MONTHLY REVIEW

Federal Reserve Bank examiners arrive to "open" an examination.

FEDERAL RESERVE BANK OF RICHMOND SEPTEMBER 1961

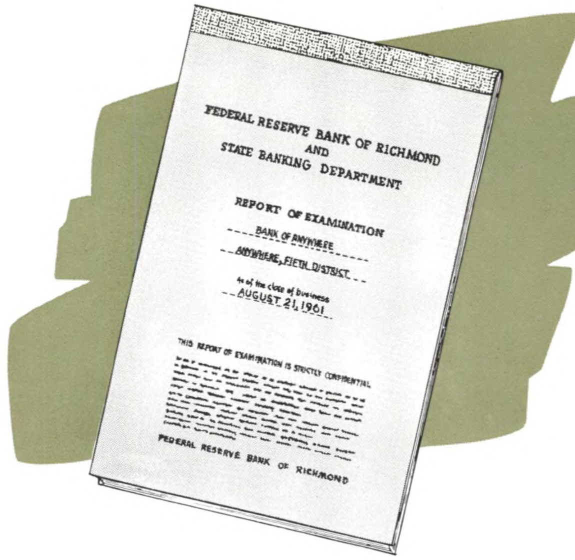
EXAMINATION OF COMMERCIAL BANKS

Cash verification is one of the first steps of an examination. Cash is kept under seal until balanced with general ledger.

Federal Reserve examiners perform one of the most important, though not well-known, functions of the Federal Reserve System—examination of commercial banks. With bulging brief cases and portable typewriters, they arrive unannounced at the door of each State member bank in this District, either well in advance of opening time or at about the closing hour, at least once in each calendar year.

Not too many years ago the job of reaching the bank was almost as difficult as the examination itself. Pioneer examiners relate interesting tales of travel by rented horse and buggy from some remote train station to an even more remote country bank. If the examination required more than one day, overnight accommodations might be obtainable only at a fourth-rate hotel, a village boarding house, or in the home of the banker.

The examiner's lot has changed with the coming of modern highways, widespread use of air travel, and establishment of motels. Many of the trips are now by the Bank's own cars; some others—particularly those to distant points not boasting air service—are by overnight Pullman. Locations once difficult to reach are now only a few hours away by airplane, and advent of the motel has brought adequate accommodations close to most banks.



OBJECTIVES The work and reports of Federal Reserve examiners have also changed materially over the years. Examinations during early days of the System were concerned almost exclusively with quality of loan accounts and eligibility of notes for rediscount at the Reserve Bank. Today the import of the preamble to the Federal Reserve Act, which states that one of the purposes of the Act is "to establish a more effective supervision of banking in the United States," is viewed in a different light—one that assigns a much broader scope to bank supervision. Briefly stated, the objective now in relation to an individual bank is to foster its maintenance in sound and solvent condition and under good management. With respect to all banks, the objective is to help maintain a banking system that can adapt itself to changing financial needs of a growing economy.

Banks are by nature quasi-public institutions since

Asset accounts as well as deposit and other liabilities are proved to controls prior to the examiner's evaluation of assets.

the public interest is closely entwined with their effective functioning and welfare. There are very few bank failures today, but, when a bank does close, an entire community or even a whole region is affected. For this reason, examinations have come to be looked upon as a service to banks and to the public, and, with few exceptions, bankers agree with this viewpoint. Why? Because, generally speaking, bankers and supervisors have the same basic objective: the maintenance of a sound and effective banking system.

The primary responsibilities which the Reserve Bank as a supervisor must discharge in order to attain this objective are (1) determination of solvency and liquidity, (2) evaluation of qualifications of management, (3) administration of applicable statutes and regulations, and (4) persuasion of management to correct unsatisfactory or hazardous conditions detected by examinations. Execution of these duties protects depositors and stockholders and safeguards the welfare of the community at large. While these are the primary Federal Reserve objectives, other agencies which have bank supervisory responsibilities generally have similar over-all goals.

SCOPE A thorough and comprehensive balance sheet examination is made on the basis of figures revealed by the books of the bank, but an examination is not an audit and the directors of each bank examined are so advised by a notation on the cover of the report of examination.

Occasionally, particularly when defalcations occur, it has been suggested that examiners should verify all liabilities directly with bank customers, verify the authenticity of notes and other obligations held in the portfolio by direct contact with obligors, and inspect in detail and verify all income and expense items—in short, "audit the bank." However, nothing in the enumeration of the functions of supervisory agencies suggests that examiners should make audits; nor does it seem fitting that public authority should so invade the province of management. Moreover, bankers themselves do not ascribe the duty to supervisors. Several thorough studies of the question have been made by groups of commercial bankers, and each has concluded that the responsibility for discovery and prevention of internal dishonesty rests with bank directors and management.

Although examiners do not make audits, they search carefully for weaknesses in the safeguards and controls employed by each bank. These matters are discussed with management and covered comprehensively in the examination report.

To be able to evaluate properly the effectiveness of internal operations and controls, examiners make every effort to keep abreast of changes in systems, procedures, and equipment. Some banks are already using high-speed electronic data processing machinery. This calls for education of examiners in the field of automation and the tailoring of examining procedures to fit the situation in institutions with such accounting devices.

NOT A TOOL OF MONETARY POLICY 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. The examiner appraises all aspects of the administration of a bank, including quality of assets, degree of flexibility, efficiency of operations, effectiveness of internal controls, and adequacy of capital. On the basis of this appraisal, and taking into consideration other relevant circumstances and business conditions, both favorable and unfavorable, national and local, he analyzes the bank's condition. His evaluation is not made with the view of implementing the monetary policy in effect at the time but rather with the purpose of presenting the clearest picture of the bank under examination.

Examinations have, however, proved conducive to

A basic examination function is loan appraisal; associates develop data for analysis and decision by the examiner-in-charge.

Examining procedures must keep pace with accounting techniques which run the gamut from Boston ledger to electronic computer.

Examination of mortgage portfolio requires detailed check of the mortgages, title certificates, appraisals and fire insurance.

closer and mutually beneficial relationships between the central bank and member institutions. Having thus obtained firsthand information on conditions and problems of commercial banks, the Reserve Bank is able to render them greater service. From their contacts with examiners, member banks are in turn more fully aware of the goals of the central bank and the nature of its operations.

OTHER DUTIES In their broader aspects, supervisory responsibilities of the Federal Reserve Banks entail other important duties in addition to visitation and examination. These include (1) processing reports of condition and earnings and dividends received from 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 applications of State banks for membership in the Federal Reserve System, (5) making recommendations with respect to applications for new national bank charters, (6) processing applications for authority to exercise trust powers, (7) handling matters pertaining to bank holding companies, and (8) processing branch and merger applications.

The many bank mergers of the past few years have increased significantly the work of processing applications and making recommendations to the Board of Governors when the resulting bank is to be a State member institution. In addition, legislation enacted in 1960 requires an expression of opinion regarding the competitive factors involved in each merger in which the merged organization is to be a national or an insured State nonmember bank.

OTHER AGENCIES In general, a bank is subject to primary supervision by its chartering authority. The Comptroller of the Currency supervises all national banks, and the State banking authorities generally supervise the banks chartered in their state. The one exception is in the District of Columbia where all banks—even those that are not national banks—are supervised by the Comptroller of the Currency. In addition, the Federal Deposit Insurance Corporation supervises insured banks that are not members of the Federal Reserve System.

Although it receives and studies reports of examination of national banks located in the Fifth District, the Federal Reserve Bank of Richmond has direct supervisory responsibility only in connection with the State banks outside the District of Columbia which by their own choice are members of the Federal Reserve System. In its work with these institutions the Reserve Bank cooperates closely with the commissioners and staffs of the State banking departments of the five states in the District.

RESPECT FOR MANAGEMENT Because of his sincere desire to be helpful and constructive, the examiner does not look upon his work as being primarily critical in nature. Nor does he attempt to invade the province of management; in fact, he scrupulously avoids doing so. For example, an examiner may point out weakness in a loan and suggest action which might prevent further deterioration or even loss, but he will not demand that the action be taken. He will, however, request that any established losses be charged off. The examiner also checks carefully for violations of law and insists on compliance with all laws and regulations designed to protect depositors, the public, and banks themselves. His philosophy is to promote good practices, sound policies, and thus good banks, not by criticism but by cooperation and persuasion.

The examiner appraises assets to the best of his ability and in his report comments upon what seem to be points of weakness in assets and asset relationships. He makes suggestions, not because he claims to know more about banking than others, but because he and his associates observe in the most intimate way the operations, policies, and characteristics of all banks—small and large. It is not too difficult under such circumstances to discern the courses of action that are in the best interest of banking.

In addition to their on-the-job observations and discussions with bankers, examiners study current publications on lending and investment policy, operations, internal safeguards, and a myriad of other pertinent subjects. Against this background they form opinions and reach conclusions as to how a particular bank measures up in soundness and effectiveness. Thus by diligent effort and study they try to attain the capacity to find the weaker spots and vulnerable points in an individual bank. It is then the role of management to take appropriate action.

RESULTS When he finishes an examination, which is climaxed by a thorough review of results with at least one senior official of the institution, the examiner returns to the Reserve Bank to complete his report. In this preparation he makes a strenuous effort to present a sound, logical appraisal of the bank's condition. His comments reflect his analysis of liquidity and quality of assets, strength of capital position, level of earnings, compliance with statutory provisions, and other pertinent factors. The analysis spotlights a bank's principal points of weakness and their relative significance.

In presenting this "picture" a sincere effort is made to focus the directors' attention on the salient features of the bank's condition by a clear delineation of facts. The bank's management is never advised that it "should" do thus and so, but an effort is always made to indicate whether a particular situation is considered good or bad.

Upon completion by the examiner, the report is reviewed by the Chief Examiner and Vice President in charge of the Examining Department and then by the President of the Reserve Bank. After being edited, it is transmitted to the bank's directors with an appropriate supervisory letter. A copy is sent to the State Commissioner of Banking and to the Board of Governors of the Federal Reserve System.

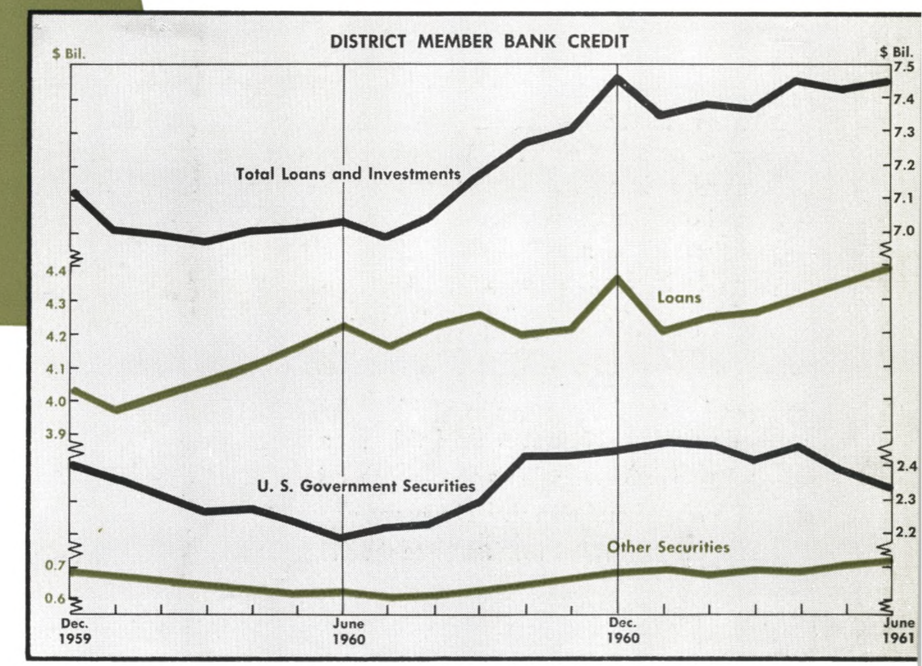
The examination process and report are concerned with both the present and the future. They are designed to show whether a bank is currently in sound condition and operated in accordance with applicable laws and regulations, and also to determine whether it is being so operated as to warrant the belief that, if now in sound condition, it will so continue; and, if not, that it will soon attain such a condition. This approach reflects the mutual concern of the examiner and the banker for the welfare of the bank and the community.

The examiner in his work is not unlike the postman in that "Neither snow, nor rain, nor heat, nor gloom of night stays these couriers from the swift completion of their appointed rounds." Whether on train or plane, in a bank in a distant corner of the District or in his office at the Federal Reserve Bank, the examiner is working in the public interest. As a co-worker of the commercial banker, he is helping to safeguard the wealth of the community.

Trust departments are usually examined simultaneously with banking departments but require specialized examining procedures.

The examiner-in-charge concludes the field examination by discussing all relevant matters with senior bank management.

How did District Membe Banks fare in the first half o1961 ?



After-tax profits of Fifth District member banks in the first half of 1961 totaled $37.6 million—$1.5 million, or 4%, above those during the first half of 1960.

This $1.5 million increase resulted from three important shifts—a decline in operating earnings, a shift from a loss to a profit in nonoperating earnings, and a rise in income taxes. Net operating earnings fell $1.5 million as rising operating expenses outpaced the growth in operating earnings. Nonoperating earnings moved from a deficit of $6.5 million to a profit of $1.0 million as a result of a $4.4 million rise in recoveries and profits and a $3.1 million drop in losses. Income taxes rose $4.5 million.

Earnings on each category of bank credit were higher: interest and discounts on loans were up $3.3 million or 2.6%; interest on U. S. Governments was $1.1 million or 3.1% higher; and interest and dividends on other security holdings were up $0.2 million or 2.3%. Operating earni rom other sources, which include commissions, fees, inco rom trust departments, and service charges, dropped $(illion or 2.2%.

Total bank credit in the first six mon f 1961 was somewhat greater than during the first half 960. Total loans and investments increased from a mo average of $7.0 billion to an average of $7.4 billion. ngs of both loans and U. S. Governments were higher, w oldings of securities other than Governments showed li hange. The proportion of earnings derived from the t principal types of earning assets remained about the sam he two years.

Almost all of the $1.5 million incre net profits went into a 10% rise in dividends declared by ict member banks during the half year. In 1961 divid absorbed 39% of after-tax profits, a somewhat greater rtion than in the first half of 1960.

DISTRICT MEMBER BANK EARNINGS

(Amounts in millions of dollars)

Item	1960		1961*	Change between 1st half 1960 and 1st half 1961	
	1st half	2nd half	1st half	Amount	Per Cent
OPERATING EARNINGS	198.7	202.4	202.6	+3.9	+ 2.0
U. S. Government Securities	34.8	34.6	35.9	+1.1	+ 3.1
Other Securities	9.2	9.0	9.4	+ .2	+ 2.3
Loans	124.7	126.6	128.0	+3.3	+ 2.6
Other Earnings	30.0	32.1	29.3	− .7	− 2.2
OPERATING EXPENSES	126.5	132.6	132.0	+5.5	+ 4.3
NET OPERATING EARNINGS	72.2	69.8	70.6	−1.5	− 2.1
RECOVERIES AND PROFITS**	3.8	13.9	8.3	+4.4	+116.1
LOSSES AND CHARGE-OFFS**	10.4	22.3	7.3	−3.1	− 30.0
NET PROFITS BEFORE TAXES	65.6	61.4	71.6	+6.0	+ 9.1
TAXES ON NET INCOME	29.4	25.4	34.0	+4.5	+ 15.4
NET PROFITS AFTER TAXES	36.2	36.1	37.6	+1.5	+ 4.0
CASH DIVIDENDS	13.4	17.5	14.7	+1.4	+ 10.2

* Preliminary.

**Including transfers from (+) and transfers to (−) valuation reserves.

MONEY AND CREDIT IN 1961

Early in 1961 the mild recession which had dampened credit demand during much of the previous year came to an end. Total bank credit increased substantially during the first half of this year, but loan demand remained sluggish and consumer instalment credit decreased on balance. However, corporate demands upon the capital market were much larger and state and local government borrowing was also somewhat greater than last year. Net cash repayment of debt by the Federal Government during the first half of the year was about half the volume during the same period of last year. In the first quarter, mortgage debt outstanding grew at about the same pace as last year.

COMMERCIAL BANK CREDIT The Federal Reserve System has continued to make ample reserves available to member banks for credit expansion. Free reserves have been in the neighborhood of $400-$600 million since the end of 1960.

At commercial banks, total loans and investments rose by about $2.8 billion over the first half of 1961, with about 80% of the increase consisting of investments. During the corresponding period of 1960, bank credit declined by $1.4 billion as a result of liquidation of a greater amount of investments than was needed to support the $4.0 billion expansion of loans over the same period.

In the first half of 1958, a period corresponding more closely to the current stage of the business cycle, bank credit rose nearly three times more than it did during the first six months of this year. The $9.8 billion increase in bank credit in the 1958 period consisted of a $1.7 billion rise in loans and an $8.1 billion expansion of investments. Nearly 75% of the investment acquisitions in 1958 were in United States Government securities. This year, when the investment increase was much smaller—only $2.3 billion—about 40% of the acquisitions were in United States Governments.

The lack of vigor in loan demand this year has reflected in large part the behavior of business loans, which declined by an estimated $400 million. Other loans recorded little net change. Recent repayments of bank loans were made in part with funds obtained through borrowing in the capital markets.

Although commercial bank loans to consumers increased about $600 million during the first half of this year, most of the increase in this category reflected the purchase by banks of the customer receivables of a large retail concern. After allowance for acquisition of these receivables, which were partially paid down as the year progressed, consumer loans increased slightly during the first half of 1961 compared to a small decrease over the similar period of 1958. Real estate loans continued to increase slowly, and security loans showed little net change.

MONEY SUPPLY Accompanying the $2.8 billion rise in bank credit this year, the seasonally adjusted money supply increased by $1.4 billion between the last half of December 1960 and the last half of June 1961. This compares with a $2.1 billion *decrease* and a $2.3 billion increase over the comparable periods of 1960 and 1958, respectively.

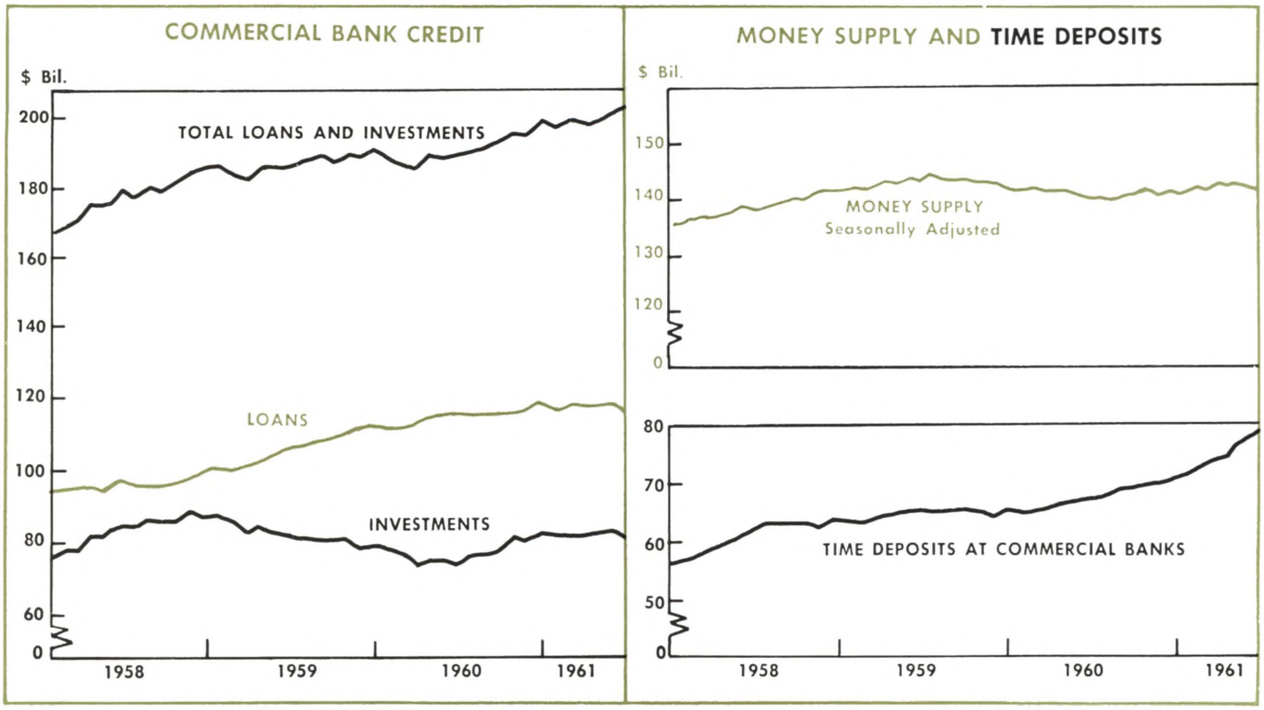
Time deposits at commercial banks, which are not a part of the money supply, increased by about $7.2 billion over the first half of 1961; in the same months of 1960 and 1958, these deposits rose by $1.5 billion and $5.3 billion, respectively. To the extent that demand deposits were transferred into time deposit accounts, bank credit expansion both this year and in 1958 resulted in smaller growth in the money supply than otherwise would have occurred.

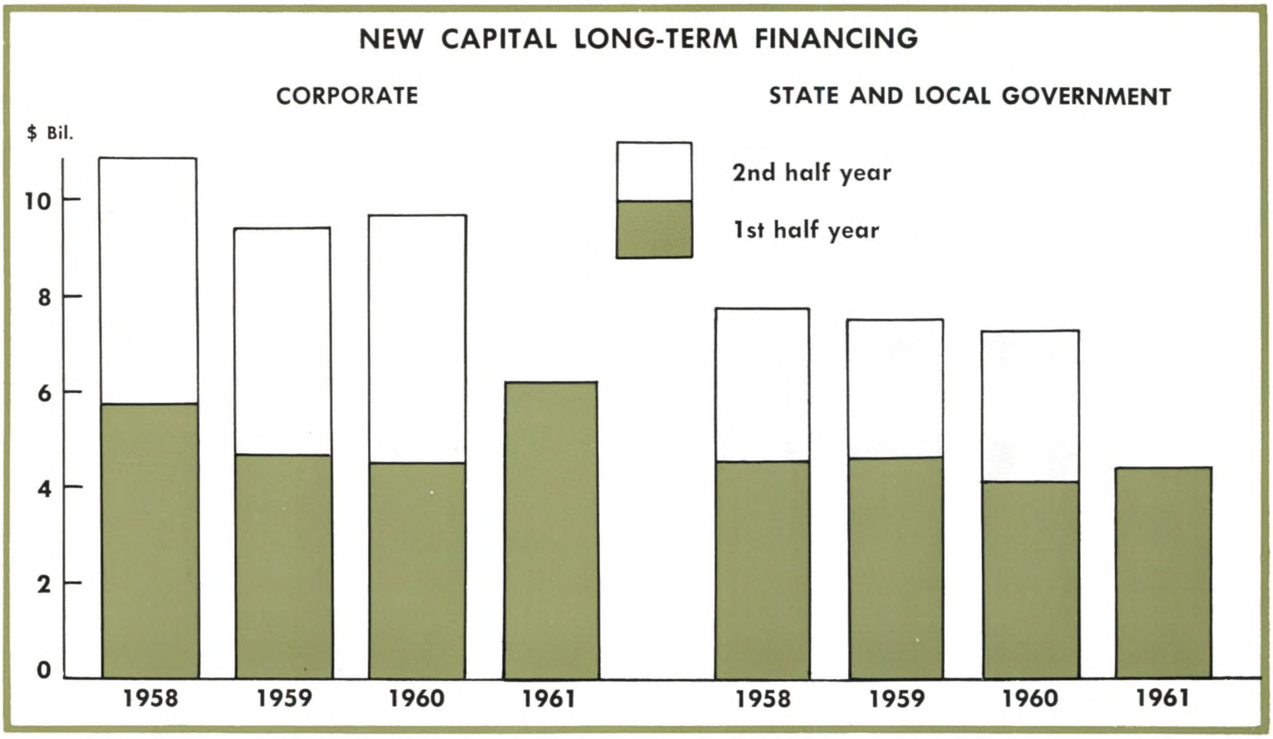
Over $1 billion of the time deposits now outstanding represent negotiable, interest-bearing certificates of deposit which large banks in New York City and elsewhere began to sell for the first time last February. Many of these certificates were purchased by corporations. Previously some of these banks had been unwilling to accept time deposits of domestic corporations because they feared a corresponding decline in demand deposits. However, the drawing down of corporate demand deposits for investment in Treasury bills and other open market paper reportedly helped induce banks to issue the new certificates of deposit.

CONSUMER CREDIT The weaker consumer credit demand apparent in bank loans is evident also in the figures for total consumer instalment credit outstanding. On a seasonally adjusted basis, such credit decreased by $275 million over the first half of the year in sharp contrast to net increases of over $2.5 billion in the corresponding periods of the two preceding years. In the first half of 1958, however, when consumers were reacting with caution to the recession of that period, consumer instalment credit recorded a decline twice as great as that of this year.

In recent months consumer credit has shown some signs of strengthening. Successive increases in totals outstanding were recorded in May and June despite a continued decline in the major component, automobile credit. The burden of repayment, measured

Much of 1961 bank credit expansion has been reflected in time deposits instead of the demand deposit component of the money supply.





Corporate new capital financing rose substantially in the first half of 1961, but sales of municipals increased only slightly.

as the percentage that repayments are of annual disposable personal income, is still near historical highs, but in the second quarter of 1961 receded to 13.3% from 13.5% in the first quarter.

CORPORATE LONG-TERM BORROWING New corporate security sales in the second quarter of 1961 were at an all-time high of $5.1 billion, 40% larger than the previous record of $3.6 billion in the first quarter of 1957. In the first two quarters of this year the net proceeds of corporate security offerings and placements amounted to $7.0 billion compared with $4.6 billion during the first half of last year. A larger amount than usual in recent years was used for the retirement of securities—$700 million this year compared with $100-$150 million in the previous two years. About 60% of the net proceeds were scheduled for purchase of plant and equipment. The percentage spent for plant and equipment in recent years has varied from 55% in 1960 to 73% in 1958.

Just over 25% of the security sales in the first half of this year were in the form of common stock. This compares with 16% for 1960 as a whole and 11% for 1958, the last recession-recovery year. The difference between this year and 1958 is accounted for by the large American Telephone & Telegraph stock issue this year.

GOVERNMENT FINANCING New capital borrowing by state and local governments totaled an estimated $4.4 billion in the first half of this year, about $300 million greater than during the corresponding period of last year but below the $4.5 billion level for the first halves of 1958 and 1959.

Although the Federal Government sold a substantial amount of new securities during the first half of this year, its debt redemptions were greater. The resulting $2.9 billion net cash debt repayment was just less than half of the amount repaid during the first half of 1960. Consequently this source supplied fewer funds to the market this year than last.

MORTGAGE FINANCING During the first quarter of 1961 total mortgage debt outstanding rose about $3.4 billion, only slightly more than during the same period last year. The funds channeled into the market by savings and loan associations and mutual savings banks, both major holders of mortgages, were somewhat larger during the first quarter of this year than of last, but life insurance companies' mortgage holdings rose by about 30% less.

THE FIFTH DISTRICT

Fifth District business generally continued its upward course in August, and businessmen were largely optimistic despite uncertainties in appraising the fall outlook. Local and national analysts expressed their agreement in the press, frequently pointing to the possibility that all major sectors will increase their spending enough between now and the end of the year to generate a sharp rise to significant new highs. A brief look at the District business recovery and comparison with that of the nation as a whole provides a point of departure for evaluating developments this fall.

In retrospect, the important broad indicators—bank debits, employment, and manufacturing man-hours, all seasonally adjusted—present substantially similar, but by no means uniform, pictures. During the early months of recovery, each of these measures showed business moving ahead more rapidly in the District than in the nation as a whole. Late in the spring the pace of national recovery increased, whereas District activity lost some of its initial momentum.

Fifth District factories produce approximately one-sixth of the 1.7 billion glass containers used annually in the United States.

The national rate of recovery in nonfarm employment as measured by the relative gain from the recession low, caught up with the District rate in May, moved ahead in June, and kept the lead. Rates of recovery in the District's bank debits and manufacturing man-hours remained ahead of the comparable national rates during the summer months but by smaller margins. Since recovery got under way, bank debits have shown relatively wider fluctuations from month to month in the District than at the national level. The opposite is true of employment and man-hours, which have been rising in the District at an unusually stable rate.

BANK DEBITS HIGH Bank debits, seasonally adjusted, broadly measuring the flow of payments in the economy, fluctuated considerably from month to month. Therefore, their trend over a longer period has more significance. Bank debits in the District reached their prerecession high in May 1960. The series declined 9.5% to its December recession low and then rose to a new high, 5% above the previous one, by May of this year. Since then seasonally adjusted District bank debits have fluctuated at high levels slightly below the May peak. In the nation, bank debits reached a prerecession high in August 1960, three months later than in the District, but their recession low and subsequent peak coincided with those of the District. The national drop from August to December was 4.4%, and the new high in May was 4% above the previous peak.

JULY EMPLOYMENT A NEW RECORD As in the case of bank debits, seasonally adjusted nonfarm employment reached its prerecession high earlier in the District than in the nation as a whole—April as against July. From these respective peak months, District employment declined only 1.7% to a February low while the national series dropped 2.3% to a trough in March. With the advent of recovery, the District fell in line fairly closely with the nation. Both exceeded their prerecession highs in July, the District by a fraction of 1%, the nation by an even smaller margin. Whereas bank debits in both areas gained considerably more between December and May than the amounts lost during the recession, seasonally adjusted nonfarm employment moved slowly (although consistently) up from late winter lows and did not surpass prerecession levels until July.

NONMANUFACTURING SECTOR LEADS The establishment of a new high for seasonally adjusted nonfarm employment in July resulted from strength in the nonmanufacturing sector. Particularly strong areas were government; contract construction; finance, insurance, and real estate; and services. However, employment in some nonmanufacturing groups was below last year's high month. Transportation, communication, and public utility companies had 3% fewer employees in July than in June 1960, the peak month for the group. The number of workers in trade establishments in July was also slightly below last year's high, and mining employment, although fairly constant for the last six months, was about 12% below a year ago.

MAN-HOURS RECOVER UNEVENLY Seasonally adjusted manufacturing man-hours in the District rose less than 1% between June and July and in the latter month were still 1.6% below May 1960, their peak month. The July gain in United States man-hours also fell short of 1%, leaving that figure still more than 3% below its January 1960 peak.

Experience among the District's manufacturing industries has varied considerably during this recovery period. Three nondurable goods industries—food, tobacco, and paper—exceeded their last year's highs earlier this year but in July were again slightly below the new peaks. Small reductions in seasonally adjusted man-hours occurred between June and July in knitting mills and apparel factories, while increases were registered by broadwoven fabric mills, yarn and thread mills, and chemical plants.

The only durable goods industries showing some degree of strength in July man-hours when compared with high months of last year were transportation equipment (5% above); machinery; and stone, clay, and glass (each 2% below). The others ranged between 5% and 12% under their respective prerecession levels, with furniture, lumber, and primary metals at the bottom of the list.

IMPORTED GLASS TREND UP Although the industry classification which includes glass making has made a generally good showing, some glassmakers are having a difficult time. Competition from foreign producers is increasing in quantity and also expanding into a greater variety of product lines.

According to latest reports there are 113 glass making plants within the boundaries of the Fifth District. Three-fifths of these are located in West Virginia. The majority are small operations making household, scientific, and other specialized glass products. The larger factories, fewer in number but employing a major fraction of the District's glassworkers, manufacture flat glass and glass containers. Makers of flat glass have recently felt the effects of foreign competition more keenly than in any previous recovery period. Between 1957 and 1959 imports of flat glass rose 90%, but this sharp increase was followed by a decline of about 15% between 1959 and 1960 as general business activity slowed. Even after this decline, however, flat glass imports represented 11% of apparent domestic consumption in 1960 compared with 7% in 1957.

Tariff duties currently in effect are on a per pound basis with rates varying according to the size of the glass sheets. Domestic producers argue that current rates are not sufficient to prevent further increases in imports and consequent serious injury to their industry. Areas adjacent to ports of entry can be reached by foreign shippers with little added cost from overland transportation. Here price cutting has already become necessary to prevent imports from making more serious inroads in the domestic market. However, industry experts believe that manufacturing costs are sufficiently lower in other countries to enable foreign glassmakers to cover additional transportation costs and still meet competitive price reductions.

CONTAINER IMPORTS RISING Seventeen plants manufacturing glass containers are listed in state directories for the District. According to the same source, and substantially verified by the Census of Manufactures, about 9,000 workers are employed in these plants, which places the District's share of the nation's glass container industry at roughly one-sixth. The volume of imports is growing, but still represents a small fraction (between 0.1% and 0.2% in recent years) of this country's annual consumption, now approximately 1.7 billion glass containers. Although they are both bulky and brittle, bottles and jars shipped to this country are earning good profits for their foreign makers. While still small as compared with this country's huge total volume, imports registered a large relative gain between 1957 and 1960 and exceeded a value of $2 million in the latter year.

PHOTO CREDITS

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