[Bank failure and their regenerative effects on supervisory procedures.]

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Before The
Alabama State Bar
Montgomery, Alabama
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During the last two and a half years, the banking system has undergone stresses unparallelled since the 1930s. The failure of two $1 billion institutions, several other relatively large bank failures, a rate of inflation unknown in this century, a liquidity crunch, the collapse of real estate markets, and other effects of the most severe economic contraction since the great Depression, have all placed great strains on our banking system. In recent weeks, these difficulties have been highlighted, and perhaps compounded, by the unauthorized and sensational publication of certain problem bank or "watch" lists as well as excerpts from the bank examination reports of certain very large institutions purportedly on one of those lists. Without asserting to you that there are no problems in the banking system or that bank supervision is perfect, I should like to place current concern about banks in some perspective by reviewing the facts about "problem" banks and bank failures; by pointing out some of the improvements in bank supervision which will flow from the lessons of the past two and a half years; and finally, by outlining the tools that we have at our disposal to minimize the disruptive effects of bank failure.

In the wake of the recent press disclosures, the FDIC, in a letter to Senator William Proxmire, Chairman of the Senate Committee on Banking, Housing, and Urban Affairs, indicated that there were 369 FDIC-insured banks on the Corporation's "problem list" as of January 24, 1976. Of these, only 29 were designated "serious problem - potential payoff," the category of banks which, in the judgment of supervisory personnel, present a 50 percent likelihood of requiring FDIC assistance in the near future. Ninety-two were designated "serious problem." These are banks which threaten ultimately to require a financial outlay from the FDIC absent drastic remedial action. Finally, 238 insured banks, or about two-thirds of the total, were classified "other problem" -- institutions evidencing significant weakness but a lesser degree of vulnerability. It is worthy of note that of the 121 banks in the two "serious problem" categories, an even 100 have less than $50 million in total deposits. None of the remaining 21 has deposits exceeding $1 billion and only two have more than $500 million.

It has been our general experience with this system of evaluation and the rigorous supervision that "problem" designation triggers, that approximately 75 percent of the banks on the "problem list" on any given date will be open and no longer considered "problem" banks two years later. During 1975, for example, 282 banks were added to the list while 106 were removed. Among these, 93 had been restored to health and only 13 had failed.

Although 13 bank failures is somewhat more than the yearly average of five which the system has experienced since 1960, it is far from startling. In evaluating

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these figures, we must bear in mind that 97-1/2 percent of our nearly 15,000 insured banks are not considered "problem" banks by the FDIC--a tribute, it seems to me, to both the vigorous action of bank supervisors and the responsiveness of banks to that supervision when we remember that we have just come through the country's most severe recession since the 1930s.

A further testimony to the basic strength and resilience of the banking system is to be found in the reaction of depositors--large and small--to the highly publicized and often exaggerated troubles of individual banks and the banking system. Only in very rare cases have depositor withdrawals resulted in a bank's closing. In several instances, we as regulators have been surprised when depositors stood firm in the face of disclosure of substantially adverse financial news and the airing of dirty management linen. These cases, taken with the public's calm reception of the sensational stories of recent weeks, reflect the depth of public confidence in the soundness of our banks and the system of deposit insurance which stands behind it.

Nevertheless, the traumatic problems of the past two years have taught us a number of valuable lessons. As a consequence, bank supervision is undergoing a reappraisal which could have more significant long-run consequences than the recent retrenchment by bankers. Each agency is undertaking careful and, at times, painful study and revision of regulations aimed at insuring safety and soundness, and the adequacy of supervisory procedures, and enforcement powers.

One example is the response of supervisory authorities to our nation's first billion dollar bank failure. The demise of U. S. National Bank in San Diego, which awakened the country to the fact that a billion dollar bank could fail, served to focus the attention of the public and bank regulators on insider abuse. USNB's insolvency was caused by the wholesale and unsound extension of credit to persons and entities controlled by or associated with C. Arnholt Smith, the controlling stockholder and former board chairman. Involving 200-300 corporate entities, the insider related transactions amounted to between $400 and $450 million. It was, in the words of Comptroller of the Currency Jim Smith, a ". . . riot of self-dealing." In response to this graphic demonstration of the harm that flows from abuse of an insider's relationship with his or her bank, the Comptroller has implemented a disclosure regulation aimed at uncovering abusive self-dealing.

The need for more vigorous supervision of insider transactions by bank boards of directors and bank supervisory agencies is not based on the USNB case alone. Abusive self-dealing has been a significant contributing factor in more than half of all bank failures since 1960. Losses to the deposit insurance fund as a result of these failures are likely to amount to at least $175 million. A review of existing and past problem bank cases also reveals a high incidence of abusive self-dealing as a source of serious difficulty. Even where the immediate result is not the bank's failure or its designation as a bank requiring close supervision, an insider transaction that is not effected on an "arm's length" basis might lead to a diminution of the bank's earnings and an erosion of its capital--thereby increasing the risk of loss to depositors and minority shareholders and ultimately to the deposit insurance

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fund. Finally, such transactions represent a diversion to insiders of resources that properly belong to all shareholders on a pro rata basis, as well as a misallocation of a community's deposited funds.

For these reasons, the FDIC published for public comment on September 3 a proposed regulation which takes an approach somewhat different from that of the Comptroller. After reviewing the comments, Corporation staff has recommended adoption of the regulation with certain modifications. I expect that the Board will act on this proposal before the end of this month. In essence, the proposed regulation would seek to minimize abusive self-dealing through the establishment of procedures which will insure that bank boards of directors supervise such transactions effectively, and will better enable Corporation examiners to identify and analyze such transactions. The board of directors of each insured nonmember commercial bank would be required to review and approve each insider transaction involving assets or services having a fair market value greater than a specified amount, which varies with the size of the bank. In addition, certain record-keeping requirements would be imposed in order to foster effective controls over such transactions by the bank itself and to facilitate examiner review.*

Although the Corporation has determined that insider transactions require special supervision by bank boards of directors and close scrutiny by the Corporation's examiners, we have carefully sought to avoid unrealistic prohibitions or unduly burdensome reporting requirements. Instead, the Corporation has attempted to develop requirements which will place responsibility where it belongs--in the hands of a bank's board of directors--and to strengthen existing bank and supervisory procedures. In so doing we hope to correct a continuing source of potential abuse without excessive bank or regulatory costs.

The problems of recent months have insured that other facets of banking, such as foreign operations and the operation of nonbank affiliates of bank holding companies, will also receive greater emphasis in the examination and supervision process. And, as a consequence of the excessive use of costly purchased funds, bankers will find examiners probing more deeply and critically into the composition of a bank's deposit structure. Most importantly, deference to size, born of the belief that large banks could not fail, is a thing of the past. We have learned that the adverse effects of large bank failures on the banking system and the deposit insurance fund are of sufficient magnitude that big banks should be supervised more, not less, strictly than their smaller competitors.

In addition to careful review of the adequacy of the examination process, concern engendered by large bank failures has led to increased interest in the development of so-called "early warning systems," which employ financial statement analysis to distinguish potential problem banks. At the FDIC, we have been at work in this area for more than three years, and our experience suggests that when fully

* This regulation was adopted by the Board of Directors of the Federal Deposit Insurance Corporation on February 25, 1976.

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operational, such systems will become an integral part of the bank supervisory process. I should hasten to point out that these systems are not "black boxes" which will magically grind out a list of all the problem institutions existing at a particular time, but rather, are tools of examination, enabling the agencies to allocate scarce resources more efficiently and, at times, identify a potential failure that might otherwise have been overlooked.

The agencies are also seeking to improve supervisory procedures for remedying problems when they occur as well as improving techniques for identifying problems. This has resulted in intensified monitoring and increased senior staff review of problem situations, an increased flow of information among the Federal agencies, consideration of the use of teams specializing in the working out of problem situations and re-evaluation of the legal remedies and sanctions available to the agencies to effect corrective measures.

In this last regard, the three Federal banking agencies have made recommendations to the Congress which would enhance considerably our ability to deal with practices which have produced bank failures and problem institutions. First of all, we have recommended legislation which would allow the supervisory agencies to aggregate loans or other extensions of credit to insiders and their interests for the purpose of applying the statutory lending limits, thereby closing serious loopholes in these provisions. Second, the proposed legislation would greatly expand the power of the agencies to impose fines for serious violations. Third, we have proposed that the existing cease and desist powers be amended to apply specifically to officers, directors, employees, agents or other persons participating in the conduct of the affairs of the bank. Fourth, the proposed legislation would allow removal of officers who are grossly negligent or demonstrate a willful disregard for the safety and soundness of a bank. And further, the package would authorize the Federal Reserve Board to order divestiture of a banking holding company subsidiary or termination of a nonbanking activity when the Board has cause to believe that the ownership or activity constitutes a threat to the holding company's subsidiary bank or banks. Although the banking agencies do not intend that increased enforcement powers will replace traditional bank supervisory techniques, it is our thought that these tools will increase significantly the power of the agencies to deal with the minority of banks and bankers that are recalcitrant or worse.

Finally, I should like to touch briefly on another lesson of the past two and a half years--one which may be the most significant of all. Although the period has not been a comfortable one, the response of bankers, bank regulators and the public to recent bank failures--especially that of Franklin National Bank in New York--has demonstrated conclusively that when a bank does fail, the FDIC has the tools to minimize the disruptive effect of the insolvency on its community and the economy generally.

First of all, the FDIC has indicated publicly that it will make every possible effort to find a suitable acquirer for a distressed institution and to facilitate such an acquisition. The American City Bank and Trust failure in Milwaukee recently is illustrative. There the lead bank in a four-bank holding company system was in

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serious difficulty as a result of bad real estate loans, but the other three small institutions were sound. Using its authority under section 13(e) of the Federal Deposit Insurance Act to assist a purchase and assumption transaction when, in the judgment of the Board of Directors, such assistance will reduce risk or avert loss to the Corporation, the FDIC assisted the purchase and assumption of the American City Bank and Trust by the Marine National Exchange Bank of Milwaukee. The Marine Bank was the winner of a competitive bidding procedure over seven other banks and bank holding companies with a purchase premium of $6,027,000.

The transaction avoided the necessity for a statutory payoff of the approximately 35,000 depositors of American City Bank and prevented financial loss and delay to the holders of approximately $60 million of deposits that exceeded the statutory insurance limit. Public funds deposits of over $40 million and deposits of other banks totalling more than $8 million were included in the deposit liabilities assumed by Marine National Exchange Bank of Milwaukee. Also, acquisition by the Marine Bank avoided disruption of the panoply of banking services provided by American City. Finally, and perhaps most importantly, any potential ripple effect was avoided, with no untoward effects being felt by other Wisconsin banks--including the other three members of the holding company system. We at the FDIC view this case as particularly significant in that it demonstrates that the difficulties of the lead bank of a multibank system need not cause a loss of confidence in the other bank members of the system--or their ultimate failure.

This procedure was also employed in the Franklin and U. S. National Bank cases as well as in the vast majority of the other insolvencies which have occurred in recent years. Of the 13 bank failures in 1975, 11 were resolved in this manner.

In addition to the power to provide assistance under section 13(e) of the Federal Deposit Insurance Act, the Corporation may directly assist a distressed institution under section 13(c) of the Act if ". . . the continued operation of such a bank is essential to provide adequate banking service to the community." Resort to this provision will entail the imposition of significant restrictions on the operation of the assisted institution and will not be employed unless there appears to be a reasonable likelihood that the institution will become an independent and viable enterprise. It is generally used only as a last resort and has been employed in only three cases in the Corporation's history.

The Corporation may also organize a Deposit Insurance National Bank under section 11 of the Act to perform, for a maximum of two years, banking functions specified by the Comptroller of the Currency upon a determination that ". . . it is advisable and in the interest of the depositors of the closed bank and the public." This device is employed as an alternative to an immediate cessation of banking services and a payoff of insured depositors when the FDIC can neither find suitable bidders for the failed bank nor make the requisite statutory finding under section 13(c). Although only the insured deposits are fully protected when a DINB is established, we have found that the use of a DINB minimizes the trauma involved when a bank fails and maintains an entity in the community which may be revitalized by local investors. This procedure was employed twice in 1975.

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In short, various tools are available to avoid the potentially disruptive consequences of bank failure. As the events of the past two years have demonstrated, these tools are quite effective.

In conclusion, I should like to reiterate what I have already said. Large bank failures and the problems of particular banks generally have been painful and disturbing, but they are not overwhelming when viewed in the context of the banking system as a whole. Moreover, while these difficulties have highlighted certain weaknesses in the bank regulatory system, they have, at the same time, sparked the sort of positive reappraisal needed to remedy them as well as demonstrated that we do have the tools to insure that even a very large bank failure does not cause serious disruption. In my judgment, the banking system will emerge from this period of difficulty strengthened, not weakened, if bankers, bank regulators, and the Congress continue to apply the lessons of recent months in a disciplined and dispassionate manner and avoid the temptation to overreact to the sometimes sensational disclosure and discussion of the problems that banking does have.

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