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FEDERAL DEPOSIT INSURANCE CORPORATION

WASHINGTON, D. C. 20429

Telephone: 393-8400
Br. 221

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BANKING — THE WASHINGTON SCENE

Address by

JOHN F. LEE, Assistant to the Director
FEDERAL DEPOSIT INSURANCE CORPORATION

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BANKING — THE WASHINGTON SCENE

Banking has experienced -- or endured if you will -- a dramatic year. Unexpectedly, the bank supervisory agencies have found themselves in the forefront of the news emanating from Washington. Banking matters, ordinarily comfortably relegated to the business pages of your newspapers, emerged on page 1, and are still there. Terms like "CD's", "bank raiders", "single bank agency bill", "disclosure rules" and "bank failures" have entered the common lexicon.

The banking world is becoming increasingly a conscious part of the average man's daily life. In Washington, those taken up with the business of government -- and almost everyone is -- have been forced to devote time and energy to some unusual problems -- problems involving banks, their condition, their regulation and their liquidation. These areas normally are the concern of the bank supervisory agencies alone, working quietly in the background -- but this has changed.

In view of this recent development, I thought today it might be appropriate to discuss one or two of those matters which currently occupy the Washington scene.

1964 was a year when bank resources, deposits, and earnings all reached new highs. It was a year in which banks continued to expand their services. But it was a year of problems as well. The industry was faced with a cost-earnings squeeze. The cost of a bank's raw material -- money -- rose and is still rising, permitted to some extent by the increase in the interest rate ceiling, which in turn was attributable to balance-of-payments considerations.

The deposit mix continued to be reshaped, with greater emphasis on time and savings funds. These are the ordinary problems -- vexing, important -- but not uncommon.

Several matters arose during the year, however, which were not ordinary. During 1964 seven insured banks failed, and five more have failed so far this year. With over 14,000 banks in the nation, this is not cataclysmic, when placed in proper perspective. Surely the system as a whole is sound, strong, and not in danger. And it might well be said that such failures are the price paid for the preservation of a diffuse, locally-oriented banking system within the framework of a free enterprise economy. We believe management must be given maximum freedom from regulation. This necessarily means freedom to commit errors of judgment. Complete insulation of bank management from judgment errors would lead to rigidity, stultification and quite likely to a banking system unresponsive to the credit needs of the average citizen. Nevertheless it is true that neither the supervisory agencies nor the industry as a whole can view even one failure with complacency. When a bank failure is not caused by the economic decline of business in a community, it lends itself more readily to correction; it is a special concern to the regulatory authorities and a stimulant to corrective action. These were the kind of failures we had in 1964-65. Failures of this kind need not and should not be tolerated.

In a sense the F.D.I.C. must act as a pathologist; it must carefully dissect failed banks. It must identify the causes of the failures. Our autopsies have shown one recurring causal

pattern in nearly all recent bank closings -- change of control, or in the new banks, acquisition of control, by persons bent upon sophisticated thievery. The obligato has varied but the melody has been the same. The bank has been force-fed. Funds have been secured from outside the normal trade area through brokered certificates of deposit and used by self-serving management for their own aggrandizement, generally in high-risk, low quality loans. Capital deficiencies have soon occurred, in some instances the deposits have been exposed to potential loss, and the bank has become insolvent.

To cope with this trend the Corporation has taken several steps. The first, and most publicized, was the filing of a declaratory judgment action in a Federal District court in Texas, and later the filing of a similar action in California. The suits seek a court determination of the insured status of certain certificates of deposit, secured through money brokers and on which interest was paid, directly or indirectly, above the maximum permitted under the Corporation's Regulation 329 and the Federal Reserve Board's Regulation Q.

It is the position of the Corporation that where a bank receives funds under any arrangement whereby the one placing money is to be compensated in excess of the maximum interest permitted on deposits, the funds placed in the bank constitutes a borrowing by the bank rather than a deposit of the funds in the usual course of business, and hence are not entitled to deposit insurance.

In this connection it should be emphasized that certificates of deposit obtained by a bank in the ordinary course of business have not been challenged, but rather have been paid promptly up to \$10,000. Also, even those certificates which have been challenged for insurance purposes continue to be general obligations against the bank's assets, and have and will continue to share on a pro rata basis with other general claimants in the assets of the bank as liquidation dividends are declared.

The Corporation has announced several times, not only to banks, but to the general press, that deposits in an insured bank, made in the usual course of business and for which there is no arrangement whereby the depositor received compensation in excess of the rate permitted on deposits under Federal regulations, are, and continue to be, insured to the statutory maximum.

We hope for an early disposition of our law suits. We are confident that we will prevail. Members of the Congress have voiced their hope that we will prevail. But the mere filing of the actions has had a salutary effect. We have reason to believe the noxious practice has been slowed considerably, if not stopped.

A second step undertaken by the Corporation to eliminate the cause of the failures has been a broad educational program to acquaint the industry and the public with the facts. Members of the Corporation's Board of Directors, in speeches, interviews, and articles, have outlined in general terms some of the problems uncovered, and have urged the industry toward self regulation. Some of the "bank raiders" were financed by other banks. Loans were made -- sometimes

100 % loans -- on collateral comprised solely of the stock being purchased. The danger in such loaning, without thorough credit investigation and appraisal, should be clear to all of you. The collateral was, after all, worth only what the borrowers made it.

Faced with a significant increase in bank failures, the Corporation has sought to improve its payout procedures. Elapsed time to pay-out for insured deposits has been reduced from ten days to five, on the average. New techniques have been developed to minimize the hardships caused by a failure. Two Deposit Insurance National Banks have been chartered where the Corporation believed continuation of banking facilities in the community was essential. These institutions may remain open for up to two years and they can offer a limited banking service. It is the Corporation's hope that local capital and management can be developed to open new banks and to absorb the assets of these two limited banking institutions. In two other cases, we used our statutory power to facilitate the assumption of failing banks by neighboring banks in sound condition.

In two California bank failures, with the help and cooperation of your fine Banking Commissioner, a new procedure was worked out whereby the depositors in the closed institutions were permitted to execute assignments of their insurance claims in favor of other local banks. On receipt of those assignments, the other banks then were able to give depositors accounts immediately. Verification with FDIC officials at the closed bank was done by telephone. In effect, the depositors were afforded immediate access to their funds without even waiting for the FDIC pay-out.

Finally, the Corporation asked the Congress for legislation which would enable it to keep abreast of changes in control of banks. The bill passed both House and Senate, and was signed by the President in about two months time, remarkably fast action for banking legislation.

When effective control of an insured bank changes hands, the bank must report this fact immediately to the appropriate Federal banking agency. The Federal Reserve and the Comptroller of the Currency are further responsible for passing on the reports they receive to the FDIC. Additionally, insured banks are required to report loans they may make which are collateralized by the stock of another insured bank. Such reports, however, are not required if the bank is a newly chartered institution and the loan is being made to finance initial ownership, if the stock has been owned by the borrower for a period of more than one year, or if the amount of stock pledged as security represents less than 10 percent of the bank's outstanding stock.

It is the view at FDIC that this simple piece of legislation has helped materially in curtailing the pernicious practice of bank raiding.

As you know, the Permanent Subcommittee on Investigations of the Senate Government Operations Committee is currently holding hearings inquiring into the failure of certain banks. It is too early to predict what might come out of these hearings, but they should be of interest to every banker.

Turning away from bank failures, another significant

problem with which the FDIC grappled last year was the passage of the Securities Acts Amendments of 1964. Because of the responsibilities given to the banking agencies by the bill, we were required to issue regulations implementing the Congressional directive.

Congress considered for many years putting securities listed in over-the-counter markets under the disclosure rules of the Securities Exchange Act. The broad study of the securities markets in 1961-63 by the SEC gave added impetus to Congressional action. Despite the traditional depositor orientation of the industry, Congress nevertheless determined to include banks within the ambit of the new regulation. However, Congress did decide to vest the administration of the law -- for banks -- not in the Securities and Exchange Commission, but in the appropriate Federal banking agencies. Initially, it is estimated that some 350 banks are affected. The law puts corporations, including banks, under the regulations if they have assets in excess of \$1 million and more than 750 shareholders of a single class of stock.

After the legislation was signed into law, the Comptroller of the Currency placed into effect skeletal regulations which he had previously issued for comment. The FDIC and the Federal Reserve Board adopted a different approach and issued for comment extensive regulations largely modelled on SEC rules -- rules which had been proven by years of use.

The banking industry was asked to comment and did -- at length. After full analysis and discussion of this commentary, and after lengthy staff discussions with and between industry representatives,

the FDIC and Federal Reserve staff members, the Board of Governors and the FDIC issued final regulations on December 31 of last year, to be effective the next day. They were issued, as we said in a press release at the time, as "living" regulations, subject to change as experience suggests need for modification. The banks subject to the rules will build up a body of experience through use, and from that experience, hopefully, will be able to assist the Corporation in further modifying and improving the rules.

At the same time I should like to emphasize that our Board views these rules not as an onerous burden on banks, but as a tool for management to use to improve its competitive position. We believe that wise use of these regulations will prove advantageous in three areas. First, they will assist in attracting new capital to those banks which seek added funds to enable them to meet expanding demands for service in a growing economy. Second, they should prove of great value in attracting added depositor funds from that class of depositors which seeks the fullest possible information about their banking connections and its management. And, third, there will be a strong benefit from the increased public confidence generated by full disclosure. Fuller disclosure, after all, was one of the key factors in restoring the public confidence in listed corporate securities following the market disaster of 1929.

Summarized briefly, these new regulations require:

1. A registration statement is to be filed within 120 days after the ending of the fiscal year by each bank covered, to include among other things a description of its business, a list of

principal security holders, a list of directors and officers, remuneration paid to the two principal officers and certain directors, the interest of management and principal stockholders in certain transactions with the bank, stock purchase options, and certain financial data.

2. Periodic financial reports must be filed by the bank, including an annual report and brief quarterly reports and current reports.

3. Rules are to be followed, both by management and others, in soliciting proxies; provision is made for furnishing information prior to annual meetings even if proxies are not solicited.

4. Reports are required on stock transactions by "insiders". The rules require the filing of initial reports of stock ownership and reports on changes in ownership as they occur.

All in all, it has been a busy year for the Corporation, as it has been for the industry. The American banking system is as strong, and offers as wide a range of service to the public, as ever before in its history. But this posture cannot be continued unless the industry and the supervisory agencies continue to look for ways to refine and improve techniques, broaden services, and strengthen the underlying support which a sound banking system gives to the nation's economy. That is the posture the Federal Deposit Insurance Corporation always has sought to maintain, and I can assure you that that is the posture which the Corporation will continue to maintain.

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