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FEDERAL DEPOSIT INSURANCE CORPORATION

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[Bank failures make us all wiser]

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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." In addition to Playboy, numerous popular journals, not known for their coverage of the financial world--including Harper's, Esquire, the New York Magazine and the Village Voice--have published articles which raised questions regarding the soundness of our banking system.

Although many of the conclusions reached in the press are exaggerated, events of the past two years warranted concern and have focused the attention of bankers, bank regulators and the Congress on some very real problems in the banking system. The failure of Franklin National Bank and U.S. National demonstrated conclusively that size alone does not insure bank safety. Together with the shocking losses of some foreign exchange desks, the publicity which has been given bank relations with REITs and some large mercantile establishments, the overhang of loan losses that may occur before recovery is complete and the distress mergers of Security National Bank and Beverly Hills National Bank, these failures have underscored the risk inherent in such fundamental features of modern banking as international operations, the holding company and liability management banking.

Because our system of banking hinges on the factor of confidence, large bank failures and the issues they raise must be placed in proper perspective. Since our two largest bank failures were experienced in 1973 and 1974, we tend 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 509 failures of insured commercial banks. Significantly, there have been only 70 failures of insured banks since 1961--an average of about five per year during this period of relatively free entry and intense growth and competition. And, in 1974 and thus far in 1975, only seven banks have failed, despite the fact that economic conditions are worse than at any time since the Depression.

Even if these numbers increase substantially in the coming months as the effects of the recession work through the economy, this record is remarkable testimony to the basic soundness of the banking system and to the effectiveness of bank supervision.

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, during the ten years from 1963 to 1973, 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 toward larger failures has accelerated. Of the seven 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 total assets of $4.9 billion as of January 1, 1974.

While bank failure is never welcome and large bank failures can be highly disruptive, I suspect that the problems of USNB, Franklin and other large banks have had certain positive long-run effects. Traumatic as they were, they did dramatize for both bankers and bank supervisors the risks inherent in international operations and such tools as liability management and proved conclusively that the giants of the industry are no more exempt from the penalties for incompetent or overreaching management than is a $5 million unit bank on the plains of Nebraska. The resulting reassessment and retrenchment that have taken place in the industry have been well catalogued elsewhere and need not be recounted here.

At the same time the banking agencies themselves are undergoing a reappraisal which could have even more significant long-run consequences than those which have occurred in the industry. Each is undergoing a careful and at times painful study of supervisory procedures, regulations aimed at insuring safety and soundness, enforcement powers and, of the structure of the agencies themselves.

The most significant change which might come about would, of course, be agency restructuring. Periodically since the Depression, proposals have appeared suggesting restructuring of our tripartite system of federal bank regulation. Consistently they have been relegated to the library shelves. In the present environment, however, the impetus for change is likely to come from a variety of sources. Describing the existing regulatory framework as "a jurisdictional tangle that boggles the mind," Chairman Burns of the Federal Reserve indicated soon after the closing of Franklin that the Board staff had been studying the subject of agency restructuring and would come forward with a proposal this spring. Since that time, two Governors have advanced different plans: one calling for consolidation of all bank supervision and regulation in the Fed and the other suggesting the creation of a new single supervisory agency separate from the Fed. In addition, there appears to be significant sentiment among the leadership of the banking committees favoring some modification of the existing regulatory structure. We at the FDIC have also had underway a staff study of this matter and will undoubtedly present views and recommendations to Congress in this area. Even though complete consolidation of supervision and regulation may well be rejected, I would rate the prospect for some future realignment of responsibility as reasonably good.

Of more immediate impact to you, as bankers, are changes in regulations or examination procedures which have been or are soon to be implemented. The letter of credit regulation promulgated by the three agencies as well as the Comptroller's recently implemented disclosure regulation, which is aimed at uncovering abusive self-dealing, is a direct consequence of the failure of

U.S. National Bank. At the FDIC, we presently have before the board a staff proposal which would take a somewhat different approach to eliminating abuse in this area. I favor a regulation which would require board of director approval of substantial insider transactions and which would make plain that any transaction between an insider or his interest and a bank which is more favorable to the insider than a comparable transaction with a non-insider is an "unsafe or unsound" practice.

Similarly, the troubles of Franklin and American Bank and Trust and the distress merger of the Beverly Hills National Bank, which was precipitated by the difficulties of a non-bank holding company affiliate, have insured that some facets of banking will receive greater emphasis in the examination and supervision process. Foreign operations and the operation of nonbank affiliates will certainly be the subject of far stricter scrutiny. In addition, while bank supervisors have never ignored a bank's liquidity, bankers will undoubtedly find examiners probing more deeply and critically into a bank's liability structure.

Most importantly, the deference to size, born of the belief that large banks could not fail, is a thing of the past. We have learned, I think, because of the cost to the banking system and to the deposit insurance fund which accrue when a large bank does fail, that big banks should be supervised more, not less, strictly than their smaller competitors.

Paralleling our efforts to improve techniques for avoiding bank problems, the agencies are seeking to improve procedures for dealing with problems when they do occur. Efforts here include intensified monitoring and senior review of problem situations, an increased flow of information among the federal agencies, a consideration of the use of teams specializing in the work-out of problem situations and a reevaluation of the legal remedies and sanctions available to the agencies to effect corrective measures. In this last regard, we at the FDIC are presently studying ways to streamline our use of the existing cease and desist power; also, we are likely at some point during this Congress to seek additional powers to deal with individuals who have misused or wasted bank assets.

Finally, either as a part of agency restructuring or separately, Congress will undoubtedly examine very closely the options and procedures presently available in dealing with failing and troubled banks, in addition to evaluating the conduct of the agencies in connection with the USNB, Franklin and Security National failures. Although these cases were, in my judgment, handled expeditiously and with a minimum of disruption, we learned a great deal from them. This experience may provide the basis for fundamental revision of the framework of laws and overlapping responsibility for dealing with bank failure which grew out of the Depression. We, at the FDIC, are carefully reviewing this experience to determine what modifications might be made in existing law and policy to expedite resolution of problem cases and to cushion the disruptive impact of bank failures when they do occur.

In this regard, the Federal Reserve Board has already proposed legislation aimed at one narrow, but potentially important problem, highlighted by the Franklin experience. The Fed's proposal would provide for the interstate acquisition by bank holding companies of distressed banks having more than $500 million in assets. In a recent speech before the Conference of State Bank Supervisors here in Kansas City, FDIC Chairman Frank Wille made this assessment of the proposed legislation:

> "Although presented to the Congress solely in terms of the Franklin National Bank experience last summer, this comparatively simple, straightforward bill actually raises some very basic issues about the nation's banking system and its future course."

At the risk of covering some of the same ground, I would like to discuss with you this same piece of legislation. I do so because I also believe that, although the proposal deals with a rather narrow problem, it does so in a manner which raises certain very fundamental questions of public policy which deserve as much open discussion and debate as possible. Moreover, I have very serious reservations regarding the bill as introduced and suggest that certain modifications to the bill are needed.

At the outset, we should recognize that the proposed legislation does attempt to meet a potentially significant problem. In recent years, the preferred mode of dealing with failing institutions has been arrangement of a distress merger or acquisition by a sound and well-managed financial institution. In certain banking markets it would be impossible to effect an acquisition of one of the largest banks in that market without serious anti-competitive effects and, indeed, it might be impossible to find purchasers of the requisite size and strength to absorb the failing institution. The proposed legislation would remedy this problem by enhancing the probability of producing a large pool of potential suitors, thereby tending to eliminate the possibility that no acquirer of the requisite size and strength could be found or that a significantly anti-competitive acquisition might be necessary to avoid payout and liquidation. Moreover, such expansion of the pool of potential bidders for the troubled bank would tend to maximize the price paid and hence the ultimate recovery by shareholders and debenture holders.

Notwithstanding these very real benefits, the proposal, as drafted, does raise substantial issues and has certain distinct shortcomings. My most serious reservation stems from the fact that, while the express provisions of the legislation do not necessarily preclude failure and payout of a bank over $500 million in total assets, they do strongly suggest a public policy of de facto 100 percent insurance for all depositors and creditors in banks exceeding the cutoff. At the very minimum, enactment of this legislation would imply Congressional recognition of two classes of banks and would tend to make those in the class over the cutoff at least marginally safer than those under the cutoff. This is objectionable for two reasons.

First of all, it has been argued that large depositors and other investors already perceive the very largest financial institutions to be inherently safer than others, causing resources to flow into these institutions from smaller institutions. It should be noted that the bank most affected is not the truly "small" bank, but rather the medium-sized institution which is dependent upon regional and national money and capital markets. If this analysis is correct, and there seems to be every reason to believe that it is, then adoption of a national policy aimed at the prevention of the failure of the largest banks can only be expected to exacerbate the current disadvantaged position of smaller institutions. Indeed, in a period of tight money and general concern such as last fall's, the existence of such a provision might encourage the flow of large deposits from smaller banks to the safer haven of the large institutions.

Secondly, and totally apart from the direct effect of such a statute on banks below the cutoff, I am troubled by the notion that when certain businesses become very large level, they cannot be allowed to fail and that existing public policy--here the prohibition on multistate banking and Congress' longstanding objection to 100 percent deposit insurance--will be bent to prevent such failure. I am, of course, well aware that the short run disruption caused by the failure of a very large concern--especially a financial institution--can be severe and even devastating. At the same time, the exclusion of large institutions from market forces which apply to smaller organizations may in the long run be even more detrimental to the economy and the banking system--in terms of concentration of both risk and resources. Accordingly, I would hope that if Congress does choose to allow interstate acquisitions in emergency situations, it will do so on a basis that does not discriminate against institutions below a certain arbitrary cutoff point.

Apart from the problem of differential treatment, another objection may arise from the fact that the proposed legislation in effect provides 100 percent deposit insurance for some banks. The concept of 100 percent deposit insurance has generated significant support in academic and other circles; however, Congress and most bank regulators have been adamant in its rejection. This aversion stems primarily from the belief that some element of risk for large depositors and creditors imposes discipline on bankers, restraining excessive risk-taking. If such an effect does exist, the Fed's proposal would tend to eliminate it for the banks which are covered.

Another, and more emotional, issue raised by the proposal is that of multistate banking. In many respects, multistate banking is already a reality. Moreover, the Comptroller's ruling that electronic funds transfer facilities are not "branches" within the meaning of the McFadden Act, will, if sustained in the courts and not disturbed by Congress, carry these developments a significant step further. Compared with such other developments, allowing interstate acquisition in the event of large bank failure would have relatively little impact on banking structure, since, in all likelihood, the provision would rarely, if ever, be used.

Nevertheless, this legislation is reflective of the steady but unplanned erosion of existing prohibitions on interstate banking. Although I personally consider the ultimate disappearance of most geographic barriers to the conduct of the business of banking to be inevitable, and, in many cases, desirable, piecemeal and unconsidered alterations of our banking structure may have unfortunate consequences. The Congress and bankers should not ignore these developments. Rather, they should face up to the question of how they can be accommodated in a system of law and regulation which avoids undue concentration of economic power and preserves the possibility of local and regional institutions competing successfully with the national giants.

Absent a comprehensive reconsideration of the existing strong public policy against multistate banking, however, it does seem to me that any enactment in this area should make plain that the exception to this policy is a narrow one to be invoked only when absolutely necessary. As drafted, the proposal requires neither that insolvency be imminent nor that all in-state alternatives have been explored. It seems to me that a more rigorous test is warranted. I would recommend the Board be permitted to approve such an acquisition only upon certification by the bank's primary supervisory agency--or the FDIC if the Corporation has been requested to provide assistance in the resolution of the distressed bank's problem--that: (a) the bank is in danger of failure and (b) the presence of an out-of-state acquirer is required to insure the continued operation of the bank's facilities or to prevent significant anticompetitive effects. The aim of the second requirement, is, of course, to assure that all potential resolutions of interstate acquisition are carefully considered.

The inclusion of such a provision would ameliorate still another problem by clarifying lines of authority and responsibility. As drafted, the proposal would seem to require the Board's intimate involvement along with the primary supervisor and/or the FDIC in the details of the resolution of the bank's problems--especially in the selection of and negotiation with one or more potential acquirers. By allowing the Board to make the requisite holding company approvals upon certification by the primary supervisor and/or the FDIC, the presently existing division of responsibility would be maintained and the potential for further duplication and conflict avoided.

Finally, it should be pointed out that the legislation as drafted sets forth no criteria to apply in determining which among the potential acquirers would get what, in many cases, could be a significant economic plum. Presumably, if FDIC assistance were required to facilitate the transaction then the sort of bid procedure used in the Franklin case would be employed. However, where

FDIC assistance is not required--and this would be more likely with an enlarged pool of suitors--there would be no statutory basis for choosing among potential acquirers. In order to avoid the inevitable charges of arbitrariness and favoritism, Congress should either include some rational criteria in the legislation or mandate that the Board promulgate regulations setting forth such criteria within a reasonable time following enactment of the legislation. Inclusion of a competitive bidding procedure such as that employed under Section 13(e) of the Corporation's Act would be simplest and would tend to provide maximum protection to shareholders and debenture holders; however, there might be other factors such as the desire to minimize further concentration of banking resources which should be considered. In any event, I do not believe that any of the agencies should have untrammeled discretion to choose which holding company is to receive such a prize.

As I have indicated, the Fed's proposal does address a problem which might be significant in some instances--the potential unavailability of an acquiring institution without significant anticompetitive effects. And, it does so in a manner which would increase the flexibility of the banking agencies in dealing with failure cases, further assuring that the disruption caused by bank failure in this country is minimal. With modifications along the lines I have suggested, this proposed legislation would do less violence to existing public objectives and would not further complicate the already sensitive and complex interaction of the agencies with failing institutions. At the same time, I would hope that Congress will not choose not to consider this proposal in isolation but rather in the broader context of its review of governmental interaction with problem and failing banks.

In conclusion, I would simply like to reiterate what I suggested earlier. Large bank failures and the problems of the industry generally during the past two years have been disturbing and painful for both bankers and bank regulators but they have not been overwhelming. Instead, they have stimulated better bank management practices and a fundamental reassessment of the structure and practices of bank regulation. As in other areas of our national life, we now find ourselves sadder but, in my judgment, considerably wiser.

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