

MAY 31, 1923.

THE WORK OF EXAMINING BANKS

BY

J. G. DEVER, MANAGER,

EXAMINATION DIVISION, F. R. AGENT'S DEPARTMENT,

FEDERAL RESERVE BANK OF ST. LOUIS.

---

(Copies handed to Messrs. Martin, Attebery, Stewart, Novy,  
Glasgow, Bailey, Wittenberg, Geiger and  
Steinman.)

*EMS*

In an examination, three considerations are of paramount importance: First, is the bank solvent? Second, are the depositors' interests properly safeguarded? Third, is the law being duly observed? In determining these matters, it is assumed that a sufficient amount of the bank's assets are liquid in order to provide for usual demands in the ordinary course of business. Insolvency is distinguished from impairment of capital, the former occurring only after capital, surplus and profits have been entirely eliminated or in other words, when the bank no longer has good assets sufficient to pay off all liabilities except those to stockholders. A bank may be forced to close its doors, while solvent, due to frozen assets and inability to maintain sufficient cash reserves to take care of demands made upon it. On the other hand, it is possible for a bank to continue operations, even tho insolvent, if sufficient reserves are maintained, provided that fact is hidden from the authorities.

Too often, personal and selfish interests dictate policies to the detriment of the bank's welfare. Pride in a large amount of business, the desire for a greater return on investment, and efforts to satisfy dividend expectations of other stockholders, are frequently factors in swaying the judgment of managing officers from fundamental principles involving investment of the funds of others. Even when conditions are dangerous, directors hesitate to suspend dividends, fearing the public will form an unfavorable opinion concerning the bank's condition and withdraw funds.

In nearly every bank are to be found at least one or more favored borrowers, who, through personal magnetism or some lapse on the part of management, are using more than their share of the bank's funds. When the management of the bank regards itself in the role of a trusted custodian of the funds of others, and not merely conducting their own private enterprise for profit, there is little probability that the bank will become dangerously involved, even under unfavorable conditions or during times of stress. They should realize that the nursing of local infant industries and even the legitimate financial needs of the community are of secondary importance, if their promotion threatens the security of funds entrusted to the bank by its customers.

The examiner can perform one of the most important duties of his office in the directors' meeting. It is the directors who bear the responsibility of the bank's welfare, and if conditions are unsatisfactory, they should be minutely informed regarding unsound practices or dangerous tendencies. Usually a bank is dominated by one or two directors through ownership of a considerable portion of stock, yet other directors may not deny an equal share of responsibility because of this fact.

During the course of the meeting, it should prove beneficial to ask each director some question regarding the bank's affairs, to stimulate his interest and determine his knowledge concerning its condition. Ask several directors if there are any conditions or practices prevalent of which they do not approve, and, if so, why they have not insisted upon a correction. There may be criticisms present, unknown to examiner, which will be brought to light, if directors are encouraged to discuss the bank's affairs freely.

When serious conditions are revealed, it is usually the plea of one or more directors that they were unaware of true conditions, or that, if they had misgivings, they permitted themselves to be overruled without serious protest. Urge them to greater activity in the performance of their duty. Are they permitting the active officers to usurp their authority? It is unfair to all concerned that

one man bear all the responsibility for the bank's loans and investments.

Chief among the examiner's attributes should be foresight and intuition. If, when confronted with unwise tendencies, he hangs out a red flag, or, more important, if he has eloquence enough to awaken the directors to full realization and action, he has performed a valuable service. In a bank of quickened conscience, it is improbable that the examiner will discover many excessive loans or large lines of credit, payment of which hangs upon the slender thread of remote possibility.

If examiner is to secure the best results, he should have some ability at character reading and retain, if possible, the banker's confidence. As conclusions are based to a large extent upon what the official tells him, it is unwise to antagonize the official unnecessarily. Some men are more sensitive to criticism than others and few are free to admit losses, so the examiner's attitude must be congenially inquisitory if he is to avoid congealing the fount of information at its main source.

Directors should welcome the examiner as their best source of information concerning the true condition of the bank. It provides a check on their officers, which, owing to their own lack of experience with banking details, they could not make even in their own Committee Examination. Although an examination by directors is usually perfunctory as to details, the clerical work frequently being done by officers and employees, it is very important, especially in regard to credits. Through their knowledge of local borrowers they should be in better position in many ways to determine bad loans than the examiner, who, through lack of financial statements and other credit information, may be altogether dependent on the officer's estimates of net worth. It should prove very beneficial when examiner can arrange for a committee of directors to assist in the examination, particularly with regard to consideration of the loans.

When bank arrives at a dangerous and critical condition, it is usually due to inefficient management and a difficult task confronts the examiner. Experienced examiners agree that seldom does a bank recover and prosper under the same management that is responsible for its downfall. It is usually very difficult to make directors realize the necessity of a change, and often when that point is reached it is too late to save the bank. It is no doubt a natural impulse for a board of directors to resent criticism of their chosen representative, coworker for many years perhaps, especially when the examiner is a stranger, although he comes vested with governmental authority. It probably does seem presumptuous to the lay mind and many directors come within this classification for an outsider to suddenly appear within their midst and after a few hours investigation, confront them with startling disclosures and demands regarding their institution.

Such corrections as can be made immediately should be made during examination.

Minutes of directors meetings, among other things, should show approval of all loans, preferably by mentioning numbers. This is important where state law makes directors liable for violations of the loan limit in case of loss. Minutes should also set out such matters as dividend declarations, charge-offs authorized, salaries of officers, etc. It is often advantageous to state in report the date on which regular monthly meetings of the Board are held.

Report should set out examiner's opinion as to solvency, unimpairment of

capital and surplus, liquidity of assets; elements of danger and unsound tendencies, if any, and general comment as to capability of management. When criticisms are made, take care to see that they are just beyond question and be prepared to defend them in case exceptions are taken. Examiner should also be prepared to offer a remedy for conditions criticised.

Remarks concerning an individual officer should be reserved for the confidential section of report. Words of high praise for an official or employee would prove embarrassing, should said official eventually prove to be an embezzler or forger.

While the examiner's duties do not primarily include those of a detective, yet verification of details should be carefully made. Individual ledger accounts of officers and employees should be scrutinized for transactions exceeding their apparent means. If they are heavy borrowers, actual interest payments can be checked to the journal. Defaults are frequently brought to light during the culprit's enforced or voluntary vacation; and if examiner's suspicions become aroused, the matter of annual vacations may be taken into consideration. Is the bond covering officers and employees large enough? Too often, no. Even in a small bank, a large sum may be abstracted before disclosure; and in the great majority of cases of misapplication, the amount of bond has been woefully insufficient. Burglary insurance should be sufficient to cover all cash and securities on hand, including safekeeping items.

In the detection of criminality, it would seem, in view of the number of cases where shortages are carried for perhaps years before discovery, that examiner can render a substantial service by recommending proper bookkeeping systems and internal checks that should automatically uncover fraud.

Federal Reserve Examiners have authority to examine officers, directors and employees of member banks on oath. This power is not ordinarily exercised. However, state examiners in Missouri place directors on oath at each meeting held with them.

Examiner should call for last report of state or clearing house examiner, also copies of correspondence from supervising authorities in regard to criticisms, and see whether all requirements have been met satisfactorily.

Have conditions of membership been fulfilled? This matter should be carefully investigated by examiner while he is in the bank.

**CASH.** The first step in an examination is usually made by counting the cash on hand. This can be done by checking and verifying items against cash balance sheet of teller. Total cash should of course agree with amount shown on daily statement. It is not considered necessary to count each bill in a package of small denomination currency, such as 1's, 2's and 5's. One package can be verified and other packages of like content inspected and compared. Packages containing bills of larger denominations should be carefully counted, although this rule may be modified in the case of banks of large size. Silver stacked in tray can be accurately figured by comparison; and silver in sacks can be satisfactorily estimated by comparative weight. Shortages in cash have occasionally been switched to ledgers or other accounts after examiner makes his appearance. This can be usually discovered by observing the average amount of cash on hand for the past several days. If any great change appears

on date of examination, the cause should be determined, although it may have been regularly caused by payroll or other unusual demand. Particular care should be exercised if the daily statement and general ledger are not kept posted up to date. In a number of cases, this work has been purposely neglected, in order that false entries might be made in case of an unexpected examination. In one bank, cashier had been showing a large amount of cash on hand and books were not posted to date. When examiner appeared, a switch was made to "Due from Banks" showing mail remittances. Immediately after examiner left, wire transfers were ordered and credits followed, reconciliation appearing regular. There are so many ways to hide discrepancies in books and accounts, however, that examiner is fortunate to locate a cash shortage on a clever manipulator, unless totals misapplied have grown so large that he has become confused or careless.

**CLEARINGS.** Tracer blanks are usually enclosed with items and packages placed under seal. Totals may be verified by drawee bank, and space is provided for list of, and reasons for, checks returned. Where the mass of checks is not too large, examiner may inspect larger items with an executive officer of the bank, and "kites" possibly discovered in this manner. A shortage was brought to light in a St. Louis bank by this method; Employee received savings deposits and made entries in ledgers. \$1,000. was charged to an inactive savings account and money deposited in another bank. Employee was purchasing liberty bonds personally at a discount from customers of the bank. When examiners appeared, employee had on hand some liberty bonds purchased with bank's money and to hide the irregular purchase, took these out and inserted his own check on another bank in the clearings for a substantial amount. The check was good and was honored, but after the discovery of an employee's check for a large amount in the clearings, close investigation disclosed the shortage in savings account.

**LOANS AND DISCOUNTS.** As this item usually includes the major part of the banks assets, and solvency depends upon their collectibility, examiner will spend the greater part of his time in an appraisal of same. Consideration should be given as to the general character of loans and whether they are well distributed, both as to classes of borrowers and amounts. The principal industries of the community, crop and business conditions, and local situation generally should be ascertained. If bank is in an extended condition, particular attention should be given to advances made to non-customers of the bank. This can be largely determined by inspecting individual ledgers to observe average balances carried, if any.

Loans to directors, officers and employees and their enterprises should be carefully scrutinized, as they are in position to abuse the borrowing privilege. It is to be assumed that directors are chosen because of their financial ability and standing in the community, but this should not excuse them from complying with customary requirements and safeguards governing extensions of credit. The mere fact of being a director appears to give that person, in some banks, a right-of-way to not less and frequently more than the maximum amount of credit contemplated by law. The boneyard of banks contains the ghastly remains of many an institution, whose downfall was caused by unwise loans to its officers and directors. Some directors appear to hesitate before objecting to the unwarranted loans of other directors, perhaps because he himself desires further credit at a later date and desires to avoid a too close scrutiny of his own demands. Inasmuch as directors are presumed to be chosen on account of some financial standing, among other possible qualifications, there would seem to be no just reason why directors should not completely secure their own indebted-

ness. The moral obligation to do so is considered even greater than in the case of the outside borrower.

If examiner believes accommodation loans are held for the purpose of evading the loan limit, credits should be checked to the individual ledgers. This has also been done where it was desired to evade the 10% rediscount limit, although the combined loans did not exceed the state loan limit. Interest payments on notes at random and officers and directors obligations may be traced to the journal or profit account.

Some banks attempt to require that balances be maintained in proportion to the amount loaned. While balances thus carried cannot be regarded as an absolute proof of the full collectibility of loan, yet an inspection of same may give examiner some insight into the activity of borrower's business and his resources.

An estimate of the amount of paper eligible for rediscount will throw some light upon the question of liquidity and bank's ability to meet unusual demands, should occasion require.

Examiner should ascertain whether proper records are kept in this department, such as discount register, maturity tickler, liability ledger, interest received journal, rediscount record, etc.

The ability to detect forgeries is either a fine art or an example of rare good fortune. If doubt arises, reference can be made to the signature card or check file.

Extension of notes by interest payment is objectionable, especially so when directors are not given an opportunity to pass upon such renewal. Endorsements may also become invalid through carelessness in this connection. Examiner should condemn this practice and recommend that new notes be taken.

It would appear to be a short sighted policy to concentrate loans among a few large borrowers, aside from the risk involved, when a wider distribution would better serve the community and permit the needs of a larger number of customers being met. From a selfish standpoint, it would appear frequently to be a loss, as the larger borrowers frequently carry the smaller balances, especially in agricultural communities.

No bank is too small to keep on file some kind of credit information, and it is becoming more customary to require financial statements on large borrowers. Even in most rural sections, the prejudice against asking for these statements is being gradually overcome.

In considering loans, the two big oversize questions to be considered are: HOW and WHEN will they be liquidated. If the answers can be correctly ascertained, conclusions follow easily. If correctly applied, all of the paper held by the bank can be classified without serious difficulty.

One definition of a "capital" loan is where it is necessary for borrower to sell a fixed asset in order to liquidate current indebtedness; or reversely, where there

are not enough quick assets to accomplish the same result. Capital loans are frequently "slow" and if so, should be described under that classification. There are cases, however, where this is not true, as in the case of liquid collateral or sufficient endorsement securing the line. Where a loan can be liquidated upon short notice from whatever source, it cannot be termed "slow" although it may be criticised when, because of long standing, it assumes the aspect of a permanent loan. The holding of a reasonable amount of capital loans, not slow, if properly distributed both as to class and amount, would not seem subject to special criticism, if the just needs of other borrowers were properly served.

There are many loans which are obviously "slow" but it is not always easy to determine this classification. The time element is not always made a fixed rule and may vary according to the character of business. If one year was set as the point beyond which loans would be classed as slow, it can be seen that in rural communities, in time of crop failure, practically all farmers' loans would be slow. It would seem to be better policy to note whether under conditions existing, borrower is making reasonable progress toward the liquidation of his debt. Where a loan is improperly secured and ultimate payment depends upon moral risk, future success or other uncertain possibilities, and where total loss would result in case of maker's death, there may certainly be said to be an element of doubt. The estimation of a loss, when not admitted, and the classification of doubtful paper, are matters closely allied, and any distinction is frequently a fine point, classification depending upon the judgment of the individual examiner. When paper is doubtful, it should be the attitude of a conservative management to remove or at least set up a substantial reserve against same, as it cannot be with certainty relied upon to liquidate liabilities. It is sometimes wise to use the terms "apparent" or "probable", etc., where an exact conclusion cannot be reached, as examiner should not make positive statements that he cannot substantiate.

It has been said that when bank's criticised assets (slow, doubtful and loss, and bond depreciation) exceed the amount of capital, surplus and undivided profits, a situation is disclosed which requires prompt action on part of the management and close attention by supervising authorities; and this is an important point for examiner to bear in mind.

A loan may be criticised although not classified as slow, on account of its being too large, or of a capital nature, or for other reasons.

In considering and classifying paper as slow, if it is under rediscount with the Federal Reserve Bank, it should be given special attention.

In commenting on unsecured loans, if no financial statement is on file, that fact should be noted and an estimate secured of borrower's net worth.

By comparing financial statements of different periods and observing the upward or downward progress of borrower's liabilities to the bank by reference to the liability ledger, examiner can be assisted in his estimation of debtor's progress.

**STOCKS AND BONDS.** Securities are to be listed upon bond sheet, and present market values obtained from financial publications or quotation books. If a substantial depreciation exists, some arrangement should be made to take care of same.

Comptroller's instructions in regard to this matter have been to require a charge off at each examination amounting to not less than 25% of estimated depreciation.

**BANKING HOUSE, FURNITURE AND FIXTURES.** Take steps to learn whether these assets are carried on the books at a fair valuation; also if a reasonable amount of depreciation is provided for annually. Figure rate of return on investment, allowing a reasonable amount for banking room.

**OTHER REAL ESTATE.** A majority of the states provide that real estate cannot be purchased outright, except for purpose of banking room. Real Estate may be acquired, however, through foreclosure proceedings under mortgage, or in the securing of previous debt, in which cases bank is usually prohibited from holding same for more than a certain period, usually five years. In many jurisdictions, no penalty appears to attach, however for failure to dispose of same within the required time and although commissioner may criticize, he usually grants further time in which to eliminate same, if local conditions are not favorable for the sale of property at book value. In a great many cases, management does not make vigorous efforts to dispose of same.

**BANK ACCOUNTS.** Reconciliation is made by making a copy of reconciliation at end of previous month, then making a transcript of all debit and credit entries in the account from the first of the month to date. Dates of entries and nature of items should be shown. Drafts issued should be listed separately and numbered. Statement is then obtained from correspondent bank and final reconciliation made. Exceptions not promptly adjusted and returned items should be given close attention.

**COLLECTION OR TRANSIT ACCOUNT.** Items may be verified by tracer. Examine recent items for evidence of kiting. Where this practice is indulged in, it is a sure sign of difficulty - either the officer or employee is personally involved, or the bank is in an extended condition.

**CAPITAL STOCK.** Proof of outstanding stock is made by listing number of shares from stubs of stock certificate book. Certificates cancelled should be properly assigned, cancelled and attached to stubs. When a certificate has been lost or stolen, affidavit and indemnifying bond should be taken from stockholder, and attached to stub. See that no blank certificates have been removed from back of certificate book. List number of shares held by directors, and observe whether balance of stock is well distributed or closely held.

**UNDIVIDED PROFIT ACCOUNT, EARNINGS AND EXPENSES.** Check last report of earnings and dividends. Examine at least superficially expense distribution book. List charge-offs and recoveries, also date, rate and amount of dividends paid. Have previous dividends been legally paid, taking into consideration whether reserve was sufficient on date paid and whether earnings were sufficient considering possible losses in loans, and should regular dividends be continued?

**DEMAND DEPOSITS.** Nearly all banks now use loose leaf posting machines for keeping individual ledgers. Owing to the ease with which sheets may be abstracted, ledgers should be proved as soon as possible during the examination. If the current day's work has not been posted, it is sufficient to list balances and prove as of the day before. It is usually very difficult to discover a shortage in the individual

books. What protection is thrown around them? Do separate parties post ledger and statements? Does someone other than bookkeeper prove his ledger occasionally at irregular intervals? One man carried a considerable shortage over a period of years in a bank that used the passbook system. He held out deposits and always managed to balance passbook of those accounts himself. He was an officer and had access to both cages and individual books. When an account which he had manipulated threatened to become overdrawn, another deposit was diverted to that account. At first these irregularities were confined to a few large accounts, but later on it spread until about two hundred accounts were involved, and keeping up with all of them became a great burden. He was always on the job and never took a vacation. Finally, during an enforced leave of absence, disclosures were rapid and startling. What rate of interest is paid on open accounts? Investigate the inactive ledgers, if any, and see what safeguards are thrown around it.

**CERTIFICATES OF DEPOSIT.** Cancelled certificates are checked against register and open items listed to proof. This list is left with the bank under seal. At time of next examination, certificates cancelled since date of last examination are checked against list up to last item thereon, the remaining ones checked against certificate register. Open items are then listed to proof.

**CASHIERS CHECKS, DIVIDEND CHECKS AND CERTIFIED CHECKS.** Proceed as in the case of certificates of deposit.

**BILLS PAYABLE AND REDISCOUNTS.** Make list of separate notes, date, maturity, amount, interest rate and detailed list of collateral, if any. Verify with creditor bank. A bank without borrowed money will seldom be found in trouble. On the other hand, the bank with a large amount of borrowed money is seldom out of difficulty. If debts of this character exceed the bank's capital, observe whether this is caused by unusual demands against deposits, or from an expansion of loans or investments. Inflation to a dangerous degree can always be considered as more or less of a criticism against the management on account of poor distribution or non-liquidity of loans. Even in the case of crop failure or business depression, the careful banker will usually weather the storm without serious difficulty. A moderate amount of borrowed money should not be taken as an item of criticism, but the absence of it is a favorable sign. Seldom does a bank find itself in a critical condition without a very large amount of bills payable and rediscounts. Poor credit judgment and over expansion seem to be twin brothers and go hand in hand.

**EXAMINATIONS - AUDITS.** The main difference is that one is primarily an appraisal of assets, while the other is a verification of details. Examiner does not have the time to make as thorough an audit of some items as a public accountant, therefore examiner should urge bank to have audits made periodically. It is a protection that every director, especially if he is inactive, should insist upon.

**BOOKS AND CLERICAL WORK.** Examiner should observe whether all books of record are in satisfactory form and properly kept. Proof of all resources and liability accounts should be made by someone in the bank at least once a month. Examiner cannot hope to detect all irregularities, but he should recommend any change which will provide a better internal check.

Determine whether bank holds the required amount of stock in the Federal Reserve Bank. Check the last report of condition against the books.

**SAFEKEEPING.** A great many banks do not provide a proper record of items left for safekeeping. Some do not have any. The manner in which this record is usually kept provides a great opportunity for misapplication. Examiner should insist upon a proper record and check same with the customary care, whether or not a control account is carried upon the daily statement. Does bond cover loss from this source? It would appear that bank might as well assume full responsibility for these items and provide for their full protection, as bank will suffer loss of prestige and possible damage if they are not returned upon demand. If bank is pledging its customers' bonds for its own liabilities, ascertain whether they have been granted authority to do this. When a bank is forced to this means of securing its bills payable, it does not on first consideration, reflect favorably upon the liquidity or worth of its own assets.

**TRUST ACTIVITIES.** Set out powers granted, if any; and those exercised. Check all trust assets against ledger. Give particular attention if bank guarantees deposits of other banks, titles to real estate, issues surety bonds, etc.

It is sometimes useful to prepare a list of comparative figures, showing the trend of the main resources and liability accounts.

**RESERVES.** Ascertain whether reserve with Federal Reserve Bank is sufficient; also whether average for past thirty days was sufficient; and whether any dividends have been paid or new loans made while reserve was deficient.

**CLAYTON ACT.** Set out in report the names of any directors, officers or employees who are directors, officers or employees of other banks.

List in report any violations of law noted. Describe fully any law-suits in which the bank may be involved. Also ascertain if possible whether any director or officer is personally involved in such a way as might reflect unfavorably upon the bank.