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THE AMERICAN BANKING SYSTEM -- DOES IT MAKE SENSE?

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THE AMERICAN BANKING SYSTEM -- DOES IT MAKE SENSE?

In the time we have together today, it might be useful to examine together some of the forces and factors that have brought the American banking system to its present form and place in our society. It is a unique system, offering unique services to the public, and it is important to all of us to understand why and how this is so.

In the foyer of the Federal Reserve building in Washington are these words of Woodrow Wilson: "We shall deal with our economic system as it is and as it may be modified, not as it might be if we had a clean sheet of paper to write upon; and step by step we shall make it what it should be."

At times like these, when the problems and issues that concern us sometimes loom larger than they really are, I am inclined to think that if Woodrow Wilson were with us here today and were given the clean sheet of paper of which he spoke, the banking system he would have us construct would not differ greatly from the system that we have. We can never be insensitive to any imperfections in our banking heritage, but let us always understand why it is what it is -- and before every change let us reconsider carefully what we want it to be.

We have all heard it said many times that the American banking system is a jumble that "just growed like Topsy." I have always felt this to be an over-simplification of the forces which developed the system, and after more than a year as a director of the Federal Deposit Insurance Corporation, I am now more convinced than ever that it is not true. The American banking system is what it is because its evolution has determined it to be right for our country and right for our time. If there is one continuous theme that has run through the entire development of banking institutions in the United States, it is one of evolution. As a nation we have usually had the courage to examine our banking problems in the bright light of public debate, and to make such changes as the times and conditions called for. Rather surprisingly, most of the distinguishing features of the structure which we have today are derived from or show similarities to forms for which there was a need and for which there was a purpose in the past.

The First Bank of the United States adhered to high standards and forced high standards on other banks -- a very wholesome influence on banking affairs in the young country. But this involved competition which provoked bitter antagonisms and induced other serious problems that we had not yet learned how to resolve. The need for a Second Bank of the United States and its usefulness are clearly attested by improvement in banking standards following its establishment and by the prompt return to conditions of disorder when this bank, in turn, passed out of existence.

If there is one lesson to be learned in these first attempts at a national bank, it is that every government institution must be attuned to the political realities and fitted into the framework of its era. It may seem unfortunate that the fate of important experiments such as these initial banks rested so little on the direct contribution which they made to the financial life of the country and so much on political facts of life. Nevertheless, it must be recognized that our institutions must be suitable to the needs of their time, and in our system this means they must be capable of functioning effectively in the political climate of their time.

Some may deplore the Jeffersonian and Jacksonian actions striking down the first two banks of the United States, but it is worthwhile for us to consider that the people at that time made a decision that they wanted more credit to develop the lands west of the Alleghenies. They felt that the credit was not forthcoming and they struck down both banks. They sought to preserve a greater local control over credit and money, and a strong central bank at that time would have defeated this effort for a diffusion of credit control.

But while in those days diffused control of credit and money dominated the nation's thinking, some steps were taken toward our eventual system. The Suffolk Banking System which functioned so successfully in New England during the early decades of the 19th Century shows interesting parallels with the Federal Reserve System that was to come 90 years later. The Suffolk Bank of Boston agreed to hold deposits for outlying country banks and in return to redeem notes of these banks at par, just as the Federal Reserve requires member banks to maintain deposit balances in return for par clearance of checks drawn on other members.

In a like manner, the New York Safety Fund System, established in 1829, might be regarded as a forerunner of the Federal Deposit Insurance Corporation. It consisted of a guarantee fund maintained by obligatory contributions from member banks for the purpose of helping to meet the liabilities of banks that failed.

The New York Free Banking Act, copied in ensuing laws of many States, must be considered a landmark in the banking history of the United States. It proceeded on a new principle. No longer did the organization of banks depend upon the grant of special charters by legislatures, a practice savoring of monopoly and political abuse. The legislature was left only with the determination and enactment of requirements to be met for permission to organize and operate banks. By setting requirements at levels consistent with the public interest, it was assumed that banking could be made "a business open to all" and not a special privilege granted to a favored few. This again emphasized the "diffusion" principle.

The primary goal -- and foremost achievement -- of the National Banking System set in motion in 1863 was to give us a safe and uniform currency, but it also performed services similar to those of the First and Second Banks of the United States. It set standards generally higher than those in effect in many states, thus improving banking conditions in the country as a whole and helping to maintain them on a higher plane than would otherwise have been likely.

But there were still defects -- an economy prone to crises and panic; a system of reserves that made for an inelastic supply of currency and credit; an inefficient exchange and transfer system; and a lack of central coordination and control to give direction to monetary affairs. With acceptance of local controls of credit firmly set in the national framework, the time came to grapple with these problems.

The Federal Reserve System effected these repairs and in so doing established the first central bank in the country -- the first institution charged directly with responsibility for central banking functions. It was dedicated to the maintenance of high standards and to the improvement of the operations of banking and the monetary system of the country. Perhaps its principal accomplishment was to provide for an elastic national currency and credit supply to meet the needs of economic development. It provided services for banks similar to those performed by banks for their customers.

The Banking Acts of 1933 and 1935 brought refinements and improvements. The establishment of the Federal Deposit Insurance Corporation and the separation of commercial banks and their security affiliates were unquestionably essential in adapting the banking system to the needs of our people and to the needs of our time. The broadening of Federal Reserve powers, and in particular of its authority to conduct open market operations, amounted to a crucial recognition that the supply of money and credit would not automatically adjust to the needs of the economy and that central banking had a significant role to play in overall economic stabilization policy.

In these several steps were woven our banking heritage, of the threads of diverse local control and of necessary national objectives. The nation discovered that it needed coordination and control. The nation discovered that the right to become a banker and start a bank -- and, yes, the right to fail as well -- was consistent with the best traditions of our freedom-determined society. The nation discovered that nationally-chartered banks and state-chartered banks could exist side by side without one destroying the other. The nation discovered that bank supervision could be undertaken cooperatively by Federal and State authorities. The nation discovered that branch banking appears more suitable in some areas while unit institutions seem preferred in other, and the choice was left to the States, localizing as far as possible control of this sensitive problem. The nation discovered that decentralization of the system could be maintained, and that the local needs of commerce and industry and the needs of our individual citizens could be cared for under the same structure that cares for our national and our international interests. The nation discovered how to manage stock market call loans, violent swings in money rates, and how to prevent the financial reserves of the country from rushing to the Eastern seaboard and back with our seasons and with our economic emotions. The nation decided that the bank deposits of its citizens are entitled to protection -- as much against the vagaries of the economy as against the acts of the embezzler.

What has been learned and what has been constructed as a result is not a banking system "like Topsy" or a random disarray that is the outcome of factors of chance. Instead, our whole national experience has evolved a unique system molded to the particular needs of our people -- to our diverse local needs and to our diverse national needs. It is like none other in the world, but the country that it serves is like none other in the world either.

After a year with the Federal Deposit Insurance Corporation, observing the system in action, meeting with thousands of bankers, a feeling has developed that the banking system is one which deserves the nation's full confidence.

There seems to be abroad in the land a more rational attitude where banking matters are concerned. Some of the things which have worried all of us are now being dealt with affirmatively and in a realistic perspective.

It was about this time last year that the FDIC began to examine the misuse of certificates of deposit by some individuals. The CD can, of course, be a useful banking instrument. But experiences in several failed banks caused the Corporation to wonder if perhaps some bankers in the country were improperly using this instrument. Today, there is a general awareness on the part of bankers and depositors that a certificate of deposit has its uses and also its limitations. Refinements of supervisory regulations, together with industry discipline, has all but eliminated recent problems. It is another case of recent experience, evolution, and self-correction within the system, which has contributed to the strength of American banking.

About this time last year the Corporation also began to worry about the fact that we had no weapon to guard the public against sudden shifts in the control of management of insured banks. It seemed to us that this was a substantial weakness in the regulatory authority and that it left the banking industry vulnerable to raids by unscrupulous looters. Chairman Joseph Barr and I did not feel it proper to load bank stock with a burden so heavy that it would be impossible to raise capital, but we did feel it necessary to protect the public and the banking industry against fringe operators. The very mild bill that Congress enacted last year was the answer. I am pleased to report that so far it seems to have functioned well. We have had 200 notices of changes of control since the enactment of this bill and, in at least two instances, we were able to head off what we felt certain were raids that might have destroyed the banks.

Also, at this time last year, the Corporation became aware of operations of money brokers, and some borderline practices were encountered. The McClellan hearings have brought out this subject. The Corporation has been instructed to conduct a study in this area and, in cooperation with the Department of Justice, we are proceeding to do so. Here again, bankers, regulators, and depositors have been alerted to the danger, and consequently we are much less concerned.

What seemed to be an extraordinary speculation in the shares of newly chartered banks was also bothering the Corporation during the last year. Various sections of the country probably will need new banks from time to time, and new banks obviously will need new capital. Our experience has indicated that banking is an industry which, if properly conducted, produces reasonable profits over a long run, but they are not usually spectacular. It has been distressing to see an industry so closely allied to the needs of the public made a speculative football -- especially in the new bank stock area. Today, a brief look at the quotations around the country would indicate that new bank shares are being appraised much more realistically.

The members of the McClellan Committee seem to be sensitive about over-competition in the banking industry. When Chairman Barr testified before the Committee, in his prepared statement he intended to use the term "fiercely competitive" to describe the banking industry but at the last minute he changed the term to "extremely competitive." Senator Mundt of Nebraska queried him on this point and, if I judge the questioning by other members of the Committee correctly, it would indicate they felt that excessive competition is not completely appropriate to the banking industry. I would agree, but the question arises as to what is the proper level of competition? I do not know, and I doubt that anyone knows, but perhaps our experiences in the past year have alerted the banking industry not only to the benefits of aggressive and imaginative competition through changes in customary banking practices but also to the dangers inherent in competitive excesses in any direction. This is a general observation but we feel this awareness does exist.

The figures on loans made to foreign borrowers by our banks in recent months gave reason for concern -- not just for our balance of payments position but for the quality of credit extended. It is difficult to forget the rather dismal experience of the late Twenties with some of the foreign loans that were contracted at that time. I can, therefore, support the President's program of voluntary restraint in foreign lending with double emphasis -- as an American citizen concerned about our balance of payments deficit and as a public official who worries about the proper evaluation of such enormous credits extended in such a short period of time.

In conclusion, it is appropriate to pay a tribute to the fairness and impartiality of the hearings being conducted by Senator McClellan. You must realize that, while failure is commonplace in commercial, industrial, and personal affairs, it is a very rare thing in banking since the days of the Great Depression and the creation of the FDIC. It is all to the good that the Congress has taken a hard look at the failures of the past few months -- and it is equally to the good that Congress recognizes how limited these failures are, when compared to the system as a whole. The candid, fair, and thorough investigation being conducted by Senator McClellan and his Committee has, in my opinion, already contributed greatly to the soundness and viability of commercial banking in this country. When the American people are aware that abuses exist, they will do their own correcting. The industry must be a leader in this posture, and, I am sure, will be, in the best traditions of responsible banking.

All of you probably have flinched in recent weeks at the publicity attending banking. But I can tell you as an official charged with responsibility in this area that we at FDIC feel more confident because this nation has shown again that it has the courage to examine its own deficiencies. This public discussion, while often painful, has always proved useful in the evolutionary process of banking development in this nation.

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