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"OUR MUTUAL PROBLEMS"

Address Of

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Before The

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OUR MUTUAL PROBLEMS

When my good friend, Rudy Reichert, invited me to be with you today, it offered an opportunity that I was happy to grasp. For it promised not only the prospect of renewing many warm friendships; it also gave me an opportunity to continue a practice which I had followed during my 26 years in Congress. When I had problems for which there appeared no ready solution I followed the practice of discussing them with my constituents. Out of such discussions, solutions to many current problems were discovered, and those which remained unsolved were usually reduced to liveable proportions. Now, in the Executive branch of the government, it is my hope that out of discussions with groups of bankers such as this I may find similar aid in solving the different types of problems which we have in common.

I might confide to you that I approached my new job as Chairman of the Federal Deposit Insurance Corporation with a fair amount of assurance; assurance, that is, that I knew the problems, not that I knew all the answers. After all, for many years I had been rather intimately concerned, as a member of the House Committee on Banking and Currency, with a great variety of banking problems, and I did not expect many that would be new. In that, I must confess, I was mistaken. It is true that many of the old problems, such as bank mergers and bank capital, soon turned up in familiarly-labeled files; but the folders in the files were different. And, gradually, the angle of my perspective as a legislator shifted toward that demanded of an administrator. What was lost in breadth of concern was more

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than compensated by depth of consideration. In addition, a galaxy of new problems came into view, it was as if I had moved from designer to operator, from architect to artisan, and new concerns appeared.

The problems which I have encountered this first year may be divided into three general areas; (I) First, there are the problems which relate directly to individual banks; (II) a second group of problems arises from the inter-relationships among the banks themselves and between them and the Corporation; (III) finally, the Corporation itself has problems of status and administration whose successful resolution largely determine its effectiveness. I shall not be able to do much more than indicate the general character of the problems in each of these areas, but I hope that the listing may to some degree enlist your help as we try together to contain them, and perhaps in time, solve them.

I. PROBLEMS OF INDIVIDUAL BANKS.

As you know, the major part of the Corporation's budget and man-hours is devoted to the examination of banks. In the course of these examinations, whose purpose is to find the extent of our risk as insurer and to reduce that risk as much as possible, we have naturally learned a good bit about banks. Much of what we learn is good, and for that we are grateful. The Corporation, however, is more concerned with the problems of banks, being almost human in its disposition to accept the constructive, and focus on the destructive. What are the principal weaknesses in banks? As I speak generally, I suspect many of you will be unable to identify them with your own bank.

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1. Bank Capital. The problem of bank capital is a chronic one. Over the past several years officials of the Corporation have documented the relative decline in bank capital; we have pointed out the moral necessity that bankers back their judgment by substance enough to match their role in allocating credit; we have emphasized that the deposit insurance fund is designed to supplement, not supplant, bank capital; and we have pin-pointed the extent and implications of the capital deficiency in certain groups of banks.

Yet, with all this exhortation and despite some encouraging response, the present capital level is not sufficient. What is more, it is likely to become even less satisfactory as the years go by unless Herculean efforts are made to keep it abreast of the prospective growth in our economy. A rapidly growing economy will bring a multitude of opportunities which banks must be alert to grasp if they are not to forfeit their financial responsibilities; to take advantage of these opportunities there must be an adequate capital foundation.

It is not possible now, and may never be possible, to set specific capital goals, or any precise ratio of capital to assets appropriate for the banking system as a whole. Indeed, ratios based on aggregate figures have a limited usefulness, since the amount of capital a bank needs depends upon the particular circumstances of each bank. Many banks today are adequately capitalized, and alert to the need for additions to capital as they extend their operations. However, there are many banks with insufficient capital even by today's standards, and too many have dangerously low capital.

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2. Management Succession. The second area to which many banks need to give particular attention is that of providing for continuity in their operation. Management succession is, of course, only one aspect of the immensely important sphere of management which encompasses all of a bank's activity. Every bank needs interested and responsible directors and a competent staff; it needs also to make sure that replacements are in prospect and in training for the responsibilities they will in time assume.

It is quite apparent that one of the major causes of the large number of bank mergers and absorptions during recent years has been the failure of bankers to provide for their successors. A survey of the number of applications for bank mergers received over a recent six-year period revealed that in about one-fourth of the cases the chief reason for the sale was the death, age, ill health, or retirement of the leading officer of the bank. Another recent study, this one by the Virginia Bankers Association, supports this general picture of neglect. This survey found that four out of ten Virginia banks, on their own admission, had no satisfactory replacement for their top operating executive; and the situation was even more acute among country banks. There is no reason to believe that banks in other States are any better off.

I commend to you a statement from a recent book by my friend, Lester Pratt. He says, "Bankers should give as much attention to 'human reserves' as they do to financial reserves." To find and enlist the calibre of personnel needed by banks, careers in banking must be made attractive and challenging. It no longer suffices to smother wages with presumed prestige

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or compound responsibility with frustration. Banks must pay the going rate to attract and keep the high calibre of personnel which to an extraordinary degree has long gravitated in their direction. That many banks were not doing this less than two years ago is indicated by a survey which showed that over 1,000 banks paid less than $5,000 to their highest paid officer.

Of course, there are compensations in banking other than salary; banks rank near the top in the extent of fringe benefits provided, and in the degree of employment security so highly prized today. These and other advantages need to be impressed upon promising young persons. The opportunities for in-service training and education should be stressed. The education courses sponsored by the American Bankers Association and the various State associations, all the way from the correspondence courses up to the graduate schools, offer a quality of training unsurpassed by any other industry or profession. That there is room at the top as well as opportunity for socially significant service needs also to be emphasized. Taking full advantage of their reputation as a good place to work, banks can readily translate this reputation into reality and insure the continuity so important to their growth.

3. Internal Security. That something is wrong when banks fail goes without saying. So far during 1958 there have been nine bank failures, the most of any year since 1942; five of these banks were not insured by the Corporation. To the extent that these failures were the result of mistakes in judgment concerning assets or operations, they may be excused. For such mistakes are bound to occur so long as we have a changing economy;

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and occurring within a private enterprise system, they must sometimes lead to failure.

The failures this year have reflected in greater degree than in other recent years the deterioration of assets under the impact of adverse business conditions. However, almost half of them included at least some element of misappropriation of funds, the primary cause of failures during recent years. That banks should do more to protect themselves against dishonesty of employees, and the temptations placed before them, has long been urged by responsible authorities. Relatively few banks have an adequate system of internal audit and control. Progress in this area has no doubt been hampered by the mistaken notion that bank examinations somehow serve as an effective audit, a delusion that supervisory agencies have long tried to dispel. The widespread if not adequate coverage by fidelity bonds has also slowed the development of internal controls. While examinations may sometimes uncover defalcations, and surety bonds provide a measure of protection against them, neither separately nor together are they an adequate substitute for a continuing and effective internal audit. In this area there is much missionary work to be done.

II. INTER-BANK PROBLEMS.

Let me turn now to two or three of the problems which arise out of the fact that each bank has a relationship to other banks and, if it is insured, to the Federal Deposit Insurance Corporation.

1. Noninsured Banks. The first problem I would mention is more an embarrassment than a burden. I refer to the fact that there are 710

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banks, holding less than 4 percent of total bank deposits, which are not insured by the Corporation. About one-fifth of these are not eligible, under statutory provisions, for Federal deposit insurance; and some of the others have not been able to meet the standards set by the Corporation consistent with factors enumerated in the law. The remainder, for various reasons, have chosen to stay outside the Federal deposit insurance system.

Now it is true that these noninsured banks do not themselves constitute a substantial hazard to our banking system. Should some of them fail, as they occasionally do, they are not sufficiently large or numerous to reduce appreciably the volume of deposit-money, whatever the unhappy consequences to individual depositors. However, the failure of noninsured banks could provoke doubts and erode confidence sufficiently to impose real strains upon our banking system. And curiously, this is due less to their being uninsured than to the widespread assumption that all banks are insured. The exposure of our banking system to misplaced confidence is a matter of deep concern to the Corporation, for the blurring of distinctions between insured and noninsured banks carries over from their operation to their suspension, and the failure of noninsured banks focuses critical attention upon all banks, insured and noninsured alike.

The Corporation is hopeful that the advantages of deposit insurance, so amply demonstrated over the years, will soon commend it to banks still outside the fold. The existence of noninsured banks, I am glad to say, is hardly a problem in Michigan. Today there are only two noninsured banks in the State, and one of them, a nondeposit trust company,

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is not eligible to apply for insurance. In our desire to extend insurance to banks still uninsured, we must do nothing to impair the principle of voluntary membership, which has made Federal deposit insurance so valuable an adjunct of our free enterprise banking system.

2. Competition In Banking. One of the historic and still preeminent goals of bank supervision is the maintenance of a competitive banking system. At the same time, concern over the soundness of banks has long been reflected in regulations which interfere with the natural course of competition. Unlike ordinary businesses, where the verdict of the market may be accepted with equanimity, banks cannot be abandoned to market decisions; for a bank failure has reverberations which resound throughout the community, and even beyond. Through the creation of deposits, which supply by far the major part of our circulating medium, banks perform a vital economic function whose interruption cannot be tolerated. In our determination to avert bank failures and their unhappy effects, however, there is danger that we may inadvertently protect selfish, inadequate, or monopolistic bank managements. To steer the narrow course between healthful competition and financial soundness as we point toward the port of the public interest is perhaps the most challenging problem facing the Corporation in its supervisory functions.

The rival claims of competition and soundness come to a focus, from the Corporation's standpoint, in the rather innocent question, Do we have enough banks? What considerations are present in determining whether to grant insurance to a new bank?

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The Federal Deposit Insurance Act is explicit in its enumeration of the factors which the Board must consider in granting insurance to a bank. Among these, and the only one not concerned with its internal structure and prospects, is "the convenience and needs of the community." Application of this criterion in individual situations is one of the most difficult matters that confronts our Board of Directors.

The expansion in the number of new banks during the first two decades of this century followed by a rising tide of failures that culminated in the banking crisis of 1933, prompted later caution if not over-caution in the granting of charters and insurance to new banks. During the last ten years the number of banks has declined in each year until now there are fewer banks than operated more than 50 years ago. The simple explanation, that deaths have exceeded births, is, however, quite misleading. For most of the banks which left the system re-entered as branches, so that the total number of banking offices has increased. Even so, the number of banking offices has not kept pace with the growth in population; in 1920 there was one banking office for every 3,000 persons in this country, while today one office serves 7,500 persons. The rapid growth of other financial institutions during the past 25 years suggests that more banks or banking offices, properly located and motivated, might have served a demand for financial services which was diverted elsewhere.

It is extremely difficult to assess the effect of these cross-currents upon the competitive character of our banking system. Notwithstanding indications of continued competitive vitality, there is a real question

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whether brakes should be applied to the merger trend. And if so, how and by whom? Many mergers are due to natural circumstances, such as the desire of banks to expand and thereby improve facilities, make feasible the utilization of new techniques and equipment, and in general offer better service to the public. Thus competition is sometimes strengthened, rather than weakened, through a merger. However, it is also true that mergers can reduce competition more than is desirable, without offering much if any additional benefit to the banking public. As you know, bills have been introduced in the Congress which would give to the Department of Justice jurisdiction over bank mergers. The Corporation continues to believe, however, that regulation of bank mergers should be in the hands of the bank supervisory agencies which are thoroughly familiar with all aspects of the banking situation.

3. Stabilizing Influence of FDIC. The past year of recession has brought to our economy its most severe test since World War II. Now it looks as though this recession is about over. One of the reasons why the decline did not snowball into a depression is the undoubted contribution that deposit insurance has made to the maintenance of financial and economic stability. Notwithstanding the nine bank failures which I mentioned earlier, there has been no depositor panic or significant destruction of money. There has been no concern about the soundness of our banks or the safety of bank deposits. These testimonials to the success of deposit insurance rest upon a vibrant confidence which it is our earnest hope to justify.

To most of us these words have an academic ring, for it has been several years, I daresay, since many of you have had personal experience of

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a bank failure. To recapture a bit of the flavor of a bank failure, and to see first-hand what it means today, let me read to you an editorial which appeared in the Bergen Bulletin, a New Jersey newspaper, upon the occasion of the failure of a bank in that State this past summer:

> Perhaps the most outstanding lesson that may be gleaned from the unfortunate case of the closing of the Manufacturers Bank of Edgewater is that the insurance protection offered by the Federal Deposit Insurance Corporation has put an end to the panic, misery and misfortune that followed bank shutdowns years ago.
>
> While the loss in Edgewater was comparatively small, because of the small size of the bank, most of the depositors took the closing of this bank calmly and with little of the old-time panic. Their deposits were fully protected, up to $10,000 per account. Inasmuch as the vast majority of the individual deposits came within this limit, these depositors will suffer only temporary inconvenience.
>
> This is the first time in many years that a local bank has had to be suspended. The depositors of the Manufacturers Bank took the news in stride. There was none of the panic of the pre-depression days, nor any run-on-the-bank such as accompanied such tragedies in the old days.
>
> Thus the lesson of the signature carried by most banks under their bank name, "Deposits protected by the FDIC," a statement which has become familiar to everyone in the past 25 years, was brought home with particular forcefulness to the people of Edgewater. Practically all banking institutions advertise this little statement to the public but its true and welcome significance is probably never realized until an unusual event such as occurred in Edgewater recently brings home the meaning of the tragedy that has been narrowly averted to hundreds or perhaps thousands of people.

That kind of testimonial tugs at the heart. To our professional concern for the success of deposit insurance it adds a human dimension, bringing a realization that the whole apparatus is designed to protect people. And that is the way we want to keep it.

III. PROBLEMS OF THE FEDERAL DEPOSIT INSURANCE CORPORATION.

I turn now from problems relating to banks to some which concern more directly the status and operations of the Federal Deposit Insurance Corporation.

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1. Independence of FDIC. When Federal deposit insurance was established, Congress provided for its administration through a corporate instrumentality for the express purpose of providing independence and flexibility of operation. The Corporation has had to protect this independence against recurrent attempts to bring it within the purview of other agencies. The repeated success of the Corporation in maintaining its independence more and more confirms its status as a monetary agency requiring independence to properly perform its functions.

That an agency having responsibilities for the nation's money supply should be independent and yet within the Government has long been recognized. It must be within the Government in order to escape private pressures; and within the Government, it must be equally free of political pressures. How to maintain independence in this delicate position has been a problem confronting financial instrumentalities of the Government ever since the chartering of the Bank of the United States in 1791; though battles are won and lost, the war is never over.

The latest skirmish in this area occurred during the last session of Congress, when a bill was introduced and hearings were held on a proposal to bring the FDIC within the budget review and related controls of the Bureau of the Budget. Since no public monies are invested in the Corporation, the case rested upon the borrowing authority of the Corporation, which proved to be a rather weak reed; for it can readily be shown that power to borrow from the United States Treasury is not an accepted criterion, inasmuch as several agencies which have borrowing power were not included in the proposed scope

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of the proposal. Aside from that, it is probable that the proponents viewed the proposal as a kind of house-keeping operation, believing that all agencies should be under review and control. However, there was no allegation of inefficiency or improper use of funds, and the General Accounting Office, which regularly audits the books of the Corporation, has been more than satisfied, in fact laudatory, in its reports.

It is not the controls as such that the Corporation opposes, but the effects which it fears would result from them. There is reason to believe that great damage would come from the requirement to draw up a budget on the basis of a prediction a year or more in advance of how many banks will fail and how great the disbursements of the Corporation must be. If insufficient allowance were contained in the approved budget, the Corporation might be unable to meet its obligation to pay depositors promptly. If, on the other hand, generous amounts were included in the budget, publicity about them might well undermine the web of confidence which sustains our whole banking system.

Some efforts have been made to solve this particular dilemma by specifying that only the administrative expenses of the Corporation be placed under Budget control. This suggestion is based upon the fallacious assumption that administrative expenses are independent of insurance expenses. Actually, if banks begin to experience financial difficulties, the administrative expenses of the Corporation go up. It is useful to recall that the number of Corporation employees is now 1,219, or less than half the 2,538 at its peak employment in 1941, when there was need for a large liquidation staff. The

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flexibility indicated by such sharp differences in size of staff, accompanied by a steady program independent of year-to-year changes in government policy, is one of the principal reasons for the Corporation's standing as an efficient and effective instrument of economic stability.

2. Adequacy of Deposit Insurance Fund. In still another direction the Corporation is the object of persistent proposals to change the basis of deposit insurance; this one, to reduce the assessment rate. This is a subject on which the Corporation has never been adamant; it recognizes that views may differ as to what size of insurance fund might be considered adequate; it appreciates the desire of the banks to pay no larger assessment than is needed; for itself, it has no desire to build up a fund larger than is required to fulfill its insurance obligation. It has always been receptive to any demonstration that a reduction in the assessment rate will not in fact imperil its ability to meet its obligations.

One of the difficulties in reaching a conclusion on this matter is the uncertainty as to just what type of contingency the Corporation should be prepared to meet. Clearly, the fund must be adequate to handle individual bank failures which may result from circumstances peculiar to the bank or to its immediate locality. Beyond this, it must be sufficient to make disbursements necessitated by bank failures resulting from a serious local or regional economic decline or generally depressed business conditions.

Were it possible to reach agreement on the type of contingency which the fund should be prepared to handle, it would next be necessary to estimate the amount of disbursements which might be required to protect

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depositors of distressed banks. This amount, I want to emphasize, is different and considerably greater than the losses which may eventually be realized. Estimates of disbursements may be made on the basis of past experience with bank failures, adjusted for various factors of improvement and deterioration in the exposure of banks to insolvency. Thus the improvement attributed to high quality of bank assets, better bank supervision, and elimination of the "over-banked" situation of the 1920's may be weighed against the relative reduction in bank capital, but again the answer varies with individual evaluation of these elements. The concentration of risk to the Corporation further complicates the picture; for each of several banks has insured liabilities greater than the deposit insurance fund, while banks with uncomfortably low capital constitute another particular concentration of risk. That the fund should bear some relationship to the amount of deposits in insured banks is also apparent.

When all the evidence is considered, and that obviously must include more than the Corporation's relatively small loss experience, it is hard to be convinced that the present fund is adequate. At the end of 1957 the fund amounted to 0.82 percent of deposits in insured banks. To make disbursements such as would have been required during the relatively prosperous period of 1922 to 1929, the Corporation would need a fund of 1 percent of deposits in insured banks; to meet a situation similar to that of 1930 to 1933, a fund amounting to at least 5 percent of deposits would have been necessary. Starting from the present ratio of 0.82 percent between fund and deposits, and assuming continuance of the present assessment, the Corporation's

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low rate of losses, and a 4 percent annual growth in deposits, it will take about fifteen years to accumulate a fund amounting to 1 percent of deposits. If these considerations can be accepted as reasonable, present proposals to reduce the assessment rate are obviously premature. The burden of assessments is, I feel, sometimes exaggerated. The effective rate since the adoption of the credit provision in 1950 has been only 1/28 of one percent of deposits subject to assessment. Do you realize that the average million dollar bank pays less for deposit insurance than it does for postage stamps to send out its monthly statements?

3. Employee Discrimination. Compared with the philosophical breadth of the problems just discussed, the final item I want to mention is quite provincial. Yet it has breadth in that it involves discrimination against the Corporation's examiners which has no reasonable basis. The United States Code prohibits insured banks from making loans to any public examiner who has authority to examine such banks. The effect of this prohibition is to permit National bank examiners to borrow from State banks, State bank examiners to borrow from National banks, and Federal Reserve bank examiners to borrow from State nonmember banks. Prohibited from borrowing from any of these classes of banks, because they have authority to examine all of them, the Corporation's examiners, ironically enough, may borrow only from noninsured banks.

The Corporation has made appropriate recommendations to correct this obvious injustice. While our examiners have the authority stated, as a matter of practice they regularly examine only insured State banks which

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are not members of the Federal Reserve System; they may make special examinations of other insured banks only under specified circumstances, and such examinations have been relatively few. If the prohibition were removed, the conflict of interest contemplated by the Code could readily be averted by making appropriate examiner assignments whenever special examinations are required.

As I come to the end of my time, I realize that I have not mentioned some problems which may well be disturbing to you. And those that I have mentioned are of varying weight and importance. If no clear solutions are indicated for those problems touched upon, I nevertheless take solace in the belief that a problem well-defined is half-solved. Together we may work on that other and more challenging half of finding solutions and in the process no doubt clarify the definition and dimensions of the problems.

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