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FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON 25, D. C.

ADVANCE -- FOR RELEASE AFTER 10:00 A.M., CDT
Friday, September 3, 1954

"THE ROLE OF DEPOSIT INSURANCE"

Address of

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Before The

CENTRAL STATES SCHOOL OF BANKING
University of Wisconsin

Madison, Wisconsin September 3, 1954

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THE ROLE OF DEPOSIT INSURANCE

Introduction

It would be possible to give a dozen lectures on the role of deposit insurance, adhering to that theme in each case, and yet deliver entirely different lectures. Such is the variety of approaches to that subject. Today my frame of reference is the development of deposit insurance as an instrument of economic and banking stability.

The conditions which brought into being the Federal Deposit Insurance Corporation determined the framework of its operations. It was clearly looked upon as an instrument for mitigating the effects of bank failures. But its function was not to stop there, although the next step was not clearly defined. One apparent way to reduce the impact of bank failures was to prevent the failures themselves. Development of this phase of the Corporation's work, embracing measures which promote the growth of sound banking operations, has become the constructive side of the Corporation's work.

Evolution of deposit insurance

Although the Federal Deposit Insurance Corporation was established in direct response to the banking crisis of 1933, that act represented the culmination of efforts of over a century to create a mechanism which would assure the safety of bank obligations. Throughout that period many attempts were made to curb the number and to mitigate

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the effects of bank failures. Prominent among the plans for securing bank obligations were those embodying the insurance principle.

The first insurance plan for the protection of bank creditors was adopted by New York State in 1829 when it set up a Safety Fund maintained by assessments which were used to reimburse creditors of failed banks. Within the next 30 years five other States adopted plans incorporating similar insurance features. Only one of these plans could be called a failure, while the others operated successfully for periods up to 35 years. However, those early plans were discontinued when most of the participating banks converted to national banks following the prohibitive tax levied upon State bank notes by the Congress in 1865.

For a time the direct guarantee of national bank notes by the United States Treasury provided substantial safety of bank obligations. But when deposit liabilities began to replace notes as the nation's major currency medium, the problem of bank failures again assumed serious proportions and there was a resurgence of interest in the insurance of bank obligations. As early as 1886 a bill for the insurance of deposits was introduced in the national Congress, and in nearly every Congress between then and 1933 similar proposals were advanced. Agitation for deposit insurance developed also in various States and in the decade from 1907 to 1917 no fewer than eight States established deposit insurance systems.

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Those later State insurance systems, in contrast to the earlier ones, were generally unsuccessful. Part of the reason lay in the development of the country into such interdependent areas that insurance of bank obligations on a State basis alone was no longer practicable. Most of those later plans, moreover, were adopted by agricultural States in which the depression after World War I was particularly severe, and few of the plans had time to muster sufficient resources to cope with the numerous bank failures of that period. By the middle 1920's all of the State systems were in difficulty and by 1933 none remained in operation.

Conditions giving rise to Federal deposit insurance

Interest in Federal deposit insurance was stimulated by the collapse of the different State systems, and heightened by the growing number of bank failures. In the 1920's an average of about 600 banks failed each year, and in each of the first four years of the 1930's bank failures averaged over 2,200. Indeed, the total number of bank failures from 1920 to 1933 exceeded the number of banks in existence today. Depositors' losses in banks during that period reached nearly $2 billion, while bank stockholders experienced even heavier losses.

The chronic problem of bank failures, though long recognized and deplored, became a critical problem only with the advent of the banking holiday in March 1933. With all the banks closed during the declared holiday, and the wheels of our economic system slowed almost to a stop, people suddenly realized the frightful power and cost of bank failures.

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The Role of Deposit Insurance

Success was finally achieved when a bill insuring bank deposits was again proposed in Congress. In some ways its enactment at that time represented a triumph of hope over experience, in view of the recent failure of several State deposit guaranty systems. However, strengthened resources and the adoption of deposit insurance on a nation-wide basis promised advantages which were to make the difference between failure and success.

Looking back upon that period, with a view to ferreting out the purposes which were in the minds of the architects of Federal deposit insurance, we are prone to rationalize their response to the conditions which confronted them. Going a step farther, we then sometimes confuse that rationale with the course of development. Actually, of course, deposit insurance was devised to meet a situation and not to satisfy a theory. Undoubtedly there were elements of theory behind the idea of insuring deposits; but they were implicit and incomplete and embraced different points of concern. It seems safe to say that what weighed most heavily on the minds of the legislators of the 73rd Congress was the enveloping and discouraging evidence of depression which, in uncertain ways, they linked to the prostrate condition of the banking system. The unhappy effects of bank failures seemed to be self-evident, and it was to alleviate the resulting distress and stagnation that they addressed their efforts.

What were some of the undesirable results of bank failures which Federal deposit insurance sought to correct?

Usually a bank failure meant the irrecoverable loss of substantial amounts of money entrusted to banks. Failures brought losses to stockholders too, which were unfortunate, but that was and is regarded

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as one of the reasonable risks attending a profit-seeking enterprise. Losses suffered by bank depositors were not merely personal tragedies; they represented also the extinction of that particular segment of the community's money supply. Moreover, losses in those banks which held deposits of other banks led to a contraction of bank credit many times greater than the amount of the individual losses.

The immediate or ultimate extinction of money was only one aspect of the loss due to bank failures. Of almost equal importance was the loss of the use of money for an indeterminate period, ranging from perhaps a few days to several years. It mattered little, so far as immediate requirements were concerned, that the depositor eventually got back 75 percent or even 100 percent of his deposit. Loss of its availability in a critical period was as real a loss as any other kind of loss.

The delay in paying off depositors was due, of course, to the necessity for prior liquidation of assets, a task whose difficulty was accentuated in a climate of collapsing banks. The necessity for liquidating assets in a depressed market usually reduced the amount of recovery much below the inherent worth of the assets. But more than that, it delayed reimbursement of depositors for interminable lengths of time. On October 31, 1929, after a period of relatively good times, there were 426 national banks in process of liquidation; about a sixth of these banks had been in receivers' hands for five years or more, and one went back as far as 1906.

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Mitigation of effects of bank failures

Those, then, were some of the consequences of bank failure which Federal deposit insurance sought to alleviate. How has it measured up to this task? Let us look at its role in reducing losses of depositors; in sustaining bank credit and averting hardship by making deposits available promptly; in making sure that failures do not deprive a community of banking facilities; and in expediting the liquidation of assets of failed banks.

The Federal Deposit Insurance Act protects each depositor of an insured bank up to an amount which has ranged from $2,500 during the first six months of 1934 to $5,000 from then until 1950, and to $10,000 since 1950. The Corporation is regarded primarily as the protector of the small depositor, since only depositors of insured banks whose accounts exceeded the limits just named have ever experienced any loss. Even those losses have been relatively small, amounting to less than $2 million during the 20 years of operation of Federal deposit insurance. So far 99 per cent of all depositors in closed insured banks have been fully protected against loss.

Not only have losses been small, but depositors have been paid promptly, averting personal hardship and sustaining the money supply of the community. In each of the 245 receiverships of insured banks representatives of the Corporation moved immediately into the regular business office of the failed bank. The records of the bank were quickly

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verified, depositors were notified to present their claims and were then either paid in cash or given demand deposit credits in another insured bank equal to the amount of their insured deposits. The time lapse between the suspension of a bank and start of payoff has been two weeks or less in most of the receivership cases in which the Corporation has been involved.

Payment of insured depositors has been even more expeditious in the 177 cases where failing insured banks have been absorbed by other insured banks, with the aid of the Corporation. In only two or three of these cases has there been any interruption of regular banking services. Where the absorption method is used depositors of the distressed bank are simply notified that their bank has been absorbed by another insured institution and that their deposits are available at the latter bank. This method of assistance, which is used when it will avert or reduce the loss to the Corporation, also has the incidental effect of fully protecting all depositors regardless of the amount of their deposits.

The needs of a community for banking facilities are carefully considered by the Corporation in the performance of its remedial activities. In many cases the bank failures themselves have been a consequence, directly or indirectly, of a community's inability to support the existing bank facilities, and it would be unwise to try to keep such facilities in operation. The inconvenience to depositors and customers in these cases is usually minimized by the availability of other banking

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facilities. It is conceivable, however, that in certain situations bank failure could cause serious inconvenience and hardship to a community. In these circumstances the Corporation has authority to organize a bank and to provide banking facilities for a period up to two years; if by that time the community has given evidence of its ability to support a bank--including among other measures the provision of necessary capital--then this bank may continue operations on a self-sufficient basis.

The liquidation of assets ceased to be a controling factor in the payment of depositors in closed insured banks after the introduction of Federal deposit insurance. Depositors are now paid promptly and independently of liquidation proceedings. Rights of depositors in failed insured banks are transferred to the Corporation. It then proceeds to handle whatever assets are acquired in the manner best calculated to preserve values and to facilitate efficient liquidation.

In all of its liquidation activity the Corporation has given primary consideration to the impact of a given sale or offering upon the affected community. This effort to avoid any disorganization of market conditions has also paid of well in terms of recoveries on assets. Despite the diverse selection of assets acquired from closed banks, the Corporation has recovered thus far about nine-tenths of the total disbursements it has made to protect depositors. This favorable rate of recovery has been due principally to the ability to

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await favorable opportunities to liquidate assets, a course materially assisted by the upward trend in prices over most of the period of the Corporation's operation.

Promotion of sound banking

Let us turn now to the positive aspects of Federal deposit insurance. As noted earlier, the Corporation was quick to recognize the necessity of supplementing its salvage activities with constructive and preventive measures. The success of deposit insurance was seen to depend substantially upon reducing bank failures to the minimum entailed by the structural changes in a flexible and progressive economic system. The promotion of high banking standards and proven banking practices thus became an integral part of the Corporation's work.

One area in which the Corporation soon made its influence felt was in the granting of insurance to new banks. At the start existing banks were accepted for deposit insurance upon a show of solvency only, which sometimes encompassed serious capital impairment; but more rigorous standards were set for admission to insurance when the act was revised in 1935. In acting upon applications from new banks for insurance the Corporation was required to give consideration to the adequacy of the bank's capital, its future earnings prospects, the quality of its management, and its usefulness in serving the convenience and needs of the community.

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The application of these criteria, in furtherance of cooperation with the chartering authorities, has tended to prevent the opening of banks entailing a high risk of failure. In contrast to earlier periods of our history, when over-banked conditions in many communities led inevitably to a sharp decline in the number of banks, there has been notable stability in banking facilities during the last 20 years. Care in insuring new banks has forestalled untold potential failures and has contributed substantially though not visibly to the success of deposit insurance.

Once banks are insured, the Corporation seeks to reduce its risk against their failure by regular examinations; and it may terminate their insurance if, after due warning, they persist in unsafe and unsound banking practices. Examinations of banks comprise the major part of the Corporation's work; nearly three-fourths of the Corporation's employees are engaged in examination activities. The Corporation regularly examines only insured State banks not members of the Federal Reserve System--some 6,700 banks--and reviews from the standpoint of its insurance risk the examinations of insured banks made by the Comptroller of the Currency and the Federal Reserve Banks. The Corporation may also make special examinations of any insured bank,but rarely exercises this authority.

Through its examinations of banks the Corporation has exerted considerable influence upon the structure and character of banking. The quality of bank assets is obviously a matter of continuing concern.

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Maintenance of adequate capital and regular provision for losses on assets are among the banking practices consistently recommended by the Corporation. Recognizing the limited scope of any examination, the Corporation has encouraged banks to maintain careful internal controls and to carry adequate fidelity bonds.

The quality of bank management, the primary asset of any bank, has been particularly stressed by the Corporation. Conscientious and far-sighted directors, capable officers and competent and loyal employees are beyond mechanical prescription, but success in this area of intangibles is the best insurance against bank failure.

The complexity of supervisory relationships in our banking system and the lack of a universal code for the operation of all banks presents to many persons an awkward appearance. Critics who see in this situation confusion of purposes and overlapping responsibilities seldom realize that the existing arrangements reflect a deliberate choice as to the kind of banking system we want. One of the bulwarks of this system is the freedom to move from the sphere of one supervisory agency to another. The respective State and Federal supervisory agencies recognize in turn that this freedom permits the flexibility and fosters the innovations in bank operations so necessary to progress. By raising the relatively small and remote banks to the level of prestige and safety enjoyed by all insured banks deposit insurance has added new vitality to the dual banking system.

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Depositors' confidence

Where does depositors' confidence fit in the role played by deposit insurance? We have seen that, in a specialized and somewhat narrow sense, deposit insurance is a specific instrument for the protection of depositors in the event of bank failures. To prevent banks from eroding to that extremity, the Federal Deposit Insurance Corporation has in various ways encouraged banks to develop an inner strength that exists separate and apart from deposit insurance. These two factors working together, protection and prevention, are the cornerstones of the edifice of depositors' confidence.

Confidence is an attitude, an appraisal of the future in the light of the past. The existence of deposit insurance and its effectiveness in protecting depositors have contributed greatly to the confidence with which our banking system is today regarded. Every industry has an important stake in public confidence, but banking heads the list; for banks deal not in goods but in promises, and confidence is the essential element in every promise.

Upwards of 120 million bank accounts today enjoy the protection of Federal deposit insurance. Holders of these accounts apparently feel little concern about the safety or availability of their deposits. The promise which banks make to pay deposits practically upon demand can be fulfilled only so long as the preponderant volume of deposits is left with

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the banks--in short, so long as confidence is maintained. Just as nothing more than a heart beat separates life from death, in the banking field only confidence lies between order and chaos. It is a slender reed; but it is a strong one too. To maintain this confidence by continuing to give it substance is the essence of deposit insurance.

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