NEWS RELEASE

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WHO WILL BE THE POLICEMEN?

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Washington, D. C.

at the

ANNUAL CONVENTION

of the

MINNESOTA BANKERS ASSOCIATION

at the

HOTEL LEAMINGTON

Minneapolis, Minnesota

Wednesday, June 17, 1964

12 Noon

WHO WILL BE THE POLICEMEN?

You and I, as bankers and bank supervisory people, have pledged our careers to service to the public. We serve in an industry which goes far beyond the normal routine of a profit-making business. We are in an industry which has a strong public service image.

We all know, of course, that ours is a limited-entry business. We do have stockholders, and they deserve a return. But there are two other facets which, taken together, place a public trust in the banking industry and lead to the industry's status in chartering.

The first is that the industry operates in large part with the public's deposits, entrusted to the banks for safekeeping. The second is that the banking system, as no other system, has been entrusted with the power to create money supply through the medium of fractional reserves.

The banking industry is protected against over-competition, and every attempt is made to insure that competitive pressures alone will not drive some banks to the wall, taking with them the deposits they hold. At the same time banking is subject to more intense regulation as a result of this protection than are most industries.

As you know, I recently moved from the lending platform of a small country bank to one of the regulatory agencies which supervises banking. In moving from the Utah bank which I headed, to the Federal Deposit Insurance Corporation, I moved from one side of the table to the other.

I have discovered new approaches, but I find that the basic problems and goals, are the same. What troubles banking as an industry troubles the supervisory agencies as well. In seeking solutions to these problems, we must work as a team, for the interests and goals of the agencies, and of the industry, are much alike: Both seek a vital banking system serving the public and assuring an adequate credit mechanism for this modern economy of ours. We are as anxious as any banker that the bank manager be competent, honest, and positive in his approach to his community's needs, both for credit and for leadership. And we are as anxious as the industry itself that banking continue to be an honest industry, fully meriting the trust of the public.

Recently some new patterns have emerged, in the age-old battle by the banking industry and the supervisory agencies against dishonesty in banking. I would like to discuss these with you today, to see if perhaps there are not some common approaches we in the supervisory agencies and you as bankers can take to police the industry, and to suggest some possible steps to eliminate these new problems.

As you know, over the past year the Federal Deposit Insurance Corporation has had to step in and start liquidating four banks, three in the Midwest and one in the Southwest. In each case insured deposits were paid quickly (in the last two cases, within five days, I am happy to report). In each case, liquidation continues and further payments to depositors and general creditors are expected. All four banks were, at one time, flourishing and in good condition. Yet all went under, subject to the same virus.

The historic pattern for bank failure has led down one of three paths. Many banks have failed because some trusted employee embezzled funds. The employee might be a clerk, or bookkeeper, or teller; more often the employee was an officer. Someone in senior management placed too much trust in the employee who could not resist the temptations. Or managers might, as in one case, pay attention to the lending side of the bank and leave administration strictly in the hands of a subordinate, who took advantage of this inattention.

Many banks have failed because the economy generally, or in an area, failed. In 1937-38 when the nation went through a recession quite a few banks failed, for economic reasons. I know of one bank taken over by FDIC in the 1950's which failed because the cash crop of the area was poor for several years in a row.

Then there are the unfortunate cases where a bank failed because the bank's officers extended credits unwisely, perhaps in an attempt to keep a customer afloat, and went under when the customer did. There was a case a few years ago in which a bank president, trying to keep a resort hotel and a manufacturing firm alive and the town's two biggest payrolls going, permitted substantial overdrafts. The bank went under with the two businesses, and for a period of time FDIC found itself managing a resort hotel.

The new pattern, however, which closed the last four banks, followed none of the three classic causes of failure. Instead, in each case promoters purchased control of the bank,not for the purpose of engaging in banking, but for the purpose of availing themselves and their corporate interests of the bank's funds. In effect, the result of the purchase was to loot the bank. A common thread ran through all the cases, a thread of action suggesting that the purchasers' only interest was self-interest, and that the meaning of being a banker completely escaped the promoters. I would like to clearly be on record that I do not believe they represent in any sense the banking fraternity.

These cases involved purchase of the banks in question, at inflated values far above book, in general on borrowed funds. In each case the promoter used the bank for self-dealing transactions, either acquisition of paper which had been substantially overvalued, or loans to firms which were not in the best of shape. In one instance a loan was made to a firm controlled by one of the promoter-types, even though the firm in question had been closed by state authorities weeks before because it was insolvent.

In two of these cases the promoters actually used, or tried to use, funds of the bank itself to purchase the bank. In a previous case, in Oklahoma City, promoters tried to pay the purchase price through a liquidation of a part of the bank's bond portfolio. The United States Court of Appeals said of this case, "This scheme was in essence a stratagem for purchasing a bank with the bank's own assets. Only O. Henry could do full justice to the plot."

These are dangerous, pernicious patterns. Four banks have failed in recent months because of this pattern. This is the open, known part of the problem, known because FDIC was called in to close, liquidate, and pay out insured deposits. Other banks have faced similar problems, which have been worked out by alert state authorities and by the Federal agencies. In one recent case, for example, the state supervisor required the promoter-types to sell the bank to local interests, which put up $750,000 in additional capital. That capital is now in an escrow fund, to serve as a reserve against almost certain losses on a large block of paper purchased by the bank at a highly inflated price. But the bank is saved, and the town still has its financial center intact. The new owners will, hopefully, get a substantial part of their $750,000 back after all losses are realized.

Now, what can we do about this, you as bankers and I as a supervisor? What lessons can we draw from these unhappy and dangerous experiences? What steps can we take to assure that it will not happen again?

Can we strengthen our dedication to sound banking, take more care in our own involvements with bank ownership transfers? Can we set forth stricter rules on bank stock loans? Can we do more about policing the entry of people into the banking world?

I think we can. I think we must. This new pattern is one which must be broken. It cannot be tolerated, and if there are no answers within the industry, I suspect that Congress will try to find some. There must be a policeman, and the question I want to ask you today is "who will be the policeman—you bankers, or the Federal government?"

Innocent stockholders, depositors, and communities have been looted, and the banking system as a whole has suffered. The promoters are still active; we hear stories every day at FDIC about activities which threaten possible dangers.

In each of these cases patterns occur which we can well look at carefully, asking ourselves if perhaps the banking industry can find cures. I suspect that the banking industry can itself, to a large extent, act as the policeman in these areas.

Certainly the first part of the pattern is one which every banker can work on. For each of these banks the acquisition by promoters was financed by another bank. Presumably the banks which financed the purchase of bank stock were motivated not only by the thought that loans on bank stocks are considered excellent loans, but also by the natural desire for correspondent accounts.

In some of the cases, however, such financing has been at 100 percent of the purchase price, and the new "owner" has no equity at all. This is a danger signal; equity always tends to make a person more careful of something he has purchased. Morever, financing without any equity tends to create high carrying charges and encourages the promoter to seek inflated returns, in salaries and in dividends, to pay off the loan. This can and often does lead to unsound lending practices and self-dealing practices.

The banks making such loans, in several cases, did not have proper credit checks prepared on the promoters. In one instance, for example, a bank made a substantial loan on bank stock to a pair of promoters on the unsupported endorsement of another bank in another part of the country. A credit check would have disclosed a dubious background, to say the least. Now that bank has on its hands a large block of bank stock held as collateral for a loan on which no payments have been made--and the bank stock is not worth very much, because the bank has been closed.

Perhaps, then, the banking industry can act as its own policeman if individual bankers are more careful in appraising all loans on bank stock. Prudent credit investigations of the persons involved, scrutiny of the terms of the loan, with extra care where excessive prices for shares are offered, and the requirement of an adequate equity in purchasing control of a bank--all of these would help alleviate the problem immediately.

The sale of a bank, especially when control passes out of the community, is a second place where bankers can perhaps exercise some self-policing. It is a fact that a banker has an obligation to his community which is inherent in the responsibility of leadership. Realistic appraisals of bank values, dedication by bankers selling control to the concept of suitable replacements and of continuity for their institutions, both will help.

In one of the cases which Federal Deposit Insurance Corporation is working out, the banker in question, wishing to sell his controlling interest, rejected an offer from local interests for 150 percent of book, and sold to promoters for 200 percent of book. The bank lasted a few months and had to be closed. Of course, the banker was out of it; he took no loss. But what of the community in which he had worked for so many years?

It seems to me that there are times when restraint is in order, and when making the last dollar is less important than assuring that an institution will continue to flourish and serve its community, which, after all, supported the bank and gave it value.

Remember that it is not the bank which makes the community, so much as it is the community and its support which makes the bank and creates the bank's value.

Perhaps, too, the industry can strive for some practical and realistic answers to the question as to what does in fact constitute a fair return for bank stocks. What is a fair selling price? What premiums over book are legitimate? Finally, development of markets for bank stocks, however this may be achieved, would be most helpful in alleviating the problems which have arisen through overly high premiums for bank stocks.

The third area where bankers can police themselves is perhaps the broadest of the group, possibly the most dangerous, and certainly one of immediate and deep concern to the federal supervisory agencies. We are looking for answers, and I hope that you will join us in that search.

This is the use by some bankers of money brokers to secure funds, most often placed in Certificates of Deposit, and often by subterfuge paying a rate of interest above the 4 percent level permitted by Federal Deposit Insurance Corporation's Regulation 329 and the Federal Reserve's Regulation Q.

At FDIC we have found several of these cases. I might cite two examples, to show you how dangerous this practice can be, and how it works:

In one case, promoters, after acquiring control of a bank, raised almost $1 million in Certificate of Deposit money, paying a premium of 3/4 percent above the regulatory maximum. They then used almost all of this money to buy a large block of mortgages for the bank from another firm they controlled. The mortages went on the books of the bank at a face value which was highly inflated. The firm selling the mortgages showed them sold at a discount, but the bank didn't get that discount - the promoters did.

If, as, and when that CD money left the bank, what coverage would the bank have for that block of mortages? The CDs were not received in the usual course of business and in the most accurate sense of the work they were "hot money." Of course, the rate of interest paid was illegal, since it was higher than that permitted by the regulations.

My second example involves another bank which went to a money broker and secured a large amount of CD money. Here too, the banker paid a hidden extra interest. Here the banker failed to enter a part of the CD money on his books, and eliminated a corresponding amount of loans from his books. The loans he eliminated were to a firm he controlled, which had been in bad shape and which had been criticized in an examination.

We have asked a court for a ruling on the insurability of such funds, and hope to have it soon, for our guidance and for the guidance of the industry. In the meanwhile, we continue to study the problem.

We know of another bank which has four-fifths of its deposits in CD money. I wonder how sound such a banking operation can be. This problem of CD money, generated through brokers, is one which merits careful consideration by the industry. Normal acceptance of time money, normal issuance of Certificates of Deposit, are a routine and acceptable tool of banking, but the cultivation of "hot money" and the possible commitment of such funds to speculative loans and investments smacks too much of the excesses of the 1920's to be at all comfortable.

These are three areas of concern for us who are supervisors and you who are bankers. Together we must find some answers, to assure the public, and ourselves, that the basic strengths and purposes of the banking industry will continue undiluted.

There are, of course, other problems. In your own state the question of non-par banking, and the related problem of absorption of exchange, are pressing issues. This is especially true since the American Bankers Association recently issued a statement suggesting gradual elimination of such a form of banking. Perhaps non-par is a holdover from earlier forms of banking, when the exchange of checks was a difficult, costly, and time-consuming process. Perhaps it is an economic necessity, even today.

There are other, national problems relating to banks. The questions of branching, of holding company operations, of broader services to the public, of automation, and many others, are matters of vigorous debate today.

Authorities in Washington are taking hard looks at many of these questions. The Committee on Financial Institutions in early 1963 made a lengthy report to the White House, and some of the recommendations have already been proposed for consideration by the Congress. More legislation may be forthcoming.

Conferences have been going on almost daily between the various federal agencies which are concerned with the banking industry. In recent years as you all know, the Bank Merger Act and the Bank Holding Company Act have passed, and new tax legislation affecting some banking competitors went through Congress. Much of that legislation, I might add, came about because of devoted and tireless banking effort.

The point is that Washington is full of people ready and willing to be the policemen whenever and wherever necessary. Perhaps to a limited extent this is the right approach. There are some things that seem to need this approach, although self-policing, or policing on the state level is always preferable if it can be done effectively.

For example, looking at this new problem of promoters entering the banking field to milk banking institutions, some tentative solutions appear immediately. Whether they are acceptable, or workable, is another story. Whether they are better than an all-out effort by the banking industry to do a self-policing job is worth debate. But if bankers refuse to do the job themselves, then someone else will.

Supervisory agencies, state and national, now have a veto control over persons entering banking, either as directors, stockholders, or manager, when a new bank is concerned. Once the bank is chartered and open, however, this power disappears.

There are grave Constitutional questions as to whether or not it would be right, appropriate, or legal, to have a veto power over the sale of a person's private property, which in essence bank stock is. But there may well be some merit in the possibility that the supervisory agencies should be informed of any change in ownership control or management of a bank.

For one thing, promoters might hesitate before buying bank stocks, if they knew that such sales were to be reported to state or federal authorities. For another thing, if the supervisory agencies knew that sales had been made, investigations of the principals might disclose the ones with poor backgrounds, and the supervisory agencies could then keep a careful check on the banks in question, to make sure no looting operations were being carried on.

Some answers must be found to these various problems. They can come in the form of new laws, or regulations. They can come from Washington, or from state capitals. But I think that they can in large part come from the industry - if it cares enough - if the banks are willing to exercise self-restraint, and adhere to existing regulations, and live up to the standards implicit in the business of banking.

If the industry will, as an industry, seek answers to problems, and exert moral suasion and a healthy caution - if, in other words, the industry will act as its own policeman - then Washington will not have to step in with additional rules, additional controls, and additional laws. But if the banking industry will not, or cannot, act as the policeman, Washington will, because, for the public's well-being, someone must.

Who will be the policemen? The answer is yours.