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FDIC NEWS RELEASE

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SUBJECTING THE FDIC TO THE APPROPRIATIONS PROCESS

Colorado Springs, May 11 -- Chairman Robert E. Barnett, addressing the Conference of State Bank Supervisors, expressed opposition to the amendment to Senate Bill S.2304, which would subject FDIC to the appropriations process. He stated that his opposition to the proposal is based on his belief that the Corporation's independence is imperative to its effective operations.

Chairman Barnett emphasized the importance of maintaining the authority FDIC has to make its own decisions on an objective, nonpolitical basis, and the flexibility it has in financing expenditures which may be unpredictable. He also pointed out that confidentiality is essential to the budget process of the FDIC. "If we decide, for example, that we should hire one hundred more liquidators to administer closed bank receiverships that we see might be developing (as we did about two years ago), we can do that without publicity." With publicity of such a decision, confidence in the banking system would be shaken.

The Chairman advised that, "More important, however, is a deep concern for the integrity of the deposit insurance program and the independent dedicated fund which supports that program, and a fear that public confidence in deposit insurance might erode if the finances of the Corporation were to become politically controlled. The Corporation feels that the annual GAO financial audit already received by FDIC, combined with the GAO operational audits to be permitted under the recent agreement reached by the two agencies, will provide thorough oversight ability to Congress and to the public without the ancillary dangers associated with subjecting the FDIC to the appropriations process."

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The banking problems of the last couple of years have been accompanied by massive publicity. The problems and the publicity have created an interest, particularly in Congress, to do something about reform of the financial system or the bank supervisory system. I believe the problem has been slightly overstated, and the proposals advanced somewhat off the mark. I want to focus on one particular proposal that, in my opinion, not only seems totally unrelated to any problem that exists, but also threatens to erode public confidence in the banking system. That is the proposal to subject the FDIC to the political appropriations procedure. I want to spell out why that is undesirable in terms of its impact on our operations and, more importantly, why I think it may be damaging to public confidence.

I would like to start by analyzing the causes of the bank problems of the last couple of years. I will argue that our traditional powers to deal with these causes are rather limited, and that we would be unwise to seek the kinds of powers necessary to control them. This leads to the need for confidence in our system as it stands, and I want to explore with you why the fiscal independence of the Federal Deposit Insurance Corporation, and more importantly, the Federal deposit insurance fund, is an important element in maintaining that confidence.

It is no news to this audience that the problems of the banking system have been particularly severe in the last couple of years. The number of banks on our problem list and yours has increased substantially. We now have bigger banks on the problem list than we used to. The number of bank failures last year was the largest number since the aftermath of the depression of the '30s.

Bank loan losses showed a huge increase last year to $3.2 billion, up from only $1.2 billion in 1973 and $2.2 billion in 1974.

All the public attention devoted to these problems has led to the view that something be done about the matter, and done in Washington. I want to deal today with the causes of the problems as I see them, the real obligations this puts on bank supervisors and the need to oppose actions which seem to meet the call to "do something" today but which may have undesirable impacts tomorrow.

The Causes of Bank Problems

I believe that the major factor in causing the increase in bank problems and losses in the last couple of years has been the recent recession. It is important that we not underestimate the relationship between the economy and bank performance. It is an unreasonable standard to expect that banking should be immune to the general trends and problems of the economy. The 1974-75 recession was much more severe than anything our economy has experienced since World War II, and since banks play such a major role in our economy, we must expect the health of banks to mirror that of the economy as a whole. In periods of economic decline, the profits of business firms fall and the number of firms encountering financial difficulties and failure always increases. This will be reflected in nonaccruing loans and loan charge-offs at commercial banks. If this were not the case -- if banks were only making loans to firms whose financial condition was so solid that even a severe recession would not affect their ability to pay -- then the banks would not be doing their job. Thus, it is not surprising to me that during the period of our most severe post-war recession, we should have a significant increase in bank loan losses and a significant increase in the number of banks on our problem list.

In addition to the problems caused by the general decline in business activity, we have had to cope with such unusual occurrences as the tremendous increase in energy costs, rapid rise in food prices, record high interest rates, and very severe problems in the real estate market.

Many of our failed banks and problem banks of the past two years have had severe real estate loan problems. I think banks as lenders and as managers of REITs through holding companies deserve a considerable share of the blame for their real estate lending problems. High rates on construction loans and REIT fee arrangements that encourage volume purchases and sales undoubtedly contributed importantly to a loss of perspective on loan quality. In many cases, bank real estate lending officers were too young and inexperienced to remember past periods of real estate lending problems. For several reasons, the lender's traditional restraint on the developer's perpetual optimism was not present.

Many banks have had problems with loans to REITs and real estate developers. A smaller number of banks have been affected by other particular problems, such as losses on foreign operations and loans on oil tankers, though it appears that some of these problems have been greatly exaggerated.

Nevertheless, these special problems, combined with the decline in the economy and the increased vulnerability of some banks, have led to increased loan losses and a larger number of problem banks.

But I would not attempt to blame all of the problems on the recent recession or even these associated events. The extent of bank problems reflects some more basic and long-lasting characteristics. I think there has been a shift in the last several years in the direction of a more aggressive, riskier posture of the banking industry, and on the part of large banks in particular.

Since the early 1960s, many banks abandoned their traditional conservatism and began to strive for more rapid growth in assets, deposits, and income. "Liability management" became the essential phrase in the modern banker's lexicon. The larger banks also began pressing at the boundaries of allowable activities for banks. They expanded into fields which some felt involved more than the traditional degree of risk for commercial banks. These activities included direct lease financing, credit cards, underwriting of revenue bonds, foreign operations, and others. The holding company movement of the 1970s certainly accelerated these developments, though most of the activities of bank holding companies could also be, and were in fact, engaged in by banks directly. I am assured by our FDIC examiners that this increased aggressiveness showed up in lowered credit standards as well.

During the 1960s, banks generally were not noticeably harmed by the diversification of activities, the movement toward greater risk in their own financial structure, and lowered credit standards. After all, the early and mid-1960s represented a fairly extended period of relatively stable growth and moderately stable prices. The first half of the 1970s proved to be a much tougher economic environment in which to operate. Even apart from the recession of 1974-75, we should not minimize the impact on banks of operating in periods of very tight credit, very high money costs, and extremely erratic movements in commodities and other prices. These factors affected not only the banks directly, but also the stability and predictability of business operations, and that, in turn, had its impact on the repayment of bank loans.

The experience of the last several years raises several important questions of public policy. The most important question for us as supervisors is simply this: Could better regulation and supervision have prevented banks from reaching a condition which required closer supervision by bank regulators?

It is my view that bank supervision as we know it in the United States, as opposed to its characteristics in other countries, is limited in its ability to dictate the soundness of the banking system. It appears that a considerable part of the bank problems of the last couple of years has been due one way or another to the general state of the economy. That is clearly a matter beyond the control of the process of bank supervision. Some of the problems have been due to specific unpredictable events like the rapid increase in oil prices and a resulting decline in the demand for oil and oil tankers. It would have been nice if we had been able to anticipate and prevent the debacle of the REITs, for example. In view of the vast number of financial experts who failed to foresee these problems, I do not think it is surprising that bank supervisors failed also.

There is one area, however, in which we do have an ability to lessen the impact of the business cycle. That is the matter of bank attitudes toward risk and the willingness of bankers to increase loan volume and decrease capital ratios. We are giving more attention to these matters at the present time, and we will continue to demand more capital from banks inadequately capitalized, as well as demand that loan, investment, and operating policies and practices be reasonable ones. We are looking much harder at management and are willing to step in quicker with formal orders requiring action on management's part. We have asked Congress for more powers to deal not only with dishonest bankers but grossly negligent ones.

We must be very careful in this area, however. We recognize that banking is a risk-taking business and we must rely on market forces, on management, and on owners, in addition to our supervisory judgment to determine the appropriate degree of risk for individual banks. I do not believe that even the most outspoken critics of banking and bank regulators want the regulators to run the banks rather than the bankers. We can all agree that that is not our function. If we are too intent upon preventing all bank failures in our regulatory posture, we may have some success in shortening our problem lists, but the banking philosophies we would have to adopt would retard the progress of the economy. So attemtping to prevent all bank failures is not our function either. In some cases, Government policy, which I endorse, has encouraged a shift toward a riskier banking posture. We have issued regulations on "leeway investments" which have broadened the types of investments that can be made.

By disapproval of redlining and promoting the concept of equal credit opportunity, we have actively pushed banks into lending that they may feel (though I do not necessarily agree) is more risky.

Public Confidence in the Banking System

After recounting this story of bank problems, our limited ability to control or prevent these problems, and the widespread publicity about these problems, one factor of particular significance stands out in my mind: despite all the bad news, despite the largest bank failures in the history of the country, public confidence in the banking system is extremely high. We have considerable evidence for this statement. There has not been a general shift on the part of the public toward holding currency or government securities in preference to deposits in the banking system. Failures of particular banks have not led to runs either on neighboring banks or on banks identified in the public's mind with the failed banks. As a matter of fact, in most cases, substantial adverse publicity about particular banks has not even led to significant deposit outflows from those banks. I was very interested in the recent Gallup poll which found that the American public has a high degree of confidence in the banking system. Specifically, 90 percent of those with bank accounts felt their money was safe in those accounts. Gallup summarized the poll as indicating that "For the overwhelming majority of all adults 'bank safety' is not a concern."

There are, of course, several reasons for this confidence. There is the actual record of sound, generally conservative performance of the nation's banks. There is our system of State and Federal supervision of banks. Finally, even with all the publicity, there are only slightly over 2 percent of the nation's banks on our problem list and considerably less that 1 percent which we feel are serious problems. All of these are sound reasons.

I am sure I will be forgiven, however, if I focus upon our system of Federal deposit insurance and our sizable and sound Federal deposit insurance fund. To me, this plays the most crucial role in creating and maintaining confidence among bank customers. Even in the case of banks whose failing condition is public and notorious, any deposits that have fled have been uninsured deposits. Insured deposits stay with the banks. To use just one example, even with all the adverse publicity that the Franklin National Bank suffered over a period of many months, its insured deposit volume remained stable. That is an overwhelming display of public confidence. And that confidence has been justified. During the last two and one-half years, banks which have failed have had over 1.3 million depositors on their books and less than 1 percent of them (all uninsured) lost anything because of the failure.

In the past, State bank supervisors, individually and as a conference, have raised questions about the appropriate role of Federal agencies in the bank regulatory and supervisory process. Many of you have been critical of the role in that process of the Federal agencies, particularly the Federal agencies that supervise State-chartered banks. This is a subject in which I have considerable interest and to which I intend to devote significant attention over the next several years.

But with respect to deposit insurance, regardless of our views on the relationship between State and Federal responsibilities, I believe that all of us agree that this is and must be a Federal responsibility. It is not only the need to spread the risks geographically that requires this, but also the need for national uniformity and equity. I doubt if any of your State Governors or Treasurers want to get into price and product competition with other States on deposit insurance; nor do any of us want to see a repetition of the many State deposit insurance system failures that preceded the original proposals for Federal deposit insurance.

Federal deposit insurance provides an umbrella of confidence under which all of us can supervise State banks. We have a mutual and not a competitive interest, in the maintenance of a sound system of deposit insurance. That cannot be maintained unless the public's confidence in that system of deposit insurance is maintained.

A few months ago, I would have thought these comments on the importance of public confidence in deposit insurance to be too obvious to be worth mentioning. Likewise, I would have thought the possiblity of the public losing confidence in that system to be too remote to bother this gathering with.

Times have changed. I now feel I must raise this issue. I now feel there is a possibility that depositor confidence in the Federal deposit insurance program might erode, difficult though it might be to believe. The cause for my deep concern is the recent vote of the Senate Banking Committee to make the FDIC subject to the political appropriations process. By a seven to five vote, the Committee on April 29 approved an amendment to S.2304, a bill originally designed to expand the enforcement authority of the agencies in dealing with grossly negligent bankers, to make the FDIC, the Comptroller of the Currency, and the Credit Union Administration (but not the Federal Reserve System) subject to the appropriations process.

I agree wholeheartedly with the Senate Banking Committee that Congress and the public must be assured that the financial affairs of the FDIC are managed in an efficient manner, even though it is not tax dollars that are being spent. We are unaware, however, of any feeling in Congress or by the public that the FDIC has been inefficient or ineffective. GAO audits the Corporation annually, and we appear constantly before Congressional committees on many subjects and, as far as we know, our integrity and openess has not been raised as an issue. Why, then, should there be a basic and serious change affecting the deposit insurance system when the FDIC has been free from serious criticism?

The fact is that Congress now has the tools to get even more assurance of the correctness of our operations without resorting to the dangers of the appropriations avenue; however, more about that in a moment.

My major concern in this matter was well summed up in Mr. Faris' testimony for CSBS on the Financial Reform Act of 1976, when he stated that subjecting the Corporation's administrative expenses to Congressional appropriations would be "an unnecessary politicizing of the Corporation."

The possibility for personal financial gain for someone who can improperly influence any agency is real, and for someone who can improperly influence a banking agency, State or Federal, the possibility is intoxicating to some. That's why, periodically, we read of indictments and convictions of individuals using improper influence to get charters, or branches, or other favors.

If the possibility were opened to permit access through the political appropriations process to the FDIC, the temptation for well-intentioned as well as corrupt individuals to try to reach the Corporation's decision-making process would be overwhelming.

Frank Wille, who was the Superintendent of Banks in New York State before becoming Chairman of the FDIC, commented on this point in his last Congressional testimony:

> It is no accident, in my judgment, that the three Federal bank agencies have remained over the years relatively untouched by political scandal or intimidation. I fear, however, that this track record could be substantially altered if the proposed Federal Banking Commission and the FDIC were to be placed on an appropriated funds basis, subject in the first stage of the process to the tender mercies of the White House and the Office of Management and Budget and in the second stage to the varied interests of individual Congressmen. The practical effect of the appropriations process would be to give the political operatives of the White House and the Congress substantial control over the personnel, the day-to-day operations and the legislative positions taken by the Commission and the FDIC, and I need not remind you how sensitive many of these agency decisions can be.
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> ....I think we must have accountability, but I truly believe that with the thousands of very sensitive and important decisions made by the bank agencies on which many financial interests ride, that it would be a mistake to go through the political process of appropriations reviewed by the White House and then by the Congressional committees. I believe that this will lead to control over personnel and legislative positions and possibly even regulatory decisions themselves.
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> It was no secret during the years of this past administration and the affairs of the Watergate, significant efforts were made on the part of the White House to place particular personnel in some of the agencies of government, who were loyal above all things to the incumbent President.
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> I think it is clear that the Office of Management and Budget has used its power to recommend budget levels in an effort to control the policy direction of agencies. And, in many cases, I think this is appropriate. When you have a regulatory agency, I have severe question that this is appropriate.

I also believe that the temptation may exist to try to influence the actual decisions that the agency must make on individual applications.

The reasons for distinguishing the FDIC from other government departments and agencies were made even more strongly by Senator Vandenberg in a Senate floor speech in 1947, delivered as he led a successful fight against subjecting the FDIC to the appropriations process:

> ....No one has yet had the temerity to propose that the Federal Reserve System should be robbed of its independence and subordinated to a political bureau of the Government. Yet, here is an institution [the FDIC] which is even more sensitive with respect to the necessities for its independence ...

Well, by now some have had that temerity, but the Senator's point is still valid as to the relative needs for independence of the FDIC.

Even apart from concern about politicization, however, there are other good reasons for searching for some alternatives to the appropriations process. Our present budgetary process allows us to budget and plan on a long-range basis for programs with long-range benefits. For example, we have developed over a period of many years a training program for bank examiners of which we are very proud. Such a program does not necessarily provide a payoff in the very beginning, but the present need for more and better trained examiners underscores the correctness of the judgment which initiated this program before the need was obvious. Many of you have been beneficiaries of that program, but can we be sure that Congress would always appreciate the wisdom of Federal agency expenditures to aid in the training of State examiners?

We are able immediately to increase our expenditures over budget estimates if an emergency involving a large bank failure occurs. We do not have to wait for a special supplementary appropriation nor do we have to build an unpredictable and probably misleading contingency fund into our budget estimates. If we decide, for example, that we should hire one hundred more liquidators to administer closed bank receiverships that we see might be developing (as we did about two years ago), we can do that without publicity. To again quote Senator Vandenberg:

> ....If the FDIC is doubtful about the year to come and has to build up a large budget in anticipation of its doubts, I know of no surer way to precipitate a crisis in the United States than to have the budget of the FDIC necessarily increased in anticipation of bank failures made public to the world on New Year's each year.

This brings us to the heart of the matter and that concerns general public confidence in the Federal deposit insurance system.

I believe that confidence is crucial to the banking system -- without the public's confidence and trust, the system simply would not work. There is no way any bank in the country can immediately meet the legitimate demands of all of its depositors presented at the same time. Depositors must be confident that this will never pose a problem to them, or banks could not function. Many banks and Government officials misinterpret confidence in the banking system and in the FDIC, however, as some sort of mystical faith. No bank charter was carved in stone on Mt. Sinai. Neither, I must add, was the FDI Act. The public has confidence, not out of blind faith, but because the solid substance of sound performance has been apparent.

It is not a happy thought, particularly in this year of our bicentennial, that the American public has a higher degree of confidence in our deposit insurance system than in other institutions of our democratic system. I can believe that 90 percent of the American public believes their money is safe in our banks. I do not believe that this confidence is fragile. But it is not unbreakable.

Senator Vandenberg commented on this very issue:

> (T)he fundamental importance and value of the Federal Deposit Insurance Corporation is psychological; it is the faith ... that America has demonstrated in this institution ... If the American people read that, at long last, in Washington something is going on which indicates that the political powers are restless and will remain restless until they can get their hands upon this great institution, the effect will be most deplorable.

Let me speak for a moment or two about the possible erosion of the fund, or just as important, the belief that the fund could be reached for purposes other than deposit insurance.

Currently we have approximately $7 billion in the deposit insurance fund, a large amount but not out-of-line with the requirements of the deposit insurance system. The amendment itself does not cover directly expenditures out of this fund, or at least we do not think it does. Nevertheless, the kind of expenditures which may be made from that fund conceivably could cover a wide range of programs which many of us might find unrelated to the deposit insurance program. The decision to make or not make particular expenditures has always been made by the Board of Directors of the FDIC immune from "ideas" or "suggestions" made by those who would, under the amended S.2304, control the administrative expenditures of the agency. That has worked in the past, and that is the way it should remain for the future. Resolving the very complex problems of the U. S. National Bank failure or the Franklin National Bank failure was difficult enough without third party suggestions. Liquidating the assets of those banks is likewise difficult enough without such suggestions.

Let me repeat: Federal deposit insurance has worked. That the American public has confidence in its banking system and knows that its deposits are safe in the nation's banks is due in large measure to the existence of Federal deposit insurance. The integrity of the fund out of which those deposits will be paid in the event of a bank closing is unquestioned; each succeeding Board of Directors of the Corporation since its beginning has proved to be excellent guardians of the fund. Any change in the financial operations of the Corporation or the methods by which the Corporation receives its money to conduct its business may well erode the public's confidence in the fund. We might note in this regard the recent concern being voiced about the soundness and solvency of the Social Security fund. Whether justified or not, similar concern about the integrity of the deposit insurance fund could prove to be unsettling. Without some overwhelming need, carefully and completely delineated, it seems reckless to expose the public's confidence in the banking system to the danger of such erosion of confidence.

The answer I would suggest to the problem of oversight is a thorough and periodic performance review by GAO. GAO has professionals who can make reasonable and considered judgments on the performance of the FDIC and the other agencies. We would welcome such a review and entered into an agreement with GAO three weeks ago to have them perform such a review.

Because of publicity about Federal Reserve objections to a GAO audit, you may be unaware that the FDIC for many, many years has been subject to a full financial audit by the General Accounting Office. We believe that the GAO has always found the Corporation helpful in assisting it in its annual audit, and we have found the audit helpful to us. There have been no instances to my knowledge of GAO raising any questions of irregularity or irresponsibility in the financial dealings or budget expenditures of the FDIC.

There has been one traditional disagreement between the GAO and the FDIC which is relevant here. That disagreement has concerned the desirability of predicting bank failures and possible losses to the deposit insurance fund. We have felt that this sort of analysis is inappropriate and we have been reluctant in the past to permit a review of our examination reports for that purpose. This issue of GAO access to our examination reports has been an issue of contention for many years. I share the FDIC's traditional reluctance to see predictions of bank failures, but I can see no harm from review of our examination procedures and examination records by the professional staff of the GAO. The safeguards which have been agreed to in our current agreement for confidentiality and privacy provide adequate protection for us, the banks and bank customers.

I may be unduly concerned about this matter -- it may be that we can put the deposit insurance fund under ordinary political control without affecting the public's confidence in it. But I cannot see any potential gain that would appear to be worth that risk.

Let me summarize: banking has had problems in the last few years. Much of the problem has been related to the general economy or events which we cannot control. Public confidence has been maintained, however, in a generally sound banking and supervisory system. Since the FDIC has performed its functions well over these years, subjecting it to the appropriations process as a response to a desire to do <u>something</u> about the banking system seems inappropriate. Our opposition to including the FDIC under the appropriations process is based on a strong desire to continue the present ability of the FDIC to make its decisions, many of which are extremely sensitive, on an objective, nonpolitical basis, and a need to maintain flexibility in our finances to cover expenditures which may be unpredictable.

More important, however, is a deep concern for the integrity of the deposit insurance program and the independent dedicated fund which supports that program, and a fear that public confidence in deposit insurance might erode if the finances of the Corporation become politically controlled. The Corporation feels that the recent agreement reached with the General Accounting Office permitting operational audits by GAO provides thorough oversight ability to Congress without the ancillary dangers associated with subjecting the FDIC to the appropriations process.

I hope that each of you recognizes that what I have been discussing here is not a matter of intramural bookkeeping or bickering within the Federal establishment. This is an issue that will affect your ability to do your job in your respective States. Confidence in the banking industry and in bank supervision may not survive a loss of confidence in Federal deposit insurance.

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