

Remarks by A. L. Mills, Jr., Member, Board of Governors of the Federal Reserve System, at the 1958 Conference of Ninth District Bank Examiners, Minneapolis, Friday, November 21, 1958

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BANK EXAMINATION



Bank examination must be viewed in two ways: from the angle of bank management and from that of the bank examiner. Where these two points of view fuse into a mutual effort that fosters the public interest for which a bank is accountable and the constructive community force that it is capable of exerting, bank examination serves its topmost purpose.

By and large, bank management welcomes examination. The physical verification of a bank's assets by a competent public authority, and an appraisal of their adequacy as protection to deposit liabilities, provide bank management with an independent test of the sufficiency of the bank's accounting methods and an impartial judgment that the quality of its loans and investments meet accepted standards, or should be brought up to standard promptly if found lacking in any respect. Bank management also realizes that the multiple examination of banks by supervisory authorities lays the groundwork for interbank comparisons that can serve examiners as an opportunity for instilling in banker minds the idea of constantly improving their operating practices so as to keep up with the best in the field. Bankers are well aware that bank examination cannot substitute for adequate internal auditing, or for outside public audits, as measures of protection against dishonesty, and that practical considerations prohibit examinations comprehensive enough to provide the kind of critical professional judgment of a bank's affairs that most bank managements would like.

Bank supervisors will be the first to acknowledge that there are inherent shortcomings in bank examination, but all will agree that its effectiveness depends on the personal attitude of bank examiners to their official responsibilities and that, in turn, depends on their conception of the role of banking in national life. The starting point to an appreciation of the public aspects and functions of banking goes back logically to an understanding of the conditions that are attendant to chartering a new bank. The bank examiner, called upon to investigate the merits of an application to organize a new bank, must give his recommendations on such key factors as the adequacy of the capital structure of the proposed bank, the character and ability of its management, its future earnings prospects, the convenience, needs and welfare of the community to be served and, lastly, whether establishment of a new bank would be consistent with the public's interest in having access to competitive banking facilities.

A composite judgment on all of these factors lies at the root of a supervisory authority's responsibility in chartering a new bank, and must be extended thereafter to ascertaining that the conditions requisite to chartering the bank are carried out faithfully in its subsequent operations. The fact that banks are endowed with quasi-monopoly privileges accounts in part for their subjection to regulatory authority. Time honored acceptance of the principle that banking is vested with a public interest is, however, the chief reason for its regulation. Inasmuch as banking is essentially a public trust, it then follows that bankers must have a special competence and degree of integrity to fit them for such a trusteeship, both in the

aspect of protecting the funds entrusted to the bank's care and in the responsibility that goes with employing the bank's resources in credit-creating operations that should redound to the community's economic benefit.

If so much is expected of bankers in safeguarding the public interest, it is equally incumbent on bank supervisory authorities to use their powers and influence in every way that will also advance the public interest. Thus it is that bank examiners in performing their duties must always be mindful of the fundamental principles that relate bank operation to the public interest. There must be mutual understanding between bankers and bank examiners that banking is a privileged field to which entrance must necessarily be limited, and once gained must be cherished through the observance of sound banking practices. When imbued with this philosophy, the bank examiner is in a preferred position to win banker acceptance of suggestions and criticisms having the public interest as their objective. At best, however, the advancement of sound and forward-looking banking policies, as between bank examiner and banker, is limited by the fact that bank examinations have only a high average as a departure point for inter-bank comparison when, in reality, an average of banking proficiency should be shunned as inadequate and the sights of examiners and bankers set at higher points of comparison and emulation if banking is to achieve the best results of which it is capable.

In the process of appraising the quality of a bank's assets, bank examination reveals the personal attitude of the banker toward the privileges and responsibilities that attach to a bank's charter rights

to engage in a field of financial and economic endeavor that is so clearly identified with the public interest. Acknowledgment of a duty to supply capital in amounts commensurate with his bank's deposit liabilities is a primary test of a banker's attitude toward the public interest. Adequate capital is basic to the proper operation of a bank, and the willingness of bankers to provide additional capital protection in proportion to the growth of their institutions, besides being a good measure of their appreciation of the public interest which they serve, is likewise a benchmark for the bank examiner's rating of the degree of recognition that is accorded to that responsibility.

[Banking is a sector of the free enterprise system and banks are, of course, organized for private profit. It is altogether fitting that that should be the case, for if it were otherwise the contribution that banks can make to national progress would be stultified by some form of bureaucratic domination. However, as the quasi-monopoly privileges and elements of public interest inherent in banking require its public supervision, by the same token bankers are obligated to carry a heavier burden of responsibility than falls to the lot of people engaged in many other walks of life.]

It is because of these exceptional characteristics of banking that bank examination affords rewarding opportunities for public service to anyone who espouses that vocation. To share in a responsibility that touches so closely on our national life and progress offers a stimulating challenge for engaging in constructive public service. Enhancement of the opportunities

inherent in bank supervision revolves around the personal equation, namely, the ability of the individual bank examiner to guide rather than drive bankers into conformance with the best in banking practices. That ability is determined by the capacity of the bank examiner to appraise the public values that reside in banking and then to enthusiastically transmit that valuation to bankers in ways that will of themselves win adherence to high banking standards.

As has been mentioned, recognition by bankers of the necessity of adequate bank capital is fundamental to sound bank administration. Bank examiners can foster the transformation of such recognition into additional tangible bank capital through the art of persuasion which, to be fruitful, must be buttressed by fact, as well as by theory, and must therefore take into account an analysis of a bank's earnings and a critique of their distribution. There is no better way for discerning whether a bank's resources are being employed to the constructive advantage of the community and the best advantage of its shareholders than by scrutinizing its earnings. The distribution of bank earnings as between additions to capital, interest paid on time deposits, salaries, and dividends will reveal not only the banker's competence for returning a profit to his shareholders but also his point of view regarding the bank's community responsibility and how it should be fulfilled.

The starting point for an analysis of a bank's earnings is to estimate the risk exposure of depositor funds as measured back against the marginal percentage of protection provided by its privately subscribed

capital. In doing so, bank examiners must painstakingly appraise a bank's assets, not only as to their protective quality to deposits and the contribution which they make toward community advancement, but also as the source of the bank's earnings and consequent ability to absorb losses and to provide additional capital. Retained earnings must always be a primary source of new bank capital, but they can rarely be sufficient to provide the full capital needs of a growing bank. As that is the case, resort to public financing is frequently necessary, but to be successfully accomplished demands a dividend-paying record on the part of a capital-seeking bank that will attract new capital stock subscriptions. Analysis of a bank's earnings offers examiners the right clues as to a bank's ability to obtain outside capital financing and likewise reflects the philosophy of its management as regards an equitable distribution of earnings between dividends and capital retentions.

Bank examiners can play an important part in developing a chain of causation in bankers' thinking that will extend from an appreciation of the fact that sound loan and investment policies contribute most to community progress, as well as to good bank earning power, through to a fuller realization that banking's public responsibilities demand that all possible steps be taken to assure the adequate capitalization of the banks which they direct.

It stands to reason that bankers will be more receptive to the guidance that bank examiners can give if they are inculcated with the examiners' respect for their own personal standing and responsibility as

public officers, and in ways that will firmly establish the premise that banking represents private enterprise at its best but largely because it is so strongly affected with a public interest. An understanding of the public responsibilities that attach to banking, both on the part of bankers and bank examiners, must derive from constantly refreshing their recognition of the fact that entry into banking is carefully restricted and that the conditions requisite to the chartering of a new bank represent not only an immediate grant of charter rights but are also a set of rules for governing its future conduct.

The privileges of engaging in the banking business are both tangible and intangible. Of the two, I rate the intangible privileges the higher as it is through them that the banker enjoys the fullest opportunity for performing his public duties. Bank examiners are an elite, not so much because of being a select group of public officers operating in a special field of public endeavor as for the opportunity they enjoy to act as preceptors and counselors to their confraternity of bankers.

Banking in both my private and public experience has been fascinating and all-absorbing. If my comments today carry any message, it is to emphasize the public service quality of banking and the opportunity that lies in the hands of bank examiners to preach and practice public service in the performance of their duties.

