Statement
of
Chairman K. A. Randall
Federal Deposit Insurance Corporation

before the
Subcommittee on Domestic Finance of the
House Committee on Banking and Currency
on August 3, 1965

Introduction

Mr. Chairman, as you know, the Federal Deposit Insurance Corporation was established by the Congress in the depths of the Great Depression of the 1930's as part of a program to rehabilitate the financial structure of this nation. It has been successful in its efforts to protect bank depositors and thereby to provide a new and important element of stability to the entire banking system. The copies of the Statement of Operations of the Federal Deposit Insurance Corporation for 1964 which have been furnished to you will provide additional background information on deposit insurance, and I direct your attention to Chart A of page 5.

When the Corporation was established, the Congress was chiefly concerned with the problem of protecting people with money in banks that they could not afford to lose. How has this protection worked out in fact? All told, 992 out of every 1,000 depositors in the insured banks that have failed since this Corporation was established have been fully protected against the loss of their funds. Notwithstanding limited insurance -- $2,500 at the beginning and now $10,000 -- the

Corporation has also been quite successful in helping depositors with larger balances to minimize their losses.

One of the powers possessed by the Corporation is the right regularly to examine insured state banks which are not members of the Federal Reserve System. FDIC's power to examine state member banks and national banks is restricted to special examinations. Our examinations, which are coordinated with the various state banking authorities, cover approximately one-half of the insured banks. Bank examinations made by the FDIC, and by other supervisory authorities, are conducted in the public interest for the protection of depositors. This important supervisory tool is the principal contact the supervisor has with the banks, and examinations are his primary source of information about the condition of banks. It should be emphasized that FDIC has no power to close a bank. The power to close a state bank resides with the state. The power to close a national bank resides with the Comptroller of the Currency. It is my belief that the Corporation's examination program, which supplements the supervisory efforts of the states, has been a most effective contribution to the success and strength of our nation's banking system.

Crown Savings Bank

Crown Savings Bank, Newport News, Virginia, chartered in 1905 and first insured by FDIC on January 1, 1934, reported approximately $8 million in assets when it was closed on September 4, 1964. The closing was pursuant to a petition of the Commissioner of Banking for the Commonwealth of Virginia, to the Corporation Court of the City of Newport News, Virginia, which appointed the FDIC receiver.

Over a good part of its insured life, Crown was a matter of special concern to the FDIC and was accorded continuing special attention designed to assist the bank's management in correcting problems and in strengthening its loan administration. It wasn't until the examination of June 8, 1964, when new problems of serious magnitude were disclosed in Crown's condition, that the extent of management's dereliction came into full focus.

The adverse developments in the affairs and condition revealed at this examination were significantly different in their nature from the criticized conditions in this bank during the preceding nine years. At the forefront of these troubles was a very substantial increase in large lines and concentrations of credit to out-of-trade area borrowers, with sizeable portions of these lines exceeding state loan limit statutes. Another adverse development disclosed at the June, 1964 examination was the fact that outstanding certificates of deposit had almost doubled the total found at the January 21, 1963 examination. The certificates of deposit volume expansion and widespread geographic beyond-trade-territory locations of the certificate of deposit holders aroused suspicion that

these funds were obtained by the bank through brokers or other forms of solicitation not consistent with accepted bank-depositor relationships. However, no payment of premiums by the bank for the certificate of deposit funds was reflected by the bank records. A further development disclosed at the June, 1964 examination was the nearly 30% increase in outstanding loans between examinations.

Facts uncovered after the June 8, 1964 examination increased the aggregate of the large lines and concentrations actually outstanding to several times the total reflected in the report of examination, and the creditworthiness of the involved borrowers was found to be substantially less than revealed by the bank's files during the examination. Although not known or disclosed by management at the time, many separate guaranty agreements of larger borrowers covering other loans were existent and were withheld from examiners by Crown's management. The concealment of the guaranty agreements prevented the examiners from ascertaining the true volume of the large lines and concentrations of credit.

Crown Management

The Crown Savings Bank had been completely dominated in both policy matters and day-to-day operations for more than twenty years by Mr. LeRoy F. Ridley, now 58 years of age, who in 1926 joined this family-controlled bank. After 13 years of service as Cashier, Mr. Ridley was elected President in 1949. The Ridley family controlled approximately 50% of the common capital stock, with the largest block (42%) in the name of former President Ridley.

Mr. Ridley was a well known citizen of Newport News, a leader in his local community and the surrounding area, and enjoyed the confidence and respect of local bankers. Active in bank organizations, he has been President of the National Bankers Association and served as Chairman of its Executive Committee for several terms.

Possessing a pleasing personality and displaying a very cooperative attitude during examinations of the bank, Mr. Ridley, in the past, was responsive to the recommendations of examiners and for the most part was willing to effect needed improvements and corrections in the bank. With the benefit of hindsight, we are now aware that for some time preceding the closing of the bank Mr. Ridley adopted deceptive practices in his relations with our examiners in the concealment of dealings with borrowers whose loans, overdrafts and kiting operations caused the bank's insolvency.

Failure

In early August, 1964, the Corporation learned that Crown was having check clearing difficulties. A Corporation examiner sent to the bank investigated and prepared a letter report to the United States Attorney advising of possible check kiting activities. This was followed by a special investigation of the bank's condition on August 21, 1964, by our examiners and the state examiners.

The situation reached a point at which it was determined on or about September 1, 1964, that the bank's estimated losses had wiped out its capital and created a deposit exposure in excess of $400,000. As a result, the Banking Department of the Commonwealth of Virginia petitioned the Court to close the bank and to create the receivership on the 4th of September, 1964. The court action creating the receivership followed on the 4th of September, 1964.

The payment of insured deposits began two banking days after the date of suspension.

Brokered Funds

Let us turn now from the somewhat detailed consideration of the Crown Savings Bank failure to certain other aspects of this hearing. The financial condition of the Crown Savings Bank and six more of the recently failed banks was brought about primarily through the acquisition of bad assets with funds obtained with the aid of money brokers rather than from the growth of deposits in the normal course of business. These funds were brought in with compensation in excess of the maximum permissible rate of interest which insured banks may pay on deposits under regulations of the Corporation and the Board of Governors of the Federal Reserve System.

In the case of each of the seven banks with brokered funds represented as deposits, there was an arrangement made either directly or indirectly to have a bonus over and above the permissible rate of interest on deposits paid to obtain the money. There were about 388 certificates of deposit of this kind issued by these closed insured banks. These certificates aggregate about $18.3 million and there was one certificate of $3 million. Insurance coverage of these deposits would amount to about $3.8 million.

Because time certificates of deposit have been involved in so many of the recent bank failures, it may be well to say just a few words in an effort correctly to describe, and identify them. A time certificate of deposit is evidence, in written form, that a specified amount of money is, and will be, left on deposit for a definite period of time at the bank. The certificate also is evidence that the depositor

will be compensated at a stated rate of interest. This kind of deposit itself is time proven and in some areas of the country it is used as a substitute for a savings account passbook.

Because of an interesting money market development in the early 1960's, certificates of deposit attracted much attention and attained a new importance in the banking system. At that time, a number of large banks in the principal financial centers began to issue negotiable time certificates of deposit on terms that provided corporate treasurers with an attractive investment for short term funds. Thus, a bank could compete effectively for deposits it otherwise might lose when funds were withdrawn to buy short-term securities - for example, Treasury bills. A necessary related development to maintain the attractiveness of these CD's was the establishment of a market by security houses to trade them over-the-counter before the maturity date. So, if the holder wanted to get his money out of the certificate of deposit, he could do so readily. Typically, these marketable CD's were issued in large units ranging in size from $100,000 to $1 million. These transactions are not a part of the failed banks' story.

This new and imaginative adaptation of a traditional banking instrument to provide American industry with a modernized financial tool emphasizes that our banking system is alert to business opportunities. This is essential for a growing economy. From a very small beginning in 1961, negotiable certificates of deposit have built to a current level of about $15 billion. In other words, this specialized investment practice accounts for nearly half of the CD's in the system of insured banks.

To repeat, in seven of our recent bank failures certificates of deposit were misused to gain control of liquid resources that would not be available to the bank within its normal sphere of operations.

Certificates of deposit do not cause banks to fail. But the trouble comes when the CD's or other deposits are misused to swell the bank's liquid resources, which in turn are diverted or invested in bad assets. Sooner or later funds must be repaid. The bank fails if its assets are so wanting in quality that they cannot be converted into the cash necessary to meet its obligations.

Under the Federal Deposit Insurance Act, in any case where the Corporation is not satisfied as to the validity of a claim for an insured deposit, it may require the final determination of a court of competent jurisdiction before paying the claim. A long line of court decisions in relation to state deposit guaranty plans, years before the formation of Federal Deposit Insurance Corporation, had established that money placed in banks under an arrangement for payment of a bonus or premium in excess of the statutory or regulatory interest rate limit was not a "deposit" insured or guaranteed by such guaranty plans.

Under the circumstances surrounding the brokered funds involved in the seven closed banks, the Corporation decided to submit the matter to the courts for a determination as to whether the funds placed in these banks under these facts constituted deposits entitled to insurance. Consequently, the Board of Directors of the Corporation authorized declaratory judgment actions in California and Texas for a determination by the courts of whether these certificates qualify as insured deposits and to what extent Federal deposit insurance may apply. Holders of certificates of deposit of Crown Savings Bank whose insurance was questioned have in many instances agreed to abide by the results of such actions.

Remedies

After these actions were filed it became apparent that these lawsuits would not end the practice by some banks of bringing funds into the bank at excessive interest rates in exchange for certificates of deposit or other evidences of deposits. This is borne out by the large amount of money involved in some of the transactions, which suggests that certain lenders of funds to banks are not concerned with Federal deposit insurance protection.

At the time of the Corporation's original suit on the question of the insured status of certain certificates of deposit, only two banks with an aggregate of $4.5 million in assets were involved. Our reports of examination had also indicated to us that the practice of brokering deposits at rates in excess of the maximum permissible rates under Federal banking regulations was becoming more widespread. Last year we thought that this problem involved in the closing of two small banks did not merit an approach to Congress for legislative action, but we did decide that it was our duty to request the courts for a determination of this matter. The failure of twelve banks in the last eighteen months with assets of about $84 million, in which the pattern of brokered funds at excessive rates of interest was important in seven of these failures, has brought me to the conclusion that this subject requires legislation.

Subsequent appraisal of this matter after the institution of our lawsuits has convinced us that litigation will not solve the problem. Denial by the courts of insurance coverage to these transactions would not restrict the circumvention of the interest regulations. On the

other hand, it might well have a serious detrimental effect on the status of an insured deposit in the minds of depositors. Weighing the desirability of preserving the confidence of the public that their deposits of funds in banks are entitled to Federal deposit insurance coverage against the fact that a favorable decision in our lawsuits would not curtail this objectionable practice of brokered funds, it has been concluded that the public interest will best be served by preserving the deposit status of these transactions and by providing by legislation a means for enforcing the interest regulations of the Corporation and the Board of Governors.

We have sent forward today a draft of proposed legislation which would accomplish this objective. A copy thereof is attached with a summary of the proposal.

I have been advised by the Bureau of the Budget that enactment of this legislation would be consistent with the Administration's objectives.

In addition to the proposal for enforcement of the interest regulations, the Corporation has under consideration a number of other remedial measures pertinent to the matters which I have discussed. These may be summarized as follows:

(1) Authority for the Corporation and the other Federal banking agencies to order banks under their supervision to cease and desist from unsafe and unsound practices and violations of law or regulations, and to suspend or remove officers and directors who are found to be engaged in such practices or violations;

(2) Additional authority for the Corporation to extend financial assistance to insured banks in financial difficulties;

(3) Authority for the Federal banking agencies to require banks to obtain independent private audits of their books and affairs; and

(4) The imposition of criminal penalties upon persons who knowingly make false statements to insured banks in applications for loans or extensions of credit by such banks.

When legislation is drafted to accomplish these proposals, such draft bills will be submitted to the Bureau of the Budget for usual review and clearance.

Another matter in which you have indicated an interest is the recent change in control of bank management legislation. The Corporation sponsored this legislation, which was enacted on September 12, 1964, relating to notice of changes in control of management of insured banks. Under the law, the chief executive officer of any insured bank is required to report promptly to the appropriate Federal banking agency the facts about changes occurring in the outstanding voting stock of the bank which will result in a change in the control of the bank.

A report is also required in cases where a loan or loans are made by any insured bank which are secured by 25% or more of the shares of the voting stock of any other insured bank. The underlying purpose of the law is to alert the banking agencies to changes in control of management of insured banks. Our experience with the statute as enacted

in 1964 has, of course, been brief but has already produced some good results.

Mr. Chairman, we welcome an opportunity to review with you the problems brought to focus by the failure of the Crown Savings Bank. It is important that we maintain perspective as we view the recent bank failure record. The failure of seven banks in 1964 is indeed a small number by comparison to the 13,820 insured banks in the United States. Notwithstanding the impact upon any community when a bank fails, it must be borne in mind that the incidence of failure is small. The Corporation has through its entire history endeavored to learn from these failures and to grow in its ability to solve new problems as they arise. Beyond question, the banking system is viable and sound, and the infiltration of undesirable elements appears to be held at a low level.

SUMMARY OF PROPOSED LEGISLATION
FOR ENFORCEMENT OF
INTEREST REGULATIONS

The attached legislation would amend section 18 of the Federal Deposit Insurance Act and section 19 of the Federal Reserve Act so as to provide effective penalties for violations of Federal regulations prescribing the maximum rate of interest which insured banks may pay on deposits. Under the proposed legislation no insured bank or officer, director, agent, or substantial stockholder thereof would be permitted to pay or agree to pay a broker, finder, or other person compensation for obtaining a deposit for the bank, except as the Board of Directors of the Corporation or the Board of Governors of the Federal Reserve System may by regulation prescribe. Any payment made by any other person to induce the placing of a deposit in an insured bank would be deemed to be a payment of compensation by the bank if the bank has or reasonably should have knowledge of the payment by such person when it accepts the deposit. Any violation by an insured bank of the prohibitions in the law or regulations issued pursuant thereto would subject the bank to a penalty of not more than 10 percent of the amount of the deposit to which the violation relates. The Corporation and the Board of Governors of the Federal Reserve System would be empowered to recover these penalties, by suit or otherwise, together with the costs and expenses of recovery.

The Board of Directors and the Board of Governors would be authorized by regulation to prescribe what would be deemed to be a payment of interest. This term would include an agreement to pay interest by an insured bank and include payments to the depositor or any other

person made by an officer, director, agent, or substantial stockholder of the bank or by any other person if the bank has or reasonably should have knowledge of the payment by such other person when it accepts the deposit. The Board of Directors and the Board of Governors would also be authorized to define payment of compensation and substantial stockholder, and to prescribe such rules and regulations as they may deem necessary to effectuate the purposes of the law and prevent evasions thereof.

DRAFT LEGISLATION

A BILL

To amend the Federal Deposit Insurance Act and the Federal Reserve Act with respect to the payment of deposits and interest thereon, to limit the payment of compensation for obtaining deposits, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That subsection (g) of section 18 of the Federal Deposit Insurance Act (12 U.S.C. 1828(g)) is amended by striking out the next to last sentence thereof, relating to penalties for violations of such subsection, by inserting "(1)" at the beginning thereof, and by adding thereto the following paragraphs:

"(2) No insured nonmember bank or officer, director, agent, or substantial stockholder thereof shall pay or agree to pay a broker, finder, or other person compensation for obtaining a deposit for such bank, except as the Board of Directors may by regulation prescribe. For the purposes of this paragraph, any payment made by any other person to induce the placing of a deposit in such bank shall be deemed to be a payment of such compensation by the bank if the bank had or reasonably should have had knowledge of such payment by such person when it accepted the deposit.

"(3) Any violation by an insured nonmember bank of the provisions of this subsection or of regulations issued hereunder shall subject such bank to a penalty of not more than 10 percent of the amount of the deposit to which such violation relates. The Corporation may recover such penalty, by suit or otherwise, for its own use, together with the costs and expenses of such recovery.

"(4) The Board of Directors is authorized by regulation to prescribe what shall be deemed to be a payment of interest by a nonmember insured bank

(which shall include an agreement to pay interest and may include payments to the depositor or any other person made by an officer, director, agent, or substantial stockholder thereof or by any other person if the bank had or reasonably should have had knowledge of such payment by such other person when it accepted the deposit), a payment of compensation, and a substantial stockholder for the purposes of this subsection and regulations issued pursuant thereto and to prescribe such rules and regulations as it may deem necessary to effectuate the purposes of this subsection and prevent evasions thereof."

SEC. 2. Section 19 of the Federal Reserve Act is amended by inserting the following paragraphs after the thirteenth paragraph thereof (12 U.S.C. 371b):

"No member bank or officer, director, agent, or substantial stockholder thereof shall pay or agree to pay a broker, finder, or other person compensation for obtaining a deposit for such bank, except as the Board of Governors of the Federal Reserve System may by regulation prescribe. For the purposes of this paragraph, any payment made by any other person to induce the placing of a deposit in such bank shall be deemed to be a payment of such compensation by the bank if the bank had or reasonably should have had knowledge of such payment by such person when it accepted the deposit.

"Any violation by a member bank of the provisions of this section or the regulations issued hereunder relating to payment of deposits and interest thereon and payment of compensation for obtaining deposits shall subject such bank to a penalty of not more than 10 percent of the amount of such deposit to which such violation relates. Such penalty may, by direction of the Board of Governors of the Federal Reserve System, be recovered by suit or otherwise by the Federal Reserve bank of the district in which the

offending member bank is located, for its own use, together with the costs and expenses of such recovery.

"The Board of Governors of the Federal Reserve System is authorized by regulation to prescribe what shall be deemed to be a payment of interest by a member bank (which shall include an agreement to pay interest and may include payments to the depositor or any other person made by an officer, director, agent, or substantial stockholder thereof or by any other person if the bank had or reasonably should have had knowledge of such payment by such other person when it accepted the deposit), a payment of compensation, and a substantial stockholder for the purposes of this section and regulations issued pursuant thereto and to prescribe such rules and regulations as it may deem necessary to effectuate the purposes of this section and prevent evasions thereof."

SEC. 3. The provisions of this Act shall be applicable to funds received by the bank after the date of its enactment and to any subsequent renewals of a deposit.