FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

NEWS RELEASE

FOR RELEASE UPON DELIVERY

PR-42-77 (5-24-77)

Address by

Robert E. Barnett
Chairman

before the

Pennsylvania Bankers Association Annual Convention
Atlantic City, New Jersey

May 24, 1977

In News Rel
not
speeches

FEDERAL DEPOSIT INSURANCE CORPORATION, 550 Seventeenth St. N.W., Washington, D.C. 20429 • 202-389-4221

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

In my judgment, the FDIC has done an excellent job of maintaining confidence in the American banking system. The bank panics of the '20s and '30s are memories of the past, even though economic cycles have continued inexorably since that time, contributing troughs as well as peaks to our economic history.

Just one year ago, I made my first speech as Chairman of the FDIC. The speech was addressed to the current problems of the banking industry which had been receiving a great deal of publicity. I would like you to try to recall the atmosphere of that time, which was not a pleasant one for the banking business. Bank failures were occurring at a more rapid rate than at any other time since the aftermath of the Depression of the '30s. We had 5 failures in the first five months of 1976, compared with an average of 6.6 for each full year from 1965 to 1975. The number of banks on our problem list had climbed at an unprecedented rate and included, for the first time, a number of large banks. At the end of last May, there were 373 banks on our problem list, up from 248 a year earlier. Thirteen of those had deposits of over $300 million, while there were only 6 of that size a year earlier. Bank loan losses were up dramatically. The possibility of further losses on loans to REIT's and oil tankers was a matter of serious concern.

I set forth these data in some detail, and hence my speech, since I wanted it to be candid, could not be a totally cheery one. My evaluation of the problem at that time traced the increase in bank loan

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

losses, the increase in the number of problem banks, and the number of failures primarily to the very severe recession of 1974-75. But I also noted the trend toward greater risk-taking on the part of the banking system that had taken place during the 1960s and pointed out the problems that trend had produced as well as acknowledging that there are some public benefits from a more aggressive approach to banking. Unfortunately, there were some unusual characteristics of the economic and international situation of the time that magnified the effect of that greater risk-taking on the banking system.

I reported on some research at the FDIC that found a consistent pattern of loan loss increases during recession periods, followed by a decline in the first year of recovery following a recession. On the basis of that analysis, I forecast a decline in the loan loss ratio for 1976.

I also noted that our problem list seems to fluctuate with the economy but, as distinct from the loan losses, with a time lag of about 12 months. I pointed out that "it is not surprising that now, about a year from the low point in the recession, we are at a high point on our problem list. If the current relationship follows previous experience, I would expect the number on our problem list to get smaller later on this year."

Now the forecasts I made in that speech a year ago turned out to have some shortcomings. In fact, bank loan losses increased in 1976 as compared with 1975. The number of bank failures for the full year of 1976 was 16 -- the highest number since 1943. And the number of

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

problem banks, while seeming to have reached a plateau, has not declined since last May and, in fact, additional large banks have been added to the list.

My forecasts a year ago were honest ones. But suppose I had been able to foretell the future more accurately. Suppose I had been able to predict that loan losses, at a record level in 1975, would increase still further in 1976. That the number of bank failures in 1976 would exceed the high number of 1975. And that the problem list already at extremely high levels, would fail to decline over 1976 and 1977 and would include more billion dollar banks. In such a scenario, most of us would have expected a great jolt to public confidence in the banking system, and concern about the ability of the banking system to withstand these events forecast for 1976. Confidence in the banking system was maintained, and even improved by any reasonable measure. While many of the problems of a year ago are still with us, we do not have great public concern about the soundness of the banking system or even about individual banks which have performed poorly or received unfavorable publicity.

What accounts for the great confidence which the American public seems to have in the banking system in spite of unfavorable developments and unfavorable publicity? It may appear immodest for me to say so, but I think the answer is, in large part, the Federal Deposit Insurance Corporation.

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

The years I have been with the FDIC, both as Chairman and as Deputy to former Chairman Frank Wille, have been the most traumatic in the history of American banking since the Depression of the 1930s. The FDIC practically had to learn from scratch how to deal with the dramatic events of the 1970s, which included the 10 largest bank failures in our history. I am very proud of the way the FDIC has been able to deal with the problems as they arose, and the role that it plays in maintaining confidence in the American banking system.

At one level, the confidence of the public in the banking system is a reflection of reliance on the fiscal solvency of the FDIC. The Federal deposit insurance fund has grown considerably during the period of the 1970s despite our largest losses ever. In 1973, before the failure of United States National Bank in San Diego, the losses on which exceeded by a large margin the losses to the FDIC on all the other bank failures in our history combined, and before the 35 failures (including Franklin National Bank) that have occurred since then, the fund was $5.6 billion. Now it is $7.5 billion. I believe that simple comparison makes an eloquent statement.

Even though the fund is only a small fraction of insured deposits in our banks, as it always has been, the public seems to have no doubts that, if the need arises, the FDIC has the financial ability to make good on its legal obligations. In fact, in recent years on those rare occasions where we do have a failure resulting in a payout of insured deposits by

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

the FDIC, we have a problem in getting people to take the time to come in and get their money. They generally are not lined up and in a great rush to get their money from us because they are sure that it will be there whenever they need it.

But more important than reliance on the size of the deposit insurance fund, I think, has been the confidence of both large and small depositors sophisticated and unsophisticated bank customers, in the ability of the FDIC to handle problem situations and to conduct its supervisory and insurance responsibilities in a professional and capable manner. The FDIC has developed techniques which minimize the disruption to a community resulting from a bank failure. It should be noted that this goes well beyond what we generally think of as the primary responsibility of the FDIC -- protecting small depositors against loss in the case of bank failure. In fact, we have not only been able to protect the small depositor, but the large depositor as well. In most cases, we have also been able to avoid any financial disruption to the on-going business activities of creditworthy bank borrowers, and we have thereby minimized disruption to the economy of the community. We have reached the point where failures of moderate sized banks, that is, banks of up to $100 million of deposits, receive virtually no attention or publicity outside their immediate area. And even relatively large bank failures have not generated much public attention during the past year.

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

Let me say a few words about these procedures and how they have worked. Whenever a bank is close to failing, we work together with the primary supervisor (the Comptroller of the Currency in the case of national banks, and the State Banking Department in the case of State banks) in an attempt to solve the problem. I might add that despite occasional comments and discussion of lack of coordination among the banking supervisors, and cries for consolidation of the agencies, we have generally found that in these situations the cooperation is excellent. If the problem cannot be solved, and failure is unavoidable, the FDIC seeks to find a sound bank or bank holding company that is capable of assuming the liabilities of the failing bank and providing banking service on an uninterrupted basis. In the interests of fairness and of minimizing our losses (and stockholder losses) we generally try to select a buying bank on a competitive bidding basis. We generally find a buyer willing to pay a premium large enough to make this arrangement cheaper to us than closing the bank and paying off insured depositors.

It is not always possible to find an existing bank or qualified group of investors willing and able to absorb the business of a failing bank. In some cases, the FDIC has used a provision of the FDI Act to provide assistance directly to the bank to enable it to survive. Though this provision has been part of our Act since 1950, it was used for the first time in 1971. We have been very careful in our use of this technique to balance off our desire to avoid disruption to the community with our reluctance to see the people responsible for a bank's problems bailed out.

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

In all cases, therefore, we have insisted on a change in management and the financial terms have been arranged so that investors (as distinct from depositors) have incurred sizable losses.

What I have described so far I consider to be a very significant achievement for which the FDIC deserves a great deal of credit. That achievement has been generally recognized, though I do not feel that the FDIC always gets the credit it deserves for the current state of confidence in the banking system. But the maintenance of confidence in the banking system has other implications that are not so obvious, and I want to spend a few minutes describing them.

One side effect of the general confidence in the banking system is that we can afford to have full disclosure of adverse information about the banking system, and frank public discussion of problems that would not be possible without that confidence. Bankers and bank supervisors have traditionally shied away from forthright disclosure and discussion of adverse developments. Actions of individual banks, the banking agencies, the SEC and our newspapers have led to much greater disclosure of financial information concerning banks than was the case only a few years ago. It has long been an item of faith embodied in our securities law that, in the business sector, full disclosure is important to investors and to the functioning of the financial markets. We have been reluctant to carry that argument over into banking because of concern that adverse publicity about banks could lead to runs and perhaps bank failures.

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

The stability of the banking system in the last year or so indicates that we can afford to have much greater disclosure than previously. The FDIC has made a recent analysis of the impact of disclosures of bad news on the price of bank stocks, particularly some which have been the subject of unfavorable disclosures. In general, there does not seem to be any significant adverse effect on bank stocks resulting from disclosure or discussion of problems of the banking industry. I am not defending leaks of confidential information, but this lack of harm suggests that we are on the right track in promoting wider disclosure of financial information by banks, and in the FDIC's decision to release information on a routine basis concerning the status of our problem bank list.

Soon after I became Chairman of the FDIC, I had the FDIC staff undertake a large-scale study of possible changes in the deposit insurance system. This was to be a review of the present system and the development of recommendations for changes in the system. I wanted this analysis not because I was aware of any major problem at the time, although there seemed to be some problems of fairness in the system, but simply because the basic structure of deposit insurance in the United States had not been significantly changed in 40 years. It seemed to me that it was time for a thorough review of the system. I spelled out my concerns, and the arguments that might be raised for and against different approaches to deposit insurance reform, in a series of speeches last year. In particular, I noted the use of the procedures I have just described have resulted in almost a de facto 100 percent deposit insurance system. I raised the question of whether

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

formal de jure 100 percent deposit insurance might not be a means of eliminating what little uncertainty about the safety of deposits that now exists at very little additional cost.

Our staff study of these issues has recently been completed and we hope to publish specific conclusions from that study soon. As one would expect and desire in a staff consisting of a number of talented and experienced individuals, we did not achieve a unanimity of views. Some of those participating in the study favored one change, some another, and some no change. I am not unhappy with the lack of unanimity or with the result that, after this intensive study, our staff has not reached a consensus for major change in the deposit insurance system. Perhaps, in fact, it was to be expected since such a relatively small number of people were injured during the large number of failures in the 1970s.

I do not expect our staff study to be the last word on this subject. Both Dr. Carter Golembe and Governor Wallich have recently addressed themselves to this subject and have come out differently from our staff. Their positions, and the positions of others who might address the subject, must and I'm sure will be considered.

With respect to the issue of 100 percent deposit insurance, our staff concluded that we could provide 100 percent insurance at little additional cost or risk. The study further pointed out that 100 percent insurance would effectively eliminate the danger of bank runs or rapid deposit withdrawals and hence would give us more time to work out the purchase and assumption transactions we always try to arrange.

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

There are two negati e considerations in the 100 percent deposit insurance issue. First is the fact that under our present system, there are large uninsured depositors who are, at least to some extent, at risk. They have an incentive to police the banking system by selecting banks on the basis of their soundness, their capital, and their conservatism. We would be reluctant to see this market force lost by eliminating all risk to depositors from the system.

Actually, our staff study investigated this issue and found that it is not a very significant factor, at least in depositor considerations regarding demand deposits. Apparently, we have been almost too successful in inspiring confidence in the banking system in that even sophisticated large depositors do not give much thought to the possibility of loss in a bank failure.

A more serious drawback to 100 percent deposit insurance is not economic but political. If the FDIC is bearing the entire risk of bank failure, it will appear logical to some that that be accompanied by greater regulation of the banking system. In fact, I mentioned that in my initial presentation on the subject. A logical extension of that was recently suggested by Dr. Golembe. He pointed out that:

> "Once all deposits are explicitly insured by the federal government, it would be a small and possibly not entirely illogical step (at least as viewed by certain Congressmen) to put into place various asset-allocation plans. The investment of deposits, in other words, could be directed by law into certain allegedly socially desirable uses, regardless of the risk involved. The rationale, of course, would be that since the government is assuming the risk of loss, it should have a say in how deposits are used."

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

If insurance were then provided to bank stockholders as well as depositors, Golembe notes:

> "...nationalization of the banking system would be but a step away."

For my part then, I find the economic argument for expansion of deposit insurance coverage, perhaps to the point of 100 percent protection of demand deposits, or some time-delayed protection such as recommended by Dr. Golembe, rather convincing. I am very concerned, however, about the noneconomic implications that I think could be damaging to the banking system and to the U.S. economy, and on balance, would be reluctant to change the present system.

The same analysis holds true for a topic which has received considerable attention over the last few years -- regulatory reform of banking supervision. A number of Congressional leaders would like to see some consolidation of the banking agencies.

There are some legitimate arguments in favor of consolidation of the bank agencies, though I feel that the disadvantages of greater consolidation would outweigh those advantages. A year or so ago, however, the argument was being made that consolidation was necessary because our present system of banking supervision was not working well; that the problems of the banking industry were due to shortcomings of the bank supervisors; and that the present structure of bank supervision had resulted in massive public loss of confidence in our banking system. This argument should have been put to rest by the course of events of the past few years.

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

The discussion of regulatory reform can go on, but it should proceed on the merits of the situation. We can discuss whether this plan or that plan will represent real improvement over the present system, without feeling that some change is necessary because the present structure of supervision has failed to maintain the confidence of the public in our banking system.

While time does not allow a full discussion of the issue of regulatory agency structure, I would like to comment briefly on a few points that have received recent attention in the press. This may be a particularly appropriate time to do so since, in view of my forthcoming departure from the FDIC, it is clear that I have no personal involvement in the future distribution of supervisory responsibilities.

As I have indicated before, I believe that the present system of coordination of banking supervision on the Federal level works rather well. In keeping with my views as to the prime importance of deposit insurance to banking supervision, I have suggested that a member of the Board of Directors of the FDIC serve as a nonvoting member of the Federal Reserve Board. The Comptroller's Office should be reorganized as a three-man board, and a member of the FDIC Board of Directors should serve on that board as well. This proposal would improve coordination without eliminating the advantages I see in the diversity and opportunity for innovation in our present tripartite structure. Further, such an approach would eliminate the undeserved criticism that the Comptroller's Office has received over the years as reflecting the arbitrary whims of one individual.

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

When all is said, however, concerning the structure of Federal supervision of banking, I must agree with the recent comments of George LeMaistre, my colleague on the FDIC Board of Directors, who has pointed out that a much more serious problem of overlap and duplication of supervisory responsibilities exists between Federal and State banking supervision.

I came to the FDIC as Deputy to Frank Wille, who had an impressive record as a State banking supervisor. He had a strong desire to strengthen State banking supervision. One of my major tasks as his Deputy was the initiation and organization of our experiment in three states in FDIC withdrawal from bank examination for three years. I logged thousands of air miles in attempting to select states that we thought capable of assuming this responsibility on their own. I continued my interest in this project as Chairman. Even though I have participated in State government, and philosophically favor reliance on State and local initiative rather than Federal whenever possible, I was reluctantly forced to conclude that the delegation of examination responsibility to the states could not be expanded to become the basic approach to supervision of State-chartered banks. Even after carefully selecting the three states for our experiment as the states where the experiment had the greatest chance for success, the most that can be said is that the experiment worked fairly well in two of the states. While there are probably a very few additional states which are capable of greater responsibility for examination, the abandonment of our examination responsibility to all states as a basis for division of responsibility in bank supervision is just not feasible. As Director LeMaistre has

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

suggested, it may make more sense for the states to leave the examination field to the FDIC and to concentrate on problem situations, consumer protection laws, and other areas in which they have demonstrated their strengths.

At the present time, there are discussions going on in the banking industry and in the Congress concerning some possible major changes in the structure of the financial system and the role and functions of various financial institutions. Proposals for the payment of interst on demand deposits, or for nationwide NOW accounts promise fundamental changes in the way banks do their business and in the nature of bank competition with each other and with thrift institutions. There are good arguments for and against these changes, but if the banking system were wavering on the brink of collapse, it would be impossible to discuss the merits of such fundamental changes at this time. It is because confidence has been maintained in the stability of the banking system that major changes can be discussed without concern that adoption of such proposals would shake that confidence. That is, we can discuss whether nationwide NOW accounts are desirable or not desirable from the point of view of the general public interest. We do not have to be concerned that imposition of this kind of shock to the banking system would disturb bank customer confidence in the ability of the system to handle that sort of shock.

I think these examples could be multiplied, but the basic point is clear. Public confidence in the banking system is at a high level, despite the undeniable problems of the banking industry over the last few years.

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

To a considerable extent, that confidence is due to public confidence in the Federal deposit insurance system, and to the way the Federal Deposit Insurance Corporation has carried out its responsibilities. The fact that that confidence exists allows us to deal with a number of issues affecting the bank system in a rational manner. We can consider public benefits and costs, and not be held hostage to fears of adverse public reaction.

# # # #

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