair market value greater than a specified amount which varies with the size of the bank. In addition, certain information, including a record of dissenting votes cast by members of bank boards of directors, must be kept available to foster effective internal controls over such transactions by the bank and to facilitate the examiner review and analysis. The regulation in effect requires bank boards of directors to determine for each qualifying insider loan or transaction whether that transaction is in the best interest of the bank.

Thus far I have addressed pragmatic reasons for adoption of banking codes of ethics. There are moral reasons also, and we need not be shy about recognizing them. Most people have well developed senses of right and wrong. Most want to do right, to be fair, and to help others. Adoption of codes gives management and staffs of banks some guidelines of approved conduct. A code also provides a means for making certain that employees follow approved courses of action and inadvertently do not step across the line of approved conduct.

This leads to the question of where a bank obtains a code of ethics. Probably the best approach is to develop it within your own organization. In that way it will fit the conditions of your local economy, your banking operations which have been tailored to meet the needs of that economy, the characteristics of your personnel, and the perceptions of your management -- especially the board of directors.

There is value in developing your own code. Directors, officers, and employees of an individual bank will have a sense of pride and responsibility for the successful use of the guidelines they have drawn up. To conceive a code of ethics is to create a sense of responsibility. Furthermore, I believe it is essential that codes be approved and followed by senior management and the board of directors. This will heighten the degree of creative thinking, will encourage observance of the code, and thus will improve the results.

Industry-wide models and some large institution guidelines can provide a useful starting point for drafting your own code. Models are being provided by the American Bankers Association and the Bank Administration Institute. BankAmerica Corporation, Society National Bank of Cleveland, and Wells Fargo Bank, among others, have published comprehensive codes.

Although it is not my role to suggest the content of a code of ethics, I would like to focus your attention on key areas of concern that may serve as useful starting points for more detailed discussion among yourselves. Charles Jarrett of Mellon Bank has suggested that a bank code of conduct should:

(1) establish criteria for standards for business ethics;
(2) define and monitor conflicts of interest, and
(3) provide for a system of compliance, including the control and reporting of fraudulent acts to proper persons.

In formulating a code, it may be useful to consider two sets of guidelines, one for the activities of the bank itself and the other covering personal relationships and activities of bank personnel.

Focusing first on corporate or banking activities, our attention might be directed to:

1. Loan policies relating to directors, officers, other insiders, and enterprises in which they have an interest;

2. Compliance with laws and regulations;

3. Corporate gifts or donations, especially when the recipient is a pet project of an insider;
4. Fees for professional services rendered by directors and other insiders and firms with which they are affiliated;
5. Accounting principles to be used;
6. Disclosure of financial information of the bank;
7. Confidentiality of information relating to customers;
8. Separation of information relating to commercial banking and to trust services;
9. Loans to political candidates; and
10. Entertainment in the name of the bank.

Directors, officers, other insiders, and employees might consider the following in a personal code of ethics:

1. Accepting and receiving gifts and entertaining and being entertained;
2. Accepting bequests from customers;
3. Entering into joint business ventures with customers;
4. Handling bank transactions with entities in which they have a financial interest;
5. Engaging in employment outside the bank;
6. Serving as an officer or director of an outside profit-making firm;
7. Using bank facilities for personal activities;
8. Reporting of outside income;
9. Giving professional references;
10. Making political and charitable contributions;
11. Making investments;
12. Speculating and gambling;

13. Engaging in business transactions with the bank;

14. Borrowing from customers; and

15. Borrowing from correspondent or other banks.

Once a code has been formulated and implemented, care must be exercised that the code does not become rigid. A good code should be flexible and subject to revision.

In summary, awareness and interest in morality have increased throughout the Nation. This is especially true in banking but is evident in other business activities and in politics as well. One cannot doubt that the demand for public accountability of the behavior by public and private institutions and professions has increased significantly. This new morality is a part of our current business climate.

I strongly recommend to you the adoption of and adherence to a code or codes of ethics in your own bank to guide the activities of the bank and the personal activities of individuals associated with it. Adoption of a code by itself certainly will not ensure public confidence. The public, jaded and lulled by the media, is not going to be impressed by the words of an industry-promulgated code in and of itself. However, use of a code of ethics and conduct as a working device or a tool in bank operations can engender public confidence. Codes can serve as valuable guides in providing flexible, responsive, imaginative bank services. Used in this way, codes will benefit the individual bank, the banking system, and the private enterprise economy. Codes also can help check the increase in laws, regulations, and paperwork.

It seems to me that the decision to use or not to use a code of ethics really is not an option that should be open to you. If bankers do not develop their own codes, there is a real danger that the people and their representatives in Congress may well do it for them. In my opinion, all would be better served if bankers took the initiative.

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