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LEARNING FROM BANK FAILURES

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LEARNING FROM BANK FAILURES

For some time, certainly the whole time of my short tenure in office, I have been concerned and the Corporation has been concerned with a single vexing and overriding problem. It appears slightly different to us in October than it appeared in March; it may appear further altered in December. But, despite the fact that it deepens, or changes slightly in appearance as time moves on, it is, and doubtless will continue to be, paramount in all of our minds for the immediate future. Because it also bears most heavily upon the general welfare of banking, I have chosen to discuss it with you today.

Some weeks ago I stood outside the doors of a small country bank, looking across the street at a group of weatherbeaten farmers. They stared back, at me, and at the door of the bank. On that door was a notice the bank had been closed. It had, simply, failed.

It was a depressing emotional experience, with echoes of the depression years. The farmers sat around and watched the bank and insisted to anyone who asked that theirs was a "good little bank, which opened after the depression, and which would open again."

Unfortunately that bank will not open again. Its career of service to that farming community is ended. That bank, like seven others in the past twenty months, had fallen victim to a new "virus" -- new at least in terms of the past thirty years.

The bank did not fail because of economic strain in the community it served, and there was little or no embezzlement in the ordinary sense. If either of these causes of failure had occurred, it would have been equally regrettable, but we would have been able to diagnose the disease much earlier and we would have been able to apply well-known remedies. Additionally, economic failures in general suggest that the fault is not primarily the bank's and that the remedy lies in an improvement of the economy itself. Where an embezzlement is the cause of a failure, the mechanics of the institution are at fault, and mechanical and technical improvements can be used in other banks to stem further occurrences.

Actually, in the past two decades, these corrective methods have been used by various authorities to help stem the number of bank failures in the country.

Actions on the governmental level, private investment initiatives, monetary policy, and other facturs have combined to create a healthy economic climate. Concerted educational campaigns by banking trade groups and the supervisory authorities, state and federal, have helped the banking system to devise and implement sounder auditing and operating procedures.

The eight failures of the past twenty months, however, pose a problem of an entirely different sort. The problem confronting us is grave, even though the number of failures is minimal when compared to the nation's over 14,000 commercial banks. These failures should not be dismissed; I believe that they are symptomatic of some rather unhealthy tendencies, reverting in one form or another to the excesses of the nineteen twenties. I feel that we as supervisors must take the lead in restricting these patterns before they swell into a disaster.

To understand what has been happening in banking, we must learn from these failures. Liquidating the banks is not enough; fulfilling insurance responsibilities is not enough. We must draw lessons from what has happened, and we must act as leaders in modifying the environment that allows the virus of failure to grow.

Eight banks have failed. I do not intend to give you a bank-by-bank review, but I would like to consider several of the prominent factors which run like a litany through most, if not all, of these cases.

Most immediately notable, of course, is that all these failures were non-economic in nature. In seven of the eight cases the communities enjoyed healthy economic conditions, and in the eighth, while the area was somewhat depressed, there had been no sudden dislocation of any sort. There was no economic reason for these banks not to have continued to flourish and serve their communities successfully, returning a decent profit to ownership at the same time.

Each failure was caused by a "raid." The banks were looted by promoters through evasions of the law, aided and abetted in some instances by people who should have known better. The type of bank selected for raiding is, I believe, of significance. With one exception, they were isolated. They were all small, and the managements were rather unsophisticated.

Five of them were the only banks in town, and there were no other banks nearby. Two of the banks were located in communities which had other banks, but both served tight ethnic groups, and were in effect operating in self-contained environments.

All eight of the banks were relatively small, with the largest at some $35 million in assets when it was taken over by the promoters and about $17 million when it was closed. All the others ranged from $1 million to at best $7 million.

All these banks in the past had maintained fairly good liquidity positions and one an extremely good one, due to the ultra conservative policies of the old management.

What kind of people took over these small, isolated, liquid institutions? In seven of the eight cases they were outsiders, men with no experience in banking, and obviously with little respect for, or understanding of, the fiduciary role of banking. The eighth case involved long-term management with a good reputation, which apparently was the victim of a confidence game by outsiders. These were men of much the same stripe as those who actually acquired control of the seven other banks.

In the banks where change of management took place the use of highly inflated net worth, as reflected in financial statements, became the tool of credit acquisition. The assets represented at best marginal holdings. Credit status was poor. One individual had a criminal record. Another was under indictment. Several of the promoters had firms which were insolvent or nearly so, and in some instances part at least of their holdings were on the verge of, or actually in, bankruptcy. Two different groups had interests in insurance companies which borrowed from the looted banks. One of these companies had at that time been closed by the state; the other closed at about the same time the bank did.

These are unsavory backgrounds.

In too many instances, acquisition of control of the banks was financed by larger city banks, eager for correspondent balances, and satisfied by the bank stock which was pledged as collateral. Credit checks in several instances were not nearly adequate. Premiums paid to purchase stock were excessive, but the lending banks chose not to question this factor.

I suppose the financing banks depended heavily on the fact that under normal circumstances bank stock is good collateral, but there is one basic flaw to that thought: bank stock is good collateral if the bank is soundly run, and if the bank remains open. If the bank closes, as these banks did, the bank stock collateral becomes virtually worthless.

The financing bankers made the error of assuming safety in a piece of paper, rather than in the individuals behind that paper. There is still no guarantee better than the person behind it, and the character of the borrower is still the single best assurance any lender can have. It seems that we are always in the process of relearning this lesson.

Once the people purchased the bank in question, aided in many instances by bank financing, a standard pattern of seeking funds and of placing them was started. Two cases involved the use of "float" mechanism, and one involved a "kite," among other operations, but essentially the pattern revolved around two key techniques, the solicitation of funds in the form of time certificates of deposit from out-of-territory groups willing to skirt existing regulations, and the placement of these and other funds in unsound out-of-territory and self-dealing loans.

The unsound loans in every case wiped out capital and caused the demise of the bank. These were the twin causes of failure that each had in common with the others. These two techniques are the tools of the new breed of bank raiders.

I would like to turn your attention to some banking practices which I think fostered these raids. These practices are reminiscent of unhappier times we do not want to repeat, and I would suggest should be eliminated from the system, by discipline in the trade and by supervisory vigilance.

As you all know, the period of the 1920's, which reached an unhappy climax in the 1931-33 period of bank failures, was an era in which banking was beset by many speculators. Many otherwise good institutions were pulled down by men whose approach was all too similar to today's raider, pyramiding unsound self-dealing loans, unsafe stock transactions, and other non-bank promotions, into edifices which had to collapse and did, almost destroying the banking system in the process.

Not speaking for the Corporation for a moment, but only for myself, I suggest that the funds secured by the promoters in the 1963-64 failures were secured by an outright evasion of the law.-- an evasion of the law condoned and assisted by other financial institutions, including a few banks, savings and loan associations, credit unions, insurance companies, union pension funds, and others. A hunger for earnings impelled these people to place certificates of deposit in the banks, when they knew that the bounties paid were illegal, unsound, and unhealthy. As you all know, there are other banks, otherwise sound, which are still looking for this kind of money, and paying the same unsound bounties.

Evading the law is evading the law, and no amount of pious words will conceal the illegality and immorality of such an action -- not to mention the inherent dangers. Every institution which placed such funds is guilty of evading the law.

Perhaps as important as anything I discuss with you today is my conviction that bankers must not jeopardize their public trust by overreaching themselves. The competitive urge, the desire for rapid growth and quick profits lead to corner-cutting and to an unrealistic wandering out of the known territory. No banker should make loans in an area far removed from his bank unless he possesses the know-how, the resources and the ability to maintain the necessary credit and economic checks needed for sound operations.

Every one of the eight banks which collapsed did so under the weight of out-of-territory loans, loans which no prudent banker in the borrowers' area would have made. Those loans went out of territory simply because the in-territory bankers knew they were not bankable and refused to handle them. It is as simple as that. The blocks of mortgages, the sales finance paper, and the other loans were of a high-risk, marginal nature.

A large bank of national scope can maintain a large and sophisticated staff to handle out-of-territory business. A regional bank does the same on a smaller scale. But even these banks use the extensive resources of the correspondent bank system when they are going into new areas. Why should a small banker risk all that his bank has when it is obvious that it lacks the expertise to go outside its own area to make loans?

The purpose and the strength of the smaller independent local bank lies in its ability to give the best service to its community, to draw its financing, ownership, and management from that community, to know the community and serve the community s needs. The unusual American banking system developed out of a desire to preserve local control over the capital and credit mechanism of the community and to provide local service. Perhaps the single sorriest element in this whole sorry story of bank raiding is the common pattern of reaching for loans out of a territory, beyond reason, ability, or size.

We as supervisors, state and national, have a moral responsibility. We are charged by the people of our states, and by the nation as a whole, to maintain a sound banking system. Bank failure may not have quite the economic impact it did in the 1920's and 1930's, largely because of deposit insurance, but the emotional impact is as great as ever. Any one of you who ever stood outside a closed bank, as I have done all to often this year, and looked at the uncomprehending townspeople, understand this. We must learn the lessons these failures teach us.

The FDIC moved this year to try to plug up at least one supervisory loophole. With the support of the Administration we secured, as you all know, a law requiring reports of changes in control to the proper Federal agency. That law requires additionally that we get reports on loans secured by 25 percent or more of a bank's stock, with certain exceptions.

FDIC did not, and does not, believe that it can with propriety ask for a veto over the sale of private property. But we do believe it is consistent with our supervisory authority and responsibility to be on notice when a new control or management enters a bank, so that that new control or management may be investigated. If necessary, it can be carefully supervised, not in any sense as a punitive measure, but both to assure that the management is honest and trying to live up to its fiduciary responsibilities, and also when and wherever possible to assist that management, to help develop the expertise to avoid some of the pitfalls that can come from inexperience.

With regard to that law, I would like to extend to you my pledge -- and I know I also speak for FDIC Chairman Joseph Barr -- that the agency will cooperate in every way with state supervisors through exchanges of information.

After all, the state supervisor is the first line of defense in the case of any state-chartered institution. We recognize in this law an implicit acceptance of the responsibility we jointly share, and an implicit acceptance of your important role. At the same time we would like to ask you to ponder this question: Is this legislation enough, or are there other steps, legislative or administrative, which you can and should take?

I believe that you may want to take note of the laws of the States of Oregon and Florida, for example. Where it is inappropriate for Federal authorities to exercise a veto power over sales of bank stocks of state institutions, this power might well be vested in the state chartering authorities. I stress chartering authorities, because I feel that the key to effective action may be found in that power. As you all know, several states are seriously considering such legislation. It will be interesting to watch the progress they make.

As chartering authorities, and as the closest supervisory agencies for the nation s state banks, there may be other tools which you can develop. Not the least of the tools you can work on is the improvement of your own departments, through upgrading examiner ability and attracting the best possible people. Personally, I would favor any steps toward improving the financial abilities of your departments to maintain good operations, adequately staffed, and able to make consistent and sound examinations. Your school, which opened this year, and which I had the honor to address, is in my mind an outstanding example of how you can improve your service to your states and upgrade the banking systems of your states and of the nation.

The American system of banking cannot be any stronger than its grassroots membership, as exemplified by the small, locally owned and managed bank. And that grassroots strength in turn demands that your state supervisory departments be healthy, effective, and good teachers of the best in banking.

Another item I would like to discuss deals with cooperation between state and Federal authorities, a cooperation FDIC prides itself in maintaining. We want to work with you as partners in this effort to maintain an effective banking system. Our first conference this year with the state supervisors from 10 western states was an exercise in this partnership and we feel, a great success. I am pleased to announce that the next such conference involving the supervisors in the states encompassed by our Districts 1 and 2 is scheduled for February 2, 3, and 4, 1965.

But there is more to cooperation than the ability of FDIC and state supervisors to sit down and talk together. We must in our day by day operations evince a willingness not only to talk together but to act together when action is necessary. Above all, we must keep each other informed.

I believe that FDIC and the state supervisors have a good record in this area. I believe the same to be generally true of the Federal Reserve and state authorities. I know that in most instances FDIC and the Federal Reserve work well together and keep each other reasonably well informed.

I am sorry that I cannot say the same for the Office of the Comptroller of the Currency. At the same time, I urge you not to react to this refusal to cooperate by "competition toward the minimum." If standards of safety and prudence are not adhered to in actions affecting your own states, by any authority outside your own states, do not lessen your own standards for the sake of maintaining a specious "competitive" balance. Be rigorous in maintaining the soundest possible local supervision despite any pressures you may feel. In the end the country will owe you a great debt of gratitude.

This nation has developed the finest, most flexible, most responsive banking system of all time; let us all dedicate ourselves to keeping it that way.

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