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MONITORING SELF-INTEREST:
A CHALLENGE TO BANK
SUPERVISION.

~~An~~ Address ~~By~~

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I. Introduction

Good afternoon. The Southwestern Graduate School of Banking has rendered major assistance to both state and federal banking supervisors by educating scores of supervisory officials, and I am honored to address you.

In carrying out your educational mission, you have benefitted from the leadership of one of the outstanding bankers in America, C.C. Hope. Now, as an FDIC Director, C.C. has decided to help straighten things out in Washington. Ogden Nash once said that "bankers are just like anybody else, except richer." I don't know about other bankers, but C.C. certainly is rich -- rich in knowledge, rich in integrity, rich in wisdom, and rich in practical insights. Through his able counsel, C.C. is bestowing those riches upon the FDIC.

Today I'd like to explore the FDIC's role in monitoring actions that are motivated by self-interest. In his treatise on Sentences and Moral Maxims, the 17th century French philosopher Rochefoucauld wrote that:

> "Self-interest speaks all sorts of tongues,
> and plays all sorts of roles,
> even that of disinterestedness."

Those words ring as true today as they did over three hundred years ago. They are at the heart of our free capitalistic economic system and apply especially well to banking. In the financial services industry, self-interested behavior comes in many guises. It may involve fraudulent conduct that is hidden away from public view. It may involve aggressive, profit-seeking actions that are clearly legal -- or transactions that fall in the gray area between legality and illegality. It may even wear the mantle of "disinterested," "public-spirited" pronouncements.

The FDIC and other banking supervisors recognize that self-interest is neither "good" nor "bad" -- it is merely a force to be reckoned with.

I believe three distinct approaches should be employed by banking supervisors in dealing with self-interested actions. First, fraudulent behavior should be ferreted out and punished. Second, parties that engage in aggressive, risky, but legal behavior should be made to bear the costs such risks impose. Third, banks that seek out sound and appropriate profitable opportunities should be interfered with as little as possible.

II. Criminal Behavior

Crooked bankers have been around ever since there have been banks. A few individuals, motivated by the basest form of self-interest, have always sought to defraud their customers and investors. In modern times, the FDIC too often has borne the costs of fraudulent schemes. Back in 1935, for example, the FDIC had to disburse four million dollars to insured depositors of the Commercial National Bank of Bradford, Pennsylvania. That bank collapsed because of fraud on the part of an assistant cashier. Four million dollars was big money in 1935. It represented a bigger outlay of FDIC funds than in all twenty previous payoffs of insured banks.

Times have changed. Four million dollars pales in comparison to the hundreds of millions of dollars in costs the FDIC has incurred thus far due to the recent collapse of the Butcher banks in Tennessee. Those costs were absorbed as a result of conduct that earned Jake Butcher and several of his associates federal criminal convictions. Even more sobering than individual loss numbers is information suggesting that fraud continues as a significant cause of bank failures in the 1980's. An FDIC survey of 75 insured banks that failed from the beginning of 1980 to mid-1983 found that criminal misconduct by insiders was a major contributing factor in 45 percent of the failures.

In today's world, with two trillion dollars in deposits to worry about, the FDIC simply cannot afford to take a casual attitude toward fraud. Rather than deal with the consequences of fraud when they appear, we must aggressively seek out those bankers who would abuse the public's trust by engaging in illegal transactions. We must take the view that finding fraud is a primary objective of bank examinations -- not an incidental activity. We are preparing a list of "red flags" which auditors will use in looking for evidence of misbehavior and we are cooperating with the AICPA committee dealing with fraud detection responsibilities of the independent CPA.

In December 1984, the FDIC, the Federal Reserve Board, the Comptroller of the Currency, the Federal Home Loan Bank Board, and the Justice Department formed a Bank Fraud Working Group. In April 1985, the Group member agencies jointly signed a cooperative agreement aimed at improving the detection, investigation, and prosecution of bank fraud cases. A key feature of the agreement was the preparation of a standard criminal referral form, to be used by all four banking agencies to transmit information to Justice Department prosecutors and the FBI. The agreement also established new mechanisms for interagency liaison and called for legislation to eliminate legal restrictions on the sharing of records.

The FDIC has developed a computer system to track criminal referrals and to provide status reports to initiating regional and field offices. Our regulation requiring banks to report suspected crimes becomes effective this month. Most banks are already reporting on the new referral form we provided them. The FDIC is also helping to establish a Federal Financial Institutions Examination Council school on white collar crime that will become a permanent source of training for bank examiners. We are committed to providing prosecutors with the technical assistance necessary to ensure successful bank fraud prosecutions.

Success in the war against fraudulent banking practices involves more than new initiatives by bank supervisors. It also requires that we strengthen the criminal laws and remove existing statutory impediments to effective law enforcement. In April 1986, the FDIC testified in favor of making money laundering a federal crime. This would permit prosecutors to attack this practice directly -- rather than having to build their cases on banks' failures to file currency reports, as currently required. We called for higher penalties and stiffer sentences for money laundering.

We also advocated clarifying amendments to the Right to Financial Privacy Act, specifying that the Act does not extend customer-privacy protection to bank insiders who are also bank customers. We have asked the Congress to exempt financial institutions from any prohibitions on the use of lie detectors to find fraud.

We are far from winning the war against those who engage in fraudulent transactions. With almost 15,000 insured commercial banks to monitor, ours is a difficult fight. While we will never wipe out criminal conduct entirely, we can lower the frequency and harm associated with abusive behavior. What we need is the right attitude. While I am at the FDIC, the anti-fraud campaign will forge ahead full steam.

III. Risky Behavior

Bank supervisors must also keep a watchful eye out for legal self-interested actions that involve excessive risks. Many bankers who would not dream of committing fraud may nevertheless engage in highly risky practices that undermine bank stability.

Increased risk-taking is becoming an increasingly prominent feature of some banks activities. As regulatory barriers fall and competition sharpens, these banks will take larger risks -- and some of those institutions are bound to incur losses.

Deposit insurance increases the possibility of taking excessive risks in a deregulated environment. It reduces the insured depositors' interest in monitoring the condition of the banks in which they place their funds. Bankers are not made fully accountable for the degree of risk they run. Thus some risk-seeking bankers take big risks. To make matters more dificult, at least in large banks the FDIC has protected all depositors, not just those insured to $100,000. As long as we continue this practice we should treat smaller banks in the same way if we can.

I'm for deregulation. It has benefitted the public by enhancing the offerings in the financial services marketplace and the competition has strengthened banks' management ability. I do not believe that federal supervisors should look over bankers' shoulders and tell them that particular transactions are "too risky" to undertake. This would involve unacceptable -- and unworkable -- government intrusion into private sector decisionmaking. What I am suggesting, though, is that bank supervisors should do what they can to make bankers bear the costs of the risks they impose on their institutions -- and on the banking system.

Adoption of a risk-related capital policy is one way of focusing the minds of risk-taking bankers on the costs of their policies. The FDIC, the Comptroller, and the Federal Reserve Board recently issued for public comment proposals to explicitly take a bank's risk profile into consideration when evaluating capital adequacy. The greater the risks an institution faced, the higher would be the level of capital it would have to maintain. Bankers who took excessive risks without a commensurate increase in their capital would quickly receive the attention of banking regulators. Marketplace discipline would also be brought to bear, once shareholders and prospective creditors noted the extent to which a bank's capital ratio did not match its risk-related profile.

Risk-related deposit insurance premiums would also make bankers pay directly for their risky ways. The FDIC is seeking congressional authorization to institute a risk-based deposit insurance program. Under the program, banks posing higher than normal risks would pay higher premiums. Higher premiums would serve to restrain risk-taking, and we believe would have an impact on management's choice of the appropriate level of risk. This approach would be more equitable and consistent with the private sector's concept of insurance.

Public disclosure is another method for harnessing market forces to discipline excessive risk-taking. The FDIC encourages banks to disclose fully all relevant information regarding their financial condition, and their future prospects. We have publicly urged the investment community and large depositors to obtain and analyze quarterly statements of condition and income as well as Uniform Bank Performance Reports -- Reports that summarize a bank's performance relative to comparable banks. We hope to develop with other regulators uniform consistent disclosure policies for all banks.

Supervisory vigilance is also needed to control risks. In an environment where so much funding is short term, massive destabilizing fund movements may occur literally overnight. That means supervisors require the earliest possible notice about risky activity that may undermine a bank's safety and soundness, so that they can take appropriate actions. At the FDIC, that means a move away from static, point-in-time bank reviews to more dynamic, continuous supervision. It means an increased emphasis on troubled bank exams and an upgrading of our CAEL offsite computer monitoring capabilities.

No single initiative will do the trick. But I believe that a coordinated approach will bring excessive risk-taking by bankers under reasonable control.

IV. Appropriate Self-Interested Activities

Finally, I would like to comment briefly on self-interested activities that are appropriate in nature. I refer to banks' efforts to seek out profitable opportunities that do not involve unwarranted risks. A bank may use loan production offices around the country to diversify geographically its loan risks. It may attempt to serve its business customers' needs by distributing their commercial paper. A healthy bank holding company may try to extend its areas of expertise by acquiring a failing bank with specialized experience in a new field, such as energy lending. Innovation in services rendered is the name of the game in banking. Bank supervisors should interfere as little as possible with such self-interested endeavors. Government officials are not likely to be better than banks' managements in shaping the direction taken by the banking industry.

Notice that I said bank supervisors should interfere as little as possible with appropriate banking transactions. But what about the profitable distribution of commercial paper, which one federal court has deemed violative of the Glass-Steagall Act's underwriting prohititions? And what about a bank holding company's well-reasoned interest in purchasing a failing energy bank? Its efforts may be thwarted by the Douglas Amendment, if the failing bank has under $500 million in assets and is located across state lines in a jurisdiction that prohibits interstate holding company acquisitions.

Do these restrictions on activities appear appropriate? I submit the answer is no. The risks associated with underwriting commercial paper are smaller and more limited in scope than the risks banks absorb every day in making new loans. The integrity of the dual banking system is not undermined by allowing the interstate acquisition of failing banks on a very limited scale. Yet these appropriate activities are restricted and "public interest" arguments are made on their behalf.

That brings me to my last point about self-interest -- it usually wears the mask of public interest when it pleads its case before Congress and the courts. It is not surprising that the securities industry has made the most vociferous "public interest" arguments about the "danger" to bank safety should Glass-Steagall prohibitions be relaxed.

Firms have every incentive to keep bankers from poaching on their terrain. After all, they are merely acting in their own self-interest. Each "public interest" argument in favor of restricting bank activities should be closely examined to see if it really makes any sense.

V. Conclusion

Well, as Charles Lindbergh said as he approached Paris on his historic flight, "I've got some gas left, but I might as well stop here."