/c.2

Chairman's speech binder

NEWS RELEASE

FOR RELEASE UPON DELIVERY (FDIC news release PR-2-77 (1-11-77))

Bk Dir/
Stat
Spch
FDIC
Chr
B

Library
JAN 13 1977
FEDERAL DEPOSIT INSURANCE
CORPORATION

Remarks by

Robert E. Barnett, Chairman
Federal Deposit Insurance Corporation
Washington, D. C.

before the

Philippine Deposit Insurance Corporation

January 11, 1977

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The development of Federal deposit insurance in the United States is a classic example of a successful national effort to respond to a severe national crisis. Although the Federal Deposit Insurance Corporation came into existence in the 1930s, the possibility of providing deposit insurance had been discussed and debated, and even tried in some states, at varying times for more than a century. The major catalyst was a severe national banking crisis with substantial losses to depositors during the Great Depression of the '30s. Our banking and monetary systems were in jeopardy and unprotected bank depositors, among others, bore very heavy personal losses. Faith and confidence in our banking system were severely shaken and with it confidence in the Government's ability to deal with the situation.

The Great Depression of the 1930s was worldwide, not simply a U.S. problem. Neither were strains on the banking and financial system confined to the U.S. In fact, some American economic historians have traced the origins of the banking collapse in the U.S. to failures of banks abroad. While recognizing the international aspects of the Great Depression, the Federal Deposit Insurance Corporation was aimed solely at the domestic problem of bank failures and confidence in the U.S. banking system.

I

The last few years have also been traumatic ones for the United States banking industry. The worst recession since the Great Depression of the 1930s, combined with double-digit inflation, imposed great strains on the banking system. More bank failures occurred in 1976 than in any

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

year since 1942. The eight largest bank failures in the FDIC's history took place in the 39-month period from October 1973 to December 1976, failures of banks whose assets aggregated over 3 1/2 times as many assets as all the other insured banks that have been closed during the entire history of the FDIC. Yet, despite these strains, and the generation of a great deal of unfavorable publicity, the public's basic confidence in the banking system and the deposit insurance system appears to be unshaken. At all times during 1976, for example, at least 97-98 percent of all the insured banks in the United States, or over 14,300 banks, were <u>not</u> on the FDIC problem list; only around 2-3 percent of them were.

The strains on the banking system of the last few years were not at all insignificant. Not only did they lead to 16 insured bank failures in 1976, but they also raised the number of banks on our problem list to the highest level in 25 years. At the end of the year, there were 379 FDIC insured banks on our list of banks we feel supervisors should be paying particular attention to, the list we call our "problem" list, or about 2 1/2 percent of all insured banks. While this is a very low percentage, far fewer than that, considerably less than 1 percent of all banks in the country, are in our serious problem categories.

One new aspect of the problem list now, as distinct from a few years ago, is that the list includes some large banks (banks with over $500 million in deposits) and a very few very large banks (over $1 billion in deposits). Of course, there are many more banks now in those size categories than there were in the past, so the existence of some of these banks on a problem list is more likely now than previously.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

But it must be recognized that in recent years larger banks assumed greater risks on both sides of their balance sheets. Some managers managed this risk more poorly than most. That fact, combined with the unsatisfactory performance of the economy, has led to problem status for a few of these larger banks.

The FDIC was not established, of course, to eliminate bank failures or to prevent banks from assuming risks. During periods such as the one we have been passing through, the FDIC has as its major function that of assuring that an individual bank failure does not lead to drastic repercussions. Our major function in these circumstances is one of maintaining confidence in the banking system so that the occasional failure, which is an essential part of a free enterprise system, can be handled with a minimum of disruption to the economy and the community.

The FDIC has successfully met its test. If five years ago we could have forecast the most severe recession since the Depression of the '30s, simultaneous high unemployment and rapid inflation, the collapse of the multi-billion dollar REIT industry, bankruptcies of major industrial corporations as well as failures of some larger banks, we might have had great concern about the ability of the banking system to avoid a major crisis of confidence. Such a crisis has not developed. To be sure, this required massive action on an unprecedented scale by the FDIC. The concept of a "clean bank" purchase and assumption transaction, one in which a take-over bank purchases only good assets from the estate of the failed bank, the FDIC substituting cash for the assets not taken by the take-over bank, has been applied in the past three years by the

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Corporation to larger banks, as well as to smaller ones. By doing so, the Corporation has removed from the banking system between October of 1973 and December 31, 1976 over $3.7 billion of questionable assets, including all of the worst assets of all of the failed insured banks. This represents a substantial removal of poor quality assets from the banking system.

Just as important as the "clean bank" purchase and assumption approach has been the Corporation's determination to attempt to arrange a purchase and assumption in each failed bank situation, rather than pay depositors their insured amounts. This approach, and our ability to implement it not only in all larger bank failures but in nearly all failures regardless of bank size, has contributed significantly to customer confidence in the banking system. Only three banks, whose total deposits aggregated only about $18 million, were paid out in 1976.

II

The size and complexity of the Corporation have grown dramatically during the past few years. The Corporation now supervises 8,981 commercial and mutual savings banks, an increase of 67 during 1976 and an increase of 779 during the past five years. These banks at mid-year 1976 had assets totalling $335.2 billion, an increase of $17.1 billion in assets of banks supervised by the Corporation from the end of 1975, and an increase of $148.0 billion during the preceding five years.

We are currently liquidating over $2.6 billion of assets in our Liquidation Division. These assets are considerably larger and more

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

difficult to liquidate than those in earlier liquidations and our recovery record will not be as high when the books are finally closed on these liquidations as it has been in the past.

The number of Corporation employees now totals 3,541, an increase of 267 during 1976, and an increase of 934 during the past five years. Our expenditures, of which at least 83 percent is for employee compensation and examiners' travel, totaled $75 million for 1976, an increase of $8 million from the previous year and an increase of $33 million from five years ago. The increase in expenditures during the past five years is directly traceable to governmental pay and reimbursement increases, increases in number of employees, and inflation.

The largest part of the increase in number of employees is directly related to the increase in number and size of banks supervised and to the number and size of liquidations we are administering. In addition, a number of employees have been added to deal with relatively new responsibilities that the Corporation has been given during the past few years. For example, while it is difficult to estimate precisely, it appears that the Corporation is spending the equivalent of 230 man-years each year in enforcing consumer laws.

III

As you know, bank regulatory agencies in the United States, such as the FDIC, examine the banks they supervise. When our examination process detects weakness in a bank, we have several means of dealing with the situation, both formal and informal. Over the last few

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

years, there has been a trend in the direction of more frequent initiation of formal actions, generally cease and desist orders issued pursuant to Section 8(b) of the Federal Deposit Insurance Act. While informal approaches are often successful, the trend toward greater use of formal actions was accelerated in 1976. There were 41 cease and desist proceedings initiated in 1976, compared with 8 in 1975 and only 7 as recently as 1971.

Section 8(a) orders, withdrawal of insurance, have remained rather constant in numbers during similar periods with 8 being initiated during 1976 and 5 each in the years of 1975 and 1972. Federal deposit insurance was terminated in one bank during 1976, First State Bank & Trust Co., Rio Grande City, Texas, and the bank failed shortly thereafter.

Major steps were taken by the FDIC during 1976 to increase efforts at enforcing bank customer oriented laws and regulations. Not only was a Director for the Office of Bank Customer Affairs selected and the efforts of that office begun to be felt during 1976, but Section 8(b) cease and desist orders for violations of the Truth in Lending Law were issued for the first time. Also instituted was a sample survey aimed at improving enforcement of Fair Housing Lending (Title VIII of the Civil Rights Act of 1968), and based on what is learned from analysis of the sample survey, we plan to extend that program during 1977. Increased training for examiners was part of our program during 1976, as were changes and improvements in our consumer complaint investigation procedure.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Our analysis of bank problems in the past has led us to conclude that an increasing responsibility for bank safety and success must lie with the board of directors of the bank. During 1976 members of the Board of Directors of the Corporation and members of the FDIC staff participated in educational programs aimed at directors of banks and we have announced a policy of conducting meetings between the bank examiner and the board of directors of banks on a more frequent basis than previously. Since we have found that a number of bank failures and bank problems have resulted from improper dealings between the bank and its insiders, we issued a new regulation in 1976 requiring approval of significant insider transactions by the board of directors of each nonmember bank.

IV

There has not been a fundamental change in the deposit insurance system since its inception. The performance of the banking industry and the FDIC during this recent difficult economic period has been good and suggests that drastic change may be unnecessary. Nevertheless, in an attempt to confirm or refute this and to review systematically our entire operations, we launched during 1976 a major analysis of the premises and procedures of our system of Federal deposit insurance. This review covers the extent of deposit insurance, the financing of the deposit insurance system, and our methods of handling bank failures. In addition, we are giving special attention to the international aspects of deposit insurance to determine whether that change in the nature of that important segment

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

of the banking business requires some change in the deposit insurance system. Any recommendations arising from our study will be reported during 1977.

In recent years, several other countries have instituted or considered deposit insurance systems of their own. In most cases this has been in response to a general banking problem or to a particular bank failure, though we like to think that one factor involved in the adoption of deposit insurance as a solution is the success of our system. While I am not an expert on the operations of deposit insurance systems outside the U.S., it is my impression that all have been reasonably successful in meeting the domestic financial problems they were set up to handle or, if not, they have been or are being modified to permit them to do so.

I am not sufficiently informed of the operations of all of the various deposit insurance systems which exist around the world to suggest that any one is "better" in any sense than any other. What I do want to suggest is that now is an appropriate time to look at certain international aspects of these domestic deposit insurance systems. There are several reasons for that. The worldwide economic decline in the mid-'70s was the greatest on a worldwide basis since the Great Depression of the '30s. This experience gave us a clear-cut demonstration, if one was needed, that the economies of the world are linked together and that serious financial or economic problems in one part of the world are rapidly transmitted to others. Second, we must recognize that in recent years larger banks have become susceptible to the problems, weakness and even failure that

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

until recently we had tended to think of as problems confronting only very small banks. Related to both these factors is the fact that banking has become more international. The largest banks in the U.S. and other countries have long been involved in international finance. But in recent years that involvement has increased, and has represented a larger fraction of their total operations. International interbank loans and deposits have greatly expanded. Further, some banks other than the very largest have moved into the international banking business. Currently over 100 U.S. banks have foreign branches or offices, and almost 70 foreign banks have set up one or more depository offices in the United States. One important aspect of that development is that the international banks are moving into consumer business abroad. At one time, the international operations of the giant banks involved international trade and the facilitation of large international transactions. But now American banks are competing in retail credit markets in several other countries and a number of non-U.S. banks are operating branch systems and competing for local retail banking business in the U.S.

These trends give me cause for concern. I do not have any particular proposal to make at this time and no particular solution to urge upon the U.S. Government or the world financial community. I do want to raise certain issues related to the international aspects of deposit insurance for consideration by experts and practitioners of the deposit insurance business in the U.S., the Philippines and elsewhere.

This issue of deposit insurance coverage of foreign banks is not simply an academic one. There have already been instances of bank

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

failures of foreign banks in various countries that have created difficulties for both governments involved. In 1966, we saw the failure of the Intra Bank of Lebanon, which had a branch in New York, causing losses to depositors in Lebanon though not to those in the United States. In 1970, a Swiss subsidiary of the United California Bank failed. While there were no government guarantees or insurance involved, the parent bank decided to make good the losses of its subsidiary even though there was no clear legal obligation to do so. The Herstatt failure in Germany in 1974 caused great consternation and financial difficulties for international customers of that bank. Another bank failure which apparently resulted in losses to international depositors was the failure of the Israel-British Bank, a bank with joint Israeli/British ownership, which failed in England in 1974. That was a case in which it appears that both governments felt that depositors should be protected, but it was not clear whether the responsibility lay with the British or the Israeli authorities.

The United States has had three experiences with failures involving international implications since I have been with the FDIC. When United States National Bank of San Diego failed, besides representing our largest bank failure up to that point, it also represented our first failed bank with substantial international business. U.S. National Bank had on its books many letters of credit dealings with European and Middle-Eastern banks, letters of credit which on their face would not qualify as deposits or non-contingent liabilities under either the FDI Act or under the terms of the agreement by which Crocker National Bank assumed deposit liabilities of the failed U.S. National Bank with FDIC financial assistance. Many of the European

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

banks had viewed these transactions as direct loans to United States National Bank, making the obligations direct liabilities of the bank. The FDIC voluntarily looked beyond the "four corners of the document" and paid the foreign letter of credit holders in those cases which were found to involve direct liabilities of U. S. National Bank. Rather than trying simply to minimize our insurance obligations, we did attempt to see that equity was served with respect to foreign banks relying on dealings with an insured American bank. There is still a great deal of litigation left concerning letters of credit which were found to be unmatured, contingent obligations of U. S. National Bank. These letters are held by both domestic and foreign banks and the final outcome of this litigation is not clear. Nevertheless, I believe that the FDIC Board of Directors acted in a responsible manner to minimize the international repercussions of that large bank failure, though it did so in the absence of formal international agreements or guidelines.

When the Franklin National Bank failed in 1974, it was operating a branch in London. The FDIC did arrange a purchase and assumption transaction whereby European-American Bank assumed all the liabilities of the Franklin National Bank. Had European-American been unwilling to take the London branch, the deposits in the London branch would not have been insured and some loss would have been likely to depositors.

The very recent failure of American Bank and Trust Co. in New York City also presents new implications for international transactions involving a domestic U. S. bank, the results of which will not be apparent perhaps for some time.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

In view of these experiences, we believe that some attention must be given to the international aspects of domestic deposit insurance by the countries of the world, certainly by the United States. I do not have any solution to propose at the present time, although it seems apparent that clear lines of communication should be established between the various deposit insurance corporations or systems in the different countries.

In the U.S., the Federal Deposit Insurance Corporation provides insurance coverage for deposits up to generally a $40,000 maximum in all insured banks in the United States. Deposits of both Americans and foreigners are covered. Branches of foreign banks operating in the U.S. are not eligible for deposit insurance, though several foreign banks have organized American subsidiaries which have obtained deposit insurance. Deposits in the branches of American banks abroad are not insured, either for American citizens or local residents. FDIC-insured banks pay assessments for insurance coverage to the FDIC based on their total deposits in U.S. offices. That is, their insurance assessment is not based on their deposits abroad, but they are assessed on total (not just insured) deposits in the U.S. This system, as I say, has worked well and seems appropriate and adequate to deal with the essentially domestic problems for which it was established.

There are some steps, however, which are being considered in the U.S. which I want to bring to your attention. A bill was considered by our Congress last year, and is sure to be considered again this year, that related to the regulation of foreign banks operating in the United

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

States. At the present time there is very limited Federal regulation of such banks. This bill would combine additional regulation and restrictions on the opration of U.S. branches of foreign banks with a program of deposit insurance or depositor protection. We have mixed feelings about this approach because we feel that although it may be desirable to the foreign banks, it is extremely difficult to develop a workable insurance system for branches, as distinct from subsidiary banks, primarily because of difficulties relating to jurisdiction over foreign property and citizens.

In the United States, however, we already have a system where virtually all banking offices are insured by the FDIC. The public now takes deposit insurance for granted, and depositors do not stop to think that a bank may not be insured. This was less of a problem when the foreign banks operating in the U.S. without deposit insurance were doing only a wholesale or international business, but now as they are competing for retail business this has become a more serious concern.

We have also been doing some thinking about possible changes in our deposit insurance system. One of the proposals which we have been considering would involve extending Federal deposit insurance protection to deposits in the foreign branches of American banks. At the present time, as I have mentioned, deposits in these branches are not insured. We believe that most of the larger American banks operating branches abroad are not interested in such deposit insurance, partly because at the present time they are not paying deposit insurance premiums on

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

those deposits, but more importantly because such insurance is probably not meaningful or necessary for most of their larger customers, and would simply subject them to increased Federal regulation without, in their judgment, corresponding benefits.

There would be international implications of such a change made by the United States. For example, American banks operating in Italy might have a competitive advantage over Italian banks if deposits in the American banks were insured by an agency of the U.S. Government, whereas deposits in the local Italian banks would not have government guarantees. That might even appear to be unwarranted U.S. Governmental interference in the economy of that country. There would also be problems with respect to American banks operating in countries where there is a local deposit insurance system. Would an American bank operating in Germany have to pay deposit insurance assessments to both German and U.S. deposit insurance systems? Who would make good in the case of failure? These are issues that cannot be resolved by one government, hence, my call for more communication between agencies which operate deposit insurance systems.

Confidence in the American banking system has remained very high during the past few years even as the U.S. has struggled through an extraordinarily difficult economic period. While deposit insurance and the FDIC cannot alone take credit for this confidence, it can take its share of credit. It is this confidence to which I'm directing my remarks, but in an international rather than a domestic

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

setting. Deposit insurance, with its implications for confidence in international financial transactions, is one of the major elements which must be reviewed carefully and rationally as the polycentric web of international finance continues to develop.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis