FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

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THE CHANGING ASPECTS OF FEDERAL DEPOSIT INSURANCE

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Over the past two years, the Federal bank supervisory agencies have been operating in an environment that has presented them with critical problems demanding new solutions and with major challenges associated with an expanding economy. The banking agencies have been called upon to discharge their responsibilities to support a vigorous and sound banking system during a period of intense pressures in the financial markets.

Shortly after the Federal Reserve, the FDIC, and the Federal Home Loan Bank Board took action in September 1966 under the flexible interest rate regulatory powers granted by Congress, these pressures moderated. A slackening in the pace of economic expansion and a lessening of competitive pressures helped to bring about an easier tone in the financial markets. The subsequent slowdown in the rate of economic growth was not accompanied, however, by any significant easing in the money and capital markets. Corporations and financial institutions took advantage of the opportunity to build up their liquidity positions to withstand any recurrence of the "credit crunch" experienced last year.

Now the economy may be on the verge of resuming a strong expansion. With appropriate monetary and fiscal policies, the expansion can be balanced and sustainable, and financial pressures can be kept within controllable limits. The economy may be embarking on another major expansionary phase.

But irrespective of one's views on the immediate prospects for the economy, from time to time it is essential to pause and stand back from

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close involvement with day-to-day concerns in order to get a better perspective of the total situation.

Because the FDIC was so deeply involved in developments in the money and capital markets in the past year or two, I should like to take this occasion to talk with you this afternoon about the Corporation's overall role and responsibilities in the economy. I don't expect to be able to give definitive answers to the many hard questions that you may want to ask, but we might usefully explore the implications of the basic issues involved.

The Federal deposit insurance system was established in 1933. It was designed to help restore public confidence in banks through the provision of insurance coverage for bank deposits and to protect the money supply furnished by the banks covered by deposit insurance. It differed from earlier deposit insurance plans because it was nationwide -- as opposed to geographically limited state systems. It therefore was able to mobilize the financial resources needed to assure a substantial measure of safety to bank deposits and to provide sufficiently comprehensive coverage to be workable.

The Corporation's initial capital resources of $289 million were provided by the U.S. Treasury and by the Federal Reserve Banks, but both the principal as well as interest for the use of the funds was subsequently fully repaid out of accumulated revenues from assessments on banks and investment income. A deposit insurance fund -- totaling almost $3.4 billion as of June 30, 1967 -- constitutes the chief financial backing for Federal deposit

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insurance. Since 1950, the Corporation also has the authority to borrow up to $3 billion from the U.S. Treasury to supplement its resources, but this authority has never yet been exercised.

The temporary deposit insurance plan introduced in 1934 provided protection only up to $2,500. The coverage was increased to $5,000 in July 1934 and to $10,000 in 1950. About a year ago, on October 16, 1966, the maximum coverage was raised to $15,000.

The introduction of Federal deposit insurance in the early 1930's was motivated by several objectives. Most immediate, of course, was the determination to create a system that would prevent recurrence of the financial crises that characterized the early years of American finance and snowballed into major proportions during the Great Depression. Not only was there concern for the bulk of the depositors in banks, who held relatively small amounts, and the adverse reactions on the larger deposits but also concern for the affected communities whose money supply, consisting of bank deposits, had been extinguished. Loss of the medium of exchange and the involuntary freezing of previously liquid assets forced economic activity to a standstill.

The establishment of a deposit insurance system that covered all depositors -- and the bulk of them up to the full amount of their accounts -- in effect recognized the overriding public interest in stabilizing the financial structure. Over the period extending from the latter half of the 1930's and up through the end of World War II, Federal deposit insurance clearly demonstrated its abilities to accomplish its initial objectives.

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The number of bank failures dropped sharply, and their impact was significantly reduced. This was achieved by rapid pay-offs of depositors in failing bank cases and by the introduction of substantial improvements in the quality and scope of bank supervision. Stress was placed on the importance of sound banking practices, on cooperation with other Federal and State banking authorities, and on strengthening of the capital structure of banking in general, whenever necessary.

As Federal deposit insurance emerged from the war and moved into the decade of the 1950's, a new aspect or focus of its activities came to the fore. That was the contribution that the FDIC and the deposit insurance system could make to economic stabilization. At the end of World War II, many anticipated a major depression once wartime production demands tapered off. The Employment Act of 1946 in effect recognized this fear and attempted to forestall its realization by soliciting the cooperation of all sectors of the economy. The FDIC, for instance, was expected to bear its share of the task within this framework. Eventually, fears of a major postwar depression receded as the demands of a peacetime economy and the demonstrated capabilities of our economy succeeded in maintaining high levels of output and income.

During this period it became evident that deposit insurance had a useful role to play through its efforts to maintain the public's confidence in the banking system. No longer were there wild scrambles by depositors to achieve liquidity when a bank closing was feared -- or even if a bank failure actually occurred. In combination with other agencies of government -- both

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Federal and local -- the FDIC was helping to establish a stable economic environment. In addition, there were many new lessons that had to be learned concerning the maintenance of an environment conducive to economic growth and widespread prosperity -- such as the flexible use of monetary and fiscal policies. But it was possible to experiment with minimum disruption and disturbance to the expansion of the economy.

With the advent of the 1960's, it has become increasingly clear that the Federal banking agencies -- such as the Corporation -- have the responsibility to assist banks in adjusting to changes in the economic environment. The complexity of the economy -- both national and international -- and of the financial mechanism has made it difficult for individual institutions to seek and find individual solutions to externally generated problems. In the first place, our economy is being continually exposed to influences emanating from international developments abroad as well as from developments at home. Secondly, in an economy such as ours, which is continuously pressing close to capacity levels, there is less room for maneuver and less room for error. Furthermore, there is less scope for experimentation by individual banks in testing out solutions for problems. The significance of these constraints is yet to be fully realized. Finally, banking is recognized -- rightly -- as but one segment of the broader financial market, although a most important one.

It is in this arena that the Corporation can increase its contribution to banking in the public interest -- by easing the pains of the transition period for banks and by encouraging flexibility and innovation within an

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acceptable institutional framework. On its own part, the Corporation must also remain ever-responsive to changing needs and to the need for change and flexibility.

To sum up then, since its inception, the FDIC has passed through two rather clearly distinguishable stages in the orientation of its activities. In its early years, a paramount consideration was the need to husband resources -- to stand prepared financially to pay off depositors where necessary and minimize bank failures. There was little emphasis on innovation. The second -- and somewhat longer -- phase has consisted of efforts to build up our deposit insurance fund to serve as the "symbol of confidence" for bank depositors. This objective could only be attained during periods of relative economic stability and through effective bank supervision that stressed the adoption of good banking practices.

It seems to be that we are entering now a third -- and new -- phase or aspect of deposit insurance. Deposit insurance provided the institutional support that allows banks to fit into the modern environment. But, in the process of evolving this institutional support, various regulations and restrictions have been imposed by the supervisory authorities in protection of the public interest, by the development of institutional rigidities in the economy, and as a consequence alone of the increased magnitude of the economy. Regulation has been substituted for decisions previously reached in the marketplace in a number of instances.

Because changes in the economy are also occurring more rapidly than before, it is essential that the financial institutions under our supervision

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receive every encouragement to innovate and to adapt to change. Nevertheless, it is harder to innovate successfully, and the penalties of failure tend to be greater than before. The consequences to the individual institution and the community can, moreover, be far reaching. On the other hand, limitations imposed by the bank supervisors on full freedom of action can in turn result in undue dependence of the regulated on the regulator -- at the same time that the regulated are protected from the full impact of their own actions.

This then is the essence of our current dilemma. Within this environment, what should be the role of the supervisor and the role of the regulated? Our present position is the end result of developments over a period of years. As a consequence, there is still time to ponder the direction in which we might go from here, some of the issues that face us, and pose some of the questions that we must be prepared to answer -- whether as a bank supervisor, a banker, or the general public.

For example, undue reliance of the regulated institutions on the "protection" of the supervisory authorities -- as in the case of interest ceiling regulations -- could disrupt the traditional channels of policy decision by management. The flexible interest rate authority granted the financial supervisory agencies in 1966 and extended for one year last September proved most helpful in dampening excessive rate competition. But once the rate pressures eased a number of banks found themselves in an awkward position. The competition for savings was still so intense that it was difficult for a single institution to lower its rates. In these

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circumstances, hope was expressed in some quarters that the supervisory authorities would adjust the ceiling rates to conform with the easing in market rates. But it is not the responsibility of the supervisory authorities to set market rates paid on time money. Nevertheless, we do recognize the existence of a problem -- and are most desirous of helping banks find a solution that will permit maximum scope for individual initiative as well as adequate safeguards for the public interest. Beyond question, it is necessary to modify the old bases for policy decisions. Criteria heretofore satisfactory are in many cases becoming outmoded.

Even through the free play of private initiative should be maximized, the realities of the marketplace preclude a return to the free and unrestricted competition we knew in the past. The economy has changed -- in structure, in the number of viable participants in the market, in the magnitude and complexity of its problems, and in the existence of various barriers to the free movement of financial resources, people, and institutions.

Nevertheless, whatever we can do to strengthen the forces of competition -- to facilitate the maximum interaction and interplay of market forces -- is healthy. Such an environment will provide the greatest support possible to the solution of problems as they arise. Otherwise, the inefficient are shielded from the consequences of their own actions or indifference, dullness and mediocrity are encouraged, and banking would be gradually displaced through failure to discharge its role effectively.

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The increasingly complex financial interrelationships of the modern world make it imperative that banks have the vigor to respond in an enlightened way -- not just in the old terms of dollars-and-cents accounting but in the broader context of the economy as a whole. Failure to respond appropriately would eventually force banks to the sidelines as more vigorous and alert competitors adapted more rapidly to the new environment. Consequently, banks must remain ever sensitive to the environment in which they operate if they expect to retain and expand their role as financial intermediaries. If banks are lax in discharging this function, their major problem could be not disintermediation -- or, for banks the diversion of funds from banks into the market that occurred last year -- but what might be called "nonintermediation" -- or complete circumvention of banks or other financial intermediaries by savers.

One means whereby banks can forestall nonintermediation is to know more -- about themselves, the financial system, and the economy as a whole. It may now be incumbent on banks -- more than ever before -- to cooperate with others, such as the supervisory authorities, in areas formerly considered solely within the province of a profit-oriented and profit-motivated management.

The bank supervisory agencies can help to ease the transition by acting as a "communicator" -- of knowledge and tools -- to the institutions they supervise. In the absence of deposit insurance, both large and small institutions are obliged to cloak their operations to a considerable extent with secrecy in order to create an image of great strength irrespective of

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condition. With deposit insurance, it becomes possible for banks to make full and fair disclosure of information regarding their resources and liabilities to the public authorities in substantial detail and to their shareholders. By this means banking emerges from the shrouds that have been considered an essential part of its facade in the past.

The FDIC itself could well find itself increasingly ineffective and inefficient if it did not recognize this problem and also have a thorough understanding of its implications. As institutions grow in size -- as even the smallest has had to in response to the general growth of the economy and advancements in the banking system, our perspective must change. Previously, there was little or no need to view banking in its entirety: the emphasis was on individual institutions. Now we need to understand the system as a whole and pursue policies dictated by the needs of that system -- whether it is banking, the financial community, or the whole economy -- rather than focus on the needs of particular units within that system.

How this perspective may be achieved is one of the major questions that we should be asking ourselves today. What we should be doing in turn basically depends on how we want the future to look -- and its needs. Do we want -- or need -- financial supermarkets or a checkless society? Or do we want a "less check" society only and the preservation of various specialized institutions? These are major decisions deserving serious thought and extensive exchanges of view. It is not too early to begin thinking.

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For the purpose of emphasis, let me summarize and restate the elements of our current predicament. Deposit insurance is now recognized as a vital element in supporting the environment essential for the operation of a modern banking system in the United States. Experience has demonstrated that modern banking requires a substantial amount of supervisory regulation and control to guide business decisions into the proper channels. In the absence of supervision, the historical profit maximization calculations can produce answers incompatible with stability in the financial community immediately and in the economy generally.

Deposit insurance has engendered confidence in the soundness of banking and the stability of its operations. The present-day banking environment therefore is conducive to the necessary free exchange of information between the individual banks and the public authorities. On this basis, bank supervisors can assist in developing guides to improve the quality of bank supervision and business decisions in banks.

In the development of the type of environment most conducive to an effective and modern banking system, it is well to remember that, as a practical matter, deposit insurance and the related supervision and regulatory activities should cover all institutions that perform a banking function. It also follows that departures from the well-recognized and time-tested channels of regulation and supervision should be made only with great reluctance and only after convincing evidence has been offered that a change is for the better.

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Notwithstanding the favorable elements in our current situation, there is evidence historically, that the heavy hand of regulation has always deadened the energy and ingenuity of the regulated. Perhaps it will be impossible to reverse this lesson of history. But certainly if we recognize the situation for what it is, and if we accept the reality that there may be no alternatives to these regulations, the inducement for devising new solutions for the old problems is indeed great.

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