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THE NEED FOR SAFE AND SOUND BANKING

by

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Federal Deposit Insurance Corporation
Washington, D. C.

at the

BANK OPERATIONS CLINIC
PENNSYLVANIA BANKERS ASSOCIATION

The Bellevue Stratford, Philadelphia, Pennsylvania

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2:15 p. m.

THE NEED FOR SAFE AND SOUND BANKING

I am delighted to be here in historic Philadelphia, a respected major financial center, the city where, in 1780, the Bank of Pennsylvania helped finance the American Revolution to victory by providing Washington's army with 3 million rations of food and 300 hogsheads of rum; and the city where Charter Number 1 for our nation's first national bank was issued in June of 1863.

The historical details of the banking industry with its many contributions toward the development of our great American free society will be observed in this city beginning in 1963, when we take note of the 100th anniversary of national banking.

Today, I would like to talk about some of our common interests, some of the ingredients that go into making up a safe and sound banking system. During the 100-year interval between 1863 and the year 1963, banking has gone from one public image to another, from struggling infancy through the period of austere marble and iron grillwork up to the present friendly super-soft carpeted bank. But we are able to detect the development of a new image slowly rearing its head in the communications media of the country, and that is the image of the dishonest banker.

And this is one image which neither you nor we can tolerate.

The term corporate image has been befogged with so much confusion lately that we may forget what it really means. There is no mystery to it. Corporate image is a person's spontaneous idea of a company or organization. It is a composite of all the things associated with the institution and its services or product.

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What are some specific instances of the nurturing of the image of the dishonest banker? A cartoon from last Sunday's comic section which pictured a prison cell with two inmates talking, one saying, "It was a calculated risk! . . . . I figured an all-out nuclear war would come before the bank examiners did."

Another example of image development. A highly respected syndicated financial writer a few days ago wrote in glowing terms about the prosperous year ahead and then concluded with this warning: "Prosperity is its own worst enemy. It leads to excesses--overoptimism, speculation, and laxity. Financial crime picked up sharply before the crash of 1929, and it's doing it again. When companies make money easily, vigilance relaxes. Underlings in banks and savings and loans want to share the wealth that they see being acquired."

He concludes with this statement: "This doesn't mean that prosperity is at the end of its tether. It does suggest that weakness--mushiness--is developing underneath."

Along with any mushiness underneath would come a deterioration in the public image of banking.

So the money you may spend on advertising, new bank buildings, flowers for the lobby, EDP machines, whatever you care to mention, may be in jeopardy if we do not call a halt to internal bank stealing now.

In 1960, claims paid by indemnity companies for losses reached an all-time high, $41 million, up from $33 million in 1959; and the 1961 figures, when reported, may set a new high.

The year 1961 also set a record of sorts for <u>financial institution</u>

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embezzlement and related offenses, according to the Federal Bureau of Investigation. During the fiscal year ending June 30, 1961, a record total of 2,238 cases, 210 more than the previous high which was established in the preceding 12-months period, were referred to the FBI for investigation. These cases involved shortages totalling $11,646,000 in assets of savings and loan associations, mutual savings banks, credit unions and commercial banks.

Since we are primarily interested in commercial banks at this meeting, let's look at the records of the FDIC. In 1961, five insured banks were closed by state and national chartering agencies due to internal irregularities or embezzlement. During 1960, we were fortunate for only one bank failed and that year gave us one of our best records for the fewest bank failures since 1933.

But where one good year such as 1960 can go almost unnoticed by the public, one bad year such as 1961 can mushroom into a cloud that overshadows the entire image of the banking fraternity.

Don't misunderstand me. Bankers continue to rate public esteem, but a fuzzy cloud is beginning to develop.

In a 1955 survey of high school students in a selected Minneapolis public high school, with a list of 10 prominent professions and occupations to choose from ranging from doctors, lawyers, teachers and others, the banker came out on top on the question, "Who would you expect to be the most honest?" Bankers also rated very high in the survey for their interest in community affairs, interest in world affairs, and dependability.

But they rated highest of all on honesty.

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I believe that were the survey to be repeated with the same group of young adults, the rating possibly would come out much the same. I say that with the knowledge that there have been several instances of catastrophic embezzlement in several communities recently, but with the conviction that these few bad apples in bank operations have not yet spoiled the entire barrel. Bankers and bank employees taken as a group continue to merit public confidence. Examiners of the FDIC and other agencies have commented upon the excellence of bank management, the soundness of bank operations, and on the superior leadership being shown by community bankers.

However, I pointed out earlier that there were five bank failures due to irregularities during the past year. Some of you may have winced a bit at that figure and wondered how five banks could possibly fail in a dynamic, prospering economy.

To make this figure less ominous, let's draw a comparison between the bank failure rate and failures in the world of commercial enterprise. In one recent month, there were some 1,200 business failures, about half of them in retail trade and the rest scattered among various other types of business.

Except among the employees, owners and creditors immediately concerned, however, these business failures created little excitement. Few of us heard about them and had we bothered to check the statistics, we would have found that the number of failures was close to an average for a typical month.

According to Norman Jaspen, a Chicago management consultant, 200 business firms were forced out of business this past year alone due to theft and embezzlement losses, and he adds that the consumer is paying about 15 percent

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more for his merchandise because of this blight of dishonesty.

I mention Mr. Jaspen's experiences for this reason. When a bank fails or a defalcation is reported, and by virtue of its Federal insurance, the loss must be investigated and adjudicated before the U. S. District Attorney. You will note that in industry this is not the case. So, consequently, in banking a misstep or occasional human frailty is given widespread publicity, more so than in business, and a handfull of bizarre cases coming one on the heels of the other, such as occurred in the three towns of Sheldon, Malvern and Knoxville, Iowa, in 1961, blossoms into a series of exciting and frequently used "image building" newspaper stories with large headlines.

What makes the bank failure and the business failure different?

Clearly, the reason for this difference lies in the fundamental nature of a bank. Banks are unusual institutions. They are different from other businesses. Through the exercise of their ability to create deposits, they supply by far the major part of our circulating money. Because of this ability to change their obligations into money, the failure of a bank affects not only its employees and stockholders, but also the entire community.

It was the breakdown of this vital function of deposit creation, through the widespread failure of banks in the 1930's that lead to the creation of the Federal Deposit Insurance Corporation.

If you want to delve into the history of American money and banking, you will find a series of financial panics in the years 1817, 1837, 1869, 1873, 1884, 1893, 1907, 1929, and, of course, the depression 30's. While we now pride ourselves on the assumption that widespread money panics such as those

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experienced in the past have all but been eliminated by our guarantee of bank deposits, we still have the occasional bank failure. These bank failures in past years have been primarily caused by embezzlement and defalcation, and reflect, in great measure, a lack of internal protection and inadequate audit control programs, as well as a low level of fidelity insurance.

The classic insured bank failure caused by embezzlement on our records is the Sheldon National Bank, Sheldon, Iowa, which was closed in 1961 following discovery of a shortage of more than $2 million. In this case, the lady cashier had engaged in unsound operations over a long period of time. The FDIC will sustain an estimated loss of $1.2 million as a result of that bank closing, and banking would have suffered a severe blow to its good public image had the FDIC not been on the job.

From our experienced examiners, we have reports that "poor housekeeping," untidy books and records, poorly kept and carelessly handled, and general lack of audit procedure are sometimes good tip-offs for possible embezzlement cases. The truth is, embezzlement is on the increase, and it is being facilitated by inadequate systems and poorly kept records.

What can we do then to maintain the image of the honest banker in the face of increasing embezzlement?

There are two principal safeguards which bank owners and management can and should employ: (1) a well organized audit control program designed to discourage employees from taking chances; and (2) ample fidelity coverage, including the $1 million excess employee dishonesty bond.

The Federal Deposit Insurance Corporation is empowered by law to require

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all insured banks to maintain adequate fidelity coverage. In the case of a bank which refuses to provide adequate coverage, the Corporation can buy the bond and bill the bank.

The Corporation, however, has preferred to rely on the cooperative efforts of supervisory agencies to convince the banks of the wisdom of full insurance protection against all types of loss. The results of such efforts in the past have been gratifying, but there are still banks carrying insufficient levels of fidelity protection. At the reasonable rates prevailing today, no bank can afford to take such a chance.

Despite the opinion of some that internal controls and audit procedures are sufficiently effective, banks of all sizes cannot overlook the possibility of experiencing a large embezzlement loss. From 1951 through the first half of 1960, defalcation losses of from $500,000 to $1,000,000 were reported in 13 insured banks; in 4 other insured banks, losses exceeded $1 million. These losses are the exception and no reasonable table of suggested amounts of bankers' blanket bond coverage should provide for such losses. The cost would be prohibitive. Further, excessive premium costs would be imposed upon 99.9 percent of the banks to help underwrite the misfortunes or laxity in management of less than one-tenth of one percent of all banks. But one of the recognized protective safeguards against massive embezzlement is the million dollar excess fidelity bond.

It is interesting to note that the development of the excess fidelity and blanket bond came about through the work of bankers who were interested in the protection of their own institutions, as well as the protection of banking's good reputation.

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Excess employee dishonesty insurance in the amount of one million dollars over a specified deductible amount was first made available to commercial banks in 1953 by the Bank Share Owners Advisory League under a group policy issued by Lloyd's of London. The insurance covers dishonesty losses discovered during the policy period, regardless of when the loss occurred.

Revisions of that earlier type of blanket or "umbrella" bond have been made by the Surety Association of America, and the American Bankers Association's Insurance and Protective Committee has been in the forefront, attempting to shape the insurance toward the fullest possible protection for bank owners, management and the public.

Partly through the urging of bank supervisory agencies, and with the cooperation of bankers associations, the number of holders of the $1 million "umbrella" bond has gone from 1,500 banks in April 1961 to the 6,500 policies today. And this last figure does not include about 700 of the larger banks which carry bankers' blanket bonds in excess of the $1 million amount and which obviates the need for an additional "umbrella" bond.

So, all in all, there are 7,200, or more than half, which have what we would term adequate protection against catastrophic internal embezzlement.

Our greatest risk when a catastrophic embezzlement hits is the small bank, those much under $25 million in deposits, and yet this is the group of banks which continues to have the lowest levels of insurance protection against internal embezzlement.

Truthfully, it can be said that the Federal Deposit Insurance Corporation was not established to protect depositors against "inside of the bank" losses

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due to theft, embezzlement, or manipulation, but rather the FDIC was created by Congress during the 1930's to alleviate the impact of the depression and to restore the public's confidence and faith in our banking system. And this has been accomplished.

Of course, if an insured bank fails, whatever the cause, the FDIC must make good up to the $10,000 insurance maximum--and does.

I think it interesting along this line to look at the record of the FDIC in making good in Pennsylvania.

Since 1934, Pennsylvania has had 29 insured bank failures. There were more than 166,900 people or accounts involved in these failures and there were some $75,756,000 in deposits. The FDIC advanced or disbursed about $51,291,000 of its funds to protect depositors of failed insured banks in the Keystone State, and fortunately the last insured bank failure in Pennsylvania occurred ten years ago.

Today Pennsylvania has a total of 674 insured commercial banks, 7 insured mutual savings banks, and 3 noninsured non-deposit trust companies, and also has 8 banks of deposit which are not insured by the FDIC.

Here is the Pennsylvania record in nonmember insured banks on embezzlements reported to the U. S. District Attorney during 1960, the last year for which we have complete figures. There were 20 irregularities reported involving a total of $920,335. The majority of these cases (9) were reported as being within the $1,000 to $5,000 range and most of them occurred at the teller's window.

In all banks of the State there were 6 cases of embezzlement over

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$10,000 each, involving some $300,000 in 1960.

While the Corporation does not collect figures on embezzlement from Federal Reserve member banks nor national banks, we do know that there were 441 reported instances of embezzlement of over $10,000 in all banks of the country during the last five years involving a total of $39.5 million.

In 1956, there were 74 cases reported totalling $9.5 million. In 1960 there were 111 cases reported with a total of $10.1 million. In the first half of 1961, there were 65 cases of embezzlement reported totalling $8.5 million.

With some pencil work you can find a rough idea of how you stand. I am sure that it will not ease your concern over the embezzlement problem facing financial institutions, nor will it serve to help you maintain the true and desirable image of the honest, dependable, ethical banker. Fortunately, the Pennsylvania embezzlement cases I have just discussed were covered by adequate fidelity insurance and the banks did not fail nor cause undue public alarm.

Federal deposit insurance has done a great deal to foster the confidence that is so vital to American banking. But banking must continue to earn this confidence through prudent, safe and sound operation. Adequate internal and external safeguards, higher levels of fidelity insurance coverage and continuous attention to day-by-day operations of the bank are important toward the maintenance of public confidence. Working together, the supervisory agencies and banking can and must maintain public confidence and faith at present high levels.

A study commission on business ethics is now underway in Washington. In reviewing the preliminary report of the commission, President Kennedy called

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for higher ethical standards in business and suggested that whole industries and companies initiate new codes and standards of conduct. The President said that the free world watches us closely for leadership in the field of business conduct, the uncommitted nations seek examples of free enterprise operations, and the Communist nations look for vulnerable points of attack.

The banking industry should be a model of high ethical conduct. It has been and should continue. While the problem of internal embezzlement is not now widespread, we must put our house in order if the image of the honest, prudent community banker is to be sustained.

The old fashioned virtues of honesty, fair play, and personal integrity need to be rekindled in your employees.

The banking industry might give thought to the drafting of a code of ethics for employees, management and owners which would have as one of its aims the reduction of massive embezzlement, with the hope that one of the fringe benefits of such a code would be the early end of the now shadowy image of the dishonest bank employee.

This workshop is a step in the right direction. You are providing a practical working conference for bank operations, an important phase of banking, which is closely allied to the overall pursuit of excellence which is so necessary to the continuation of our freedom in today's world.

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