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"BANKING IN A CHANGING WORLD"

Address of

JESSE P. WOLCOTT, CHAIRMAN

FEDERAL DEPOSIT INSURANCE CORPORATION

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BANKING IN A CHANGING WORLD

Twenty-five years ago this month, on September 11, 1933, the directors of the newly established Federal Deposit Insurance Corporation met for the first time, and thus inaugurated a system of nation-wide deposit insurance. It is tempting, and would in a sense be appropriate, for me to use this time today to relive with you the momentous events of this past 25 years, and to point with considerable pride to the accomplishments of this period. I have chosen not to do so, for I am convinced that this is not a time for relaxation and reminiscence, but a time for facing up to the problems which the onrushing course of events will bring to us.

Before proceeding along these lines, I should make a few observations on the nature of the interest which the Corporation has in bank supervision. In a fundamental sense, the Federal Deposit Insurance Corporation is not a bank supervisory agency - it is an agency of the Federal Government established and maintained for the purpose of insuring deposits. Our authority and responsibility extend first and foremost to the protection of the Nation's depositors. This protection was - quite properly - made available in the original legislation to all qualified banks and not limited, as some had advocated, to those already supervised by a Federal agency. Thus it was equally proper to extend supervision by a Federal agency to those banks not already so supervised, but which applied for the benefits of Federal deposit insurance. At midyear 1933, seven percent of the banks operating under State jurisdiction were, because of membership in the Federal Reserve System, subject to examinations and regulations of an agency of the Federal Government; today 90 percent are subject to regulation by a Federal agency, the great majority because of their own decision to participate in Federal deposit insurance. Over the years the supervisory program of this Corporation has retained its basic purpose - to examine the risk underwritten by the insurance of deposits in so far as that risk is not already examined by another Federal agency.

The title of my talk today - "Banking in a Changing World" - carries an implication which I should like to dispel. I have no intention of suggesting that it is the world alone which changes while banking continues on, frozen and unchanging. This could be a fatal error, for if there is one thing certain it is that banking is an industry in which change - fundamental change - is constantly taking place. These changes resemble the movement of an iceberg - we can see only a small part at any one time, but we know that to ignore the rest would be dangerous.

A simple review of changes in the number of banks suggests that significant events are occurring. During the 1930's and through the years of World War II the number of banks operating in this country tended to decline, year by year. Following World War II it appeared that this trend was reversed, and for several years we witnessed an increase in the number of banks. However, as you all know, during the last ten years the number of banks has declined in each year until now there are fewer banks in this country than operated more than 50 years ago.

The surface explanation of these changes is clear: more banks are leaving the banking system - primarily by way of mergers and consolidations - than are being newly organized. This, of course, tells us little; we must know more about the reasons underlying both the large number of mergers and the smaller number of new bank organizations. For the moment, however, let me continue with the other indications of change which we are witnessing.

Coincident with the decline in the number of banks there have been two offsetting developments of considerable importance to bankers. The number of banking offices has been increasing, particularly during recent years, as the formation of new branches in each year has far exceeded the number of banks going out of existence. Also, there has been a truly remarkable growth in both the number and assets of non-bank financial institutions. I refer, of course, to such organizations as savings and loan associations, credit unions, personal finance companies, and insurance companies.

Lest I be accused of directing attention only to those elements of change which suggest decline in our unit banking system, I should also point out that there are encouraging signs of vitality. For example, the number of newly organized banks has been rising. During the past five years 459 banks have begun operation, compared to 351 during the preceding five years. Another sign of the basic strength of the banking system is found in the record of its deposit growth during the past 25 years, and particularly during recent years. Deposits in all banks insured by the Federal Deposit Insurance Corporation have increased by $71.4 billion, or 46 percent, in just the last ten years. Finally, all of us are aware of the many and varied innovations which banks all across this country are constantly adopting in an effort to better serve the public.

What are we to conclude from this? As I see it, the crucial point to keep in mind is that the problems which will appear in the future, the questions we will have to answer, will frequently be only reflections of the vast shifting and turning within the banking industry itself.

Unless we recognize this fact our actions are likely to be, at best, superficial and at worst, damaging. Frankly, there is a natural tendency for any supervisory authority to fight most strenuously those battles whose outcomes have long-since been determined. History reveals that bank supervision has been no exception to this rule. It will be fatal or futile if any of us proceed in the future on the assumption that little is happening in banking and that all of the rules and standards applied yesterday are valid today and will serve us tomorrow.

To keep abreast of the changes which occur in our banking system is not enough. Unless we have basic goals we are ineffective. I like to think of bank supervision as having two goals, equal in importance: maintenance of a sound banking system; maintenance of a competitive banking system. If we can steer a course which will assure us of approaching these goals we will have contributed to a banking system which can best serve the interest of the people in a free-enterprise society.

There are some who might maintain that these goals are not compatible; that a competitive system is not a sound system, and that a sound system cannot be a competitive system. I disagree with this premise. Within limits we can have both. But we should remember that it is not the function of competition in the banking industry - as it is in other industries - to provide strength through a sort of natural selection process, in which the efficient and strong survive and the weak and inefficient die. It is the job of supervisory authorities to see to it that unhealthy situations are not permitted to arise or, if they do, to secure their immediate correction. To that extent we interfere with the full working of competition, but we do so because we know that a bank failure is some-thing quite different from the failure of an ordinary business. The danger, of course, is that we may forget our other goal and go too far in this direction. Of course we cannot tolerate unlimited competition. On the other hand, let us not become so overly concerned with soundness that we end up by inadvertently protecting selfish, inadequate, or monopolistic bank managements. During the years to come there will be many problems which involve consideration of the effects our actions will have on the competitive nature of the banking system. In each instance the decision should take into account the twin goals we seek to achieve: healthful competition and financial soundness; and above all, it should be made with the primary end in view of serving the interests of the public.

Let me make one paranthetical observation at this point. I hear it stated frequently that the Federal Deposit Insurance Corporation cannot, by its very nature, be interested in the maintenance of a competititve banking system. This is nonsense. Deposit insurance makes no sense except in terms of a competitive system. If we ever reach a situation, such as that in some nations, in which only a few banks do all of the banking, deposit insurance would not be feasible; no more than you could run a life insurance company with only five millionaires as clients. The Federal Deposit Insurance Corporation was established in an effort to make certain that this country could continue to enjoy the type of banking system it had but, at the same time, avoid the one serious drawback - losses to depositors and the shock to the Nation arising from large numbers of bank failures. If some other type of system had been desired in 1933 - say a nationalized system or one dominated by gigantic branch systems - there would have been no place for deposit insurance. In one form or another we have been frequently beset by politically selfish inspired attempts to nationalize banking and credit. The fact that we have been successful in combatting these attempts has made possible the continuance of Federal deposit insurance, with its attendant wholesome effect upon the soundness of our financial system and our economy.

In looking to the future, one conclusion stands out clear and sharp - this Nation will enjoy continued, and possibly accelerated, economic growth. This is a development which we may not only fervently desire but confidently expect. And with this growth there will be an expansion of bank deposits, and a corresponding rise in bank assets. I will not pretend that I can tell you precisely what this expansion will amount to in the next quarter century, but I can at least suggest its possible order of magnitude. If our economy continues to grow, on the average, at a rate of 3 to 4 percent a year, and if deposit growth remains closely related to this growth in output so that we have no long periods of inflation or deflation, bank deposits will be approximately $600 billion in 1983. This compares with the present $230 billion in deposits.

When we ponder this rate of growth one of the first questions which comes to mind relates to the amount of additional bank capital which will be needed. If just the present relative level of capital to assets is to be maintained during the next quarter century, we shall need an estimated $30 billion of additional capital by 1983. During recent years banks have shown themselves capable of maintaining - and even slightly improving - the current ratios of capital to assets through retention of earnings and the sale of new stock. Thus if there is no change in current practices we may assume that the additional capital can be made available.

Unfortunately, this conclusion assumes that we can be satisfied with the current level of capital, an assumption which is incorrect. The current ratios of capital to assets would have been reasonably satisfactory had they prevailed at the end of World War II, given the prominence of U. S. Government obligations in bank portfolios at that time. These ratios are not sufficient today. They will be even less satisfactory in years to come, as banks seek to meet the ever increasing needs for credit by a growing economy. It is not only natural but also desirable that banks should participate and assist in the Nation's economic growth, but this requires that the capital position of the banking system be strengthened. In fact, the banking system must provide adequate credit for the needs of the expanding economy, and perforce, if private enterprise in banking is to survive, it must provide capital in volume in order to support the assets which will be acquired. Where will the needed additional capital come from?

Retained earnings will, of course, continue to be an important source of new bank capital. In addition, banks should not lose the opportunity to secure new equity capital whenever favorable conditions are present. Perhaps over-emphasis on retention of earnings by supervisory authorities has been one of the reasons why banks, in general, have turned away from what is potentially a very important source of new capital - the sale of stock to the public. In addition to serving as a source of capital, new stock issues may well result in wider distribution of the ownership of bank shares, which in itself has many desirable consequences. In any event, supervisory officials during the next quarter century must make it a cardinal point in their supervisory programs to see to it that the banking system is adequately capitalized in order that it may meet the credit needs of a growing economy.

Before turning from this capital question I should like to make a few observations on the danger of becoming complacent with respect to the capital problem. In the first place, it has become the habit in some quarters to regard the growing size of the deposit insurance fund of the Corporation as an indication that the pressure for additional capital in individual banks is thereby lessened. I should not have to remind this audience that although the deposit insurance fund is increasing in dollar amount, in relation to deposits in the banking system it is growing very slowly and, as a matter of fact, is no higher today than the relative level prevailing at the end of the first year of deposit insurance. Secondly, and perhaps even more important, it should be remembered that the deposit insurance fund was never intended to replace bank capital, or to do the job which bank capital must do. In a sense, the deposit insurance fund stands as a kind of mobile capital, to be used for stamping out banking troubles singly, as they arise, thereby preventing the development of multiple banking disorders reaching catastrophic proportions. The capital of individual banks, on the other hand, must carry the burden with respect to the strengthening and the growth of the banking system. The deposit insurance fund cannot be effective in the absence of strongly capitalized banks.

The danger of becoming complacent over the capital problem is also present if we concentrate too much on aggregate figures and ratios. Despite the overall improvement in recent years there still remains an uncomfortably large number of banks with inadequate capital. To give just one example, in a recent survey we found that there are 200 insured commercial banks with capital ranging from only 5 to 9 percent of their risk assets, which we defined quite narrowly by excluding from total assets all cash and cash balances, all United States Government obligations, and all loans insured or guaranteed by agencies of the Federal Government. These banks have deposits of $3 billion, of which $2 billion is insured by the Federal Deposit Insurance Corporation. I am sure that all of you are also aware of individual cases in which more capital is urgently needed.

Growth in banking over the next quarter century will necessarily be accompanied by changes in the kinds of loans made by banks. Change is essential in a free economy, and as our patterns of industry and agriculture shift, the volume and type of loan needed in various localities will in turn be altered. The really effective banker - and the same can be said of the bank supervisor - must not only be familiar with the latest business trends and practices but should also have some knowledge of the constantly developing technological processes by which our great variety of goods are produced.

With respect to this question, let us also recognize that considerable variation exists between the loan needs of customers of individual banks. As supervisors we have a natural tendency to regard the average as the norm, and therefore as the best. It is easy to forget that there must be some variation from bank to bank, reflecting not only the individual banker's ability but the loan needs of his community. Any attempt to force all banks in a given area, or in the country, into a fixed mold, determined by the average, will be a disservice to bankers and to the public.

In the economic growth to come, and the financing it will require, the question of the financing of small business will continue to be important. Here it is necessary to distinguish between, on the one hand, short and medium-term loans and, on the other hand, long-term loans.

So far as the former are concerned, it is frequently said that the banking system discriminates against small business, particularly during periods of credit stringency to fight inflation. Although there may be individual instances of such discrimination, there is little merit to this criticism. It is often forgotten that because of the present structure of our banking system, the overwhelming majority of banks are of small size and cannot, therefore, make loans to any but small business. However, I do not want to play down the problem which small business has in securing long-term capital financing. In this field we have recently had new legislation: the Small Business Investment Act. I believe the business development companies provided for in that Act may be valuable additions to our financial structure. The membership of the Banking and Currency Committees of the House and Senate has given long and ardous consideration to the devising of a workable plan, and banks should not overlook the possibilities for their own participation in the program. The Act not only provides for such participation, but also appears to provide a means by which the risks inherent in long-term loans can be pooled.

As I noted earlier, the number of mergers and consolidations in the banking system has been quite large in recent years. It is, of course, possible to overemphasize this development and to forget that mergers and consolidations are to be expected in an industry with over 14,000 separate units. Also, it is well to remember that the number of bank mergers and consolidations in recent years is much smaller than that which took place during the 1920's. Nevertheless, in view of the fact that in recent years the number of banks entering the system has consistently run below the number of mergers and consolidations we must recognize that such mergers are contributing to the shrinking of our unit banking system.

I do not believe that we can afford to stand aloof from this development, comforting ourselves with some vague thought that all that is happening is the removal of uneconomic units and, accordingly, that the system as a whole is being strengthened. While this is undoubtedly true in some cases, it is by no means true in all, and may not even be true in a majority of cases. If, as I suggested earlier, one of our goals is the maintenance of a competitive banking system, we should make a strong effort to understand this merger and consolidation movement and to impede it when the result is simply, or largely, the diminution of competition.

Although we do not know nearly enough about mergers and consolidations, we can distinguish some of the motives behind them. For example, in a study at the Corporation in which we analyzed the reasons underlying bank mergers and absorptions approved by the Corporation over a six-year period, we found that in approximately one-fourth of the cases death, age, ill-health, or retirement of the leading officer of the merged bank was the chief motivation underlying its sale. In other words, failure by bank managements to provide for their successors contributes significantly to the merger movement. This is at least one aspect of the situation in which we can be helpful - by urging upon bankers the importance of having a definite program for management succession.

In the same study, we found that in one-third of all cases of bank merger the banks involved were already controlled by the same interests. Another feature of the increasing concentration of banking which has been of concern is the use of the holding company device. In the latter instance, however, there has been recent legislation, the efficiency of which will have to be tested by experience. In any event, we must watch carefully all of these developments to learn whether the problem is being dealt with adequately.

There have been various suggestions for additional legislation to cope with this problem. I am convinced that the authority for regulating the merger movement should be placed in the hands of the bank supervisory agencies, where full attention can be given to the twin goals of soundness and maintenance of competition, rather than in the hands of an agency unfamiliar with banking.

The final problem I should like to mention is one with which we deal almost every day - and one which will become increasingly important in years to come. I refer to the opposite side of the coin of the merger problem - the organization of new banks. Let me cite a few figures. By 1933 the large numbers of failures and mergers during the 1920's plus the catastrophic consequences of the depression left us with nearly 18,000 banking offices, or about 1 for every 7,000 people, compared with 1 for every 3,000 people in 1920. Today we have about 23,000 banking offices, but our population has grown so rapidly that there are now 7,500 people per banking office. In other words, the total number of offices, including main offices and branches, is growing at a slower rate than our population.

It would be difficult to know to what extent this is a development to be deplored, and still more difficult to decide what part supervisory authorities have played in it. Perhaps our fears of an "overbanked" economy have persisted too long and we have been overly cautious in authorizing new banks or, in the case of the Federal Deposit Insurance Corporation, granting insurance to new banks. Certainly the fact that non-bank financial institutions have grown so rapidly since 1933 suggests that there is a public demand for financial services, some of which, at least, could have been provided by banks. This is a problem which requires much more time than I can possibly give it here. The best I can do is suggest that we give serious attention to the question, perhaps re-appraising all of our existing attitudes towards new banks and new branches, for it is certain that the next 25 years will bring this entire problem increasingly to our attention.

As I come to the end of this talk I am becoming aware of the fact that instead of providing you with a crystal-ball look into the future I have only managed to suggest that it will contain many new situations and pose many new problems. It will be a challenging future, of that I am sure. I am confident that, together, we will solve these problems and contribute thereby to the building of an even greater banking system than we enjoy today.