FDIC Press Release

FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON 25, D. C.

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ADVANCE -- FOR RELEASE AFTER 10:00 A.M., CST
September 6, 1957

"THE ROLE OF DEPOSIT INSURANCE"

Address Of

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Before The

CENTRAL STATES SCHOOL OF BANKING
University of Wisconsin

Madison, Wisconsin September 6, 1957

SCHOOL OF BANKING

at the

UNIVERSITY OF WISCONSIN

Sponsored by the Central States Conference

Basic Economic Problems

First Year

John H. Wills, Section Leader

Lecture on

Role of Deposit Insurance

by

H. Earl Cook, Chairman

Federal Deposit Insurance Corporation

Washington, D. C.

September 6, 1957

"THE ROLE OF DEPOSIT INSURANCE"

In the village of Napanoch, New York, in the Catskill Mountains, there is an old paper mill which has not been very profitable for many years. In 1949 it was purchased by a new owner who attempted to rehabilitate it, and in the process ran deeply into debt. Last December it was found that he had obtained about $900,000 from a bank in an adjacent town, The Home National Bank of Ellenville. This involved illegal actions and excessive risktaking by the bank, and resulted in its closing.

Both the bank and the paper mill were relatively small enterprises in terms of number of employees and invested capital. The bank had 30 employees, the mill 34. The bank had a capital investment, including surplus built up from previous earnings, of $750,000. Nearly as much had been put into the plant and machinery of the mill. It was the financial difficulties of the mill, temporarily met in an illegal way by the bank, which precipitated the bank's failure.

The failure of the bank created a situation in the community described by newspaper reporters as a crisis and a time of gloom.

> "A ... bank shortage ... erupted today into a major economic disaster. Payrolls are late, installment buying is impossible, checks are temporarily worthless."

> "For many of the 4,500 residents of the resort village deep in a valley of the Catskills, the holiday season was marked by fear of economic distress--and in some cases, ruin. ... merchants reported sales down one-third, one-half, even three-quarters below last year ... Few people in Ellenville this year had cash for anything but daily necessities. What occurred there early this month doesn't happen very often any more. But when it does, as Ellenville found out, it can cause chaos."

> "The people of Ellenville were demoralized and frightened."

> " ... an air of tragedy hovered over the entire community."

As you know, the people of Ellenville were seriously disturbed by this bank failure only temporarily. Because of deposit insurance the crisis in the community's affairs was short. Without the benefits of deposit insurance, the closing of the bank would indeed have been a real tragedy for the community that would have lasted a long time.

The handling of the Ellenville bank failure is, of course, an illustration of the role of deposit insurance, and I might go on to describe in detail the actions of the Federal Deposit Insurance Corporation in this case. However, I would prefer to discuss a more fundamental question: What is the real basic role of deposit insurance? Let us approach this question by supposing it had been the mill which had closed because of its financial difficulties instead of the bank, and asking the question: Would the closing of the mill have disturbed the community to the same degree? If that had happened about the same number of employees would have been out of work and the loss to investors would have been nearly as large. However, the closing of the paper mill, it seems clear, would not have resulted in most of the other disturbances in the community. While the employees who lost their jobs would have had a difficult time, there would not have been the widespread curtailment of buying at the stores. Other business enterprises in the area and public institutions such as the schools would not have been face-to-face with trouble in meeting their payrolls.

Clearly there is an important difference in the impact upon a community between the failure of a bank and a failure of similar magnitude, in terms of employment and investment, of a firm in some other industry. The reason for this difference involves the fundamental nature of a bank. This was described by Alexander Hamilton 167 years ago in a definition of a bank which it would be difficult to improve:

> "For the simplest and most precise idea of a bank is," he said, "a deposit of coin, or of other property, as a fund for <u>circulating</u> a <u>credit</u> upon it, which is to answer the purpose of money."

It is because the deposits of a bank are used as money or circulating medium that when a bank fails it immediately produces disaster not only among its employees and investors, but also throughout the entire community.

It is commonplace to speak of bank deposits as the major part of the money supply, and therefore it is appropriate to describe the role of the Federal Deposit Insurance Corporation in terms of its function as a monetary agency. The specific monetary duties of the Corporation are: first, to restore to a community as quickly as possible, if a bank failure occurs, all or a very large part of the deposits of the bank which were being used by the community as a circulating medium; second, to avert the destruction of circulating medium by aiding banks in maintaining sound operations and thereby helping to prevent them from getting into a position leading to failure. That this is the role of deposit insurance as understood and intended by the founders of the Federal Deposit Insurance Corporation is indicated by the statements of members of Congress who were most active in the adoption of deposit insurance.

Among the witnesses at the hearings in 1932 on deposit insurance before a subcommittee of the Committee on Banking and Currency of the House of Representatives was Robert L. Owen, a former Senator. Senator Owen had been a leading advocate of deposit insurance for many years, having introduced bills for this purpose in 1908, 1913, 1917, 1918 and 1920. His proposal in 1913, when he was Chairman of the Banking and Currency Committee of the Senate, was adopted by the Senate as part of the Federal Reserve Act but did not become law because the provision was deleted in the final conference with the House of Representatives. In the 1932 hearings Senator Owen stated:

"The first observation I wish to make is that to provide the people of the United States with an absolutely safe place and a convenient place to put their savings and their deposits is essential to the stability of banking, bank deposits and loans, the checks which function as money, and business conditions in every line. It is essential to the stability, therefore, of manufacturing and distributing goods in this country through the merchants and jobbers and wholesalers. It is essential to the maintenance of the commodity prices in this country, including the price not only of textiles and all manufactured goods, but also of those things which are produced by the farmers, miners, foresters, and persons engaged in railroads and public utilities.

It is essential to the stability of the income of the Nation, which, of course, includes the revenues to the Government of the United States and the revenues to the States and the counties and the cities; but the revenues also to the railroads of this country.

It is a far greater matter than the very important end of protecting the individual depositor or the bank from loss."

Another witness at the 1932 hearings was Representative William W. Hastings, also an advocate of deposit insurance for many years, who testified as follows:

" ... I have been very deeply interested in the securing of bank deposits for a number of years, and for the past 10 years I have introduced in each session of the Congress a bill, and I have reintroduced that bill the present session ...

"It is a terrible thing to have a bank failure in a town, as we all know. It not only affects the bank and the shareholders, but it affects everybody in the entire community."

Representative Henry B. Steagall, Chairman of the Committee on Banking and Currency of the House of Representatives, opened the 1932 hearings with a statement in which he said:

"We must not fail to safeguard the Nation against a repetition of the disasters and distress resulting from bank failures during the past 10 years. It has brought ruin to banks, suffering to depositors, distress to the public, and destruction to business. The one sure method of prevention is protection to depositors."

The next year, the report of the Committee on Banking and Currency to the House of Representatives accompanying H. R. 5661, the bill which became the Banking Act of 1933, stated:

"Experts advise us that more than 90 percent of the business of the nation is conducted with bank credit, or check currency. The use of bank credit has declined to the vanishing point. ... The result is curtailment of business, decline in values, idleness, unemployment, bread lines, national depression, and distress. We must resume the use of bank credit if we are to find our way out of our present difficulties."

Going farther back we find the role of deposit insurance described as a monetary function by the Supreme Court of the United States. Nearly a half century ago several States established systems of deposit insurance. The constitutionality of these laws in Oklahoma, Kansas, and Nebraska was challenged and when the cases reached the United States Supreme Court the laws were upheld. The basic ground for this decision was stated by the Court as follows:

" ... few would doubt that both usage and preponderant opinion give their sanction to enforcing the primary conditions of successful commerce. One of those conditions at the present time is the possibility of payment of checks drawn against bank deposits, to such an extent do checks replace currency in daily business. ... the primary object of the required assessment is ... to make the currency of checks secure, and by the same stroke to make safe the almost compulsory resort of depositors to banks as the only available means for keeping money on hand. ... the device is a familiar one, and seems never to have been questioned until now."

There had, in fact, been several State systems of bank-obligation insurance in an earlier period of our history. The first of these, in the State of New York, was established in 1829. Mr. Joshua Forman, who suggested the plan, described its purpose in a letter to the Governor of the State:

"The object to be attained, is of incalculable importance to the prosperity, happiness, and moral character of this highly commercial and growing state--to secure them a sound, well regulated currency."

James a Hamilton, a son of Alexander Hamilton, described the goals of this legislation to be

" ... the stability of the currency of the country; and, second, the security of the depositors and holders of the notes of the banks ..."

When the national banking system was established the circulating notes of the national banks were guaranteed by the United States Government, and this continued until all the national banknotes were retired in 1936. Many people felt that deposits, because deposits are used as circulating medium or money, should be given a similar type of protection. In 1886 a Representative from Wisconsin introduced into the Congress a bill providing for the insurance of deposits in national banks. Other proposals followed, and by 1933 there had been 150 bills for the insurance or guaranty of deposits introduced into the Congress.

Adoption by the Congress of the principle of deposit insurance was an exercise of its sovereign power to provide and control the nation's circulating medium, or supply of money. As a matter of fact, most of the functions of State banking departments and of the Comptroller of the Currency are also monetary functions. That this was the intention of Congress in the case of the Comptroller of the Currency is clearly indicated by the title of the office. It is because banks have been given the privilege of issuing their own credit, as Alexander Hamilton said, in a form designed for use as money, and have thus had delegated to them a governmental prerogative, that they have been subject to more detailed control and regulation than any other privately-owned industry in the country. The purpose of this detailed regulation of banking, including that of deposit insurance, is to make the liabilities of banks suitable for use as circulating medium by minimizing as much as possible the risk involved in the use of bank credit as money. The assessment levied upon the banks for deposit insurance, like the fees levied upon them to defray the costs of examination by State banking departments and the Comptroller of the Currency, represents merely one of the costs, relatively small, for the special privilege of having their liabilities used as circulating medium.

The Federal Deposit Insurance Corporation is not the only part of the Federal Government with monetary functions. The chief monetary agency of the Government is the Board of Governors, together with the Open-Market Committee, of the Federal Reserve System. Does this indicate a duplication of functions? Not at all. The responsibility of the Corporation, though monetary in character, is very specific and is different from that of the Federal Reserve System. The major duty of the Federal Reserve System may be described as that of assuring the maintenance of an appropriate quantity of money, or circulating medium, for the conduct of the nation's business. The Federal Reserve System does not have the responsibility which falls upon the Corporation, namely, that of restoring to a community and to the individuals concerned the circulating medium that has been lost or made unusable in a bank failure. The basic duty of the Federal Reserve System pertains to the operations of the banking system as a whole, whereas the basic duty of the Federal Deposit Insurance Corporation, like that of State banking departments and that of the Comptroller of the Currency, pertains to the operations of individual banks.

Let me turn to a few comments on the accomplishments of the Corporation with respect to its monetary duties of restoring deposits lost or made unusable by bank failures, and of preventing bank failures. In more than 23 years of operation the Corporation has provided funds so that the deposits of 432 closed banks could be paid to the insured limit of $10,000 per depositor or transferred in full to another insured bank.

The closed banks had deposits of nearly $600 million, of which all but $3 million, or one-half of 1 percent, has been restored to the depositors. The number of depositors in these banks was about 1,400,000, and less than four thousand of these, or three-tenths of 1 percent, failed to recover the full amount of their deposits. In three-fourths of the closed banks, all deposits were paid.

The most spectacular difference between the banking situation since the Federal Deposit Insurance Corporation began operations, and that for an equal length of time previous to its establishment is in the number of bank failures. Since the beginning of deposit insurance 540 banks, including both insured and noninsured banks, have been closed because of financial difficulties. This is an average of 23 banks a year. During a period of equal length prior to 1934 nearly sixteen thousand banks suspended because of financial difficulties, or an average of about 640 a year. Of course, not all of this difference is due to the influence of deposit insurance. Doubtless, the major part of the difference should be credited to other developments. Nevertheless, there can be no doubt that the number of bank failures since the Corporation has been in operation has been much smaller than it would have been in the absence of deposit insurance.

The influence of the Corporation tending to reduce the frequency of bank failures has been exerted in many ways. Some of these can be specifically described, others are somewhat intangible but nevertheless real. About half of the insured banks, those that are not members of the Federal Reserve System except in the District of Columbia, are examined about once a year by the Corporation's examiners. The fact that the Corporation must pay the losses, or most of them, in a bank failure has tended to keep our examiners alert to conditions likely to lead, if continued, to failure. In addition, our examining processes and our contacts with the State banking departments and other bank-examining agencies have helped to improve the standards of bank examination generally. The provisions of the law regarding termination of insurance of a bank that continues to engage in unsafe or unsound practices, or in violations of law or regulations, and the citation by the Corporation of 177 banks under these provisions, have had a salutary effect on banking practices. The Corporation's studies of bank failures in the past and the conditions under which they occurred have helped in the development of preventive policies. Finally, the vastly increased confidence of the public in the stability of the banks, and the assurance to depositors that their accounts are protected, up to the insurance limit, in case of failure, has undoubtedly averted many runs on banks that might have led to suspension even though the assets of the banks were in good condition.