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COMMON SUPERVISORY OBJECTIVES

By

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Before

NATIONAL ASSOCIATION OF BANK AUDITORS

AND COMPTROLLERS

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I am delighted at this opportunity to visit Los Angeles here at the core of America's Golden West. And I am especially pleased to be able to talk to this fine audience representing the auditors and comptrollers of many of our nation's financial institutions.

I am here to discuss a business in which you people are the specialists. But what I have to say revolves around the broad theme of our common supervisory objectives.

In that connection, I have a little bit to say about attaining these objectives, and about the need for an ever-improving standard of bank operation. Much of what I have in mind has been gleaned from discussions with bankers and businessmen, from talks with our own examiners and auditors, and from some years of experience in the practice of law and on the national scene as a Congressman.

In the main, however, I am going to concentrate on the need for well thought out internal and external bank controls.

You are an ideal forum for my thoughts because the National Association of Bank Auditors and Comptrollers has for its objective sound and safe bank operation.

Since we have, in a manner of speaking, common supervisory objectives, let me define the fundamental supervisory objective of the Federal Deposit Insurance Corporation as: the desire for a sound banking system -- a sound banking system which

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is capable of meeting its liabilities without difficulty, while serving the legitimate credit demands which are made upon it and being of service to the public.

Now I would believe that your objective as a supervisor and an agent of the board of directors of your bank would be the assurance of a strong bank; that is, one with sound assets and adequate capital, operated in harmony with sound banking principles and in accordance with banking laws and regulations. In other words, each of you, ideally, would serve under proper and conscientious management, a bank of strong financial condition.

On the other hand, as a Federal supervisory agency, the Corporation's purpose is to insure the depositors of all banks which are entitled to the benefits of insurance under the law. This means that we are eminently concerned with the safe and sound operation of insured banks.

As I see it, the most dominant similarity of interest between the Corporation and NABAC lies in a common supervisory objective: the assurance of safe and sound operation of banks.

To this degree, then, we do have much in common, and it is on this point of mutual endeavor that I want to pin most of my remarks.

Deposit insurance, of course, has the responsibility of reducing the impact of bank failures upon the community, whatever the cause. However, banks themselves have a particular

responsibility for the prevention of defalcations and other internal abuses which may lead to failure; a responsibility recognized by their capital structures and through the fidelity bonds they carry. They also have an obligation, in meeting demands for credit, to make a prudent selection of assets. When insured banks have not made adequate provision against defalcation, or when they encounter losses in their operations severe enough to cause insolvency, the Corporation is obliged to step in to protect depositors. The Corporation has the further responsibility of cushioning the impact of failures due to economic developments beyond the control of individual banks.

If a bank fails, and especially if it is the only bank in the immediate area, the entire community is affected. It is the responsibility of the Corporation quickly to restore the availability of deposits which have been made temporarily inaccessible by bank failure, and thus to restore the web of confidence that sustains our banking system.

We pride ourselves on the assumption that money panics, such as those experienced in the past, have all but been eliminated by our guarantee of bank deposits.

We all recognize that it is confidence which sustains our banking system. In fact, every industry and business has a large stake in maintaining public confidence, but none so large a stake as has banking. For banks deal in promises, not in goods,

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and confidence is an essential element of every promise. Confidence is the keystone in the arch of financial and economic stability. Federal deposit insurance has done a great deal to foster this confidence that is so vital to the American banking system today.

The requirements which banks must meet in order to become insured are clearly set forth in the Federal Deposit Insurance Act. Once a bank is insured, the Corporation seeks to reduce its risk by regular examinations, and by review of reports of examination prepared by other Federal banking agencies. Although the Corporation has no authority to close a bank, the Corporation may terminate a bank's insurance if, after prescribed corrective procedures have been recommended, it persists in unsafe and unsound banking practices. This termination procedure is used sparingly, since most banks charged with unsafe and unsound practices, or violations of law, cooperate by making corrections. Examinations have come to comprise the bulk of our work, and we believe through them the Corporation has exerted beneficial influence on the character of banking.

As I have already stated, bank supervision entails, primarily, examination. Of course we issue regulations, enforce statutory and administrative requirements, and analyze and publish reports and studies. But bank examination gets us into the operation of the individual bank for a first-hand look at our insurance risk.

Supervisory authorities conduct bank examinations in the interest of the individual depositor; the stockholders; the directors and officers; and the operating personnel. And of most importance, bank examinations are conducted in the interest of the public.

In the Corporation we believe the prime objective of an examination is to evaluate the financial condition of a bank on a given date and thereby assure that its assets in excess of its capital requirements are adequate to enable it to meet all of its liabilities to depositors and other creditors. In addition, the examination should ascertain whether or not the management is conforming to the applicable banking statutes and regulations.

In contrast, the performance of a bank audit is a means of verifying that transactions are correctly recorded and that assets and liabilities are correctly reflected by the books of the bank.

I have checked these two definitions of functions against the recommended practice of "internal control" as agreed upon by the Committee on Auditing Procedure of The American Institute of Certified Public Accountants, and find that they are closely parallel in concept.

From this you can clearly see that the Corporation's objectives in examination, including all of banking, do closely parallel those goals of your own professional organizations.

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Both of us are striving for safe and sound banking operations, through intelligent management programs. But before any program can be successful two basic principles must be accepted as essential.

First, a bank's control program is vital, and should rank at the top of management's primary concerns.

Second, control procedures must be designed to fit the special needs of individual banks.

We can all agree that the primary purpose of internal audit and control is the protection of the weak from temptation, and of the innocent from involvement. There is no guarantee that fraud losses will not occur, but an adequate system of control assures a two-fold benefit: a strong deterrent to malfeasance and the possibility of early detection. The responsibility for maintaining a system of internal control lies with the bank's board of directors, both by law and administrative regulation. Ideally, each bank's board of directors should seek out a competent, thoroughly trained, objective auditor and appoint him responsible for the maintenance of an effective control program. I realize that for the very small bank the cost of a full-time auditor is often prohibitive. In such cases, other means of control can be utilized effectively, and I shall refer to this matter again, further on.

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On several occasions I have called attention to the fact that most bank failures in recent years were primarily caused by defalcation and embezzlement. These failures, in great measure, reflected a lack of internal protections and inadequacy of audit and control.

There are yet some bankers who feel that an annual examination by one of the supervisory authorities can somehow serve as an effective audit and means of control. This is a delusion that all supervisory agencies have sought to dispel.

Records show that bank embezzlements are on the increase. Millions of dollars are taken each year; but it is not possible to make an accurate estimate of the losses sustained, because many of the shortages have existed, though concealed, for years.

In the past calendar year, a total of 1,632 irregularities in banks was reported to the Federal Bureau of Investigation. A total of at least \$13 million was involved. There were 349 convictions.

Motives for embezzlers' activities are many and varied -- as are their methods. Generally these latter fall into the categories of (1) misappropriation of money or property before it is recorded; (2) misappropriation of income; (3) manipulation of expenses; (4) forgery and false entries; and (5) acting beyond authority.

In one of our recent bank failure cases, where several bank employees were involved in irregular transactions, we found

that salaries paid to these employees were inadequate; a promotion and vacation policy was lacking; there was no rotation of duties; and employees of the bank were engaged in extensive outside-business activities. Probably the most unorthodox activity engaged in by the failed bank was the practice of sending an employee by car to a neighboring town, some ten miles away, for cash for daily operations.

The employee gave his personal check to that bank for the amount of currency required, which may have been \$5,000, \$15,000 or \$20,000. This cash was then returned to the bank and credited to the account of the individual who drew the check. When this large check came in it normally would be charged to the drawer's account, but here was an item which was made to order to be charged to someone else's account, or at least a portion of it distributed elsewhere, and that is what was done in a number of cases.

I need not sketch further details of this picture for this audience.

Suffice it to say that even the smallest bank can, and should, carry out a sensible program of internal checks and controls by: (1) rotation of employees to the greatest possible extent; (2) separation of duties; (3) mandatory full and uninterrupted vacations away from the bank; (4) clearance of counter or window differences daily; (5) provision of individual facilities for each teller's cash.

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This is a minimum program. No bank can afford less. But I am sure that there exist a few banks which have not implemented even this minimum program.

There is talk of high cost, both of the program and of the manpower needed for good internal control. This may be true, but the bank's owners and management must resolve only one question: does the result justify the cost?

Of the 13,400 insured commercial banks, there are about 9,400 with deposit totals of \$5 million or less. Generally speaking, most authorities on audit have tacitly agreed that these banks are too small for a full-time auditor. This does not mean that an auditor is completely out of the question -- but rather that an auditor with other duties might well be put on the staff of some of these small banks.

As the only supervisory agency with actual dollars at stake in 96 percent of the nation's banks, the Corporation has great self-interest in the conduct of internal audit and control programs.

As a result we hold two additional common objectives with your organization: (1) improved appreciation by bankers and bank directors of the need for adequate control systems; (2) and a fuller recognition of the functions and importance of the auditor and an understanding that he should be granted broad authority and should be accountable only to the board of directors of the bank.

But even under the most ideal conditions of control, losses do occur. A bank which has taken upon itself a full-scale program of control still needs the protection offered through fidelity bond coverage.

The maximum amount of fidelity insurance may not be necessary for all banks--but this decision should be based solely upon the bank's efficiency in controlling risk.

We like to follow the old adage here, "Better safe than sorry."

Then finally we have the larger question: "Who audits the auditor?" I will not discuss this question in detail, except to say that an independent, outside audit is always in order for any business institution -- a practice which all banks should follow.

ELECTRONIC AGE ADVANCES

Then there is the further question:

How quickly can we assimilate and prepare for the electronic data processing equipment and coming developments in business record automation?

Now I will admit that when I started in the law business some years back, I used a very hesitant typewriter, a roll-top desk and a few other things that were thought to be right up to date and modern for the times. But today, when I read the publications in the banking field and stop in to visit with my

banker friends, I find that they are talking a strange new electronic age language. It consists of EDP, MICR, off line systems, Monte Carlo methods, and a raft of other expressions that leave me blinking.

I will readily admit to a great appreciation for the historical development of the business machine, from the abacus to the processing of data by programed digital computers -- but I can also envision some worrisome areas for both NABAC and the FDIC as the electronic age rushes toward us.

These new machines surely have their benefits: there will undoubtedly be an improvement in the quality of customer services. This will be matched by the simplification of routine and the easing of drudgery-type work, increasing employee morale. There will be more timely information for management with an improved opportunity for more accurate decision making by operating management. And coupled with all of these benefits will come completely new staff and operating level opportunities for bank personnel.

As these new developments begin to forge their way into the world of banking, we must be alert to their many and varied uses, we must be alert to the problems of internal control, to the costs of the equipment, to the obsolescence factors and to our own developing needs. We take heart in the good work being done by the National Association of Mutual Savings banks,

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the American Bankers Association, the American Management Association, and by your own NABAC Research Institute in bringing this new age of data processing into focus. The authorities are striving to keep in step with these developments and we always hope at least to keep abreast of current developments.

But the problems loom large before us. I cite the case of the New York brokerage house which only some months back found it had been victimized \$170,000 by an auditor's manipulation of IBM cards. This new era of the electronic swindler could pose a knotty problem. When books were changed with pen and ink, it was easy to trace the handwriting -- but electronic data processing cards are purely impersonal -- there's really no way of knowing who changed what.

BANKING -- A DYNAMIC BUSINESS

But aside from the problems I have outlined, I like to think that banking is a dynamic business, and I am convinced of it because of the innovations and ideas that have been developed within the past 15 to 20 years.

More people than ever, know more about banking today, than ever before.

Bank personnel have become aggressive, sales minded, community active. These people are constantly on the alert for new improved ways of doing things and generally have the ability and knowledge to carry out their ideas.

The machines I have already briefly discussed have opened up new ways of doing things. They have made it possible for banks to offer services impossible under manual methods a few years back.

People on the move today -- something like one person in five changes his residence every year -- make continual new banking business opportunities.

This rapid evolution and change in bank operation and service makes the business one of dynamic action and interest. It is a challenge to our ingenuity. And to our imaginations.

This is convincing proof of the leadership and dynamic role being played by our nation's private financial institutions. Banking has come into its own. Today, this segment of business stands high on the scale of public approval. This expression of public approval wasn't acquired with "Madison Avenue" techniques -- but rather through effective, and continuous service to the public. A service that has come to be recognized as safe, sound, and efficient.

I believe that we must be professionally minded and that we cannot allow the slightest degree of neglect, of unsound and unsafe practice, of incompetence, to enter our business.

Public acceptance and approval needs constant sustenance. It needs informed spokesmen who can state the cause for private banking and for our free market economy. And who are also alert and sensitive to valid criticisms.

Change, in the sense of the self-challenge and self-improvement of our business and society, is the essence. We are all aware that there will always be better ways of doing tomorrow tasks which confront us today. Toward this end your association will continue to show the way, and your association, I hope, will continue in the forefront.

In conclusion, I want to express the appreciation of our Board and staff for the continuance of a fine spirit of cooperation and helpfulness, shown over the years.

It has been truly pleasant and beneficial.