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FOR RELEASE ON DELIVERY PR-67-73 (10-11-73)

SOCIAL PERFORMANCE OF FINANCIAL INSTITUTIONS: A SUPERVISORY PERSPECTIVE

Comments of

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On a speech by John Diebold

before the

Annual Convention of

The American Bankers Association

Chicago, Illinois

October 9, 1973

SOCIAL PERFORMANCE OF FINANCIAL INSTITUTIONS:
A SUPERVISORY PERSPECTIVE

When a bank regulatory agency reviews the financial condition of a financial organization, its basic purpose is to determine how well that institution is managing its risks. The evaluation of loans, the review of a securities portfolio, the identification of undue concentrations of credit and of undue risks on the liability side, judgments as to the effectiveness of internal controls, and finally conclusions as to capital adequacy are all part of our efforts to assess the management of risk. Similarly, when an agency advises a legislature as to the wisdom of granting a given power to a particular class of institutions, or when it acts itself to interpret existing authority to encompass some new operating power, it has normally considered the potential risks involved and the capacity of such institutions to manage those potential risks.

In this recitation of basic regulatory purpose, risk in our financial system is presupposed--and expected. Indeed, I know of no bank agency, at either Federal or State levels, that considers a relatively "risk-free" bank to be worthy of industry-wide or even local imitation. Banks of this kind are perhaps too easy for the agencies: We should be asking whether, in fact, they are adequately serving the convenience and needs of the public in accordance with their corporate franchises.

No doubt, some bankers will receive John Diebold's suggestions with skepticism as to their long-run profitability for banks or with a determination to let other, possibly larger banks experiment first before they themselves get involved in their own local communities. I think a more open-minded reaction, coupled with a sense of commercial bank history and purpose, is called for in this period of rapid technological progress and changing public demands.

Historically, commercial banks have grown and prospered as the fledgling community businesses to which they gave credit have themselves grown and prospered. Such businesses created local jobs, encouraged new homes, and led to higher income levels and growing retail trade. Not coincidentally, loan, deposit, and trust business also improved. Nowadays, banks lend their financial skill and credit to whole industrial park complexes, seeking regionally the benefits of greater economic activity without the earlier dependence on single-purpose businesses. No doubt, the banks involved have tried to reduce their risks by helping generally those businesses that were well managed with high potential for success. But the mere fact that a business utilized a new technology or provided a new service to the public did not deprive it of needed credit.

Moreover, banks themselves have introduced new financial services to the American people, frequently at considerable short-run risk to their earnings. Bank credit cards are one example. Heavy equipment leasing is another. Some types of international financing, essential to the multinational activities of a growing number of American companies, are a third. The introduction of time CDs is a fourth.

Not only have commercial banks been historically willing to take risks that made sense, they also have considered it essential to innovate as times have changed. A wide variety of computer services has been born out of the physical necessity to handle the increasing volume of bank business generated by more than two hundred million Americans. Automated clearing houses, direct payroll debiting and point of sale terminals are logical progressions for the nation's commercial banks. Single monthly statements, unmanned teller facilities, bill check payment arrangements, and extensive financial counselling are other examples of innovations that benefit bank customers throughout the country.

Meeting the changing needs of their customers, at a long-run profit, thus has been the goal of most American banks even if the introduction of new services or new types of credit has entailed substantial risks initially of financial loss or of nonacceptance by their customers. If the profit incentives are there, I see no reason why commercial banks would turn away from investigating or financing new methods of providing the American people with what have heretofore been known as "public" or "municipal" services.

The bank regulatory agencies, by their supervisory attitudes, can breathe life into such innovations or stifle them without a chance for success. Most of us today would choose the former, and I am pleased to note so many supervisory officials at both Federal and State levels who are willing to use their good offices to encourage the new banking services which technology makes possible and who are seeking the necessary changes in law or the necessary changes in supervisory policy that will encourage banks themselves to move forward. All of the Federal supervisory agencies, for example, are prepared to see banks under their jurisdiction make limited investments in community development obligations even if these securities do not measure up to traditional "investment grade" standards expected by their examiners. Similarly, loan classifications that are reasonably related to a bank's capital are unlikely to result in supervisory censure so long as the trend of total classifications remains approximately steady from one examination to another. In other words, if the risks which a bank takes are within prudent limits, the supervisory review process will generally end with an identification of the risks involved and not their prohibition.

Some social activists and some users of credit would have the bank regulatory agencies go much further than merely clearing the obstacles to bank participation in service innovation, community development or socially desirable financing. Government incentives by way of subsidies or tax credits or deductions are not enough for them. Instead, they seek mandatory allocations of credit to this purpose or that--apparently without regard to risk of loss or long-run profitability. Fortunately, I know of very few bank regulators who would want this authority over the institutions they regulate. That kind of government direction runs far too strongly against our whole tradition of letting the people themselves decide how their own money should be invested. As a practical matter, they might also remember that someone else's sense of the "socially desirable" is likely to differ in significant respects from their own. I agree with Governor Holland that the proper forum for determining our social priorities is among our elected representatives interacting within the legislative process.

On a voluntary basis, however, acting to take advantage of any government incentives that are provided, banks and bank managements have significant opportunities today to influence the social priorities of our times and to participate in developing new services and new industries. Bank officers are natural leaders who can bring disparate groups together for some local project more easily than many others in the same community. Their financial skills, if effectively utilized, can mean the difference between success or failure of a community enterprise or some new business venture. Bank officers generally know how to evaluate risks and how to manage them, and these skills can help the people at large select between a number of different options--all of which may appear on the surface to be of roughly equal social desirability. The commitment of officer time and effort may, but need not, be accompanied by a commitment of bank funds as well. So long as the bank's financial commitment is part of a balanced portfolio of risks, I see no reason to anticipate any adverse reaction from a supervisory agency. On the contrary, we are likely to be encouraging just such commitments because we believe banks cannot serve their customers and communities well without taking risks and because we believe banks generally know how to manage the risks they take.

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