FDIC Press Release

FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON 25, D. C.

OFFICE OF PUBLICATIONS
AND INFORMATION
Phone EXECUTIVE 3-8400
Extensions 226-7

ADVANCE -- FOR RELEASE AFTER 10:00 A.M., CST
Friday, September 2, 1955

"THE ROLE OF DEPOSIT INSURANCE"

Address of

H. EARL COOK, CHAIRMAN

FEDERAL DEPOSIT INSURANCE CORPORATION

Before The

CENTRAL STATES SCHOOL OF BANKING
University of Wisconsin

Madison, Wisconsin September 2, 1955

"THE ROLE OF DEPOSIT INSURANCE"

When I addressed the Basic Economic Problems class a year ago, my topic was the development of deposit insurance as an instrument of economic and banking stability. Establishment of the Federal Deposit Insurance Corporation in 1933 represented the culmination of efforts of over a century to create a mechanism which would assure the safety of bank obligations. Prior to that year 14 States had had insurance systems of one kind or another; but most of these proved unable to survive the concentration of risks inherent in local insurance systems and none remained when the banking crisis of 1933 arose. The fruition of these efforts and of 150 bills for Federal insurance came to rest in the legislation of 1933 creating the Federal Deposit Insurance Corporation.

Today I want to direct your attention to the actions taken by the Federal Deposit Insurance Corporation to assist depositors of insured banks which are in financial difficulties, and to follow the course of these actions until the assets acquired from failed banks have been liquidated.

Preventive and corrective measures. To provide a proper perspective, I should mention first that the Corporation directs most of its effort toward preventing the development of conditions in individual banks which might otherwise result in their insolvency. These preventive measures go back to the rigorous statutory requirements and administrative standards which must be satisfied before the Corporation grants insured status to a bank. To maintain this initial health, the Corporation, in cooperation with other supervisory authorities, conducts regular examinations. We place great stress and reliance upon competent bank management to such constructive banking practices as the regular provision of reserves for losses, the improvement of capital accounts, adequate fidelity bonds, regular audits and the maintenance of suitable records.

If, notwithstanding these efforts, adverse situations develop in individual banks, a series of corrective measures may be pursued. Such unhealthy conditions as inadequate bank capital, weak or hazardous management, lax lending policies, and direct violations of law are typical of situations which require attention. If these conditions persist through succeeding examinations and management is irresponsive to measures prescribed for their correction, the Corporation may then require the bank

concerned to show cause why its deposit insurance should not be terminated. If, after hearings, the required corrections are not forthcoming, the bank's insurance may be terminated. This action does not automatically close a bank, for authority to close a bank against its will resides solely in the appropriate chartering authority. Only three banks, however, have remained open after termination of their deposit insurance, and one of these suspended three months later.

In contrast to the time-consuming negotiations with problem banks, most calls to the Corporation for help have been sudden and dramatic. In cases where large shortages are discovered and the situation seems beyond correction, the appropriate authority may close the bank within a few hours. In either case the Corporation is confronted with essentially the same questions. It must decide how best to protect insured depositors at minimum cost to itself and with least disturbance to the community.

Methods available for assisting depositors of distressed insured banks. The Corporation has available three general methods of assisting depositors of insured banks which are in financial difficulty. If the bank is placed in receivership, the Corporation pays off insured depositors up to a maximum of $10,000 per depositor. However, if the Corporation believes that it can thereby reduce its risk or avert a threatened loss, it may make a loan to the failing bank or purchase assets from it to facilitate the assumption of its deposit liabilities by another insured bank. Finally, if the bank is deemed to be essential to provide adequate banking services in the community, the Corporation is authorized to make deposits in it as well as make loans or purchase assets.

It should be understood that the Corporation is not always free to choose among these alternatives. When an insured bank has been placed in receivership by the appropriate chartering authority, the only course open is to pay the depositors up to the insured maximum in exchange for their claims up to that amount against the appointed receiver. The Corporation is further constrained by the wishes of the banks concerned in providing financial assistance. A distressed insured bank cannot be compelled to borrow from the Corporation or sell assets to it. Neither can any bank be required to take over the liabilities or assets of another bank which is in difficulty. The first and necessary step in an assumption case is for the distressed bank to make formal application to the Corporation for assistance. An assumption transaction is accomplished only when it has been approved by the appropriate supervisory authorities and agreement has been reached between the Corporation and the banks involved, each having considered its own interests and alternatives.

Determination of appropriate method of assistance. Within these limitations the Board of Directors of the Corporation is required to exercise its discretion as to which method is best in keeping with the letter and spirit of the law. Although dollar-and-cents considerations bulk large in the Corporation's thinking, it is obliged to consider also the intangible elements in each case.

An impression has grown that the assumption method is superior from the standpoint of protecting the community. For it does preclude any interruption of banking services and, incidentally to its statutory justification, provides full protection to all insured depositors. It should be recognized that the receivership method also provides substantial protection.

When a receivership occurs, there is necessarily a brief interlude in the availability of insured deposits while determination is made of the amount due to each depositor. But such waiting hardly compares with that of pre-insurance days when depositors had to wait for the liquidation to get under way. In most receiverships of insured banks payoff has started within two weeks. Meantime, the knowledge that the Corporation is on the job encourages an extension of local credit arrangements to meet the emergency. In the recent case of Twentynine Palms, California, a branch of another insured bank was promptly established in the quarters of the bank placed in receivership, thus minimizing the interruption to banking services.

The degree of protection afforded insured depositors in receivership cases has also been substantial. Despite the fact that depositors with accounts in excess of the basic insurance coverage stand to lose in receivership cases, over 99 percent of all depositors and 98 percent of all deposits in receivership cases have been fully protected.

Along with considering methods to protect depositors and their community, the Corporation is required to estimate its own liability under the alternative methods available in individual situations. Uncertainty regarding the bank's condition is one of the major factors influencing the Board's decision. Since time is usually of the essence, and frequently action is required before we have found out all that we should like to know about a given situation, we sometimes make mistakes. In one case, for instance, where the assumption method was adopted, subsequent discovery of shortages increased the Corporation's liability much beyond its estimate. This and other experiences have taught us to favor a payoff when the element of uncertainty is large or disproportionate.

Uncertainty also enters the picture when the extent of excess deposits and other liabilities are not readily determinable without a detailed and time-consuming analysis. A cursory tabulation of deposit accounts does not always show the amount of excess deposits. For analysis may well reveal that some accounts held under different names are in reality held in one right and capacity, thereby reducing the Corporation's insured liability if their sum exceeds $10,000. On the other hand, a large account in excess of the insurance maximum may be held in different rights and capacities, and be completely protected. Deposits of public funds and trust funds particularly require time to segregate and analyze, for they present more than the usual complexities of separate rights and capacities. In addition, public funds sometimes enjoy secured or preferred status independent of deposit insurance. There might also be liabilities other than deposits, such as a suit or judgment against the distressed bank or an appreciable

amount of unpaid bills. In a payoff the Corporation is not liable for excess deposits and other liabilities; but in an assumption case it must take responsibility for all valid claims. It is clear that where such liabilities appear to be substantial they discourage use of the assumption method.

A third factor that requires evaluation is the prospective net cost of handling and liquidating the assets acquired under the different procedures. In both receivership and assumption cases the Corporation charges the costs incident to carrying out its insurance function to its overhead expenses. This parity places the costs incurred under the two procedures upon the same basis; but it does not permit as a basis for action comparisons of the net costs attributable to receivership and assumption cases as distinctive groups.

Each insured bank which requires financial aid has its own unique distribution of assets. Since factors other than the character of assets determine the method used by the Corporation in extending financial aid to insured depositors, it is obvious that differences in the amounts realized on assets are attributable to the individual asset situations rather than to the procedure adopted. Moreover, it is unfair to compare the amounts realized on assets acquired under the different methods; for in a receivership case the Corporation participates in recoveries on all of the bank's assets, while in an assumption case it acquires and liquidates only those assets not accepted by the assuming bank.

History casts another shadow of caution upon comparison of the economy of the two principal methods. The results obtained in liquidations depend in part upon the economic conditions of the time. Even though the Corporation follows a policy of awaiting favorable opportunities for liquidation, results cannot but reflect variations due more to the economic climate than to the chance that individual cases embody one or another procedure. Another fortuitous circumstance which in the past affected recoveries was the fact that the Reconstruction Finance Corporation bore losses which might otherwise have fallen upon the Federal Deposit Insurance Corporation; our avoidance of such losses, of course, was not influenced by the procedure adopted in assisting depositors of particular banks.

Let me now try to sum up the factors to be considered when deciding which method to use in extending financial assistance. Where the convenience of the community must be considered, the assumption method offers some slight but generally over-rated advantages. Where uncertainty prevails as to the extent of the distressed bank's and the Corporation's prospective liabilities, the receivership method agrees better with the Corporation's mandate to minimize its losses. The question of relative net recoveries on assets acquired under the two procedures is independent of the procedures themselves and varies according to the circumstances of individual cases. It is clear that each case must be decided on its merits.

Corporation claims in receivership cases. Now let us consider what happens to the assets of the distressed bank as a result of the Corporation's

intercession on behalf of depositors. Where the bank is placed in receivership, the appointed receiver takes charge of the assets and liquidates them to satisfy so far as possible the legitimate claims of creditors. The Corporation itself is automatically receiver for closed national banks and may be appointed as receiver or liquidating agent for closed insured State banks in 40 States. Since the Corporation is also the principal creditor in cases where insured banks are placed in receivership, having succeeded to the insured claims of depositors, it is vitally interested in the progress of receiverships, whether or not it is itself the receiver.

Deposit insurance has greatly changed the administration of bank receiverships. Substitution of the Federal Deposit Insurance Corporation as a single claimant for a large number of depositors whose accounts it has paid simplifies and expedites procedure. Where the Corporation itself is receiver -- as it has been in 81 of the 249 receivership cases -- the responsibility for liquidation is placed upon the largest creditor whose interest is to obtain the maximum possible recovery consistent with the credit needs of the community. Where another is receiver the Corporation, as principal creditor, has maintained close contact with the appropriate State supervisory authority and assisted as much as possible in the efficient liquidation of the closed banks. It has also frequently purchased the residual assets of a receiver, in competition with other bidders, in order to facilitate termination of a receivership.

Provision of financial assistance and Corporation claims in assumption cases. When authority to extend financial assistance to depositors of distressed insured banks was first granted in 1935, it was authorized only where it would reduce the loss to the Corporation. The conditions under which it might be granted were extended in 1950 to include also the circumstance where the continued operations of the bank is essential to provide adequate banking services in its community. The usual methods of assistance, whereby the Corporation makes loans or purchases assets of distressed insured banks, are available under either condition. An additional method by which the Corporation may guarantee an insured bank against loss by reason of its assuming the liabilities and assets of another insured bank is available where it will reduce the loss to the Corporation. And still another method, whereby the Corporation may make deposits in an insured bank when lack of liquidity threatens suspension, is available in order to maintain adequate banking services in a particular community.

In actual practice, only the loan and asset purchase methods have been utilized to any considerable extent. The loan method, supplemented by the outright purchase of assets in cases where loans were impracticable, was the method used until about 1940. But it has seldom been used since then, having been almost supplanted by a less cumbersome purchase method which has come to be the typical method of handling an assumption case.

Under the present purchase method the Corporation purchases from the failing bank the assets which are not acceptable to the assuming bank, paying for these assets cash equal to the difference between the bank's

deposit liabilities and the amount paid for the acceptable assets by the assuming bank. The assuming bank is under no pressure to accept assets which it may not like, but is instead encouraged to take only cash and funds due from banks. After the Corporation acquires the unacceptable assets and the assuming bank has had time to examine them, the latter is then given first opportunity to purchase them.

The purchase method is a distinctive legal arrangement which affords the Corporation full discretion in the disposition of assets acquired from distressed banks, yet provides for the bank's stockholders the benefits of an additional purchase price depending upon the net proceeds of liquidation. Under the purchase agreement the Corporation liquidates the assets acquired, maintaining separate accounts for the assets of each bank aided. The collections are applied first against liquidation expenses and advances for protection of assets, and then against the total amount paid by the Corporation for the assets. If this amount is fully recovered, additional collections are applied to an allowable return to the Corporation upon its invested funds at the rate of four percent per year. Should all these claims of the Corporation be met, an additional purchase price in the amount of the excess collections is given to the stockholders of the failed bank or their agents.

Liquidation of assets acquired by the Corporation. Our discussion so far has centered around how the Corporation has rendered assistance to depositors of distressed insured banks. Now let us direct our attention to how it disposes of the assets it acquires in the process of protecting them.

In receivership cases where it is receiver, the Corporation has two identities -- one as the principal creditor and the other as receiver. Its actions as receiver are to some extent under the control of a court of competent jurisdiction, in contrast to the complete freedom it has as liquidator in assumption cases. Both as receiver and liquidator of acquired assets, however, it has enjoyed a degree of freedom which has brought about a quiet revolution in the unhappy history of bank liquidations.

The advent of deposit insurance has materially changed liquidation pressures. The clamor of depositors for a dividend is eliminated as the insured portion of their deposits is paid by the time the liquidation has begun. The pressure on debtors is likewise reduced to the extent that they and the receiver can agree on orderly liquidations and thus minimize the need to sacrifice valuable collateral. The same advantages inhere in loan and asset purchase liquidations. The diversion of these pressures to a Corporation which can and will wait for its money has spelled the difference between chaos and continuity in banking. At the same time the prompt availability of deposits sustains the economic life of the affected community and contributes much to banking stability.

Assets handled by the Corporation in fulfillment of its insurance function run the gamut of bank investments. There have been grazing lands in North Dakota, oil rights in Louisiana, office buildings in

New Jersey, apple orchards in Washington, rice plantations in Arkansas, and even a gold mine in Idaho. There have been wheat fields, coal mines, municipal bonds, apartment houses, dairy farms, grape vineyards and retail stores. In one case where we took over an appliance store, it became necessary to repossess some of the appliances sold, and we became involved in servicing reverted refrigerators and radios, preparing them for resale. We have become a party to exciting prospects, as in the Williston basin, where we have a royalty interest in lands which could benefit from a certain turn in the direction of oil development. We have had to learn about insect pests, mining equipment, and wage scales of elevator operators. It is apparent that such a broad range of assets and interests precludes any rigid prescription as to their disposition but instead demands an open mind and flexibility of treatment.

The main principle guiding the Corporation in its disposition of assets, as laid down by law, has been an active regard for credit conditions in the community. Different assets have been handled in different ways. Real estate has ordinarily been liquidated through negotiated sales, as this method offers opportunities for salesmanship which lead to larger recoveries. Occasionally liquidations of large properties have been expedited through competitive bidding, either by sealed bids or at auction, but the Corporation in these cases has reserved the right to reject all bids. Competitive bidding is also used when the Corporation offers for sale and enters protective bids for the residual assets of a receivership in order to close it. Market conditions are followed closely in the disposition of securities, which are liquidated so as to obtain maximum returns while avoiding disruption to the market. Some assets are necessarily held a considerable length of time as debtors are enabled to pay off their debt through orderly arrangements satisfactory to the Corporation. Where necessary, legal actions are taken to conclude liquidation.

These methods have benefited all interested groups. First of all, the community is spared a depression of property values and the nation a seed of deflation. Worthy debtors are enabled to continue in business, thus bolstering the community and enhancing their ability to liquidate their debt. The Corporation benefits from the maintenance of values as well as from the earnings obtained through continued operations of debtors. These procedures help to keep Corporation losses to a minimum, despite the adverse selection of assets which necessarily accompanies most of its salvage operations. Actual and expected recoveries on disbursements to protect depositors amounted by June 30, 1955, to about $303 million out of potentially recoverable disbursements of almost $331 million, or over 90 percent.

Perhaps the most important influence in this favorable result has been the rising trend of values since the beginning of the Corporation. Assets which were of small value at the time of acquisition increased in value with the growth in economic activity and the spread of prosperity. Poor assets were made good by the trend of the times. Yet that alone was not sufficient, for the advantages from the rising trend in values would not have been realized had the Corporation been obliged to liquidate

its assets immediately. The policy of orderly liquidation has thus been a key factor in the favorable record of recoveries. And at this point I want to pay tribute to the Division of Liquidation and its able staff, headed by Ed Tefft, without whose fine judgment and perseverance the wisdom of this policy might not have been fully realized. Deposit insurance owes much to their patience and intelligence in developing appropriate techniques to carry out a policy of orderly liquidation.

The Corporation is, of course, most gratified over the protection it has been able to afford depositors of the 428 insured banks which it has aided. About 1,400,000 insured depositors have benefited from its intercession in failing banks. This demonstration of purpose and strength is a tangible testament of the worth of deposit insurance, and accounts for a good measure of the public confidence in the safety of bank deposits. By continuing to promote sound banking and aiding depositors of distressed insured banks, we are determined to justify that confidence. Since our favorable liquidation experience is an important element of our strength, we hope that it may continue, assuring us the resources necessary to come to the aid of insured depositors whenever they need help.

***