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ADDRESS BY  
GEORGE A. LE MAISTRE, DIRECTOR  
FEDERAL DEPOSIT INSURANCE CORPORATION  
BEFORE THE  
MONTGOMERY COUNTY BANKERS ASSOCIATION  
GWYNEDD, PENNSYLVANIA  
MARCH 19, 1975

"RECENT BANK FAILURES IN PERSPECTIVE"

PLAYBOY MAGAZINE BEGAN AN ARTICLE IN ITS FEBRUARY  
ISSUE WITH THE ASSESSMENT "AMERICA'S BANKS ARE IN TROUBLE."  
THE TITLE OF THAT ARTICLE WAS "BANKS ON THE BRINK." NUMEROUS  
OTHER POPULAR JOURNALS HAVE PUBLISHED ARTICLES WHICH RAISE  
QUESTIONS REGARDING THE SOUNDNESS OF OUR BANKING SYSTEM.

THIS IS, OF COURSE, TO BE EXPECTED. NINETEEN SEVENTY-  
FOUR WAS A DIFFICULT YEAR FOR THE INDUSTRY. SUCH FACTORS AS  
THE PROTRACTED ORDEAL OF FRANKLIN NATIONAL BANK, UNPRECEDENTED  
INTEREST RATES, THE SUDDEN DEMISE OF AMERICAN BANK AND TRUST  
IN SOUTH CAROLINA, THE DISTRESS MERGER OF SECURITY NATIONAL IN  
NEW YORK, NOTORIETY GIVEN BANK FAILURES AND OTHER DEVELOPMENTS  
ABROAD, AND THE CURRENT PROSPECT OF LARGE LOAN LOSSES RESULTING  
FROM THE ECONOMY'S DECLINE HAVE CREATED AN AIR OF UNCERTAINTY  
AND CONCERN. WHILE THE BROAD BASE OF PUBLIC CONFIDENCE REMAINS  
UNSHAKEN, BANKING'S IMAGE HAS BEEN TARNISHED.

MOREOVER, THE ECONOMIC OUTLOOK FOR THE REMAINDER OF 1975 AND 1976 IS MORE GLOOMY THAN ANY SINCE THE THIRTIES. PRESIDENT FORD IN HIS RECENT ECONOMIC REPORT OF THE PRESIDENT STATED:

"THE ECONOMY IS IN A SEVERE RECESSION. UNEMPLOYMENT IS TOO HIGH AND WILL RISE HIGHER. THE RATE OF INFLATION IS ALSO TOO HIGH, ALTHOUGH SOME PROGRESS HAS BEEN MADE IN LOWERING IT."

AND, STILL MORE RECENTLY, ARTHUR OKUN, RESPECTED ECONOMIST AND FORMER CHAIRMAN OF THE PRESIDENT'S COUNCIL OF ECONOMIC ADVISORS IS REPORTED TO HAVE USED THE TERM "DEPRESSION" IN REFERRING TO THE CONDITION OF THE ECONOMY.

THE "BANKING HOLIDAY OF 1933" MAY HAVE OCCURRED MORE THAN FORTY YEARS AGO, BUT THE DISLOCATION AND SUFFERING THAT RESULTED FROM THE MASSIVE CLOSINGS ARE ALL TOO VIVID IN THE MINDS OF MANY.

THUS, IT IS IMPORTANT THAT YOU AS BANKERS KNOW THE FACTS ABOUT RECENT BANK FAILURES SO THAT YOU CAN RESPOND TO QUERIES IN YOUR OWN COMMUNITY WITH CANDID AND PLAIN TALK.

CARTER GOLEMBE STRUCK WHAT SEEMS TO BE A PROPER BALANCE IN HIS RECENT REPORT "BANK FAILURES AND ALL THAT"--WHICH, ALTHOUGH I DO NOT AGREE WITH EACH OF HIS CONCLUSIONS, I WOULD RECOMMEND TO THOSE OF YOU WHO WISH TO PURSUE THIS SUBJECT FURTHER.

APPROPRIATELY ENOUGH, IN LIGHT OF PRESS COVERAGE SUCH AS THE PLAYBOY ARTICLES, HE BEGAN HIS DISCUSSION WITH THIS FAMILIAR EXCERPT FROM A CHILDREN'S STORY:

"ONE DAY HENNY PENNY WAS PICKING UP CORN IN THE FARMYARD, WHEN AN ACORN FELL OUT OF A TREE AND STRUCK HER ON THE HEAD.

'GOODNESS GRACIOUS ME!' SAID HENNY PENNY, 'THE SKY IS FALLING. I MUST GO AND TELL THE KING.'"

DR. GOLEMBE WENT ON TO STATE: "WE DO NOT BELIEVE THAT THE SKY IS FALLING. . . . BUT WE DO BELIEVE THAT THE TIME IS PROPITIOUS

FOR A CLOSER LOOK AT SOME OF THE IMPORTANT ISSUES RAISED BY RECENT BANK FAILURES." IN MY JUDGMENT, DR. GOLEMBE IS CORRECT ON BOTH COUNTS.

SINCE OUR TWO LARGEST BANK FAILURES WERE EXPERIENCED IN 1973 AND 1974, THERE HAS BEEN A TENDENCY TO FORGET THAT BANK FAILURE HAS BEEN A RARE EVENT IN RECENT TIMES. SINCE THE ESTABLISHMENT OF THE FDIC IN 1933 THE TOTAL NUMBER OF FAILED BANKS, BOTH INSURED AND UNINSURED, IS APPROXIMATELY THE SAME AS THE AVERAGE ANNUAL NUMBER OF BANK FAILURES DURING THE PROSPEROUS YEARS OF THE TWENTIES. SPECIFICALLY: AN AVERAGE OF 634 BANKS FAILED PER YEAR FROM 1921 THROUGH 1929. SINCE 1934, THERE HAVE BEEN ONLY 647 FAILURES IN ALL, INCLUDING INSURED AND UNINSURED INSTITUTIONS. SIGNIFICANTLY, THERE HAVE BEEN ONLY 63 FAILURES OF INSURED BANKS SINCE 1961--AN AVERAGE OF ABOUT 5 PER YEAR DURING THIS PERIOD OF RELATIVELY FREE ENTRY AND INTENSE GROWTH AND COMPETITION. MOREOVER, DESPITE THE VERY SEVERE STRAINS ON OUR ECONOMY AND THE INDUSTRY, THE

RATE OF FAILURE HAS NOT INCREASED. IN 1974 FOUR BANKS FAILED AND THUS FAR IN 1975, TWO BANKS HAVE FAILED.

ALTHOUGH I WOULD NOT BE SURPRISED IF THE RATE OF BANK FAILURE INCREASES SOMEWHAT IF ECONOMIC CONDITIONS CONTINUE TO WORSEN, THESE FIGURES ARE, IT SEEMS TO ME, REMARKABLE TESTIMONY TO THE BASIC SOUNDNESS OF THE BANKING SYSTEM.

WHILE THE NUMBER OF BANK FAILURES HAS NOT INCREASED IN RECENT YEARS, THERE HAS BEEN A MARKED INCREASE IN THE SIZE OF FAILED INSTITUTIONS. DURING THE 20-YEAR PERIOD FROM 1943 THROUGH 1963, NO INSURED BANK LARGER THAN \$17 MILLION IN TOTAL DEPOSITS FAILED. IN CONTRAST, SIX HAD DEPOSITS IN EXCESS OF THE \$17 MILLION FIGURE. THE \$1.028 BILLION BANK OF THE COMMONWEALTH WOULD HAVE FAILED IN 1972 BUT FOR A \$35.5 MILLION INFUSION OF SHORT-TERM CAPITAL BY FDIC. IN 1974 AND THUS FAR IN 1975, THIS TREND HAS ACCELERATED. OF THE SIX FAILURES DURING THIS PERIOD, THREE HAD DEPOSITS IN EXCESS OF \$100 MILLION. ONE, THE FRANKLIN NATIONAL BANK, HAD \$1.3 BILLION IN DEPOSITS AT

THE TIME OF CLOSING--A FIGURE WHICH, THOUGH DRAMATIC IN ITS OWN RIGHT, UNDERSTATES THE CASE, SINCE FRANKLIN HAD DEPOSITS OF \$3.7 BILLION AND ASSETS OF \$4.9 BILLION AS OF JANUARY 1, 1974.

WHILE DISTURBING TO MANY, THE FACT THAT VERY LARGE INSTITUTIONS MAY FAIL REFLECTS CERTAIN BASIC TRENDS IN THE INDUSTRY AND SHOULD NOT HAVE COME AS A SURPRISE.

THE PAST FIFTEEN YEARS WERE UNDOUBTEDLY THE MOST INNOVATIVE PERIOD IN BANKING HISTORY. RESPONDING TO COMPETITION AND THE NEEDS OF CUSTOMERS, BANKING BURST OUT OF ITS STODGY AND CONSERVATIVE SHELL. GEOGRAPHIC BARRIERS IN COMPETITION FELL AS THE HOLDING COMPANY MECHANISM ALLOWED A MULTISTATE PRESENCE, BRANCHING RESTRICTIONS WERE MODIFIED AND BANKS DEVELOPED EXTENSIVE INTERNATIONAL OPERATIONS. INNOVATIVE TECHNIQUES IN STRUCTURING AND MANAGING ASSETS AND LIABILITIES ALLOWED BANKS TO RESPOND TO BOTH THE INCREASED DEMAND FOR CONSUMER SERVICES AND THE SOPHISTICATED REQUIREMENTS OF BUSINESS CUSTOMERS. IN SHORT, BANKS WERE IN TUNE WITH AND RESPONDED AGGRESSIVELY TO

THE NEEDS OF A COMPLEX, PROSPEROUS AND EXPANDING ECONOMY. HOWEVER, THE BENEFITS WHICH FLOWED FROM THESE DEVELOPMENTS WERE NOT WITHOUT COSTS. DURING THIS PERIOD, IT IS UNDOUBTEDLY FAIR TO SAY THAT THE LEVEL OF RISK FOR OUR LARGER AND MORE AGGRESSIVE BANKS INCREASED SIGNIFICANTLY .

ACTIONS OF THE FED WITH REGARD TO HOLDING COMPANIES HAVE HIGHLIGHTED ONE AREA OF INCREASED RISK. WHILE THE TOTAL EQUITY OF SOME HOLDING COMPANY SYSTEMS IS GREATER THAN THAT OF THEIR BANKING SUBSIDIARIES, THAT IS NOT ALWAYS THE CASE. EQUITY CAPITAL MAY ACTUALLY BE LESS WHEN COMPUTED ON A CONSOLIDATED BASIS THAN FOR THE BANK ALONE. AS A RESULT, THE AMOUNT OF EQUITY WHICH ONCE SUPPORTED THE RISKS OF A SINGLE BANKING SYSTEM NOW SUPPORTS THE BANK PLUS A VARIETY OF OTHER ENTERPRISES. THE RAPIDITY WITH WHICH THIS CHANGE OCCURRED IS SEEN IN STATISTICS PUBLISHED BY SALOMON BROTHERS LAST YEAR WHICH SHOW THAT THE COMPOSITE RATIO OF TOTAL CAPITAL FUNDS TO TOTAL ASSETS, LESS

CASH AND DUE FROM BANKS, OF THE TWENTY-FIVE LARGEST BANK HOLDING COMPANIES DECLINED FROM 8.3 PERCENT IN 1972 TO 7.7 PERCENT IN 1973. SIMILARLY, THE RATIO OF EQUITY CAPITAL TO NON-CASH ASSETS DECLINED FROM 7.2 PERCENT IN 1972 TO 6.2 PERCENT IN 1973.

POTENTIALLY MORE TROUBLESOME THAN THIS DECLINE IN THE CAPITAL RATIO IS THE FACT THAT THE FAILURE OR DISTRESS OF AN AFFILIATE IN THE HOLDING COMPANY SYSTEM MAY AFFECT THE BANK ITSELF. THE DANGER IS TWOFOLD. FIRST OF ALL, THERE WILL BE GREAT TEMPTATION TO TAP THE BANK AS AN ANSWER TO THE PROBLEMS OR NEEDS OF AFFILIATES. SECONDLY, EVEN WHERE THE BANK IS EFFECTIVELY INSULATED FROM DIRECT FINANCIAL DRAIN, HOLDING COMPANY PROBLEMS ARE OFTEN REFLECTED IN MARKET JUDGMENTS ABOUT THE BANK ITSELF. THIS IS ENCOURAGED BY THE FACT THAT MANY HOLDING COMPANY EXECUTIVES WOULD AGREE WITH RONALD TERRY, PRESIDENT OF FIRST TENNESSEE NATIONAL CORPORATION, WHO STATED: "I THINK WE SHOULD KEEP THE BANK'S PRESTIGE BEHIND THE CAPITAL MARKET ISSUES OF AFFILIATES." THE DARK SIDE OF THIS APPROACH WAS GRAPHICALLY ILLUSTRATED IN THE BEVERLY HILLS BANCORP CASE--

UNDOUBTEDLY A SOURCE OF FED CONCERN IN THIS AREA. AN AFFILIATE OF THE BEVERLY HILLS BANCORP, THE BEVERLY HILLS NATIONAL BANK, HAD BEEN SELLING SOME OF ITS PARENT COMPANY'S COMMERCIAL PAPER. WHEN THE TROUBLED PARENT WAS UNABLE TO MEET INTEREST PAYMENTS ON THE PAPER, A RUN ON THE OTHERWISE SOUND BANK WAS TRIGGERED. AS A RESULT, THE HOLDING COMPANY WAS FORCED TO LIQUIDATE THE BANK'S ASSETS THROUGH SALE TO WELLS FARGO.

THE GREAT EXPANSION OF INTERNATIONAL BANKING OPERATIONS IS A SECOND SOURCE OF INCREASED RISK. ASSETS RANGE BETWEEN 42.8 AND 30.4 PERCENT OF THE TOTAL ASSETS OF OUR FIVE LARGEST BANKS, AND THEY ARE, IN MANY CASES, RESPONSIBLE FOR THE DRAMATIC DROP WHICH HAS BEEN SEEN IN THE CAPITAL RATIOS OF SOME OF OUR LARGER BANKS. FOR EXAMPLE, ONE MONEY CENTER BANK HAS A RATIO OF EQUITY PLUS RESERVES TO TOTAL ASSETS OF 6.6 PERCENT WHEN COMPUTED ON DOMESTIC BASIS AND 2.9 PERCENT WHEN INTERNATIONAL OPERATIONS ARE INCLUDED.

IN ADDITION TO SPREADING MORE THINLY THE SYSTEM'S CAPITAL RESOURCES, SUCH OPERATIONS CONTAIN THEIR OWN PERIL. FRANKLIN NATIONAL BANK'S EXPERIENCE IN THE FOREIGN EXCHANGE MARKET IS A CASE IN POINT, BUT THE LOSSES OF LLOYD'S SWISS BRANCH IN THE FOREIGN CURRENCY AREA DEMONSTRATED THAT EVEN THE MOST ESTABLISHED AND PRUDENT OF INSTITUTIONS CAN BE BURNED. FURTHERMORE, THE PRECARIOUS STATE OF THE INTERNATIONAL PAYMENTS SYSTEM, THE DISRUPTIVE EFFECTS OF THE FLOOD OF PETRODOLLARS AND THE FINANCIAL PROBLEMS OF COUNTRIES WHICH ARE SUBSTANTIAL DEBTORS TO AMERICAN BANKS HAVE EACH SERVED TO GREATLY INCREASE THE RISK OF INTERNATIONAL OPERATIONS.

ACCOMPANYING AND TO A SIGNIFICANT DEGREE FUNDING EXPANSION ABROAD HAS BEEN THE APPLICATION OF THE LIABILITY MANAGEMENT THEORY OF BANK LIQUIDITY. IN ESSENCE, LIABILITY MANAGEMENT MEANT THAT BANKS WERE NO LONGER SUBSTANTIALLY LIMITED IN THEIR TRADITIONAL SOURCES OF FUNDS. THE NEW VIEW WAS DESCRIBED BY LEHMAN BROTHERS ECONOMIST LEONARD SANTOW WHEN HE STATED:

"THE PRAGMATIC VIEW OF BANKS IS THAT YOU CAN'T  
LOOK AT THE OLD RATIOS. THEY DON'T APPLY ANYMORE  
WHEN PEOPLE CAN BUY ALL THE LIQUIDITY THEY WANT IN  
THE MARKETPLACE IF THEY ARE WILLING TO PAY THE PRICE."

THE BENEFITS OF THIS APPROACH ARE SUBSTANTIAL. NOT  
CONSTRAINED BY THE LEVEL OF DEPOSITS GROWING OUT OF NORMAL  
CUSTOMER RELATIONSHIPS, MONEY CENTER AND REGIONAL BANKS  
RESPONDED TO BURGEONING CREDIT DEMANDS. IT ALSO ALLOWED  
REGIONAL BANKS TO ACHIEVE OR BEGIN TO REALIZE THEIR INTERNATIONAL  
AMBITIONS. SMALLER BANKS HAVE BENEFITED AS WELL SINCE MANY  
PROFITED HANDSOMELY AS NET LENDERS OF FEDERAL FUNDS. THE  
RAPIDITY OF CHANGE IN THIS AREA IS REFLECTED IN THE FACT THAT  
THE RATIO OF PURCHASED FUNDS TO ASSETS FOR LARGER BANKS GREW  
FROM 7.8 PERCENT IN 1965 TO 14.3 PERCENT IN 1970, AND TO 26.5  
PERCENT IN JUNE 1974. FOR MANY INSTITUTIONS, GROWTH WAS FAR  
MORE DRAMATIC.

NOTWITHSTANDING ITS BENEFITS, RESORT TO THE MONEY MARKETS AS A SOURCE OF LIQUIDITY WAS NOT WITHOUT ITS PERILS AND SERVES TO ADD ANOTHER ELEMENT OF RISK TO THE SYSTEM. THESE WERE DRAMATIZED BY EVENTS IN 1974, WHICH INCLUDED THE FAILURES OF FRANKLIN AND AMERICAN BANK AND TRUST AND THE STRESSES CAUSED BY THE LIQUIDITY SQUEEZE ENGENDERED BY TIGHT MONEY AND BUSINESS BORROWING FROM BANKS, THAT GREW AT AN ANNUAL RATE OF MORE THAN 25 PERCENT THROUGH THE SUMMER.

FRANKLIN, OF COURSE, IS THE CLEAREST EXAMPLE OF AN INSTITUTION WHICH RELIED FAR TOO HEAVILY ON PURCHASED FUNDS AS A BASIS FOR RAPID EXPANSION. ANXIOUS TO ACHIEVE STATUS AS A MONEY CENTER INSTITUTION, THE BANK PURCHASED FUNDS IN INCREASING PROPORTIONS TO SUPPORT RISKY ASSETS. MORE IMPORTANTLY, AS THE BANK PENETRATED NEW MARKETS, GROWTH FAR OUTSTRIPPED MANAGEMENT SKILL. WHAT WAS ONCE A RELATIVELY SOUND LONG ISLAND INSTITUTION BECAME A MULTINATIONAL ENTERPRISE SITUATED IN LAVISHLY APPOINTED

MANHATTAN QUARTERS YET LACKING THE DEPTH AND MANAGERIAL EXPERTISE REQUIRED TO RUN THE SUDDENLY COMPLEX OPERATION. UNABLE TO CONTROL EXPENSES, MANAGEMENT SOON FACED A SERIOUS EARNINGS PROBLEM, WHICH WAS PROBABLY THE ULTIMATE CAUSE OF THE BANK'S DOWNFALL. INDEED, ONE MIGHT SPECULATE THAT FRANKLIN'S WELL-PUBLICIZED FOREIGN EXCHANGE LOSSES WERE THE RESULT OF ATTEMPTS TO RECOUP LOSSES.

THE MOST DRAMATIC ELEMENT OF RISK INVOLVED IN THE VIEW OF BANKERS THAT THEY "CAN BUY ALL THE LIQUIDITY THEY WANT IN THE MARKETPLACE IF THEY ARE WILLING TO PAY THE PRICE" LIES IN THE FACT THAT ACCESS TO THE MONEY MARKETS CAN BE LOST. AS THE FRANKLIN AND AMERICAN BANK AND TRUST EXPERIENCES SUGGEST, ONCE THE LIQUIDITY PROVIDED BY THE ACCESS TO SUCH MARKETS IS LOST, IT IS DIFFICULT, IF NOT IMPOSSIBLE, TO REGAIN. IN EACH CASE A SETBACK WHICH OTHERWISE MIGHT NOT HAVE PROVEN COMPLETELY DISASTROUS TRIGGERED A LOSS OF CONFIDENCE AND THE OUTFLOW OF "HOT" FUNDS. THERE IS EVIDENCE WHICH SUGGESTS THAT WHILE DEPOSIT INSURANCE MAINTAINED THE CONFIDENCE OF MOST SMALL DEPOSITORS IN

THE FACE OF THE WORST SORT OF ADVERSE PUBLICITY, WILLINGNESS OF THE LENDER OF LAST RESORT TO PROVIDE FUNDS AND THE STABILIZING EFFORTS OF OTHER AGENCIES DID NOT STIMULATE THE CONFIDENCE OF LARGE INDIVIDUAL AND INSTITUTIONAL DEPOSITORS.

AS THIS DISCUSSION INDICATES, THE ADDED ELEMENTS OF RISK PLAYED A PART IN THE FAILURE OF BOTH FRANKLIN AND AMERICAN BANK AND TRUST AS WELL AS THE DISTRESS MERGER OF BEVERLY HILLS NATIONAL BANK. EVIDENCE SHOWS THAT, NOT ONLY THE SIZE OF THE BANK FAILURE, BUT THE PRECIPITATING CAUSES HAVE CHANGED WITH THE PASSAGE OF TIME, AND I WOULD SUGGEST THAT THE MAJOR BANK FAILURES OF 1974 MAY INDICATE ANOTHER SUCH CHANGE.

A STUDY PUBLISHED IN THE 1958 ANNUAL REPORT OF THE FDIC DISCUSSED THE CAUSES OF BANK FAILURES BETWEEN THE YEARS OF 1934 AND 1958. THE STUDY STATED:

"IN THE MAJORITY OF THESE CASES, PARTICULARLY THOSE OCCURRING DURING THE FIRST DECADE OF DEPOSIT INSURANCE, THE PROBLEM WAS THAT OF POOR ASSET CONDITION AND

CONSEQUENT CAPITAL IMPAIRMENT, WHICH IN TURN COULD BE TRACED TO A NUMBER OF CAUSES, SUCH AS MISMANAGEMENT, DETERIORATING LOCAL ECONOMIC CONDITIONS, OR AN INABILITY TO RESTORE FINANCIAL POSITIONS WHICH HAD BEEN SERIOUSLY IMPAIRED DURING THE 1930-33 DEPRESSION YEARS. IN APPROXIMATELY ONE-FOURTH OF THE BANKS, DEFALCATION OF LOSSES ATTRIBUTABLE TO OTHER FINANCIAL IRREGULARITIES BY OFFICERS OR EMPLOYEES APPEAR TO HAVE BEEN THE PRIMARY CAUSE OF FAILURE. SUCH IRREGULARITIES HAVE BEEN RESPONSIBLE FOR MOST OF THE CASES OCCURRING SINCE WORLD WAR II."

THUS, MOST BANK FAILURES PRIOR TO 1946 WERE THE RESULT OF A FAILURE TO RECOVER FROM THE BANKING PROBLEMS WHICH LED TO THE CREATION OF THE FDIC. THE REPORT SEEMS TO INDICATE THAT AFTER WORLD WAR II THE ILLEGAL ACTIVITIES OF ONE OR MORE EMPLOYEES WERE BY AND LARGE THE PRINCIPAL CAUSE OF BANK FAILURE. IF WAS, AT THAT TIME, ONLY IN THE SMALLER INSTITUTIONS THAT SUCH

ACTIVITIES COULD ACTUALLY BRING THE BANK DOWN.

STATISTICS COMPILED BY OUR LIQUIDATION DIVISION SUGGEST FOR THE PERIOD JANUARY 1, 1960 THROUGH 1973 THAT A NEW FACTOR ASSUMED PARAMOUNT IMPORTANCE. AMONG THE SIXTY-THREE BANK FAILURES, SELF-SERVING TRANSACTIONS WERE A SIGNIFICANT FACTOR IN 37 OR 58.8 PERCENT OF THE CASES. DEFALCATIONS, EMBEZZLEMENTS AND MANIPULATIONS CAUSED 20, OR 31.7 PERCENT OF THE FAILURES WHILE MANAGERIAL WEAKNESS IN LOAN PORTFOLIO MANAGEMENT ACCOUNTED FOR ONLY 6, OR 9.5 PERCENT OF THE FAILURES.

AS YOU PROBABLY KNOW, THE FAILURE OF U. S. NATIONAL BANK IN SAN DIEGO AWOKED THE FINANCIAL COMMUNITY TO THE FACT THAT A BILLION DOLLAR BANK COULD FAIL. USNB'S INSOLVENCY RESULTED FROM THE WHOLESAL AND UNSOUND EXTENSION OF CREDIT TO PERSONS AND ENTITIES CONTROLLED BY OR ASSOCIATED WITH THE CONTROLLING STOCKHOLDER AND FORMER BOARD CHAIRMAN. OR, IN THE WORDS OF COMPTROLLER OF THE CURRENCY JIM SMITH, INSOLVENCY WAS LARGELY THE RESULT OF A ". . . RIOT OF SELF-DEALING." IN EFFECT,

U. S. NATIONAL BANK WAS NOT ONE, BUT TWO BANKS. ONE, AN APPARENTLY SOUND AND EFFICIENT INSTITUTION, SERVED THE SAN DIEGO PUBLIC. THE SECOND PROVIDED CREDIT TO ENTERPRISES RELATED TO OR AFFILIATED WITH THE DOMINANT STOCKHOLDER. INVOLVING 200-300 CORPORATE ENTITIES, THESE TRANSACTIONS INVOLVED BETWEEN \$400 AND \$450 MILLION.

NOR WAS USNB AN ABERRATION AMONG LARGE BANK FAILURES DURING THIS PERIOD. ON JANUARY 25, 1971, THE SHARPSTOWN STATE BANK IN HOUSTON, TEXAS, WITH ASSETS AMOUNTING TO APPROXIMATELY \$81 MILLION WAS CLOSED. IT WAS THEN THE SECOND LARGEST FAILURE IN FDIC HISTORY. THE PRIMARY CAUSE WAS THE SELF-SERVING ACTIVITIES OF A DOMINANT SHAREHOLDER. THREE WEEKS LATER IT WAS DROPPED TO THIRD PLACE BY THE FAILURE OF BIRMINGHAM-BLOOMFIELD, UNTIL USNB, THE LARGEST FAILURE OF AN FDIC-INSURED BANK. HERE, AS WELL AS IN THE BANK OF THE COMMONWEALTH CASE, SELF-DEALING WAS COMBINED WITH AN UNSAFE AND UNSOUND INVESTMENT POLICY DICTATED BY THE DOMINANT SHAREHOLDER.

IN CONTRAST WITH THESE CASES, ABUSIVE INSIDER DEALING DOES NOT SEEM TO HAVE BEEN A PRIMARY CAUSE OF BANK FAILURE DURING 1974 AND THUS FAR IN 1975. RATHER, MAJOR BANK FAILURES, AS WELL AS THE PROBLEMS OF THE SECURITY NATIONAL AND BEVERLY HILLS BANKS, SEEM TO HAVE BEEN CAUSED BY A VARIETY OF IMPRUDENT AND INEPT BANKING PRACTICES, INCLUDING UNCONTROLLED GROWTH, A LOSS OF CONTROL OVER COSTS, POOR ASSET JUDGMENT AND SPECULATION. AS WE HAVE SEEN, RISK INCREASED SIGNIFICANTLY AMONG OUR LARGER INSTITUTIONS DURING THE PAST FIFTEEN YEARS, AND AS YOU KNOW, 1974 AND 1975 PRODUCED THE WORST ECONOMIC ENVIRONMENT IN THE POST-WAR ERA. IN THIS ENVIRONMENT, BANKERS AND BANK REGULATORS LEARNED THAT CARELESS BANKING PRACTICES WHICH WERE ADEQUATE AND EVEN PROFITABLE DURING THE GO-GO DAYS OF THE SIXTIES AND EARLY SEVENTIES WOULD BE PENALIZED UNDER ADVERSE AND UNSTABLE ECONOMIC CONDITIONS. MOREOVER, WE ALL HAVE LEARNED THAT LARGE BANKS ARE NOT EXEMPT FROM THE DISCIPLINE OF THE MARKETPLACE AND THAT THEY CAN AND WILL PAY THE PRICE OF UNSOUND BANKING PRACTICE.

REACTING TO THIS SITUATION, MANY BANKERS HAVE RECOGNIZED PROBLEMS IN THEIR OWN INSTITUTIONS AND MOVED QUICKLY TO REMEDY THEM. CERTAIN GENERAL PRINCIPLES HAVE BEEN ACCEPTED. NEITHER EXPANSION NOR CREDIT COMMITMENT CAN ANY LONGER BE BASED ON THE PRESUMED AVAILABILITY OF PURCHASED FUNDS. SIMILARLY, VOLATILE AND POTENTIALLY HIGH-PRICED FUNDS OUGHT NOT TO BE USED TO FUND RISKY OR LONG-RANGE ASSETS TO ACHIEVE MARKET PENETRATION.

RATHER, EXPANSION SHOULD BE A FUNCTION OF THE NATURAL LEVEL OF DEPOSITS, ADDITION OF CAPITAL AND RETENTION OF INCOME, AND THE COMMITMENT OF RESOURCES BASED ON CAREFUL PLANNING, BALANCING PRESENT AND FUTURE CREDIT DEMANDS WITH ANTICIPATED RESOURCES.

BANKS SHOULD ALSO RECOGNIZE THAT, IN THE SHORT TO MEDIUM RUN, AT LEAST, CAPITAL NECESSARY TO SUPPORT EXPANSION MUST BE GENERATED FROM EARNINGS, SINCE THE PRESENT PRICE OF BANK STOCKS AND THE COST AND UNSUITABILITY OF DEBT FINANCING FORECLOSE THE CAPITAL MARKETS FOR A GREAT MANY BANKS. ACCORDINGLY, BANKS

WISHING TO EXPAND WILL HAVE TO RELY ON THE BASICS OF SOUND BANKING. GREATER ATTENTION MUST BE PAID TO COSTS, THE PRICING OF SERVICES AND THE PROFITABILITY OF LINES OF SERVICES AND LARGE CUSTOMER ACCOUNTS.

YET AT THE SAME TIME, THE DANGER OF OVERREACTION DOES EXIST. THE FACT THAT SOME INSTITUTIONS HAVE BEEN OVERZEALOUS DOES NOT MEAN THAT IT IS NOW APPROPRIATE FOR ALL TO PULL IN THEIR HORNS, ADOPTING AN ULTRARESTRICTIVE ATTITUDE TOWARD THE PROVISION OF CREDIT. IT IS TRUE THAT MANY INSTITUTIONS ARE STRETCHED TO THEIR LIMIT AND SHOULD BE RESTRAINED; THE DATA, HOWEVER, WHICH I REVIEW INDICATE THAT OTHER INSTITUTIONS ARE ADEQUATELY CAPITALIZED AND HAVE SECURE AND PRODUCTIVE PORTFOLIOS. IN THE PRESENT RECESSIONARY ENVIRONMENT, THESE SHOULD MOVE AGGRESSIVELY TO RESPOND TO THE NEEDS OF CREDITWORTHY BORROWERS. INDEED, FOR SOME INSTITUTIONS, THE ASSUMPTION OF A HIGHER LEVEL OF RISK WOULD NOT BE AT ALL INAPPROPRIATE.

THUS, INSTEAD OF UNIFORMLY REACTING TO THE GLOOMY PICTURE PRESENTED BY THE ECONOMY AND THE CAUTIONARY NOTE STRUCK BY

SUPERVISORY AUTHORITIES, BANKERS SHOULD SIMPLY APPLY IN DISCIPLINED FASHION THE TOOLS OF MODERN ASSET AND LIABILITY MANAGEMENT. THE WIDESPREAD FAILURE OF SOLID INSTITUTIONS TO RESPOND IN THIS MANNER COULD HAVE THE EFFECT OF REINFORCING THE RECESSIONARY SPIRAL. INDEED, THERE IS REASON TO BELIEVE THAT RESTRICTIVE LENDING POLICIES, COMBINED WITH A LOSS OF CONSUMER AND BUSINESS CONFIDENCE, ARE RESPONSIBLE FOR THE EIGHT PERCENT ANNUAL RATE OF DECLINE IN CURRENCY AND DEMAND DEPOSITS WHICH OCCURRED IN JANUARY. THIS POINT UNDERSCORES THAT THE PROPER APPROACH OF BANKERS TO RAPIDLY CHANGING AND TROUBLED ECONOMIC CONDITIONS IS TO RESPOND INDEPENDENTLY TO THE FACTS AND CIRCUMSTANCES OF THEIR OWN MARKET ENVIRONMENT IN LIGHT OF THE PECULIAR STRENGTHS AND WEAKNESSES OF THEIR OWN INSTITUTION AND NOT THE FAD OF THE MOMENT.

GIVEN THE NOTORIETY OF RECENT LARGE BANK FAILURES AND THE APPARENT SERIOUSNESS OF OUR ECONOMIC CIRCUMSTANCES, IT IS ESPECIALLY APPROPRIATE TO DISCUSS, IN CONCLUSION, EXPECTATIONS

WITH RESPECT TO THE OBLIGATIONS AND CONDUCT OF THOSE WHO OVERSEE OPERATION OF OUR NATION'S FINANCIAL INSTITUTIONS AND THE STANDARDS WHICH DEFINE THOSE EXPECTATIONS. CONFIDENCE, THE KEY TO OUR ECONOMIC SYSTEM, DOES NOT FLOW PRIMARILY FROM THE SIZE OF THE FDIC'S FUND NOR FROM THE FED'S WILLINGNESS TO OPEN THE DISCOUNT WINDOW, THOUGH THESE CONSIDERATIONS DO HAVE THEIR IMPACT. RATHER IT IS DERIVED FROM THE PUBLIC'S COLLECTIVE EXPECTATIONS ABOUT THE SOUNDNESS AND INTEGRITY OF THESE INSTITUTIONS.

AT A TIME WHEN SEVERAL RECENT LARGE BANK FAILURES HAVE REFLECTED THE DOMINATION OF AN ENTIRE BOARD BY A SINGLE INDIVIDUAL, IT IS IMPORTANT TO EMPHASIZE THE NECESSITY OF EACH BOARD MEMBER'S EXERCISING AND EXPRESSING HIS OWN INDEPENDENT JUDGMENT. WHENEVER A BANK DIRECTOR FUNCTIONS AS A RUBBER STAMP FOR MANAGEMENT OR CONTROLLING INTERESTS, OR MERELY GOES ALONG WITH THE MAJORITY AS A RESULT OF RETICENCE OR IGNORANCE, HE HAS CEASED TO SERVE HIS INSTITUTIONAL FUNCTION AND HAS THEREBY ABDICATED HIS LEGAL RESPONSIBILITY. IT HAS BEEN SAID AND I AGREE THAT THERE ARE

TIMES WHEN A "DIRECTOR SHOULD RISK HIS POSITION TO THE EXTENT OF BRINKMANSHIP IF HE IS TO CONTRIBUTE TO THE WELFARE OF THE BANK AND TO DISCHARGE HIS TRUST."

THE DUTIES AND OBLIGATIONS OF A DIRECTOR ARE NOT DIFFICULT TO DESCRIBE. HAD THEY BEEN ADHERED TO CONSCIENTIOUSLY, BANK FAILURES WOULD BE SIGNIFICANTLY LESS LIKELY. IN SUMMARY:

- A DIRECTOR SHOULD INSIST UPON SUFFICIENT INFORMATION TO MAKE CONSIDERED DECISIONS; MOREOVER, HE SHOULD SATISFY HIMSELF THAT THE BANK'S INFORMATION AND DECISION-MAKING SYSTEMS PROVIDE HIM AN ACCURATE PICTURE OF WHAT IS GOING ON IN THE INSTITUTION.
- A DIRECTOR SHOULD ANALYZE AND QUESTION CRITICALLY THE INFORMATION PROVIDED UNTIL SATISFIED THAT A GIVEN TRANSACTION OR POLICY IS IN THE BANK'S BEST INTEREST AND CONSTITUTES A SAFE AND SOUND BANKING PRACTICE.

- A DIRECTOR SHOULD EXERCISE AND EXPRESS  
INDEPENDENT JUDGMENT, NOT FEARING TO GO ON  
RECORD AS A DISSENTER.
  
- AND, OF COURSE, THE REQUIREMENT OF GOOD FAITH  
DEMANDS A DIRECTOR RESPECT HIS FIDUCIARY DUTY  
IN HIS OWN DEALINGS WITH THE BANK, EXERCISING  
EXTREME CAUTION AND RESOLVING CLOSE QUESTIONS  
IN THE BANK'S FAVOR.

THESE PRINCIPLES ARE APPLICABLE WHETHER A DIRECTOR IS  
REVIEWING A TRANSACTION BETWEEN THE BANK AND ITS DOMINANT  
STOCKHOLDER, DECIDING WHETHER THE OPENING OF A NEW BRANCH IS  
WARRANTED OR COMING TO GRIPS WITH HIS BANK'S ENTRY INTO  
INTERNATIONAL MARKETS. BY APPLYING THEM, A DIRECTOR PROTECTS  
HIMSELF FROM POTENTIAL LIABILITY, AND, MORE IMPORTANTLY,  
SATISFIES HIS OBLIGATION TO THE PUBLIC WHICH RELIES ON THE  
SOUNDNESS AND INTEGRITY OF HIS INSTITUTION. THE FAILURE AND  
DIFFICULTIES OF A FEW LARGE FINANCIAL INSTITUTIONS IN RECENT

YEARS OFFER ILLUSTRATIONS OF WHAT CAN OCCUR WHEN THEY ARE NOT APPLIED.

IN SIMPLER AND MORE STABLE TIMES, THE COSTS OF A LESS RESPONSIBLE APPROACH MIGHT HAVE BEEN IGNORED. THE FAILURE OF THE FRANKLIN NATIONAL BANK AND ITS CONSEQUENCES, FOR INDIVIDUALS ON LONG ISLAND AND THE INDUSTRY GENERALLY, INDICATE THAT THEY CAN NO LONGER BE COUNTENANCED. THE PUBLIC HAS A RIGHT TO EXPECT THAT BANK DIRECTORS TAKE SERIOUSLY THEIR FIDUCIARY DUTIES. ACCORDINGLY, IT SEEMS TO ME THAT THE BANKING AGENCIES AND INDUSTRY ASSOCIATIONS MUST CONSIDER SERIOUSLY WHAT MORE CAN BE DONE TO INSURE COMPLIANCE WITH STANDARDS WHICH ARE GENERALLY AGREED UPON.

IN CONCLUSION, I WOULD LIKE SIMPLY TO REITERATE MY VIEW THAT AMERICAN BANKS ARE NOT "ON THE BRINK"--THAT THE SKY IS NOT FALLING.

INDEED, IF WE PROPERLY APPLY THE LESSONS TO BE LEARNED FROM RECENT BANK FAILURES, THE RESULT WILL BE A SOUNDER, MORE RESILIENT BANKING SYSTEM.

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