Statement
of
Chairman K. A. Randall
Federal Deposit Insurance Corporation
before the
Committee on Banking and Currency
House of Representatives

May 6, 1968

I am happy to appear today before the House Committee on Banking and Currency to present the views of the Federal Deposit Insurance Corporation concerning H.R. 16064, a bill "To amend the Federal Deposit Insurance Act with respect to the scope of the audit by the General Accounting Office."

Under H.R. 16064, the scope of the audits would give representatives of the General Accounting Office access to all material "used by the Corporation, including examination reports of the Federal Reserve Banks and the Comptroller of the Currency relied on by the Corporation in making its examination, pertaining to its transactions." Information obtained by the General Accounting Office concerning the operation and financial status of any individual bank would be held confidential and not released without prior approval of this Corporation, except for the release of information upon court order or by direction of Congress or any Congressional committee.

The present law, which was enacted in 1950, provides for the submission of a report each year by the General Accounting Office to

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Congress on the financial operations and condition of the Corporation. The General Accounting Office employees are given access to Federal Deposit Insurance Corporation records, reports, and other papers pertaining to the Corporation's financial transactions. As indicated by the record of the legislative hearings, the language now incorporated in the statute was adopted by the Congress at that time to clarify the relationship of the Corporation vis-a-vis the General Accounting Office regarding the scope of audit activities.

Whether the examination process, including the reports of examination and the records of individual insured banks are beyond the scope of an audit covering the financial affairs of the Federal Deposit Insurance Corporation was resolved in accord with the Corporation's views by Congressional enactment in 1950. Recent testimony by the Comptroller General of the United States in the course of a hearing before this committee on March 6, 1968 recognized this position when he stated that, "...the Federal Deposit Insurance Act should be amended to specifically provide for our (General Accounting Office) unrestricted access to the examination reports and related records pertaining to all insured banks."

Thus the proposal once again opens up the issue that was settled in 1950 when the Congress, after full consideration of the issues, enacted language in the statute that denied access by the General Accounting Office to examination reports covering individual banks.

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In effect, the General Accounting Office's request for this proposed legislative authority would create and superimpose on the existing structure of bank supervision what amounts to another bank examination system -- covering all insured banks irrespective of whether they were chartered by one of the 50 states or the Federal Government pursuant to the National Bank Act.

At present, bank examination powers are shared by the Federal agencies and the 50 states of the Union. Their supervisory activities are coordinated to maximize the effectiveness of bank examination, minimize disruption of the internal operations of banks and reduce duplication of examining efforts. These arrangements have been developed in the course of more than a century of bank examination work by the existing supervisory authorities. The General Accounting Office proposal, if enacted, would furnish the legal basis for yet another layer of examination activities by the Federal Government to bank supervision.

So, in considering the proposed legislation, the Congress should face squarely the question. Do we need another agency such as the General Accounting Office to review the examinations of the banking agencies already charged with responsibility for this activity -- under the guise of Congressional authority to audit all records and papers of the Federal Deposit Insurance Corporation?

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The present proposal reflects a basic misunderstanding of the nature of the central problem involved in evaluation of administrative agency performance. Congress should, of course, be interested at all times in the total performance of the various agencies of the Executive branch, including the Federal bank supervisors. Likewise, the 50 individual states should be concerned with the performance of their administrative agencies. To implement this legitimate concern is it necessary or appropriate to project the activities of the General Accounting Office into the supervision of banks chartered under both State and Federal law?

Beyond question, the Congress or its Committees have the power to conduct investigations of the bank examination process and the work of supervisory authorities to determine whatever shortcomings might exist in the bank examining activities of any of the Federal supervisory authorities. Moreover, such an investigation would be indicated whenever the members of Congress believed that bank supervisory performance was unsatisfactory. Almost 60 years ago, however, President Taft and his Attorney General, George W. Wickersham, expressed the view that the responsibility of Congress for investigative activities in the field of bank supervision should not be shifted to an administrative agency.

There is, underlying the proposal, I think, the failure to recognize the importance of the role of the bank supervisors -- both state and Federal -- in maintaining confidence in banking and finance generally.

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The establishment of Federal deposit insurance by the Congress in 1933, for example, contributed importantly to strengthening the environment for banking. By itself, the creation of Federal insurance for deposits was effective in alleviating the fears of depositors and the public generally in the soundness of banks and the money supply consisting of bank deposits. The establishment of the Federal Reserve System in 1913 represented an earlier effort by the Congress of the United States to provide the public generally with an institution which would help maintain confidence in the soundness of the nation's financial and monetary structure. Antedating the establishment of the Federal Reserve by about 50 years was the system of national banks which provided for a hand-to-hand currency in the form of well-secured national bank notes that could be depended upon to retain their face value.

All of these efforts to develop and maintain public confidence in banking and in the money supply through a system of Federal- and state-chartered but privately owned banks depend to a considerable extent upon the examination process to effectuate supervision. Recurring bank examinations are a major element and tool in the process wherein every important aspect of the institution and its management is closely and carefully scrutinized.

So it is most important that the privileged and confidential relationship existing between the examiner and the management of the bank under examination be preserved. This relationship has been carefully nurtured over the years, and its value is supported by decades of experience as well as sound logical reasoning. The basic element of confidentiality in this relationship was accepted as well-established

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at least as far back as 1913 when a Subcommittee of the House Banking and Currency Committee, under the Chairmanship of the Honorable Arsene P. Pujo of Louisiana, conducted an investigation of the money trust. In the course of a hearing session and in response to a set of questions propounded by counsel, the Comptroller of the Currency, Mr. Lawrence O. Murray, stated that information gathered by his examiners was always regarded as confidential and that the courts had ruled that bank examination reports need not be produced in court under subpoena. Subsequently, this view has been reaffirmed in a number of significant court decisions -- one as recently as 1955.

The recurring explanation of the courts in support of confidentiality is that violation of the relationship would be inimical to the public interest. In the event that confidentiality is violated, the data compiled by examiners may be exposed to the public in circumstances that could lead inevitably to misunderstanding and misinterpretation of their true significance. Thus, the confidence of the public generally and of depositors in individual banks and in the banking system would be impaired by such unfortunate disclosure.

Another strong reason for the need to observe confidentiality with respect to the entire bank examination process is to protect sources of information as well as to encourage a full and fair exchange of views between examiners and bank management. Otherwise, a bank examination could be reduced to a mere formality. There is genuine force to this argument. Public access to the work and the reports of the examiner

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would tend to encourage comments and the submission of data by either the examiner or bank management in a form perhaps to serve their own interests rather than to disclose an accurate picture of actual operations or to conduct an effective bank examination.

On the other hand, the public can have confidence in institutions known to be supervised under adequate law and regulations, particularly if the public feels assured that the examiners are competent and that they have full access to the facts in the banks under supervision. The examiners in turn are fortified by the knowledge that their work can be carried out on a professional and straightforward basis.

Although the General Accounting Office has the authority to review the examination reports of savings and loan associations, their situation cannot be equated with the situation in banks. The differences between nonbank and banking institutions are significant, but doubtlessly the differences will narrow over time as savings and loan associations seek and acquire powers similar to those of commercial banks. In the first place, individual banks comprising the fractional reserve banking system are an important link between credit allocation and monetary control. In contrast, savings and loan associations are thrift institutions, and their assets consist mainly of real estate mortgages. Secondly, the extension of mortgage credit by savings and loan associations is relatively simple. Much less supporting credit information is needed, and the criteria for risk appraisal are quite standardized and easy to apply. For example, the valuation of the property secured by a

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home mortgage is a relatively simple task. Appraisal techniques covering the value of land and building are well-established and quite precise. Furthermore, there are well-recognized relationships that must be observed between the amount of the real estate mortgage and the value of the residential property being financed. Once these determinations have been made by a credit officer, the only remaining factor is the current financial ability of the borrower to service the debt. This determination likewise is simple. For the most part, it depends upon a review of the borrower's present financial capacity and prospects for improvement or deterioration. Thereafter, only a minimum of surveillance is needed to safeguard against default. As the mortgage debt is amortized, moreover, the savings and loan association obtains a steadily growing margin of protection.

Now contrast home mortgage financing by savings and loan associations with the extension of credit by commercial banks to large and small businessmen, farmers, consumers, and the many other users of bank credit. In some instances, the credit worthiness of the borrower is very easy to determine, but in most cases the determination is exceedingly complex. It involves the collection of many different kinds of information and the weighing and evaluation of numerous troublesome and mutually dependent pieces of information.

Although examinations of savings and loan associations are different from bank examinations, the present Chairman of the Home Loan

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Bank Board, Mr. John E. Horne -- in hearings in 1967 on extension of the interest rate control authority -- commented on the existence of some problems arising from the exposure of savings and loan association examination reports to the General Accounting Office. Should the scope of the credit-granting activities of savings and loan associations increase over the years -- that is, if these nonbank financial institutions become more and more like banks -- the danger of inadvertent public exposure of information contained in savings and loan examination reports will become progressively more troublesome for the supervisory authorities. Inevitably, public confidence in these nonbank financial institutions would be impaired -- possibly seriously -- and mortgage financing incidentally adversely affected.

In addition to the possible erosion of public confidence in our banking system that might result from the exposure of data obtained in the examination process to the public, the Corporation is also concerned about the possible invasion of the individual's right of privacy. Reports of examination necessarily contain information -- both fact and opinion -- concerning the personal, business, and financial affairs of individuals and the ability and character of bank borrowers and management personnel. Such reports contain much of the same kind of material as the field reports of the Federal Bureau of Investigation,

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and most of the same objections to release of these reports apply to permitting bank examination reports to be made public. There is also a danger that the general public as well as the reputation of banks could be unnecessarily and unjustifiably injured if information contained in examination reports concerning the assets and operations of individual banks was in some manner placed in the public arena.

Thus, the primary issue of confidentiality comprises (1) protection of individual privacy -- safeguards against the exposure of personal affairs to the public by governmental action through inadvertence or otherwise; (2) the need of the bank supervisory authority to maintain an environment conducive to its ascertaining a reasonably precise picture of the facts applicable to individual banks; and (3) the need to avoid unnecessary and irrelevant disclosure of information which might have the effect of disturbing public confidence in banks and the monetary system and lead to public misunderstanding of the financial situation.

The proposed legislation includes wording ostensibly designed to safeguard the confidentiality of information to which the General Accounting Office may have access. Without doubt, the staff members

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of the General Accounting Office are as competent professionally as bank examiners to handle both confidential and secret information. Pursuant to the terms of the draft legislation under consideration, however, confidential information could move by a series of steps through currently protected channels and eventually be lodged quite lawfully in the hands of individuals who are not subject to -- or constrained by -- criminal statutes. The terms of H.R. 16064 would therefore tend to make more easily obtainable information heretofore protected by law and practice over the decades in order to maintain public confidence in the banking and monetary system.

The radical nature and implications of the proposed amendment might best be emphasized by a look at what could happen if the provisions breaching confidentiality of the bank examination process were vigorously applied.

If public confidence in an individual bank were eroded because of breach of confidentiality, it is possible that credit users and other bank customers would be reluctant to use bank services. Think of what this could mean to bank customers in small communities where people are likely to be intimately acquainted with each other. Local businessmen would be encouraged to shift their banking connections to large banks in the major cities because this would tend to reduce the likelihood that adverse credit information about their affairs would be exposed in their own local community. This is inevitable because the objective of bank examination is to detect and judge elements of

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weakness uncovered in terms of the bank's total condition. Credit data pertaining to small customers of large banks would have only a relatively limited place in its examination report. The proposed bill therefore would tend to expose the customers of the smaller bank to the public more than the large bank -- to the small bank's detriment.

These are some of the broad issues and implications contained in the proposed legislation, many of which are not explicitly stated nor obvious to those unfamiliar with bank supervision.

Let us turn now to some specifics. The General Accounting Office has taken the position that it cannot evaluate the contingent liability of the Federal Deposit Insurance Corporation without access to bank examination reports, specifically the reports of banks classified by the Corporation as problems. Actually there is no direct relationship between the potential demands on the Corporation's deposit insurance fund and the number of so-called "problem" banks. Banks on the "problem" list are so identified because of their need for closer supervisory attention than the vast majority of insured institutions. With a few exceptions, the experience of the Corporation has demonstrated that banks which fail have seldom been on the problem list. Fraud and dishonesty are the more common causes of recent bank failures, and these happenings typically strike without any advance warning signs and despite recurring bank examinations. With respect to the so-called problem banks, however, intensive supervisory efforts in most cases,

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have usually been effective in achieving the necessary corrections of those situations that weaken a bank's ability to serve the public well.

The General Accounting Office's contention that access to the examination reports of problem banks is necessary to evaluate the potential adverse effect of these banks on the solvency of the Federal deposit insurance fund is not well founded. From 1934 through 1967 the Corporation was called upon to extend financial aid to depositors in 470 banks that experienced financial difficulties. In so doing, the Corporation disbursed about $430 million but, after recoveries on assets acquired in the course of deposit insurance activities are taken into account, net disbursements totaled only about $53 million. The total income from assessments paid by the insured banks and from investments of the deposit insurance fund was $263 million in 1967. This income for one year was more than 60 percent of the entire amount of disbursements for the protection of depositors over the life of the Corporation. At the same time, net disbursements since the establishment of the Corporation totaled about one-fifth of the Corporation's income in 1967. At the end of 1967, the deposit insurance fund had reached $3.5 billion.

In addition, concentration on accessibility to the examination reports of those banks receiving intensive supervisory attention suggests that the nature of deposit insurance is not clearly understood.

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It is the catastrophe hazard rather than isolated cases of bank failure that is the overriding consideration in the concept of deposit insurance. Determination of the probability of recurrence of a catastrophe similar to the banking crisis of the 1930's, for example, and its probable magnitude remains as inscrutable as ever. Should a catastrophe occur -- irrespective of whether it is a man-made atomic or institutional disaster or a natural cataclysm -- a review of the individual reports of examination for each of the banks insured by the Federal Deposit Insurance Corporation would prove of little or no value in assessing the potential loss. Institutional changes, which have served to strengthen the banking system, and the availability of various economic stabilization measures have made the probability of a major crisis rather remote. Nevertheless, Federal deposit insurance must be prepared to assist if a crisis should occur. Federal deposit insurance in this manner provides added support to public confidence in the prevailing system of banking and serves also to minimize any "snowball" effect that might develop from individual bank failures.

Throughout the entire 35-year history of Federal deposit insurance, serious students of the subject have been concerned with questions regarding the adequacy of the deposit insurance fund and measurement of the deposit insurance loss potential on an actuarial basis. All of the studies along these lines have agreed that the risk of deposit insurance is not amenable to the application of actuarial computations.

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Furthermore, there is a consensus among these students that it is the risk of catastrophe and not isolated cases of bank failure that constitutes the primary threat to the insurance fund.

These conclusions have to some extent been consistently recognized by the General Accounting Office itself in its annual reports to Congress on its audit of the Corporation. The latest report of the General Accounting Office's audit of the Federal Deposit Insurance Corporation contains -- as it has for a number of years -- the statement that the General Accounting Office "cannot express an overall opinion" on the Corporation's financial statements "because the adequacy of the Corporation's deposit insurance fund to meet future losses is dependent on future economic conditions," in addition to other difficulties mentioned. (Italics added: Audit of Federal Deposit Insurance Corporation for the Year Ended June 30, 1966.) So, it is possible, in my opinion, that the stress placed on the use of the problem bank may reflect as much misplaced emphasis rather than any failure to comprehend the essential nature of the deposit insurance hazard.

One of the features of the legislative proposal now under consideration deserves the particular attention of the Committee. The bill in effect gives the General Accounting Office audit powers over at least part of the work of Federal bank supervisory authorities that under statute currently cannot be audited by the General Accounting Office and of the bank supervisory authorities at the state level that do not derive any power from the Federal Government.

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The examination process conducted by the staff of the Office of the Comptroller of the Currency and by the Federal Reserve Banks under present law is not subject to audit by the General Accounting Office. Although the Congress could give the General Accounting Office authority over the Federal Reserve and the Office of the Comptroller of the Currency, up to now it has not sought to do so. Nor has there been any effort on the part of the Congress to extend the authority of the General Accounting Office over the bank supervisory agencies that are empowered by the 50 state legislatures. Moreover, exposure of reports where an examination program is conducted on a joint basis with State authorities could seriously impair our present satisfactory working relationships and weaken the effectiveness of our programs for cooperation with the States.

To sum up then, the Corporation views this legislative proposal as an effort to impose another examination system upon the existing Federal and state complex of banking that has been set up by the Congress and the legislative bodies in the various states. Furthermore, the efficiency of individual banks -- particularly small banks -- operating in the private sector of the economy could be seriously handicapped if all of their affairs were exposed to public scrutiny. The end result could be the development of large banking combines, a weakening of public confidence in the privately owned banking system and less effective bank supervision.

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The draft legislation under consideration fails to take into account adequately the possible impact of breaches of confidentiality on the effectiveness of bank supervision and the dangers of invasion of the individual's right to privacy implicit in the proposal. Failure to fully comprehend the nature and concept of the Federal deposit insurance hazard, moreover, may account for the attempt to gain access to the bank examination reports of problem banks in an effort to measure what I have termed the catastrophe hazard in Federal deposit insurance. It is also essential that a clear line of separation be maintained between the functions and responsibilities of an auditing agency, such as the General Accounting Office, for evaluation of management and management policy determinations themselves, which come within the purview of the supervisory agency.

We have been advised by the Budget Bureau that there is no objection to the submission of this statement.

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