NEWS RELEASE

FEDERAL DEPOSIT INSURANCE CORPORATION

WASHINGTON, D. C. 20429

Telephone: 393-8400
Br. 221

FOR RELEASE TO A.M. PAPERS, WEDNESDAY, OCTOBER 19, 1966 PR-67-66 (10-17-66)

BANK SUPERVISION: OLD PROBLEMS AND NEW CHALLENGES

Address of

K. A. Randall, Chairman
Federal Deposit Insurance Corporation
Washington, D.C.

before the

Annual Convention of the

NATIONAL ASSOCIATION OF STATE BANK SUPERVISORS

in

Salt Lake City, Utah

Wednesday, October 19, 1966

BANK SUPERVISION: OLD PROBLEMS AND NEW CHALLENGES

Bank supervision today is carried on in an environment that appears to be in sharp contrast to the early years of this century as well as to the early 1960's. Financial interrelationships seem to be increasingly complex, and financial flows are being diverted from what had been previously considered traditional channels. But a number of the changes are to some extent superficial. Although the problems basically have not changed, they obviously are of much greater magnitude simply in terms of the total dollar volume of financial flows, the number of people involved, and numbers of financial institutions. There is furthermore a better understanding today--and therefore greater public concern--as to the dangers and potential damage that could result from financial crises, and also more effective methods available to deal with them.

There have been some major changes in banking, however. Banking cannot be considered a separate and distinct industry to the extent it has been in the past. Banks more than ever before are a major participant in the broad, diversified and integrated financial markets. We need only look at present patterns of financial flows to realize this change.

At the same time, the economy is operating at high and still rising levels of activity--in contrast to 1961, for instance, when there was substantial idle plant and manpower capacity. There is consequently less latitude for maneuver in making decisions than before and less freedom to choose among alternative courses of action. This is an environment to which we as bank supervisors are not yet fully accustomed and an environment in which new challenges vie with old problems for our attention.

Among the old problems are the adequacy of bank liquidity and the quality of credit. In earlier years, banks were expected to maintain a more or less generally accepted proportion of their assets in cash and short-term Government securities. But growth of the economy and of credit needs has led to the commitment of an increasing share of bank resources to less liquid claims. Cost pressures have also encouraged banks to invest in higher yielding and less liquid assets.

The customary liquidity ratios with which an individual bank's performance was measured were not inflexible standards; nevertheless, the recent decline in liquidity has been a source of concern. The sale of securities and loans at a discount in order to obtain additional liquidity is limited because sales must stop well before the point where accumulated losses would erode the capital margin. A significant proportion of the short-term Government securities in bank portfolios, moreover, is not readily available to satisfy liquidity needs because they are pledged or otherwise tied up.

Some of the impact of lower liquidity ratios has been offset on the asset side by increased cash flow through amortization of credit and by the development of broader and more active secondary markets for some types of bank-held assets. More recently, the large, negotiable certificate of deposit and consumer-type savings instruments have enabled banks to "purchase" liquidity from the liability side of the balance sheet.

These latter two sources of added liquidity cannot always be depended upon, however, especially during periods of strong credit demands and credit stringency such as we are experiencing today. For example, the country bank cannot as a matter of course refer excess loan demands to its city correspondent as easily as in times past nor as easily persuade its correspondent to participate in a loan. Rather the reverse is true; the city correspondent has been tapping the liquid funds of country banks to an increasing extent by placing loans with them. Nevertheless, the ability of the banking system to remain viable with lower liquidity ratios is to some extent a natural outgrowth of the more stable economic environment that has resulted from the operations of the Federal Reserve, the deposit insurance system administered by the FDIC, and implementation of the provisions of the Employment Act of 1946.

The decline in cash margins has two important implications. In the first place, banks have less time in which to produce satisfactory answers to their problems. If an adjustment is made and the adjustment is either too large or too small, the scope for further corrective action may be severely restricted. Secondly, mistakes tend to be more costly under these circumstances because there is less leeway for error or experimentation. The role of the bank supervisor in these situations can be crucial in assisting banks to seek and find solutions that will produce maximum benefits and yet minimize the costs of miscalculation, without narrowing unduly the freedom of banks to exercise their own judgment.

Assessment of credit quality is surely at least as difficult a task as a determination of adequate liquidity. The Corporation is supporting research in this area because of its importance to bank supervision. Like liquidity ratios, judgments about credit quality have been modified over time--with our increasing knowledge of the characteristics of new types of credit and with the development of new techniques in the extension of credit.

Again, as in the case of liquidity standards, the growth of the economy and its diversification, as well as a more stable environment, strengthen the quality of credit. Credit quality perhaps tends to vary with the phases of the business cycle--improving during an economic upswing and weakening in its later stages--but this is a question that deserves much more intensive study. To some extent, evaluation of credit quality rests upon a judgment decision. For this reason, bank credit analysis is not a science. To assure that the qualitative judgment is as balanced and as free of subjective elements as possible, the examiner and the banker should study all relevant facts and circumstances and utilize the latest analytical tools.

In the process of examining banks recently, we have encountered some old problems with new twists. The factors responsible for bank failure have assumed somewhat different forms in recent years, for example. Weakness in the domestic economy and the lack of institutional safeguards--such as the Federal Reserve and deposit insurance--were at one time major contributors to bank failures.

Several years ago, a few rather novel manipulations of bank assets for the benefit of unscrupulous operators presented the banking authorities with a number of supervisory problems. In response, the Federal banking agencies, with your support, quickly obtained Congressional passage in September 1964 of a law instituting a reporting system for changes in stock ownership and control in banks. In 1965--the first full year of operation under the new law, 409 reports on changes of control were received from state and national banks and carefully scrutinized. Where the circumstances seem to warrant it, investigations are conducted or additional information requested.

Finding qualified individuals to manage banks is another old--and increasingly serious--problem. The complexities of modern banking place heavy demands on management skills. The lack of competent management can weaken an existing bank and handicap a new bank. It can encourage an undesirable degree of concentration in banking because of the inability of a smaller bank to attract management talent in order to stay in business. This is a problem with which we are all deeply concerned. The caliber of management is a major factor in a bank's earning capacity, for example. Good management can spell the difference between a good bank and a bad bank or between a good bank and a merely adequate bank. The Corporation, like you, addresses itself to questions such as these because the answers are vital to the future of our banking system.

The Corporation is at the same time moving away from the traditional concept of examination as primarily an evaluation of a bank's overall condition.

No longer is a sharp distinction drawn between examination activities and audit activities. We have been moving toward a broader concept which, among other things, calls for an expansion of the normal audit functions performed in every examination to include direct verification of selected accounts, both assets and liabilities. In today's banking environment, we believe the broader concept constitutes a more realistic approach to bank supervision.

We desire, moreover, through consultation and mutual exchange of information, to develop examination procedures, report forms, and techniques that are compatible with state laws and programs and their overall orientation. Our cooperative efforts have produced significant progress. Some duplication has been eliminated and both state and Federal examining staffs have been used more efficiently. In half of the states, we alternate with the state in making independent examinations. In 17 other states, we conduct concurrent examinations--one entry to the bank is made with examiners from both agencies, but each agency prepares its own report. In the remaining jurisdictions, a combined crew also makes a single entry to the bank but only one report signed jointly by representatives of each agency is prepared. Consistent with our own responsibilities as insurer of deposits, we will continue to be receptive to any proposals designed to strengthen further our cooperation in this area.

We take pride also in the success of our cooperative efforts in the areas of uniform asset appraisal, uniform reporting forms and procedures, and in personnel training programs. The Uniform Agreement for bank examination and reporting procedures among both Federal and state examining agencies dates back to 1938, and was slightly revised in 1949. A common examination report format, shared at least in part with 32 states, results in a more uniform approach to and evaluation of the problems confronting both state and Federal bank supervisors. The manual of instructions provided our own examiners is available to you and has received wide distribution among the states as well as among other Federal and international agencies concerned with the supervision of banks. Likewise, you have been helpful to us. For example, the instructions issued to your examination staffs are made available to us and enable us to keep current on your thinking in specific areas of bank examination. Coordination of approach also has been successful in the development of the Condition and Income and Dividend reports that must be submitted to the supervisory agencies, and information essential to the evaluation of a bank is freely exchanged.

The Bank Examination Schools conducted jointly with the Board of Governors of the Federal Reserve provide training at various levels for assistant examiners, examiners, and trust examiners. They have been attended by representatives from the state banking examination staffs as well as ours. In the past few years, training programs on the use of electronic data processing in banking have been conducted in various sections of the country. Hopefully, all of these programs should contribute to a desirable uniformity of approach to similar problems.

The issues and problems I have touched on today are in many cases not new--but are particularly relevant today and deserving of special emphasis. I hope some of my comments will stimulate you to look at these old problems in a new light and in their new context. Let us engage in this challenging task together.

The Corporation has benefitted greatly from the cooperation we have received from state bank supervisors in many fields of common interest. Recently, Congress passed a bill granting cease-and-desist powers to the Federal Reserve, the Federal Home Loan Bank Board, and the FDIC. The added authority is designed principally to enable the Federal agencies involved to assist the state bank supervisors in problem situations where the state is legally unable to act. This authority will be used sparingly and primarily as a useful supplementary tool in bank supervision after consultation with the state banking authorities. Here is another instance where cooperative state-Federal efforts should be beneficial to both of us.

Cooperation also implies a continuing effort to achieve common goals. The Corporation's programs and plans for its recently installed large-scale research-oriented computer are intended to serve this purpose by providing information and analytical material useful both to us and to other bank supervisors as well as banks. Studies of bank operating costs, the cost of capital, loan-deposit feedbacks, and training aids for bank supervisors and bank management are just a few of the projects contemplated or underway. The results will be made available to you and to the banks.

Our goal is to make "good banks better banks." To achieve this objective, the Corporation would like to improve the quality of its own efforts. With the assistance we have received from you, I am sure we shall succeed.