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FEDERAL DEPOSIT INSURANCE CORPORATION

THE FDIC: DEPOSIT INSURANCE

Address by

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before the

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There are times when it seems most propitious to encourage public examination and discussion of issues that affect our banking system for the purpose of seeing whether and how things might be improved. This would appear to be one of those times. Many banks that had encountered difficulties in the past year or so seem to be gradually working out of them. Things are likely to be better for most banks during the balance of this year and next. Both bank regulators and Congress are less preoccupied with emergency situations and thus, hopefully, better able to view issues in perspective. In light of all of this, I would like to discuss the adequacy and fairness of deposit insurance as it exists today, and make a few preliminary remarks about 100 percent deposit insurance as one alternative to the current system.

Except for occasional increases in the limits of deposit insurance coverage, there has not been any fundamental change in our system of federal deposit insurance since the beginning of the FDIC. While I am far from dissatisfied with our present deposit insurance system, there are several reasons for raising the issue of change of the system at this time -- if the mere passage of some forty-odd years is not sufficient in itself.

First, the Hunt Commission made suggestions for change that relate to deposit insurance, but none of the Commission's recommendations in that area found their way into the legislation the Congress has recently considered. Neither have other possible changes, among which was 100 percent deposit insurance, which the Commission considered but rejected. These issues have thereby escaped the public attention and discussion which the legislative process always provides.

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Further, deposit insurance is obviously linked to bank failures, and some recent failures are different enough from earlier ones to require reconsideration of our unspoken premises. For most of the life of the FDIC bank failures have involved relatively small banks. From the beginning of the Corporation in 1934 through 1970, only one insured bank which failed had over $50 million in deposits, and almost all of them were under $5 million in deposits. The number of depositors and dollar amount of deposits in any failure, therefore, were quite small. In just the last six years, however, we have seen failures of some very large banks, including two over $1 billion in deposits, two of $100 million to $500 million and five between $50 and $100 million. Even though banks generally have grown dramatically in size,* the number of depositors affected by recent failures has grown relatively as well as absolutely.

Finally, the appropriate role of the FDIC and other bank agencies in bank supervision has been raised in a number of ways recently, and I believe it is appropriate to review the varying functions of the Corporation, including its role as an insurer, in some depth.

Today I plan to discuss the adequacy and fairness of the current deposit insurance system, in part by describing how the FDIC deals with bank failures and the basis for our decisions. I will then briefly consider the rationale for the one alternative normally suggested -- 100 percent deposit insurance. In

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* In 1956, a $500 million deposit bank would have been the 42nd largest bank in the U.S., and a billion dollar bank would have been the 18th largest. As of June 30, 1976, a $500 million bank would be only the 186th largest, and a billion dollar bank only the 89th largest.

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other scheduled speeches over the next several weeks, I intend to explore more thoroughly the arguments and implications not only of 100 percent deposit insurance, but also of other alternatives to the present system.

It is not the present intention of the FDIC to propose such legislation, nor do I wish to leave the impression that the Corporation would favor such legislation if it were proposed at the present time. But we do plan to review all the issues surrounding the matter as well as others basic to the FDIC.

The basic purpose of deposit insurance is to protect the banking system against destructive runs on deposits as well as to protect the depositors themselves. With respect to the latter, most depositors have fared extremely well in the 519 insured banks which were closed since the establishment of the Federal Deposit Insurance Corporation. About 99.8 percent of all depositors, large or small, fully recovered their deposits almost immediately, with only one-tenth of one percent having to wait for the liquidation of bank assets. And less than 5,000 out of nearly 3 million depositors are expected to experience any deposit loss at all. Out of $4 billion in deposits at failed banks through 1975, approximately $267 million was lost or is expected to be lost. Of this amount, unprotected depositors stood to lose about $13 million, the Corporation absorbing the remainder. These loss figures do not take account of foregone interest in situations where recoveries have required extended periods of time. If we take this into account, even using modest interest rate levels for this purpose, losses on an opportunity-cost basis would be approximately 50 percent greater than the figures I have cited. In view of the number of years involved and the volume of deposits, most would agree that losses of this magnitude are not substantial.

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The high recovery rate for depositors is attributable at least in part to the fact that $9 out of every $10 in deposits were in bank failures which were handled by purchase and assumption transactions in which the FDIC provided assistance enabling another bank to assume the failed bank's liabilities. This arrangement provides, in effect, 100 percent insurance to uninsured depositors and general creditors as well as to FDIC insured depositors. If one or more of the large bank failures (United States National Bank or Franklin National Bank, for example) had been paid off, the number of depositors _not_ having de facto 100 percent insurance would have been substantially larger.

However, even in banks which were handled by a payoff of insured deposits, more than 99 percent of the depositors are assured of payment in full and more than 98 percent of all deposits (in dollars) are expected to be recovered. Insurance covered about 70 percent of these deposits, and another 16 percent were protected via pledged assets, preference, or loan offsets; as in a purchase and assumption, these deposits were made available to depositors almost immediately.

But the consequences of a payoff to individual depositors who held the remaining 14 percent of the excess deposits were not quite so favorable. Although one-third of these depositors have historically recovered their deposits in full, in a typical payout, the depositors who are not fully insured have lost about 12 percent of their individual deposits. In addition, these depositors, including those who are lucky enough to recover in full, must forego interest on the recoverable portion of their deposits while waiting

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for the bank's assets to be liquidated. In many instances, the foregone interest has been considerable and, as I have suggested, may equal one-half of the losses of principal incurred.

The depositors caught in this situation comprise a mixed group, and a group that to a great extent includes depositors that would have to be among the more sophisticated and knowledgeable about the condition of a bank. Savings and loan associations accounted for close to one-third of the total of these deposits. The next largest amount was held by individuals, followed by nonfinancial corporations, credit unions, public entities and banks, in that order.

In a deposit payoff, balances in secured and preferred deposits, as well as insured deposits, are paid over to their owners, usually beginning five to seven days following the closing of the bank, for which the Corporation receives the subrogated claims of these owners against the bank's assets. Owners of uninsured deposits having any indebtedness to the bank also may request to have their loans offset against their deposit balances. Both the Corporation and uninsured holders of excess deposits not protected by the foregoing features must await recovery on their claims from an often lengthy liquidation of the bank's assets and must bear a pro rata share of any loss that ensues.

In a purchase and assumption, the acquiring bank assumes all the deposit liabilities of the failed bank ensuring little or no disruption in banking services to the community and providing full protection to both insured and uninsured depositors alike. To the extent that the initial transition also involves little change in personnel and facilities, the transaction is also likely to

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minimize any secondary reactions affecting the public's confidence in the banking system. Where relatively large banks are involved or where the failure coincides with uncertainty in financial markets, this confidence factor is one that should not be minimized.

If the acquiring bank acquires or purchases a substantial amount of assets, this not only facilitates the disposition of the assets for FDIC but also is consistent with maintaining the established banking relationship between loans and deposits which is necessarily severed in a payoff. In recognition of the value of acquiring a going business, the assuming banks will usually pay a premium for the assets and deposits of the failed bank, thus reducing the net loss resulting from the bank failure. In effect the FDIC is able to recover, for the benefit of creditors and shareholders, a "going business" value or goodwill from the failed bank. In contrast, the necessary transfer of deposits to other banks by individual depositors following a payoff commands no such special price from the recipient banks.

Despite these advantages, it has not always been possible for the FDIC to arrange a purchase and assumption. Since January 1, 1971, for example, purchase and assumptions could not be arranged in 15 of the 40 banks that closed. In unit banking states, it may be impossible to find a nearby bank that is interested or in a position to acquire the failed bank. Since the office of the failed bank must be closed, the potential purchasing bank cannot be sure of retaining the bulk of the failed bank's business. Similarly, in unit banking states or states in which branching statutes are restrictive, otherwise suitable banks located elsewhere in the state cannot even be considered.

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Even in unit bank or restricted branching states where multibank holding companies are permitted, the cost or complexities of establishing another bank (as opposed to a branch) may be enough greater as to make the acquisition of the defunct bank unprofitable. Of the 13 payoffs since January 1, 1971, all of them have been in states which at the time of failure had either unit banking or limited branching laws.

Even in full branching states, however, it may be that the market served by the defunct bank simply has insufficient value to attract the interest of any bank large enough to manage the assets and liabilities.

In order to make the purchase and assumption transaction attractive to potential takeover banks, the FDIC indemnifies that bank against unknown liabilities that may surface after the takeover. That indemnity is one given by the Corporation in its role as a Corporation, not in its role as a receiver, and therefore is not limited by the estate of the failed bank, but rather is supported by the deposit insurance fund. In cases of fraud, the consequences may be so severe as to convince the Corporation that granting such an indemnity to the acquiring bank may involve too much risk to the insurance fund. More specifically, since the Corporation is permitted under Section 13(e) of the statute to assist in a purchase and assumption transaction only if doing so will "reduce the risk or avert a threatened loss" to the Corporation (interpreted over time by the Corporation to mean "only if its cheaper") if the assets and contingent liabilities of the closed bank are too ill-defined for the Corporation to make a reasonable estimate of the comparative costs of an assumption versus a payoff, it may not do so. Despite our care, under such uncertain

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conditions the Corporation probably has erred on both sides, opting for a payout in some instances of fraud or embezzlement when subsequent developments suggested that a purchase and assumption transaction would have been less costly and, in a few instances, opting for a purchase and assumption which later proved to involve considerably more liabilities or worthless assets than expected.

In several recent bank failures FDIC has concluded that it was necessary to exclude from assumption contingent and suspected claims in order to determine that the purchase and assumption was cheaper. We believe we have the power to do that. But that determination is being challenged in court. If the claimants prevail, under our present statue it may be difficult to arrange a purchase and assumption where we are unable to define the liabilities of the bank on the date it closes.

Even in bank failures not beset by embezzlement or wrongdoing, however, there are still many uncertainties concerning the financial status of the closed bank and the possible outcome following closure. Since 1951, the Corporation has attempted to make informed cost estimates in accordance with statutory requirements to choose the most economical alternative. Under the method used, we first estimate the insured and uninsured shares of the expected loss. The Corporation assumes the full loss in an assumption and only the insured share of the loss in a payout. Thus, the difference in these two figures -- represented by the uninsured share of the loss -- determines the additional cost to the Corporation of an assumption. From the resulting figure, we also usually subtract the administrative costs of distributing deposit balances to

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insured depositors -- costs, which are incurred in a payout but not in an assumption. The remaining difference must be made up in some manner in order for the Corporation to justify a purchase and assumption on a cost basis. Typically, this is done by a premium paid by the acquiring bank which assumes the liabilities and certain of the assets of the failed bank. The premium offered is usually determined through closed bids submitted by potential buyers -- usually, but not always, existing banks or bank holding companies.

In practice, the assuming bank usually does not take over all of the assets of the failed bank. Many of those are of such poor quality that we do not want to weaken the takeover bank by requiring it to take them. These are taken over by the FDIC which then provides cash to make up the difference between assets purchased and liabilities assumed (less, of course, the premium paid).

For example, assume a bank fails with deposits and nonsubordinated liabilities of $100 million and of this total $75 million (75 percent) is insured deposits. Anticipated losses are projected at $20 million. In a payoff, uninsured depositors and other creditors would absorb 25 percent of the loss, or $5 million. In a purchase and assumption, assuming the FDIC buys back all questionable assets, all losses would be absorbed by the FDIC. Thus, an acquiring bank would have to bid at least a $5 million premium (less the saving to the FDIC of avoiding the cost of paying insured depositors in a payoff) to justify the transaction on a cost basis.

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Since October of 1974, following an announcement to that effect by then Chairman Wille, the FDIC has made a special effort in all failures to arrange a purchase and assumption transaction, including developing and using the concept of an "all cash" or "clean bank" transaction, one in which the Corporation delivers to the takeover bank cash equal to the liabilities assumed less the premium. Since that time, only 4 of the 24 banks which have failed have been handled by a payoff rather than a purchase and assumption transaction. These four banks were each under $20 million in deposits when they failed. As I have suggested, it is the preferred method for reasons other than cost, and one might expect that this might lead us to fudge our cost estimates in favor of a purchase and assumption. However, that does not seem to have been the case. In fact, a recent review of our method of calculating comparative costs revealed that some additional considerations should properly be taken into account which would significantly improve the relative cost status of assumptions so that in even more cases than now they would be less costly to FDIC than payoffs, even if the premium bids were to fall short of the uninsured depositors' share of the loss as currently calculated.

Depending on how long a bank is known or suspected to be in trouble before being closed, there is a strong likelihood that a significant number of uninsured depositors, especially those holding sizable demand deposits, will have withdrawn the exposed portion of their deposits, leaving balances that to a considerable extent are protected from any loss by preferred status, pledged assets or offsetable loans. The latter had not figured in our calculations until examination of the Franklin National Bank failure showed how

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significant a factor offsets could be, particularly in a large-bank failure. We estimate that about three-fourths of the uninsured demand deposits and one-third of all uninsured domestic deposits remaining at Franklin at the time it closed were protected by loan offsets. On this basis, the premium required to justify arranging a purchase and assumption rather than paying off insured depositors was nearly one-third smaller than the amount estimated by ignoring offsets.

Where there is sufficient time and the stakes are relatively high, we have tried to structure the transaction so that the acquiring bank takes a considerable portion of the assets of the failed bank. This both puts individual borrowers in much better position than they would be if their loans were left in the receiver's hands, and disrupts the community less. In addition, it minimizes the FDIC's cash outlay and foregone interest, and tends to reduce our losses on collections as well as liquidation expenses.

Our liquidators are skilled professionals who do an excellent job of collecting on the assets of closed banks. Nevertheless, in many instances an acquiring bank has advantages in loan collection compared with the FDIC acting as receiver. Where loans are current and associated with a deposit relationship, they are worth more to the bank than to the FDIC. A bank may be very happy to carry or even extend a loan arrangement where sizable deposit balances are involved. Where workouts involving additional advances are necessary, the bank as an ongoing financial institution typically has more flexibility than the FDIC acting as a receiver. Frequently, though not always, the acquiring bank has staff, experience, and expertise in the local market

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and because of this may be able to move more knowledgeably in the early phases of the collection process. In practically all cases, buildings, leases, and other physical facilities are worth more on a going-concern basis to the acquiring bank than they would have if they were liquidated in a payoff. If a collection matter ultimately ends up in court, the FDIC sometimes appears as an outsider with unlimited resources attempting to take all the assets of an unfortunate local merchant or businessman.

In many of the smaller purchase and assumption transactions, we have not required bidding banks to take loans of the failed bank. Even in these transactions, however, acquiring banks frequently buy some loans, thereby facilitating the liquidation process. Within the FDIC we have been looking at the purchase and assumption process to see how such transactions might be modified and improved. It may be feasible to structure transactions so that acquiring banks usually take a high percentage of assets. By minimizing FDIC cash outlays, foregone interest, and liquidation expenses, the overall cost to the FDIC might be further reduced.

In 1951 a Congressional committee was severely critical of what appeared to be an automatic FDIC decision to use the purchase and assumption alternative in all bank failures. In fact, there had been no payoffs between 1944 and 1951, and comparative cost tests had been virtually ignored. The result, of course, could be predicted: One bank with total assets of only $637 thousand required an outlay by the FDIC of $1.8 million and an ultimate loss of $1 million, to effect FDIC-assisted purchase and assumption with accompanying indemnities to the takeover bank. Following that criticism, the FDIC became and has

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remained very careful to arrange purchase and assumption transactions only when the costs justify that decision, and, as I have mentioned, there have been a few instances in which payoffs have occurred.

Nevertheless, all of the considerations I have mentioned suggest that we are likely to continue to handle most bank failures through purchase and assumption transactions as we have during the past few years. While subordinated creditors and equity investors typically lose most or all of their investment in purchase and assumption transactions, depositors and nonsubordinated creditors incur no losses.

As a result we have had de facto 100 percent insurance for all depositors in most banks in recent years. What we have not had is equity, fairness, and logic in determining which are to be the few depositors who do not have 100 percent insurance. Those instances where depositors have experienced losses in payoffs have reflected special circumstances from the FDIC's standpoint -- not from the depositors'.

For example, there were some cases where it was not possible to arrange for a purchase and assumption because of the location of the bank, because of the state's branch and holding company laws, because the FDIC could not get a good fix on liabilities because of pending lawsuits or suspected fraud, etc. Uncertainty and potential cost considerations may have afforded logical reasons for a payoff in such cases as far as the FDIC was concerned. However, uninsured depositors were not necessarily at fault. They were unlucky. I recognize that these were large depositors who presumably were sophisticated and knowledgeable enough to scrutinize the condition of the bank

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before making their deposits. The fact is, however, that would not have helped in all cases. The sophisticated depositor is more likely to be able to detect poor management, which will probably lead to a purchase and assumption transaction in which he will be 100 percent insured if he leaves his deposit with the bank, than to detect fraud, which is more likely to lead to a payout and some loss on his deposits.

In a few other instances where the continued existence of the failing bank was essential to the community served, the FDIC has provided direct assistance under Section 13(c) of its statute, thereby eliminating or postponing the need for closing the bank and losses to depositors. This section has been used rarely by the FDIC, at least partly because it requires a finding that preservation of the bank in question is essential for providing adequate banking services to the community. While I do not quarrel with the appropriateness of this test, it has nothing to do with any equitable determination from the depositor's standpoint of which depositors get covered in full and which do not.

Another factor affecting depositor losses has been the timing of bank closings. Decisions on bank closings are made by agencies that charter the banks: the Comptroller of the Currency and the state bank supervisors. The Federal Reserve may play an important role in connection with advances to member banks and the FDIC provides input to the Comptroller and the states. Delays in closing a bank, avoidable or unavoidable, particularly after adverse publicity, enable some large depositors to withdraw funds to avert a possible loss. In some instances such delays have benefitted specific depositors,

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perhaps just those depositors which we have argued over the years provide the discipline to top management. It may also be, however, that those depositors who leave during the delays just happen to be those whose deposit certificates mature during the period, a relatively illogical basis for preferring one uninsured depositor over another. Such withdrawals, whatever the basis, increase the share of loss borne by other uninsured depositors if the bank is paid off.

If we almost have 100 percent deposit insurance and the present system appears to work in an almost random way in its treatment of depositors -- similar depositors are treated differently in different cases -- why not go to 100 percent deposit insurance? Obviously, this proposition is more complicated than that. The possibility that presently uninsured depositors will lose money in the event of a bank failure, for example, does make a difference in the behavior of some depositors and, as a result, in the behavior of some bank managers. This difference is important and its impact, I believe, has some good and bad consequences. I do not have the time today to trace those effects in detail -- that is in fact another speech which I plan to make soon -- but I would like to briefly review the arguments for and against 100 percent deposit insurance, without, at least for the time being, committing to the support of any of them.

First, the obvious arguments in support:

1. One-hundred percent deposit insurance obviously will provide additional protection to those depositors whose deposits are not now fully protected. Based on past experience, the cost of this additional insurance coverage to the

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FDIC would be small. We have calculated that the additional cost to the FDIC of payoffs made throughout the Corporation's history, if none of the loss had been borne by uninsured depositors and the same banks had failed, would be about $13 million. Of course, that is a small figure in part because large bank failures have been handled through a purchase and assumption. For example, if USNB had been handled as a payoff rather than a purchase and assumption, this figure would be $88 million. An important point, as we have noted, is that in effect, we already have almost 100 percent deposit insurance because of our policy of arranging purchase and assumption transactions wherever possible.

2. With 100 percent deposit insurance, depositors would have no need to withdraw funds from banks with problems, and runs on such banks would not be likely to cause a failure. Under our present system, when a bank gets into difficulty or is exposed to adverse publicity, some uninsured depositors tend to flee, exacerbating that difficulty. One-hundred percent deposit insurance would limit deposit outflows in adverse circumstances, thus providing more time to work out a solution for the problem bank or for management to turn the bank around. If these considerations prevail over other contradictory considerations, we would expect to have fewer bank failures under a system of 100 percent deposit insurance.

3. One-hundred percent deposit insurance would have a beneficial impact on competition among banks. At present, institutions deemed to be more solid or more conservative have an advantage in competing for deposits. Perhaps this is as it should be. However, depositors may not be able to

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differentiate accurately among banks according to risk, and for some depositors, size becomes a proxy for soundness. Or depositors may simply assume that we will not allow a large bank failure to result in a payoff.* One-hundred percent deposit insurance would probably improve the competitive positions of small vs. large banks and of new vs. established institutions. Over time this would ordinarily be expected to reduce the level of concentration in banking, and to lead to more competitive pricing of banking services.

4. Because, as I have mentioned, we would not need to fear provoking runs on troubled banks, fuller public disclosure of adverse information on a bank's financial condition could be made. This would lead to more informed business decisions by investors and customers of the bank.

5. There has been much discussion in the past about the distortions caused by state pledging requirements for deposits of public funds. With 100 percent deposit insurance, such requirements could be eliminated without any risk of loss to the depositors.

The obvious arguments against 100 percent deposit insurance:

1. The principal and traditional argument against 100 percent deposit insurance is that uninsured depositors place limits on the riskiness of bank

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* Statistically, there is some support for that position, as evidenced by the following: During the period 1971 to September 1, 1976, of the banks that closed, 29 were less than $25 million in deposits. Twelve of these were paid out, 15 were acquired by a third party in an FDIC-assisted purchase and assumption transaction, and 2 became Deposit Insurance National Banks. Seven of the failed banks were between $25 million and $100 million, and of these only 1 was paid out. Four were over $100 million and none of those were paid out. Logically, legally and historically, however, the fact remains that no one can be certain that the FDIC will always be able to avoid paying off even a large bank.

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operations. While there is some debate about how effective such influence is, few would deny that to a degree at least, it exists. With 100 percent insurance, banks anxious to increase their risk by bidding aggressively for deposits and loans might be able to do so without any market restraints. No banker wants to lose money or fail, but some would be willing to take on considerable risk if they consider potential rewards in the form of growth and earnings to be sufficient.

This weighing of risk and reward works in most sectors of our economy, but we normally expect most of the risk to be assumed by equity investors. Where leverage is sought lenders restrain the extent of overall risk by imposing restrictions -- higher interest rates -- and limiting available funds as risk is increased. In the banking system, depositors provide most of the funds, and if 100 percent deposit insurance were to exist, much or most of the risk would be borne by the deposit insurance fund.

Let me emphasize that the argument is not that most or even many bankers would behave irresponsibly if we had 100 percent deposit insurance. Rather, it is that 100 percent deposit insurance would eliminate market restraints that many believe presently exist which limit the amount of deposits available to the overly risky, overly aggressive, overly optimistic or self-serving operation.

2. To protect its position, the FDIC might need authority to restrict leverage or the composition of bank asset portfolios if 100 percent deposit insurance were to exist. Traditionally, the FDIC has opposed the regulation of the operational mix and I think most bankers have opposed it, fearing that regulatory restrictions might be more costly than the benefits of 100 percent deposit insurance.

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3. As long as there are no runs or liquidity pressures on banks in difficulty, supervisors might be reluctant to close banks that are insolvent or operating in an excessively risky fashion.

4. In view of the greater risks which banks might take and the longer time before they are closed, the ultimate losses to the insurance fund might be large. In fact, our past experience of very limited losses may not be a true indication of the potential risks under 100 percent deposit insurance.

There are, of course, other issues involved that I have not even mentioned. These include the premium structure for deposit insurance. The suggestion has often been made that deposit insurance premiums be tied to the riskiness of the bank, a suggestion that is easier to justify in principle than to work out in practice. Others argue that there is an inequity in that banks pay premiums on all deposits even though part are not insured. What should we do about insurance coverage for deposits of American banks abroad? Or about the deposits of U. S. branches of foreign banks? If deposits are insured 100 percent, what are the implications for capital needs in a bank? Would the new mix of risks affect monetary policy mechanisms? I cannot resolve all these issues today, but I believe that the banking system would benefit from public discussion of the issues I have raised today and, as I indicated at the outset, this is probably a good time to begin such discussion.

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