BANK SUPERVISION

Federal Reserve Bank of St. Louis

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RRY A. SHUFORD
PRESIDENT

December 16, 1963

This booklet consists of papers which were delivered at a staff conference of this Bank on March 15, 1963. It is presented, not as a statement of Federal Reserve policy nor as a manual of techniques, but, rather, in the hope that it may contribute to better understanding of an important public service on which relatively little material is available.

The Bank is grateful for the review and commentary of Dean William H. Baughn, Professor Lewis E. Davids, and Professor Elmer Wood, all of the University of Missouri. Needless to say, their kindness does not commit them to responsibility for the views herein.

Harry A. Shuford

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FOREWORD

by

J. L. Robertson, Member of the Board of Governors
of the Federal Reserve System, Washington, D. C.

WITH thirty years of active work in the field of bank supervision behind me, I was privileged to attend the conference at which this group of papers was presented. As I listened to each of the participants, I was impressed by the grasp each had of his subject. The presentations were clear and concise. In addition, they consisted of fundamentals that form the warp and woof of the fabric of knowledge that clothes the "good" examiner.

It occurred to me at the time that it was unfortunate that information of this type was not available to those members of the public who have reason to be interested in this technical but important phase of public service. One can search libraries from coast to coast without finding information in one place — or, for that matter, in any place — which presents a picture of bank supervision as accurate and well-rounded as that to be gleaned from these papers.

Consequently, news of the decision to publish the material was not only welcome; it also aroused in me a desire to publicly commend the individuals whose efforts made the decision possible — which I hereby do.

I am certain that this material will prove helpful to those young people who might be considering a career in this field. It will be educational for those who have an academic — or even a general curiosity — interest in how banks are supervised in the United States. It will prove invaluable to those members of bank supervisory forces — State or national — who have not been privileged to attend sessions of the School for Examiners which the Federal Reserve System and the Federal Deposit Insurance Corporation conduct as a part of their training programs.

Needless to say, bankers themselves will be found poring over this volume in the hope — a hope which can be fulfilled — of finding ways to improve their banks by learning the "what's" and the "why's" of the bank examination process.

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The General Nature of Bank Supervision

by

ORVILLE O. WYRICK

BANKS differ from most other corporations in several respects. Most of these differences are related to the unique position of banks in the national economy. They are the custodians of the bank deposits that form the bulk of the nation's means of payment, its money supply. There is strong public interest in the safety and mobility of bank deposits, and this has both a general and a specific application for it is the effective operation of the individual banking institutions which is essential to the orderly functioning of the whole banking system. The current financial needs of commerce, industry and agriculture are met partly through loans and investments made by individual banks and the bulk of the nation's payment is made through the checking deposits resulting from these lending activities. Failure of banks to meet their liabilities can reach far beyond depositors and borrowers and the immediate territory that the banks serve. The business of banking, therefore, has long been regarded by the Federal Government, the States, the public generally and the bankers themselves as one that is properly subject to government supervision.

As a government activity, bank supervision encompasses a wide variety of technical functions relating to the operation of banks. These concern: (1) the issuance and enforcement of supervisory and other regulations; (2) the organization and chartering of banks; (3) the periodic examination of banks and the requiring of steps by bank management to correct unsatisfactory or unsound conditions found through such examination; (4) the review and analysis of periodic reports of conditions and earnings and expenses; (5) the rendering of counsel and advice on bank operating problems when requested, particularly in the case of smaller banks; (6) the approval of proposed changes in the scope of corporate functions exercised by individual banks and of proposed changes in their capital structures; (7) the authorization of establishment of branches and of the exercise of

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trust powers; (8) the approval of bank mergers and consolidations; (9) the organization and regulation of bank holding companies; (10) the regulation of bank service corporations; and (11) the liquidation of banks. The four supervising agencies do not each perform all of these functions, but all are the responsibility of one or another. For instance, only the Comptroller of the Currency and the State Supervisory Authorities have the statutory power to charter or close banks, while the Board of Governors of the Federal Reserve System has the sole Federal Supervisory responsibility for the regulation and supervision of bank holding companies.

As the history of banking and bank supervision bears out, one of the prime requisites for effective supervision is control over entrance into the banking business. Formerly, the belief was held rather generally that any group of men with the minimum amount of capital required had the right to establish a bank, and over a long period of time, charters were granted rather freely. This resulted in the chartering of a large number of uneconomic units often with incompetent management. "Too many banks and not enough bankers" has often been said to have been one of the causes for the great number of failures during the twenties and early thirties. The general aim of the chartering authorities today is to grant charters only where there is demonstrable need for the bank and reasonable assurance of its success. However, it might be significant to note that there were 178 new banks opened for business in 1962, 63 National and 115 State banks, topping the previous high totals of 136 in 1946, and 109 in 1961.

Of perhaps equal importance as the authority to control entrance into the banking system is the authority of supervising agencies to control bank expansion through the establishment of branches, mergers and consolidations, or bank holding companies. The power to limit undue concentration of banking resources and thereby contribute to a healthy, effective and competitive banking system is one of the best possible protections of the economic interest and public well-being.

The broad objective of all supervisory agencies is to foster and maintain sound banking conditions and so to protect the public interest. In relation to the individual banks, the objective is to foster the maintenance of each institution in sound and solvent condition under good management in order to protect the depositor and to enable the bank to serve adequately the needs of the community. In stating that the objective of supervision is the maintenance of sound

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banking conditions, there is no intent to overemphasize the powers of supervision. That supervision has not always been successful in attaining its broad objective, as is apparent from the several major upheavals in the nation's banking history, does not make the broad objective a less desirable one, or even an unachievable one. It is fully recognized that supervision, even at its best, is no substitute for intelligent and competent bank management, and that of itself it cannot insure the maintenance of a sound banking system. It can only contribute to that end.

Obviously bank supervision comprehends more than the examination of banks. Although, according to popular usage, "bank supervision" and "bank examination" have come to be used interchangeably, and although bank examination is the very foundation of bank supervision, "supervision" is a much broader term than "examination" and embraces many additional activities. Here at the Federal Reserve Bank, bank supervision entails other important duties in addition to bank examination. These include: (1) processing of reports of condition, and income and dividend reports of member banks; (2) analyzing reports of examination of national banks received from the Comptroller of the Currency; (3) maintaining analytical information with respect to condition of all member banks; (4) processing branch and merger applications; (5) processing applications to organize or expand bank holding companies; (6) administration and interpretation of laws and regulations; and (7) the processing of applications of State banks for membership, or termination of membership of banks in the Federal Reserve System.

Bank examination is the fact finding function of bank supervision. Its purpose is to develop information that will disclose the current asset condition of the individual bank, its ability to meet demands of its depositors and other creditors, the adequacy of its capital structure, its earning ability and future prospects; to evaluate and appraise the competence of its management; and to ascertain whether it is complying with applicable laws and regulations.

Before discussing the role of the bank examiner, I would like to point out a few things that bank examination and supervision do not include. An examination of a bank does not generally include an audit of it. As you perhaps know, an examination concerns itself primarily with appraisal, while an audit concerns itself primarily with verification. Naturally there are certain audit aspects to an examina-

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tion and the extent to which an examination approaches an audit properly varies from bank to bank, depending on the extent of internal controls, personnel and other relevant factors in the particular institution. It is one of the functions of an examination to determine weaknesses in safeguards and controls in each bank so that these may be discussed with the management with a view to obtaining corrective action. Bank supervision does not engage in the management or operation of banks. It cannot play the role of both umpire and player. The responsibility for the management and operation of a bank rests with its board of directors. It is the responsibility of bank supervision to evaluate the capabilities of bank managements and to seek to strengthen or replace it in those situations where it is determined that it is inadequate to cope with the situation in which it finds itself and the safety of the bank's depositors is involved. Finally, bank examination is not a tool of monetary policy. Since the Board of Governors, in addition to its supervisory responsibilities, is concerned with national credit and monetary policies, it is sometimes mistakenly believed by some that one of the objectives of Federal Reserve examination is that of credit control. However, this is not the case. In all phases of examination and supervision there is full recognition of the distinction between the Federal Reserve System's responsibilities relating to bank supervision and those pertaining to monetary policy. Examinations are not made with a view of implementing the monetary policy in effect at the time, but with the purpose of determining whether the bank under examination is being so operated as to warrant the belief that if now in sound condition, it will so continue; and, if not, that it will soon attain such a condition.

Since supervisory policy is administered largely through the process of bank examination, the role of the bank examiner is indeed an important one. His function is to inquire honestly and as carefully and impartially as possible into the affairs and management of a bank as revealed by the records of operation. In performing his duties he is required to verify and appraise all assets; to verify liability accounts as shown by its general books, insofar as this may be practicable through comparing subsidiary record totals with general ledgers control accounts, or through direct verification with creditors; to check on the observance of laws, rules and regulations; to appraise the qualifications of directors and the competence of officers, and to some extent employees; to appraise overall operations, to observe trends, and to submit a report with comments, criticisms, and recommendations.

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In the light of the facts developed by the examiner in the field, the officers in charge of supervision are in a position to prescribe any necessary requirements regarding corrections and formulate expressions of supervisory policy. Moreover, the supervisory officers take the important facts and experiences developed by examiners regarding not just one bank, but all banks supervised, and temper supervisory action regarding the individual institution by the experience derived from all. The extent of correction required or advice given naturally varies with the specific situation.

Supervision of the larger percentage of our member banks amounts to little more than making routine examinations and requiring the submission of condition and earnings reports. Unfortunately there do develop situations where drastic supervisory action is required. These are usually the result of speculative or incompetent managements and in such cases the duties of supervision are clear — a strengthening or change of management. Between the well managed and the hazardously managed groups is a relatively small group of banks whose operations are not all that might be expected or desired. Supervision can and does render its best service to such institutions by acquainting them with the prevailing practices of sound banking and by arousing the interests of the managements to make corrections of a fundamental nature. The timing and extent of corrective measures to be instituted in respect to specific situations is a judgment which must be carefully arrived at by the supervisor. To be effective he must scrupulously avoid imposing conditions "too quickly and too great", but he must be even more alert to avoid committing the unpardonable sin of bank supervision of doing "too little, too late".

The foregoing is the general nature of bank supervision. It is as you can see only a means to an end and has been adapted in times past to meet changed or changing conditions. Its broad objective, the maintenance of a sound banking system, is well established, but the question of what procedure, practices and allocations of responsibilities are needed to make supervision more effective in the accomplishment of this purpose, not only with respect to individual banks and their particular problems, but also with respect to problems affecting the banking system as a whole, continues to be debated by supervisors, bankers, economists and legislators.

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The Legal Basis of Bank Supervision

by

Gerald T. Dunne

BACK in the days of World War II, it was the custom at one naval station to accompany the promotion of enlisted men to the rank of midshipmen in the United States naval service with the reading of a letter from John Paul Jones on the subject of command at sea. The gist of the message was that while an American warship might fight for democracy and freedom, her company would experience comparatively little of those conditions.

Something of a parallel of this apparent contradiction (which is really a summary of cause and effect) is suggested by the subject of the legal basis of bank supervision. Commercial banking as we know it is not only representative of private, rather than governmental, allocation of resources, but it is absolutely indispensable to the entire private enterprise system. Yet, as Mr. Wyrick has already suggested, and as the remarks of our subsequent speakers will amplify, it would be difficult to find a sector of the economy more subject to governmental regulation and restraint.

Entry into banking is highly restricted and granted only on proof of the public's need for service and the applicant's capacity to fill it. The cost of the principal commodity, money, is hedged on both the supply and demand sides with legal — as distinguished from economic — limitations. The areas of choice in both loans and investments are elaborately circumscribed. There are restrictions on persons who may be associates in the business and on the place where business may be conducted. The ability to combine with similar enterprises or to dispose of it to a corporate buyer is sharply conditioned. The enterprise itself may be closed down or its personnel ousted from office in comparatively summary fashion. And, finally, both as part of the pattern of regulation, and, so to speak, the cutting edge of the regulatory blade, there is a continuous process of compulsory disclosure. One part of this process is submission of reports on the business, not only to the authorities, but to the public at large. The second, and, by far the more important, is unannounced, uninvited, and unexpected on-the-spot verification of the affairs of the bank.

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There are perhaps three salient characteristics of both the overall pattern of regulation and its specific apparatus of examination. For one thing, it exists under the laws of every state as well as those of the Federal Government. Secondly, while these laws involve considerable diversity in context and — as Mr. Welman will show — in application, they also have a core of common ideas and procedure. And, finally, most of them are fairly old laws, that is to say, they were adopted during periods when the idea of governmental regulation of, and intervention in, economic enterprise were not the rules but very much the exceptions. Only the FDIC supervision and examination authority (Section 10 of the FDIC Act) is rooted in fairly recent history. Contrarywise, we are now approaching the golden anniversary of the Federal Reserve Act and its Section 11 which authorizes the Board of Governors "to examine at its discretion the accounts, books and affairs . . . of each member bank . . . ." We have already passed the centennial of the national bank counterpart of such legislation, both in general and with specific reference to examining authority first given by Section 54 of the National Currency Act of 1863. Finally, and to take Missouri laws as typical of state legislation, we might note that while most Missouri banking statutes date from 1907, a legislative tradition of bank regulation, including examination, has been in effect in this state since 1837.

Perhaps we might pause for a brief look at the present Missouri "examination" statute[1] because its form not only sets out the business of supervision in fairly comprehensive and systematic fashion, but does so in language which suggests the legal background and tradition involved. Omitting unnecessary material, it reads as follows:

> 361.160. *Examination of banks and trust companies*
>
> 1. The commissioner, at least once each year, either personally or by deputy or examiner appointed by him, shall visit and examine every bank . . . doing business under the laws of this state . . . .
>
> 2. The commissioner, or the deputy or examiners designated . . . shall have power to examine any such corporation whenever, in his judgment, it may be deemed necessary or expedient . . . .
>
> 3. He and his deputy and examiners shall have power to administer oaths to any person whose testimony may be required in such examination . . . and to compel . . . attendance of any person for the purpose of any such examination . . . .

[1]Section 361.160 Rev. Stat. Mo. (1949).

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4. On every such examination inquiry shall be made as to the condition and resources of such corporation, the mode of conducting and managing its affairs, the actions of its directors or trustees, the investment of its funds, the safety and prudence of its management, the security afforded to its creditors, and whether the requirements of its charter and of law have been complied with in the administration of its affairs, and as to such other matters as the commissioner may prescribe.

When the Missouri legislature passed this law, it did not take either its ideas or its language out of a vacuum. Rather, it drew on not one, but two, legal traditions, which stretched back almost a thousand years. Specifically, when it proposed that the commissioner should "visit" every bank, it meant no inference whatsoever of neighborliness or sociability. Rather, the word "visit" comes *verbatim* out of the part of Blackstone's *Commentaries*[2] which refers to the royal prerogative in England of inquiring into the affairs of certain corporations, and this lineage of sovereign prerogative also is suggested by Section 5240 of the Revised Statutes which provides:

> No (national) bank shall be subject to any visitorial powers other than such as are authorized by law, or vested in the courts of justice or such as shall be or shall have been exercised or directed by Congress, or by either House thereof or by any committee of Congress or of either House duly authorized.

Again, we must place this concept in context and note that it emerged in the same historical process which made a man's home his castle and developed the thought that while the snow and wind might come through the doorway of a house, the King of England could not enter without permission. But this latter idea referred only to private persons and private homes. It did not apply to corporations subject to the royal prerogative. For these the King's officers needed no writ, no warrant, no court order to subject them to inquisitorial examination.

But this right of royal visitation is only half the legal tradition and it deals with method rather than content. For the substance of bank supervision we must turn to another venerable legal concept and this is the "business affected with a public interest." In its most general sense, this concept means that the activities of certain enter-

[2]Blackstone's *Commentaries*, 108 (Ehrlich ed. 1956).

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prises involve responsibilities and consequences which require, or at least justify, extensive governmental regulation. This idea has been worked particularly hard and the courts have held that a legislative declaration that a business is "affected with a public interest" does not necessarily make it so. Indeed, Justice Oliver Wendell Holmes of the Supreme Court went so far as to suggest that in many cases this was merely a fiction intended to beautify what is disagreeable to the sufferers.

Yet, without entering into an analysis of where the line need be drawn, there is general agreement that widespread consequences of misconduct or bad judgment in certain businesses are such as to require governmental rather than market sanction. Moreover, as in the case of the prerogative of royal visitation, this is a very old concept. Almost a century ago Chief Justice Waite noted that with respect to its application "it has been customary in England from time immemorial, and in this country from its first colonization, to regulate ferries, common carriers, hackmen, bakers, millers, wharfingers, innkeepers, etc..... To this day statutes are to be found in many of the States upon some or all of these subjects; and we think it has never yet been successfully contended that such legislation came within any of the constitutional prohibitions against interference with private property."[3]

It is worth pointing out one omission in the Chief Justice's list, and that is the business of banking. Certainly even from the earliest times the failure of a banker involved consequences far more serious than the collapse of a miller or a baker. Yet, while the justification for the public regulation had early origins, the recognition of the relevance of the concept to the enterprise was a long time in coming. Indeed, the opposite point of view prevailed with extraordinary tenacity and as late as 1839, Chief Justice Taney could look back at the Anglo-American legal history and assert that "at common law, the right of banking in all its ramifications, belonged to individual citizens and might be exercised by them at their pleasure."[4]

Yet, we can almost write the history, both legal and economic, of the first three centuries of American monetary experience as the slow turnabout of this attitude in the tediously emerging preception that the public welfare was immeasurably harmed by a completely haphazard system in which the monetary medium consisted of the

[3]*Munn v. People of Illinois*, 94 U.S. (4 Otto) 113, 125 (1876).
[4]*Bank of Augusta v. Earle*, 38 U.S. (13 Peters) 519, 596 (1839).

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obligations of anyone who wished to call himself a banker and regulation of the industry proceeded accordingly. Finally, it was this slowly emerging concept of banks as belonging to the class of businesses affected with a public interest which furnished bank supervision with still a third legal — or, more precisely, constitutional — base. This is power vested in every national sovereignty to define, protect, and regulate its monetary medium. It would make for a tidy and symmetrical treatment if we might establish for this particular aspect of supervision the same sort of legal family tree, so to speak, as we did with the other two. However, this is simply not the case and this notwithstanding the flashes of insight on the part of early judges. Thus, in 1758, an English judge held that the notes of private bankers differed from every other kind of property because "by the general consent of mankind . . . they are as much money as . . . any . . . current coin . . ."[5]

Yet, such penetrating conclusions were the exception rather than the rule, and indeed we can find the rule in the second quotation from Chief Justice Taney with respect to common-law right of free banking. Once there came recognition that "by the general consent of mankind" bank notes and bank credit did the work of gold and silver, there followed in inevitable consequence a particular type of governmental concern, attention, and action. This reaction was not so much involved with the governmental responsibility for the public safety and welfare which underlay the "public interest" concept. Rather, it was a governmental concern for the exercise of *its* sovereign prerogative of the money power. We now approach the fiftieth anniversary of the first comprehensive and systematic recognition of this situation. It is particularly relevant to the general topic of bank supervision to recall how this subject was involved in this process by noting the four specific objectives singled out by the preamble to the Federal Reserve Act — the organization of Reserve Banks, the furnishing of an elastic currency, the rediscount of commercial paper and the "more effective supervision of banking in the United States."[6]

[5]*Miller v. Race,* 1 Burr. 452, 457 (1758).
[6]38 Stat. 251.

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Allocation of Supervisory Responsibility Today

by

JOSEPH C. WELMAN, JR.

IF YOU were to examine a chart designating the present allocation of supervisory responsibilities, you would probably assume that at some point in time the Congress enacted this allocation as it presently exists. Perhaps you would wonder how such a diversification of duties was conceived. Not as a defense, but as an explanation, we should examine the network of supervisory relationships and see how they chronologically evolved. Excluding a discussion of the controversial First and Second Banks of the United States, which functioned somewhat as central banks and somewhat as commercial banks, the first purely commercial banks were State-chartered institutions subject only to a nominal amount of supervision from the State authorities (Exhibit I).

The lingering agrarian distrust of the First and Second Banks of the United States somewhat offset by the need for funds to finance the war effort brought about the passage of the National Currency Act of 1863 which provided for Federally-chartered "National" banks which would be privately owned but subject to the supervision of the Comptroller of the Currency (Exhibit II).

Although the term has been recently subject to vehement disputes regarding definition, probably it may be said that at this point in time we had a "dual" banking system — that is, we had a system of State-chartered banks subject to supervision by State authorities and a system of Federally-chartered banks subject to supervision by a representative of the Federal Government, the Comptroller of Currency.

As we progressed through the industrial revolution and the rapid urbanization of the country, the inelasticity of our individual National Bank Note currency and the need for a source of additional liquidity brought about the passage of the Federal Reserve Act in 1913, which its preamble states was an "Act to provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means

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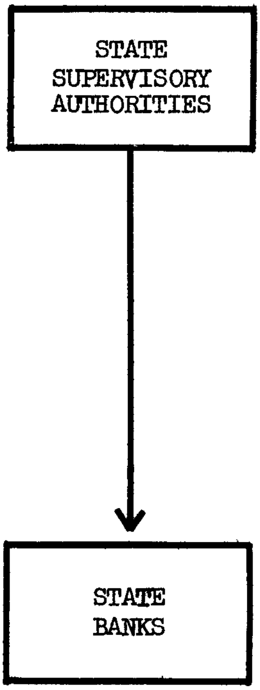
ALLOCATION OF AUTHORITY TO EXAMINE PRIOR TO 1863



POWER TO EXAMINE

EXHIBIT I

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ALLOCATION OF AUTHORITY TO EXAMINE FROM 1863 to 1913

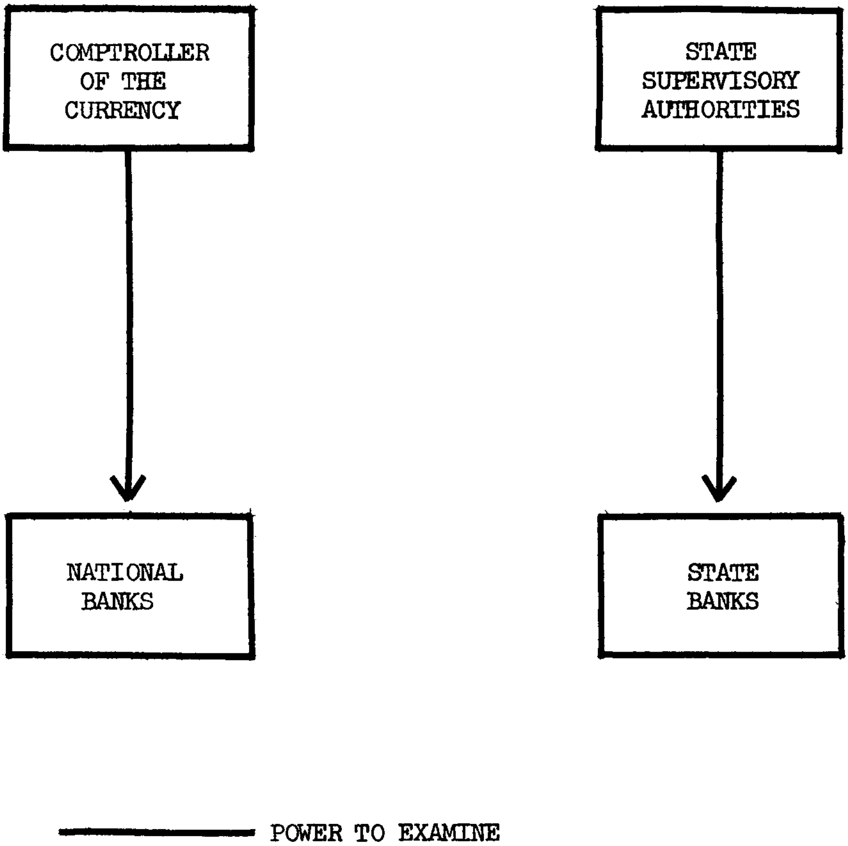

EXHIBIT II

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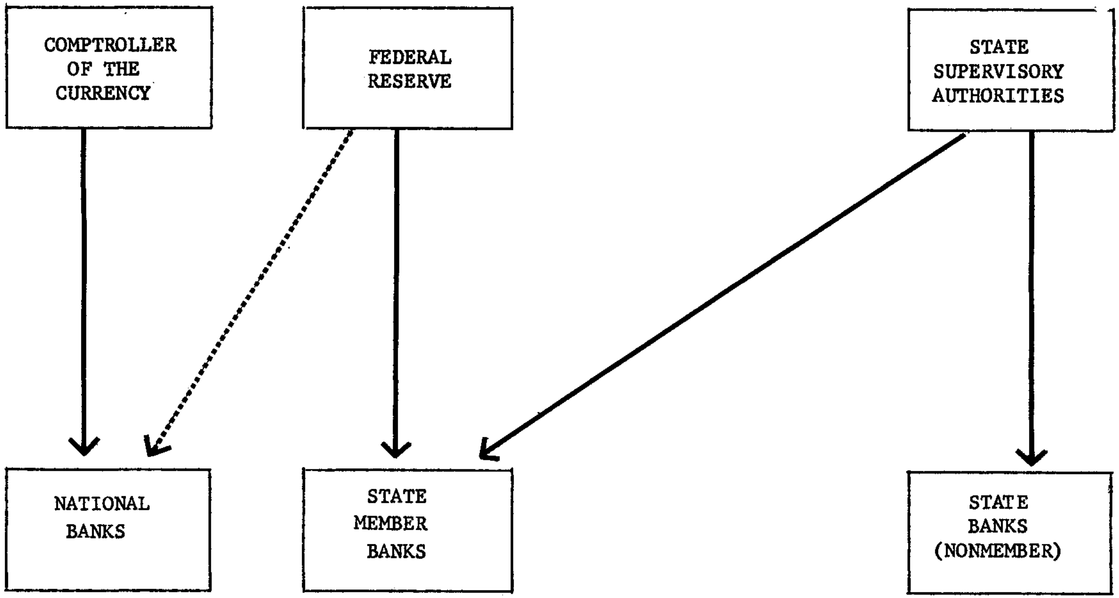
EXHIBIT III

ALLOCATION OF AUTHORITY TO EXAMINE FROM 1913 to 1933



POWER TO EXAMINE

POWER TO EXAMINE AUTHORIZED, BUT NOT ORDINARILY EXERCISED

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of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes."

It is important that we note here that the preamble specifically states the Act is to establish "a more effective supervision of banking". However, since the Federal Reserve Act provided for membership of all National banks and the voluntary membership of State-chartered banks and since the ultimate goals of the Comptroller of the Currency might not have been the same as the goals of the Federal Reserve System, Congress apparently felt it best to vest in the Federal Reserve System the powers of regulation and supervision over all member banks. The creation of the Federal Reserve System created another class of State-chartered institutions, which we refer to as State member banks, which were subject to the supervision of the Federal Reserve System and continued to be subject to the supervision of the State authorities. In addition, because all National banks are members of the Federal Reserve System, the Federal Reserve has the seldom, if ever, exercised power to examine National banks (Exhibit III). At this point, National banks and State-chartered member banks became subject to supervision by a body other than the chartering agency. If we seek to find a beginning for the so-called tiers of supervision, it may well be here with the passage of the Federal Reserve Act.

The great depression and the attendant banking crisis brought about many additional statutory limitations on banks and an addition to the Federal Reserve Act called deposit insurance to be underwritten by an instrumentality of the United States Government — the Federal Deposit Insurance Corporation. Originally, after July 1, 1936, only banks which were members of the Federal Reserve would be insured by the F.D.I.C. The effective date of this requirement was postponed from time to time, banks with deposits of less than one million dollars were exempted by the Banking Act of 1935 and the requirement was repealed entirely by the Act of June 20, 1939. Thus, the statute allowed the acquisition of Federal Deposit Insurance by banks which were not members of the Federal Reserve System. Once again Congress created another class of State-chartered banks, which we refer to as insured nonmember banks, which are subject to the supervision of the Federal Deposit Insurance Corporation and continue to be subject to supervision by the appropriate State authorities. Since any bank which is a member of the Federal Reserve System automatically has its deposits insured by the Federal Deposit Insurance Corporation, the F.D.I.C. has the seldom, if ever, exercised

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power to examine both National and State member banks (Exhibit IV).

At this point in time, we come to four different readily definable classes of banks — National banks which are automatically members of the Federal Reserve with deposits automatically insured by the F.D.I.C., State-chartered banks which choose to become members of the Federal Reserve and automatically obtain F.D.I.C. insurance, State-chartered banks which choose only to become insured by the F.D.I.C., and finally, State-chartered banks which are not associated with any of the three Federal agencies.

The first four exhibits show the exercised and the normally unexercised power to conduct examinations. It will be noted that banks first of all are examined by their chartering authority. National banks are chartered by the Comptroller of the Currency and State banks are chartered by the various State authorities. In addition, any State bank whose deposits are insured will be examined by representatives of the Federal Deposit Insurance Corporation unless the bank has chosen to become a member of the Federal Reserve, in which case the Federal Reserve will examine the bank in place of the F.D.I.C.

However, the supervisory function is not limited to examination. Some of the more significant of the other supervisory functions and their present allocations are shown by Exhibit V. It might be well for us to pause for a moment and consider several of these allocations.

A bank is subject to the regulations of and must submit reports to its chartering authority plus any Federal agency of which it is a member. In addition, State banks which are members of the Federal Reserve are subject to the regulations of the Comptroller of Currency regarding investment securities.

Reserve requirements are established by the Federal Reserve and the State authorities. Therefore, National banks are subject to the reserve requirements of the Federal Reserve. State-chartered banks which are members of the Federal Reserve System are subject to the reserve requirements of the Federal Reserve and may be subject to the requirements, if any, of the State authorities, although State member banks in the Eighth Federal Reserve District are exempted from the State reserve requirements. Finally, State-chartered banks which are not members of the Federal Reserve are subject to the reserve requirements, if any, of the State authorities.

Trust powers are authorized by the chartering authority, that is, the Comptroller of the Currency or the appropriate State authority. However, State-chartered banks which are members of the Federal

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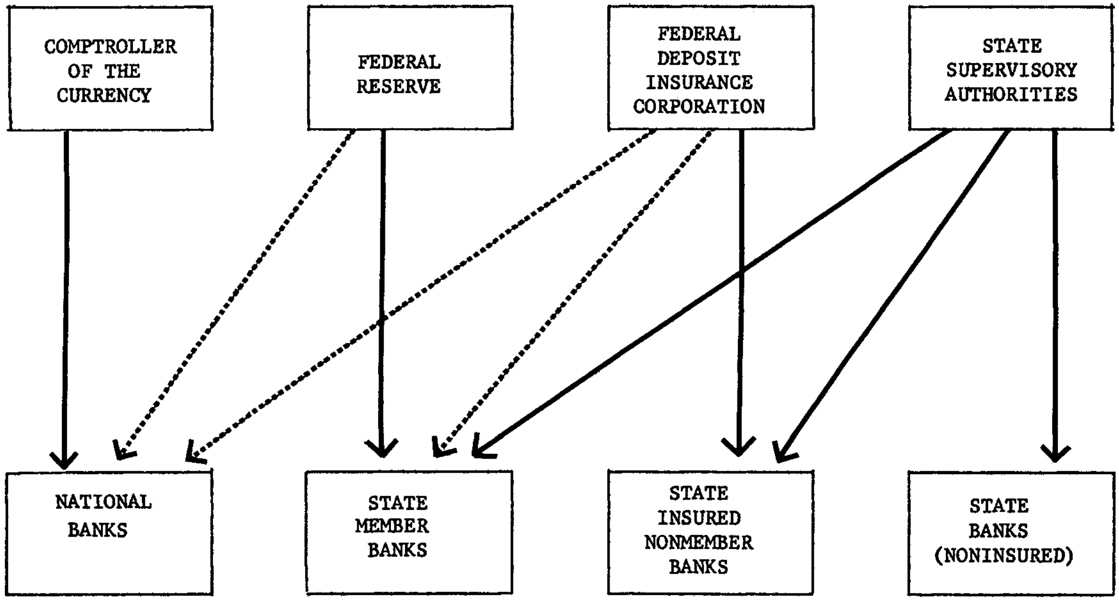
EXHIBIT IV

ALLOCATION OF AUTHORITY TO EXAMINE SUBSEQUENT TO 1933



POWER TO EXAMINE

POWER TO EXAMINE AUTHORIZED, BUT NOT ORDINARILY EXERCISED

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SUPERVISION OF THE COMMERCIAL BANKING SYSTEM
Principal Relationships

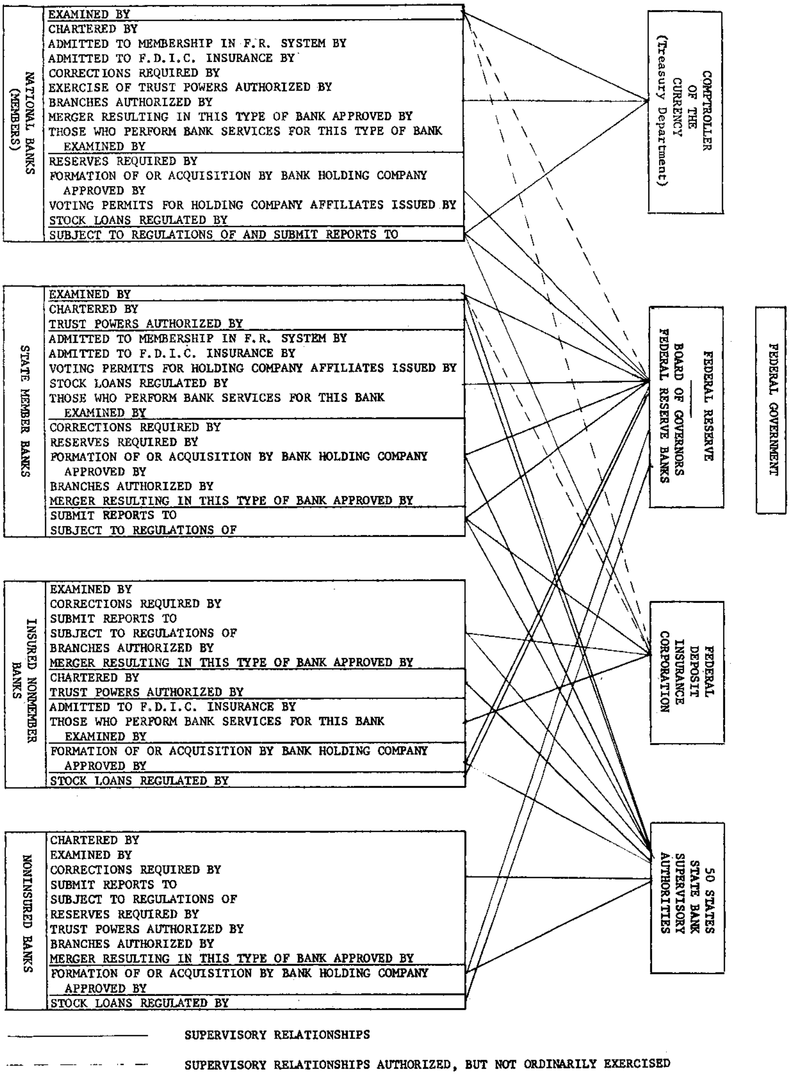

EXHIBIT V

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Reserve must seek permission of the Board of Governors to exercise any trust powers not being exercised at the time of its admission to membership. Also, State-chartered nonmember banks whose deposits are insured by the F.D.I.C. must obtain the consent of the F.D.I.C. to exercise any trust powers not exercised at the time of the issuance of the certificate of insurance.

Mergers are approved by the State if the resulting bank is a State bank. In addition, any merger involving insured banks must have the approval of the Federal agency which will actually examine the resulting bank after receiving the views of the two other Federal supervisory agencies and the Attorney General. Bank holding company formations and acquisitions *may* need State approval but *must* have the approval of the Federal Reserve; and branches need the approval of each supervisory agency which actually examines the bank.

Any corporation which acquires control of a bank which is a member of the Federal Reserve, regardless of whether it is a National or State bank, must apply to the Board of Governors of the Federal Reserve for a permit before it can vote the stock of the member bank.

All banks are subject to the limitations of the regulation of the Federal Reserve regarding loans which are secured by stock and are for the purpose of purchasing or carrying stocks registered on a National Securities Exchange.

Any "Bank Service Corporation" or any other corporation or individual which performs bank services for any insured bank must give assurances, in addition to those given by the bank, that the performance of the services will be subject to the regulation and examination of the Federal supervisory authority which actually examines the bank for which the services are performed.

Finally, National banks are closed by the Comptroller of Currency, but are liquidated by the F.D.I.C. and State-chartered banks are closed and liquidated by the State supervisory authority, although upon request of the State authority the F.D.I.C. may act as receiver for insured State banks.

Now that we have examined the statutory duties of each of the Federal Supervisory agencies, it would be well to look for a moment to see who actually does the administrative chores.

Each of the three Federal agencies has a Washington office, with staff members engaged in various aspects of supervisory work. The Comptroller of the Currency has a Regional Chief National Bank Examiner with a staff of examiners in each of the fourteen National

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bank regions. The F.D.I.C. has twelve district Supervising Examiners with their respective staffs. Each of the twelve Federal Reserve Banks has an examination department, headed by a Vice President, which is charged with the responsibility of supervising the member banks in that particular district. The National bank regions and the F.D.I.C. districts are not co-terminus with the Federal Reserve districts since there are no split States in the former. Also, the National bank regions and the F.D.I.C. districts are not co-terminus since they do not include the same States. To give you a somewhat extreme example of this, if a National bank in Evansville, Indiana, — which would be subject to the regulations of all three Federal agencies — desired an explanation of a certain regulation, a National bank regulation would be explained by the Regional Chief National Bank Examiner in Cleveland, Ohio; a Federal Reserve regulation would be explained by the Vice President in charge of examination at the Federal Reserve Bank of St. Louis, Missouri; and an F.D.I.C. regulation would be explained by the F.D.I.C. District Supervising Examiner in Madison, Wisconsin.

As a rule, the central office of each supervisory authority directs in general and reviews in detail the process of examination as a part of its supervisory activity. The offices coordinate the activities of the district offices with a view to uniformity of procedures. The district offices may operate with a greater or lesser degree of autonomy, more marked in the case of Federal Reserve Banks, and take steps to secure some corrections without direction from the central office. Through the district offices the operations of field examiners are coordinated with a view to uniformity.

Thus, the allocation of supervisory responsibilities today was not created in its present state by one all-encompassing statute. Much of the enabling legislation was enacted under the pressure of economic crisis and reflects the varying needs and beliefs of a span of over 100 years.

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Techniques of Bank Examination

by

Earl H. Chapin

THE objective of bank examinations is the appraisal of individual banks. It is reached by the technique of verifying that the books show all assets and liabilities at correct, or at least prudent, valuation, checking compliance with applicable laws; assessing the adequacy of capital and managerial ability and capacity. Examination, therefore, is essentially a finding of facts and an expression of judgment. It is *not* an audit nor, contrary to popular opinion, is it a search for embezzlements. While some defalcations may be disclosed by an examination such discovery is generally incidental and often accidental.

Disclosure, however, is often the result of surprise and this element has an important place in examining techniques. Thus, morning starts are preferred because of this condition and also because the examiner is better situated to establish effective control over the assets and the records that may be subject to manipulation. Normally, this entails the sealing of all vaults or vault compartments containing cash, securities and similar valuables, and taking physical control of counter assets, deposit ledgers, and the like. Generally, however, the time element restricts morning starts to the smaller banks. In the medium sized and larger banks the volume does not permit establishment of appropriate controls by the time the bank opens its doors for normal business. Consequently, the majority of our starts are after closing hour in the afternoon. This permits the examiner to work as long as necessary to complete the verification of items the bank needs for the opening of business the following morning. With control effected, verification then goes forward, and while it might be repeated that an examination is not an audit, it does follow auditing methods and procedures in proceeding through a systematic review of balance sheet items.

Cash

A physical count of cash is made in the presence of each individual teller. The results are recapped on a cash sheet with a description of any balancing items in the teller's cage, after which his cash is placed under seal. This is done, of course, to prevent his cash from being

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substituted to cover a shortage elsewhere. After all tellers are balanced and the reserve cash is counted the examiner checks the total resulting figure with the bank's general control. Even after the cash is balanced it is usually desirable to leave it under seal until the following morning.

Clearings and Cash Items

The total of checks on other local banks which are being processed for clearing and collection the following day are noted and later checked with the Reserve Bank's daily statement. All return items are scrutinized for the next few days to determine that all checks were paid or, if returned, the reasons therefor. Other cash items, including those not in process of collection (i.e., return items, bookkeepers' kickbacks, checks held to avoid overdraft, and so on) are singled out for special attention. Frequently, they include "loss" items and they must be described by the examiner in sufficient detail so their disposition may be checked at a later date.

Due from Banks

These are deposits carried with other banks and include the reserve account. Statements are obtained from those banks in order that the accounts may be reconciled. All open items must be accounted for, and all return items intercepted and reviewed for a period of four or five days. The counterpart liability of this account is *Due to Banks*. These are deposits made by other banks. Statements are sent each bank together with a request for verification. After the account has been reconciled, the form is signed by an officer and returned to the examiner. Open items on these accounts must also be accounted for.

Deposit Ledgers

Trial balances are recapped and balanced against the general ledger control. Overdrafts, large balances and public funds are listed and accounts scanned for income accounts, accounts with unusual activity in the form of large deposits and withdrawals but with only a small daily balance representing possible payment against uncollected funds. Determination is made as to whether dormant accounts are properly segregated and controlled. Where internal controls are weak or inadequate there are various procedures that are occasionally used to detect irregular practices.

Securities

All banks have a bond ledger containing a complete description of every issue held. This information is transcribed on bond line cards by

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the examiner and balanced against the general ledger control. A physical count is then made of the bonds on hand and those not on hand are accounted for by direct verification with holder. Issues acquired since the previous examination are checked for proper recordation.

At this point we might briefly note the Uniform Agreement which the three Federal supervisory agencies and many State Banking Departments adopted for the establishment of uniform standards and classifications for loans and investments. Bonds are classified by quality and the Agreement stipulates the manner in which depreciation in the account is to be treated. This is a key part of the examiner's work for proper or prudent valuation of an asset is essential. As part of this analysis schedules are made of maturities, classes and ratings. The examiner also checks for legal eligibility, concentration of issues and trading for profit. Under the Uniform Agreement, the treatment of securities profits in bank examinations provides that "Until losses have been written off and adequate reserves established, the use of profits from the sale of securities for any purpose other than those, will not be approved".

Loans (In General)

This brings us to the most important part of the examination where the ability of management is especially tested. Here, as in the case of investments, present standards of appraisal are based on the Uniform Agreement and here again a large element of the examiner's work will be valuation — that is, requiring a loan to be written off or carried at a reduced value where circumstances so justify.

Instalment Loans

This is a highly specialized volume operation for which traditional credit yardsticks are not applicable, and our techniques are shaped accordingly. Briefly. we look at (1) general credit policies as reflected in down-payments, terms, delinquencies, repossessions and losses; (2) collection policies (i.e., bank's practice for follow-up on past due notes) and (3) whether adequate internal safeguards and controls are provided. Preliminary to this appraisal, we obtain control of notes and payment cards, list the outstandings and balance to the control.

Real Estate Loans

By this I mean loans secured by real estate which is the largest single class of loans held by our State member banks. They constitute over one-fourth of total loans outstanding. Here the technique is to

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balance to the general ledger control, transcribe individual loans on line cards and to review the supporting papers, including mortgages, certificates of title, insurance policies, and appraisals.

Collateral Loans

These vary considerably with the locale. In country banks collateral, other than real estate, consists principally of liens on livestock, farm machinery or crops; in the city banks, stocks and bonds, assigned life insurance, deeds of trust and like property. These loans are transcribed on line cards, collateral checked and valued or quality estimated. Loans on stock and bond collateral require special attention for compliance with the particular — and often complex — provisions of law relating to such security.

Unsecured Loans

As would be expected, the examiner generally devotes most of his time in developing information on and the analysis of unsecured loans since such loans generally constitute the greater risks to the bank. Normally, after the loans are run and balanced, the examiner will review the "liability ledger" from which he will establish the lines of credit to be posted on his line cards. The liability ledger is one of the most important records in the bank. It contains the borrowing history of each of the bank's borrowers. It indicates whether the loan is new, old, seasonal or continuous, its high and low point and whether or not borrower has other indebtedness to the bank.

After transcribing the information from the liability ledger, the examiner then posts the individual notes to his line cards, taking off pertinent information. He then releases the notes and begins his review of the credit files, which vary considerably from bank to bank and are often supplemented by information supplied by the banker. In the larger banks, the credit files usually contain all the necessary facts and figures to support the credit. This information, in most instances, is sufficient to enable the examiner to "pass" many loans without further review.

With all available loan information in hand, the examiner will make his preliminary review of all loan line cards. He ties in related lines, recaps past due loans, flags concentrations and "passes" those lines in which, in his opinion, the ultimate repayment seems reasonably assured. Weaker credits, inadequately secured loans, or those developing unfavorable trends are held out for further discussion with the bank's officers.

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Bank Premises and Furniture and Fixtures

Transactions affecting these fixed asset accounts are transcribed and the former is checked for compliance with law. The investment is viewed in the light of the bank's capital position, whether adequate depreciation is being taken and if the bank has adequate insurance coverage in relation to the value of the asset.

Other Assets

These assets are the "catch-all" accounts and frequently include items of questionable value. Hence, they require particular attention and careful review to determine whether or not they represent sound value.

Earnings

The bank's income and expense accounts and related capital and reserve accounts are transcribed and carefully analyzed. In the language of the examiner this is "working the earnings". To me, this has always been one of the more interesting and satisfying tasks. For, with the greatly varying accounting systems in use in banks, it is always a challenge to analyze and balance the earnings schedule which is prepared from the operating accounts. The respective items of income and expense are carefully compared with previous years' figures for operating trends and the resulting ratios of that bank are then compared with the average ratios of other banks of comparable size. The bank's dividend policy is reviewed and checked for compliance with the law.

There are many other steps to be taken to complete the examination, including a review of the bank's fidelity insurance coverage, directors' minutes, salaries of personnel, an analysis of stockholdings and a review of the economic characteristics of the community and of the competitive situation.

Now comes the intermediate analysis — loans are discussed with the bank's executive officers and classification of assets determined. The results are carefully weighed in the light of capital protection, with investment in fixed assets receiving appropriate consideration. Earnings and dividends are considered in relation to capital adequacy. Retained earnings are assessed in the light of growth and other corporate responsibilities. A very important aspect of consideration is the analysis of the bank's liquidity position (i.e., cash and short-term securities of investment quality) in relation to the deposit structure.

As we progressed through the examination, each step provided some

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indication of the capacity of management in the light of its resourcefulness in handling problem situations as well as indicating the adequacy or inadequacy of records, systems and internal controls.

These conclusions provide the yardstick for the measurement of the bank's overall condition and for comparing the results with those of other banks. Problems, if any, have been determined and the examiner is now prepared to discuss his findings with the bank's directors with whom rests the responsibility for the formulation of the bank's policies. This is a practice of long standing with this Reserve Bank. It gives the directors first hand information as to the examiner's conclusions and an opportunity to take action without waiting for receipt of the report of examination. If no action is required, the directors are always interested in discussing ways and means of improving the bank's operations. On the other hand, it is generally the only contact the examiner has with this group and it affords him an opportunity to appraise their qualities and the support they give the active management.

As I mentioned earlier, the examiner is concerned with facts and estimates based on fact. Sometimes adverse findings of fact can be and are immediately corrected. Needless to say, there are many situations where the opposite is true and which require more extended effort by the supervisory authorities.

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Review and Appraisal

by

Wilbur H. Isbell

I *Appraisal*

APPRAISAL begins when the field examiner and his assistants commence an examination and is a process that continues during the examination, and until the report is mailed to the bank and the Board in Washington. In fact, it does not end at that point. The Board's Division of Examinations has a staff of review examiners and experienced specialists which review the reports and transmittal correspondence. As has been previously brought out, the authority for supervision is vested in the Board of Governors. The Board determines broad supervisory policies. The bank examination function has been delegated to the Federal Reserve Banks. The reports and results of examination activities are reviewed and appraised by the Board's staff to assure the Board that its responsibility in the field of bank supervision is being faithfully discharged.

The field examiner appraises the assets of a bank, the qualifications of its officers, directors and employees, trends in the bank's operations and compliance by the bank with the laws, rules and regulations to which it is subject. He then must prepare and submit a report containing factual schedules, comments, criticisms, recommendations and, of course, any commitments obtained from the bank's officers and directors to strengthen weak loans or to eliminate unsatisfactory conditions or trends that may have been disclosed during the examination.

The examiner's report must be accurate and contain a clear summary of his appraisal of the condition of a bank as of the close of business on a given day. His responsibility in the preparation of a report is a grave one since it is the prime source of information upon which the officials in supervision rely and becomes their tool, or basis, for seeking corrective action from banks or taking disciplinary action against them.

Notwithstanding the qualifications, competence and responsibilities of the bank examiner, there is still a major area left for the examination officers of the Reserve Bank. A supervisor would be the first to ac-

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knowledge that an experienced examiner, particularly in problem situations, makes his job easier and often has presented the needs of the bank in such a way that there is little need for action other than active support for the corrective measures suggested before the examiner left the bank. However, all areas of action involving an exercise of judgment are not clearly definable. All the banks accept deposits and pay checks but the forms of deposit tickets and checks are not alike or standardized. Likewise, do the operations of these banks and their assets vary in quality — all the way from practically riskless to worthless. The term practically riskless is used because banking is risk taking. If we were to attempt to classify all the risk — and in examination language to "classify" is to mark as substandard or worse — we would classify all the loans. We do note, however, those in which there seems to be more than an ordinary banking risk. Reviewing officers also keep a sharp eye on the capital account and ascertain that profits are being conserved as it is this account that will have to absorb the "real" risk in the loan account sooner or later.

Review and appraisal continues in the Examination Department at the Reserve Bank. This may be done by a senior examiner, a review examiner, a junior officer, or by the Vice-President in charge. Reports of examination prepared by the bank examiner are critically reviewed to determine the adequacy and appropriateness of his summary and to inform the Department's officers concerning the characteristics of the bank's assets, its liabilities, its trust and other corporate responsibilities, its management — as well as its history and prospects, its customers and community. The reviewing officers look for important facts or developments, weigh them against the performance of all banks and come to a judgment as to supervisory action, if any, that is required in a particular situation.

In making an appraisal of a bank's condition the supervisory officer gives much attention to the bank's loans, its lending procedures, its collection program in trying to determine the soundness of its lending function. We have noted that banking is risk taking. Aside from large defalcations, banks only infrequently experience large losses in trust department operations, from bad checks, forgeries, even bond accounts (except where it is advantageous tax-wise to do so) but this is not the case in the loan operation. (Just last month the newspapers carried accounts of an $800,000 "sick" loan on a shopping center development which a local bank was trying to collect, and in the face of $250,000 in mechanics liens, which are

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always prior to the real estate mortgage liens). Loans, therefore, are the heart of the banking business.

In appraising the lending operation, of course, an attempt is made to determine its present status, and then to watch for evidences of change in lending policies and trends. In making such critical analyses, supervision is sometimes tagged as being against loans. Of course, this is not so; a sound profitable lending operation in every bank is the hope and goal of all bankers, and bank supervisors. Every competent examining officer must "concede the dog some fleas" and seek to avoid becoming bogged down in inconsequentials. Accordingly, there is no excitement when a weak loan or two shows up in the examination report of a bank where the management knows what it is doing and probably had a good reason for making the loan. In this situation examiners would ordinarily expect to not see these loans in the succeeding report. They would probably be reduced in amount or additional security or support obtained. If, however, the next report showed no change in these credits and a few additional loans subjected to examiner criticism, we would sharpen our appraisal and try to determine whether there had been a weakening in the loan servicing procedures or in the bank's basic lending policies. Thus, it is one thing for a credit to deteriorate and quite another to find the bank is making weak loans. For if the bank has made a weak loan, policy is reflected, whereas, if a credit went bad an entirely different set of circumstances is involved.

During the past year the investment or securities account has received increasingly important scrutiny in the review and appraisal process as the banks reached for higher yields. This may well be the inevitable consequence of a previous decision to go into the market and literally purchase money for investment, in the form of savings and other time deposits. Some banks have been very selective in acquiring municipal securities to obtain tax free income and thus enhance gross operating revenues. Unfortunately, a few have just purchased all or a part of a bond salesman's inventory and with little thought as to quality or grade of municipal issues, whether such obligations have widespread or limited distribution and with little regard as to whether these, like other bank investments, must provide appropriate primary and secondary reserves against the deposit liabilities. These two asset categories—loans and investments—command the most attention in review as they are the principal sources of both income and RISK.

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On the basis of the examiner's classification of assets, a close appraisal of the trends in the assets acquired and progress made in strengthening or eliminating weak credits and all measured against a capital account which, as we said earlier, will eventually have to absorb the "real" risk, a judgment or appraisal will be made as to the quality of the bank's assets. A rating is placed on this factor and is determined from the actual or potential seriousness of the problems in the assets.

A closely related appraisal then requiring considerable attention from supervisory officers is that of the adequacy of bank capital. Always reviewed in every examination report passing through the office is the adequacy of capital to (a) the volume of marginal and inferior quality assets (b) volume of deposits and (c) volume of risk assets. Here too, supervision is interested in the bank's policies with respect to providing and maintaining adequate capital protection. This involves dividend policies, expense control, earnings retention and the bank's record in these important areas of operation. This analysis will provide some basis as to whether the bank is providing, and may be expected to provide, protection and backing for its operations and future growth.

This in turn brings us to the appraisal of the management. The order in which these appraisal factors have been presented in this discussion are not indicative of their importance, because the management factor is the most important. Logic, dictates, however, that it be appraised in this order as the competency, ability and soundness of management policies and decisions are all reflected in the asset condition and in the capital protection that has been conserved and built up to support the bank's business. Management, from the supervisory standpoint, is the board of directors. The banking laws are essentially all the same in this respect and provide that "the bank shall be managed by a board of directors". Usually a bank is less than the best it could be, or should be, if it is "run by any other" i.e., by a competitor, influential depositor or even a one man banker. Of course, a bank must have leadership and it normally comes from a president or chairman elected from the board of directors and to which some of its *duties* have been delegated. It will be noted that *duties* was emphasized as the courts, through the years, have scrupulously held that directors cannot delegate responsibilities. A strong bank president supported by an aggressive, interested board of directors is a great and admirable combination in the banking world today.

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Unfortunately, some active officers and some boards of directors lack the competence to meet all their responsibilities or to cope with the problems with which they are, or may likely become, confronted. Also lacking in banking generally is adequate management succession; particularly in the smaller unit banks which so characterize the non-branching States in our district. Too, many directors are prone to read about this subject, and even occasionally discuss it, but dismiss it with the thought that this problem "will not strike us". We know of course by now that it has struck and is striking in our district.

II Action

Careful review and appraisal of the three important factors of asset quality, capital adequacy and the ability of management in administering the bank's affairs can be counted on to provide a trustworthy basis for a judgment as to the general condition of a bank. Other factors which are never overlooked in analyzing bank condition are: the composition of the loan account, the general quality of the bank's clientele, any unusual developments in deposits, loans or investments and the economic environment in which the bank is operating. Seasonal variations are well known to us, we must be alert to any economic risk in a particular community, and we must therefore appraise the nature of its industry and agricultural activity at each examination.

Analysis then brings us to *supervisory action.* About half of the letters accompanying reports of examination are routine transmittals containing no requests or recommendations to the banks. Another important total requests notification that an excess loan has been reduced to comply with law, as promised, or that steps have been taken to avoid a recurrence of a violation of a law or regulation, which has been disclosed, governing the bank's operation.

It is with regard to the banks below these two groups that bank supervisors "earn their salt" and have opportunity to make a contribution to banking. The severity of a bank's problems dictates action taken and varies with the circumstances of each situation. A noticeable increase in classified loans would result in a transmittal letter urging the directors to review the bank's lending policies and to take such action as is necessary to obtain additional security for weak loans, reductions or definite repayment programs. However, if the primary

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asset problem was severe and there were additional problems apparent in large lines, bond concentrations, coupled with a heavy investment in fixed assets, the urgency to improve the lending standards would be emphasized. Should the asset condition be determined to be unsatisfactory, the bank would be requested to make reports at 30- or 60-day intervals on the status of important criticized loans in order that its progress in eliminating the unsatisfactory conditions could be reviewed, appraised and followed.

In those few situations, but which unfortunately still develop, in which the bank's asset quality is viewed as hazardous, the directors are called into conference, usually convened jointly with State banking authorities, at which time definite conditions are imposed as to steps that must be taken to assure that any unsafe and unsatisfactory practices will be discontinued, and to restore the operation to a more conventional and sound basis as soon as possible.

In those cases where the examination disclosed a critical situation, by reason of serious capital impairment or otherwise, the Board of Governors is advised as to the general condition of the bank as soon as practical and without waiting for the submission of the complete report. Discussions follow with the officers in the Division of Examinations, either over the telephone or when visiting the Board's offices, as to the progress being made toward eliminating unsatisfactory conditions and the Board is kept advised of all significant developments.

Supervisory requirements and conditions in problem bank situations are subjected to close follow-up action. Reports on disposition of loans are required and as to the status of each weak loan, often at 30-day intervals. The most effective tool available for enforcing corrective measures is the special examination. Bankers and bank directors, especially in the smaller towns, do not like questions from their customers as to why the examiners are in the bank so often. Aside from this psychological factor, this procedure is also supervision working closely with a board of directors in a mutual problem and with the directors who have the greatest interest in seeing the condition of the bank show improvement. However, if improvement is not forthcoming, if speculative tendencies, bad credit judgment or other management defections and weaknesses persist, it sometimes becomes necessary to replace, or at least strengthen, the management. If this is not possible by suasion, supervision is then obliged to avail itself of the provisions of Section 30 of the Banking Act of 1933 which stipulate

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procedure for the removal of directors and officers who have continued to violate any law relating to the bank or shall have continued unsafe and unsound practices in conducting the business of the bank, after formal warning.

Finally, supervision seeks to foster an effectively functioning and solvent banking system in which the public interest is properly safeguarded. Eddie Cantor, long ago reminded, after reading about a defunct financial institution, that the public is more interested in the return *of* its money than the return *on* its money. Supervision holds that view. It is no substitute for good bank management, but it hopes to make some contribution to it.

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