ADDRESS OF MR. HOMER JONES, FEDERAL DEPOSIT INSURANCE CORPORATION, BEFORE THE AUDITORS AND COMPTROLLERS OF THE MUTUAL SAVINGS BANKS OF THE STATE OF NEW YORK

NEW YORK CITY OCTOBER 13, 1938

"OPERATIONS OF THE FEDERAL DEPOSIT INSURANCE CORPORATION"

Introduction

We were very happy at the Federal Deposit Insurance Corporation to have you ask us to come up here to discuss with you some aspects of the Corporation. While I know that many of you have a very complete knowledge of the Corporation, I shall run the risk of boring you by reviewing some of the elementary facts about the organization.

Insurance of Deposits by the Several States

Deposit insurance is commonly thought to be a very new idea but in fact it has been a long time in development. A famous forerunner was the Safety Fund system of your State of New York, established over one hundred years ago. The main end in view under that system was to insure the circulating notes of the banks of the state. Since bank notes were a chief form of circulating medium in those days, much as are bank deposits today, the Safety Fund system of your state a century ago played much the same role that deposit insurance plays today.

The State Bank of Indiana, also established over one hundred years ago, involved a type of deposit and bank note insurance.

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The branches of that bank were in effect independent banks subject to the supervision of a central office and jointly responsible for the liabilities of the system. This joint liability constituted a type of insurance.

After the inauguration of the national banking system in the 1860's, these early systems of insurance disappeared. But toward the end of the 19th century, demands for deposit insurance again appeared. Beginning with Oklahoma in 1907, eight states established systems of deposit insurance by 1917. As is well known, before the system of Federal deposits insurance was established, all these State systems had come to grief or had ceased operations. Looked at simply and without complete analysis, it appeared that the State experience had proved deposit insurance a failure.

But a somewhat fuller analysis throws a different light on the matter. It is worth while to inquire what factors operated to cause the failure of the State systems.

1) The national banks were not included in the systems. This meant that the principle of diversification of risk and the law of large numbers did not apply so fully as would otherwise have been the case. It meant that banks which objected to the system or to the assessment could escape by transfer to the national system, thus not only limiting further the application of the large numbers and diversification principles, but in many cases causing adverse risk selection. The principles of insurance can best operate when they apply to a whole

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population or to a favorably selected portion of the population, not when an adverse selection operates. The experience of the states along this line seems to indicate that an insurance system applying to only a portion of the banks of a single state is subject to great limitations.

2) The State schemes also failed because they were set up primarily in agricultural districts just on the eve of a great agricultural depression and just before a technical revolution which rendered a great many banks superfluous. Any insurance system which insures banks of only one type, banks having a concentration in one type of asset, banks loaning very largely on one type of security, runs into an enormous catastrophe hazard. So long as that type of asset or security has a favorable experience, the insurance system is unnecessary. Whenever that type of asset or security comes upon evil days, the insurance system cannot handle such a concentration of risk.

3) Finally, the State systems failed because they were not adequately financed and did not have the complete confidence of the public. A successful insurance fund not only must be safe, but the public must believe that it is safe. If the public does not have complete confidence in it, it will fail to serve its chief purposes even though it is actually safe. For the public to have confidence in a deposit insurance principle there must be a simple understandable central fact. I believe that Federal deposit insurance will succeed because the public believes that the good faith of the Federal government stands behind the deposit insurance organization which it has created. Thus we see that

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the factors which doomed the State systems seem to have been largely eliminated in the case of the Federal system.

Development of the Federal Deposit Insurance Corporation

The Corporation owes its existence to the bank failure record in this country. In the period 1886-1933 inclusive, approximately 120 bills were introduced into Congress providing for Federal insurance or guarantee of deposits. The proposals were most numerous following each banking crisis. The banking crisis of the early 30's and the banking collapse of 1933 resulted in the marshaling of public opinion into effective demand for the enactment of the present system of Federal insurance of deposits.

The Act of June 16, 1933 provided for deposit insurance to go into effect January 1, 1934. Contrary to popular opinion, this original Act provided for insurance as a permanent thing. A temporary form of insurance was provided for the first six months and a revised temporary insurance was later extended to 18 months and finally 20 months. But at all times, from June 16, 1933 on, there was provision in the law for a permanent insurance system which would automatically go into effect upon expiration of the time limit on the temporary insurance.

During the first six months of deposit insurance, coverage was limited to $2,500 for any one depositor in any one bank. Since then the coverage has been $5,000. In the absence of a change in the law, this will remain the coverage permanently.

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Source of Funds

One of the most important aspects of the insurance system is, of course, the amount and the source of its funds. Congress originally allotted to the Corporation approximately $289,000,000. This has been supplemented by receipts from insured banks and returns from investments until, on June 30, 1938, the Corporation had $403,000,000 of assets. These assets were distributed as follows:

Cash and U. S. Government securities	$374 million
Appraised value of assets acquired through bank suspensions and mergers	29 million
Total	$403 million

The annual income of the Corporation is currently derived to the extent of about $9 million from investments and to the extent of about $39 million from assessments paid by the banks. The assessment rate is currently one-twelfth of one percent per annum of the total deposits of each insured bank.

This flat assessment upon total deposits has been subject to considerable criticism. I wish, tonight, neither to defend nor to attack this system, but simply to make a few remarks which may be useful to you in thinking about the problem.

Total Deposits vs. Insured Deposits as Base

Considerable objection has been raised to placing the levy upon total deposits rather than upon insured deposits. Apparently some

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people feel that assessments upon total deposits as a base are in some sense "unjust", while assessments upon insured deposits as a base would in some sense be "just". But in my opinion, this position fails to recognize that it is not possible to isolate the benefits of deposit insurance. If deposit insurance renders net benefits, and I believe that it does, those benefits cannot be allocated to particular depositors or particular banks or to particular types of banks. The Federal insurance of bank deposits makes possible the working of the existing banking system. Its benefits are benefits to that banking system as a whole.

The Flat Rate

Suggestions have been made to the effect that assessment rates should be lower on classes of banks which in the past have shown a favorable failure rate or that the assessments upon these banks should be placed in a special fund from which the losses incurred in connection with that type of bank should be paid. While these suggestions might be combined, for purposes of analysis I shall discuss them separately.

Rate According to Experience

The proposal to vary the assessment rate according to past loss experience is, of course, subject to the suggestion I made earlier, - that the chief benefits cannot be allocated. Even though a particular class of bank may not be subject to great chance of failure, it and its depositors will benefit from the certainty and stability which are provided the banking system by deposit insurance. But entirely aside from

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this point, the difficulties of arranging differential rates seem quite insuperable.

Any differential in rates would have to be justified on the grounds that the loss rate with respect to certain readily isolated and defined banks will probably be less in the future than the loss rate with respect to other banks. The proof of this probability must depend upon the experience of the past or upon other logical analysis. The experience of the past is not significant except insofar as it indicates what the experience of the future will be like. This cannot be relied upon blindly.

Some studies have shown an unfavorable loss experience for small banks as compared with large, for state banks as compared with national, and for the banks of certain middle-western states as compared with the banks of the rest of the country. But closer analysis indicates that the underlying factors in this record were the agricultural depression after 1920 and the decline in demand for banks in very small towns with the development of the automobile and the surfaced road. There is no reason to suppose that those two experiences will be very closely repeated in the near future. Consequently, no evidence is supplied by these investigations to show that the classes of banks with relatively favorable loss experience in the past will show relatively favorable loss experience in the future.

Furthermore, it is possible that certain classes of banks which appear to show favorable past loss experience simply have not yet

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taken their losses. It is possible that certain classes of banks which were subject to unusually large withdrawals were forced to close and the losses in their assets were realized while other banks with just as much loss in their assets are still operating simply because they did not happen to be subjected to these unusual withdrawals. If this is the case with respect to any class of bank and if they still have a large volume of frozen assets of questionable value, it would be most unfair to grant to them an especially favorable rate.

The Special Fund Question

The suggestion that the funds contributed by a certain class of banks might be placed in a special fund raises serveral questions.

1) Such a practice has not commonly been found feasible in the case of other insurance systems. Other classes of insurance corporations often find it desirable to vary the rates upon different classes of risk but to pool the receipts in a common fund. Insurance depends upon the operation of the law of large numbers and any splitting up of reserves into separate categories militates against the operation of that law. This law probably will operate only imperfectly with respect to deposit insurance in any case. It would be most regrettable if any practices were to be followed which would place further limitations upon the operation of the law.

2) If the assessments upon various classes of banks were placed in special funds, how much of the reserves which were supplied by Congress would be allocated to each class of bank? Or would each category

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be free to draw upon all those reserves if necessary? It seems to me that these questions indicate that the deposit insurance system will be much more useful if it is kept relatively simple and no attempt is made to set up a multiplicity of funds.

Payment Limitations, Liquidation, and Failure

Building and loan associations and mutual savings banks have often been able to avoid failure and liquidation through limitations upon deposit withdrawl in time of strain, while commercial banks faced with similar withdrawals have been forced to close their doors and liquidate. Neither of these situations was a desirable one. When deposits are withdrawn in time of stress, this is either because the depositors need to spend the funds or because they have lost confidence in the bank and wish to hoard cash or transfer the funds to another bank. If the funds are desired for spending purposes, then any limitation upon their withdrawal will certainly be economically undesirable at that stage in the business cycle. One of the chief reasons people maintain savings deposits is in order that they may be available for use on a rainy day. If when the rainy day comes they find payment limited, the whole system of savings deposits has largely failed in its purpose.

On the other hand, if the withdrawals are based upon lack of confidence in the bank concerned, the most efficacious treatment is scarcely the freezing of deposits. Legislation of the past few years has been designed on the one hand to keep funds available to those who wish to spend them in time of crisis and, on the other hand, to allay the panic

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which causes depositors to hoard and wildly transfer their funds. The ability of the Federal Reserve banks and other Federal agencies to make loans to banks which are being subjected to withdrawals and the insurance of deposits by the Federal government should prevent unreasonable withdrawals in the future and at the same time permit the banks to meet all reasonable withdrawals.

We conceive the most useful function of Federal deposit insurance to be not the actual payments to depositors in case of failure, though that is important, but the confidence and certainty which it supplies to depositors and thereby to bankers. When bankers are haunted by the fear that they may not be able to meet the demands of their depositors their activities are unsatisfactory both from their own standpoint and from the standpoint of the economy. When they attempt to put themselves in a more liquid condition by selling securities, collecting loans, and holding back from making further extensions of credit, they only add to economic collapse. When a great body of bankers is attempting to sell even the most liquid securities, the market collapses. When they try to collect simultaneously even the highest grade loans, the borrowers cannot repay. We believe that Federal deposit insurance will help substantially to prevent panic and thus limit periodic strife for liquidation by the bankers.

Uniformity of Government Policy

Our observations as insurer of deposits in most of the banks of the country, lead us to believe that there is great necessity for uniformity of government policy with respect to creation of new

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financial institutions and promotion of new business in those institutions. We believe that when banks or other financial institutions have developed to take care of certain types of business and are adequately carrying on that business, it would be unfair for the government actively to promote the creation and expansion of other types of savings institutions which would take business away from the banks. Such policy would not only be unfair but socially wasteful. Government agencies must not promote some business institutions without taking into consideration the effect upon other businesses. On the other hand, to the extent that there are needed functions which existing businesses are not adequatly performing, it is desirable that the government either promote new institutions which can adequately perform the functions or that it require existing businesses to perform them.

You may be interested in hearing a little concerning how our organization fits into the government supervision of banks in the country. One often reads or hears of the duplication of bank supervision and examination which exists, but for the most part these allegations of duplication are incorrect. As a general rule, the Federal Deposit Insurance Corporation examines only the insured State banks not members of the Federal Reserve System. In only a few cases in which special problems have arisen do we examine national banks or State banks members of the Federal Reserve System. We review the reports of examination made by the national and Federal Reserve examiners, and in cases in which we find violations of law or unsafe and unsound banking practices, the law gives

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us power to demand corrections. We make such examinations only in very rare and special cases. No Federal agency other than the Federal Deposit Insurance Corporation regularly examines insured State banks not members of the Federal Reserve System. The Reconstruction Finance Corporation may make examinations of banks in which it holds preferred stock, but such examinations are made only in special cases.

The Federal Deposit Insurance Corporation does regularly examine about 7,400 insured State banks not members of the Federal Reserve System which are also regularly examined by State officials. But every effort has been made to prevent a situation of duplication from developing. Two approaches are used. In some states it is possible for the Federal Deposit Insurance Corporation to make one examination of each bank each year and for the State authorities to examine approximately six months later. Thus the banks are examined twice each year just as is the case with the national banks. There may be some advantage to this system in which the point of view of a different examining agency is procured. In other states the Federal Deposit Insurance Corporation and the State authorities make joint examinations. In these cases less personnel is needed by either authority than would be the case if each were examining separately. Thus, wasteful duplication is avoided. In more than half the states either alternate or joint examinations are regularly employed.

The supervisors of State banks and the Corporation, together with other Federal bank supervisors acting cooperatively, have

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made great advances in securing uniformity of bank supervision and bank examinations. In the progress in this connection, no one has played a more constructive and outstanding role than your own Superintendent of Banks, Mr. William R. White.

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