DEPOSIT INSURANCE AND BANK SUPERVISION

Remarks Before the Graduate Seminar in Money and Banking
of Columbia University on Thursday, March 2, 1939

by

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OUTLINE

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Bank supervision and deposit insurance developed in response to demand of public for safety. The development of bank supervision and of deposit insurance reflects efforts on the part of the public to secure safety and stability in their financial relationships, and assurance that the obligations of banks will be met with reasonable certainty. The search for this security has been reflected in four developments: (1) requirement of pledge of special assets against particular liabilities; (2) insurance or guaranty of bank obligations; (3) bank supervision; (4) creation of the Federal Reserve System. These four developments have not been mutually exclusive nor do they fall into consistent chronological order.

Early efforts to secure safety. The earliest efforts to obtain security of bank obligations in the United States took the form of provisions for bank commissioners to examine commercial banks and to perform other functions similar to those of present day supervisory agencies. Several of the New England and Middle Atlantic States appointed bank commissioners during the first three decades of the nineteenth century. Very soon afterward proposals were made for the establishment of safety

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1/ These remarks represent the views of the author as an individual and are not to be taken as a statement of official policy or attitude of the Federal Deposit Insurance Corporation except when so indicated. The conclusions reached in this paper are based upon research conducted by the author's colleagues but his colleagues are not to be held responsible for the statements contained herein.

funds or mutual guaranty plans, or for the pledge of specific assets to assure the safety of bank notes, which at that time constituted the chief obligations of banks.

Six States - New York (1829), Vermont (1831), Michigan (1836), Indiana (1834), Ohio (1842), and Iowa (1858) - established "safety funds" or mutual guaranty plans for a part or all of the banks operating within those States. These plans of guaranty of bank obligations were of two types.

In New York, Vermont and Michigan the banks made annual contributions to a "bank fund", or "safety fund". In case of failure of any of the participating banks, this fund was responsible for all debts which could not be met from liquidation of assets. In each of the three States a bank commissioner, or board of commissioners, was appointed to make examinations and to exercise other supervisory powers of the same general character as those exercised in recent years by State banking authorities.

The Indiana, Ohio and Iowa plans of guaranty of bank obligations were of a different character. These States established banking systems which were entitled "State banks" but which were actually groups of unit banks. Each "branch" of these State banks issued its own capital stock, had its own board of directors, and distributed its earnings to its own stockholders. The central boards of these banks were in effect supervisory authorities. Their most important specific duties were to supervise note issues, pass upon applications for the organization of "branches", examine the "branches", and to assume full control of the affairs of any "branch" found to be in a dangerous condition.

These experiments with guaranty of bank obligations met with varying degrees of success but on the whole appear to have served their purpose relatively well. However, in the States which established safety funds or mutual guaranty plans, as well as other States, there was great pressure for the establishment of "free banking" with less supervision than was entailed in the safety fund and mutual guaranty plans.

In the "free" or "independent" banking systems which were established in a large proportion of the States during the second quarter of the nineteenth century, the safety of circulating bank notes, which at that time constituted the chief obligations of banks, was to be secured by the pledge of assets. In most of the States the assets so selected under the system of free banking included many types of assets which proved to be subject to high degrees of risk. As a consequence, the circulating notes issued by banks in a considerable proportion of States were subject to substantial and varying degrees of depreciation.

Establishment of the national banking system with guaranty of circulating notes and provision for bank supervision. The national banking system was created in part for the purpose of financing the Civil War and in part for the purpose of securing a safe uniform circulating currency. Only United States Government securities could be pledged to secure national bank notes, and these notes were further safeguarded by guaranty of redemption by the Federal Government. Provision was also made for the examination of banks by examiners appointed by the Comptroller of the Currency applying to the country as a whole the superior standards then to be found in the State of New York. In addition, a system of legal reserve requirements was set up to give further assurance of the banks' safety. Imposition of a tax on State bank note circulation led to the virtual extinguishment of the State banking systems and the previously established guaranty systems which were still in existence were discontinued.

Movement for insurance or guaranty of bank deposits. The excitement caused by the first three national bank failures and the congressional investigation of those failures affords some evidence of the shock resulting from the realization that national banks could and would fail.[1/] The panics of '73, '93 and 1907 revealed shortcomings in our national banking system and the inability of our system of bank supervision to prevent bank failures. The seriousness of these failures was increased by the growing importance of deposits, the payment or redemption of which were not guaranteed, relative to the circulating notes, the payment or redemption of which were guaranteed by the Government. Widespread use of bank checks in making payments had also contributed to the rapid development of State-chartered banks so that by the close of the nineteenth century a large proportion of the nation's banks were banks without a government guaranty for any part of their obligations.

1/ First National Bank of Attica, N. Y., for which a receiver was appointed April 14, 1865; Venango National Bank of Franklin, Pa., receiver appointed May 1, 1866; Merchants National Bank of Washington, D. C., receiver appointed May 8, 1866. See T. P. Kane's The Romance and Tragedy of Banking, pp. 36-45.

As a consequence, there was considerable agitation for insurance or guaranty of bank deposits. Between 1886 and 1918, 70 bills were introduced into Congress providing for the guaranty of bank deposits by a Federal Government agency. How many of these bills received serious consideration by banking and currency committees is not known. Only one, however, appears to have been reported upon favorably by such committees. In 1913, the Federal Reserve Act as reported upon by the Senate Committee on Banking and Currency, and as passed by the Senate, contained a provision placing a part of the earnings of the Federal Reserve banks in a depositors' guaranty fund. This provision was stricken out by the conference committee.

During the same period many proposals were made in the various States for more effective supervision over State banks and for the establishment of systems of deposit guaranty for State banks. Between 1880 and 1915 bank supervisory authorities were re-created in States which had permitted them to go out of existence or to become dormant after the establishment of the national banking system and were organized in many of the States which had not previously established them. Between 1907 and 1918 deposit guaranty systems were created in eight States - Oklahoma (1907), Kansas (1909), Nebraska (1909), Texas (1909), Mississippi (1914), South Dakota (1915), North Dakota (1917), and Washington (1917).

<u>Bank supervision under the Federal Reserve System</u>. An examination of the propaganda and literature designed to bring about banking reform during the several decades prior to the establishment of the Federal

Reserve System in 1913 shows that concern for the safety of bank obligations used as currency - i.e., deposits - was prominently in the minds of the public and of proponents of banking reform. Preoccupation with the question of safety is also revealed by the preamble to the Federal Reserve Act which provides for "elastic currency", "a means for discounting commercial paper", and for "a more effective supervision of banking in the United States". Apparently it was believed by both legislators and students of banking that an elastic currency, coupled with the ability of banks to rediscount commercial paper under pressure and with an improvement in bank supervision, would largely eliminate bank failures. It was generally believed that panics would be impossible under the new system. The belief on the part of Congress that more effective bank supervision would be forthcoming is indicated both by the preamble to the Federal Reserve Act and to some extent by the lessened agitation for deposit insurance or guaranty.

Perhaps it was the accident of history imposing upon the Federal Reserve banks the burden of financing the Great War, together with the magnitude of post-war adjustments, that resulted in a shift of emphasis in actual administration away from bank supervision. However that may be, by 1923 or 1924 the central bank philosophy of the Federal Reserve System began to emerge and bank supervision and bank examination as such were practically abandoned by the System or completely subordinated to other activities. From the middle 20's to the early 30's the Federal Reserve System conducted very few examinations, restricting most of their visits to the banks to so-called credit investigations.

During part of this period the Federal Reserve Board did not even have a Chief Examiner. The twelve Federal Reserve banks received and reviewed copies of reports of examinations of their member banks by the Comptroller of the Currency and the State authorities but their staffs were generally small.

The introduction of the Federal Reserve System did not change, in any significant degree, the character or effectiveness of bank supervision. During the two decades from 1913 to 1933, as in the previous three decades, bank supervision continued to be exercised by the Office of the Comptroller of the Currency and by the various State banking departments without substantial modification.

The wave of bank failures during the 1920's and the collapse of the banking system in the period from 1930 to 1933 revealed the inadequacy of bank supervision and of the central banking system as they then existed to provide the security which depositors of banks demanded. Agitation for the guaranty or insurance of bank deposits was renewed. From 1919 to May 1933, over 50 bills for this purpose were introduced into the Congress of the United States. The Federal Deposit Insurance Corporation was created in response to the demand which these bills reflected.

Present day structure of bank supervision. With the creation of the Federal Deposit Insurance Corporation there are now three Federal bank supervisory agencies and 48 State bank supervisory agencies supervising banks in the continental United States. The three Federal agencies are the Comptroller of the Currency, the Board of Governors of the Federal

Reserve System and the Federal Deposit Insurance Corporation. The Comptroller of the Currency supervises national banks primarily; the Board of Governors of the Federal Reserve System supervises State banks members of that System primarily; and the Federal Deposit Insurance Corporation supervises insured State banks not members of the Federal Reserve System. In addition to supervision by Federal agencies, all State banks which are insured, including both those members and those not members of the Federal Reserve System, are supervised by the authority of the State in which they are located. Noninsured banks are supervised by their respective State supervisory authority.1/

Duplication in bank supervision. There is practically no duplication between the Federal Deposit Insurance Corporation and the other Federal agencies with respect to supervisory activities as they relate to any single subject and any individual bank or group of banks. No other Federal bank supervisory agency issues regulations on the same subjects to the same class of banks that the Federal Deposit Insurance Corporation does, and no other Federal agency exercises supervisory power over the same class of banks with regard to those matters in which the Corporation exercises such authority. There may be overlapping, but the overlapping is of the same degree as that which exists by virtue of the fact that

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1/ The Reconstruction Finance Corporation is not listed as a bank supervisory agency because its relationships with the banks grow out of its subscription to capital and partake more of the nature of the relationship between a bank and an important stockholder than between a bank and a supervisory authority. Furthermore, the Reconstruction Finance Corporation does not now examine regularly any bank examined by any of the three Federal bank supervisory agencies.

banks have to account for their income to the Bureau of Internal Revenue, pay taxes to State tax authorities, and, in the case of many banks, submit to the authority of the Social Security Board.

The Board of Governors of the Federal Reserve System has the authority to examine national banks but does not exercise it. The Federal Deposit Insurance Corporation has authority to examine national banks only with the express consent of the Comptroller of the Currency, and State banks members of the Federal Reserve System only with the express consent of the Board of Governors of that System. As a consequence, there is practically no duplication in the examinations conducted by the Federal agencies.

From its inception to the close of 1938, the Federal Deposit Insurance Corporation conducted approximately 50,000 examinations, of which 110 were examinations of 100 national banks and State banks members of the Federal Reserve System. These 100 banks were examined for the following purposes:

(a) To determine eligibility for insurance of State banks members of the Federal Reserve System filing notice of intention to withdraw from the Federal Reserve System and filing application for admission to insurance as banks not members of the Federal Reserve System; and of national banks seeking to convert into State banks and filing application for admission to insurance as banks not members of the Federal Reserve System - 78 banks;

(b) To determine the applicability of law to proposals for mergers with the financial aid of the Federal Deposit Insurance Corporation and to appraise assets for the purpose of making loans - 8 banks;

(c) To conduct proceedings for the termination of insurance status of banks engaged in unsafe and unsound practices - 14 banks.

The cost of these 110 examinations - estimated roughly at $20,000 - has been borne by the Federal Deposit Insurance Corporation and no part assessed against the banks.

There is duplication betweeh the Federal establishment and the State authorities with regard to supervision of those State banks which are members of the Federal Reserve System and those which are not members of that System but which are insured. Insofar as the Federal Deposit Insurance Corporation is concerned the effects of this duplication have been lessened by arrangements for joint examinations and alternate examinations so that in the case of insured State banks not members of the Federal Reserve System the burden of examination upon these banks is little if any greater than that upon the national banks which are examined twice each year. The direct cost upon the banks is less due to the practice of the Federal Deposit Insurance Corporation of bearing the cost of its examinations.

Development of bank supervision empirical. The history of bank supervision shows that its development was a phase of our demand for safety and soundness in our banking structure and did not grow out of any considered theory or principle of the relation of government to business or out of any theory of social control of business. The development was wholly empirical.

Bank supervision is not analogous to the supervision and control of public utilities. The essence of the public utility is legal recognition of the existence and necessary continuance of an essentially monopolistic situation. Supervision in our banking system assumes, at least in principle, the existence of a competitive situation. The prime duty of the supervisors of public utilities is to prevent the public utilities from charging monopoly prices and from discriminating against customers. Except for general usury laws, the control of interest rates charged by banks has been chiefly a relatively recent development of central bank money market control exercised not for the purpose of maintaining fair charges but for the purpose of maintaining general economic stability through influencing the cost of money. At times it may be the aim of the central bank to raise the cost of money so high as to choke off customers' demand for credit. It does not appear that discouraging customers' demand has never been an object of public utility regulation. Public utilities have generally been required to do business with all comers who are prepared to abide by the publicly supervised rules. Banks have the unreviewed right to refuse to serve individual members of the community.

Neither did bank supervision develop as an instrument of monetary control. As I have pointed out elsewhere, when the Federal Reserve System developed its central banking philosophy it practically abandoned or at least greatly subordinated its supervisory activities.

On the whole, I think it fair to say that bank supervision has developed with a view to assuring soundness in our individual institutions with a minimum of interference with the conduct of the banking business.

The Federal Deposit Insurance Corporation and the need for an appraisal of bank supervision. A survey of the systems of insurance or guaranty of bank obligations which had been operated prior to inauguration of Federal insurance, indicates that certain conditions are necessary if insurance is to provide the safety sought by depositors. These conditions may be enumerated briefly as follows:

(1) Funds available must be sufficient to pay losses. If these funds are obtained by assessment the rate must be approximately equal to the rate of loss over a long period of time. The annual rate of assessment is about one-third as great as the annual rate of losses to depositors over the 70-year period preceding the establishment of the Corporation. If the Corporation is to provide the safety desired, therefore, the rate of loss from failures must be lower than in the past or additional funds must be obtained;

(2) Risk must not be concentrated in one section of the country or in a few very large banks;

(3) The insuring organization must have the power to establish and maintain specified conditions of admission and bank operation so that it is not forced to insure abnormal risks. The Corporation has the power and does maintain specified conditions of admission to insurance of banks not members of the Federal Reserve System. It has no such power with respect to banks members of the Federal Reserve System but must insure any national bank chartered by the Comptroller of the Currency and any bank admitted to membership in the Federal Reserve System. As a matter

of practice, however, the Comptroller refers all applications for national bank charters to the Corporation for a statement of the Corporation's opinion or attitude with regard to the granting of such charters. While the Comptroller is not bound by the recommendation of the Corporation, that recommendation does carry weight in the granting of charters. Similarly, the Federal Reserve System as a general practice does not admit to membership banks which could not qualify for insurance under the standards set up by the Corporation;

(4) Stockholders must take a reasonable share of the risks by providing adequate capital funds. The average ratio of total capital to total assets has declined substantially over the past 75 years and since the World War has averaged lower than in any previous period;

(5) The insured banks must be kept in a sound condition so that the probability of an excessive number of failures in times of business depression is reduced. Prompt supervisory action must be taken to close or to eliminate from insurance banks which get into an unsound condition and cannot be rehabilitated during relatively prosperous times.

(6) Adequate rediscount facilities must be available to the banks to enable them to convert sound assets into cash when necessary. This point will be alluded to later.

The Federal Deposit Insurance Corporation was faced with a 70-year record of banking which made essential a reexamination and appraisal of supervisory principles and procedure. Over the past 70 to 75 years the banking system as a whole has had to absorb $14 billion of losses. Of these losses, approximately $2.5 billion were losses of depositors, approximately $2.5 billion were lost by stockholders through assessments or contributions in the case of suspended or reorganized banks, and more than $9 billion were written off by active banks in the course of their operations. We do not know how much was lost through unrecorded voluntary contributions.

The ability of our banking system to continue to function under a system of private enterprise is dependent upon its ability to absorb these losses. Bank supervision must be concerned not alone with the losses to depositors but with the nature and origin of the $14 billion of losses sustained by the banks. If, as has sometimes been proposed, bank supervision should be divorced from the Corporation and either weakened or directed to purposes other than the maintenance of sound banks, we should probably have to establish insurance reserves and an annual income sufficient to pay losses not in terms of the $2 billion to $3 billion over a period of 75 years but of substantially higher amounts and proportions.

Supervisory policy and post-war banking crises. In reviewing the causes of the failure of our supervisory and our central banking authorities to cope with the situation that developed in the 30's, I have reached the conclusion that if any blame is to be attached to either of them for that debacle it is because of the adherence by each to the commercial loan theory of banking which, while having some basis in history for its existence, did not describe our banking system as it actually functioned in the 20's and the 30's. Bank supervisors in classifying and valuing assets did so on the basis of concepts revolving around self-liquidating commercial loans, liquid open-market paper, and liquid short-term securities. These assets constituted a relatively small proportion of bank assets, and they as well as other assets did not prove to be liquidable in the markets as they existed in the 30's. With non-liquid assets the banks were unable to meet the deposit withdrawals to which they were subjected. The banks' final recourse was to the central bank which was operating under the same basic philosophy, and was unable to provide the convertibility which the banking system needed.

Whether or not greater flexibility in our banking system would have prevented a collapse cannot be determined. It does appear, however, that the collapse of the banking system in 1933 resulted more from the inability of banks to rediscount assets to meet withdrawals than from the pressure of bank supervisors for liquidation.

Development of supervisory standards under the Federal Deposit Insurance Corporation. The early work of the Corporation revealed the existence of lack of coordination in standards and activities of the Federal and State bank supervisory authorities. Such coordination appeared to be essential to the smooth functioning of our banking system and of our supervisory and deposit insurance systems.

Following a number of conferences between representatives of the Federal Deposit Insurance Corporation and the Executive Committee of the National Association of Supervisors of State banks, that committee, on

April 15, 1938, adopted or endorsed certain principles and procedures governing examinations of banks and recommended their adoption by the various State authorities. The Corporation agreed to these recommendations and advised the other Federal bank supervisory agencies of its intention of putting them into effect. By the summer of 1938 general agreement was obtained among the Federal agencies in Washington. The principles and procedures finally adopted as standard in the summer of 1938 by all of the Federal agencies in Washington and most of the State authorities were substantially similar to those endorsed by the State supervisors earlier in the year.

Principles underlying current supervisory standards. The basic principles underlying the standard examination procedure may be summarized as follows:

(1) The banks' affairs should be so conducted as to assure the ability of the banks to meet their customers' demands and to serve the legitimate credit needs of their communities;

(2) Bank liquidity is dependent not so much upon the actual liquidation of assets through sale in open markets or maturity and retirement of obligations held, as upon the transfer of sound assets from banks under pressure to banks not under pressure, or to other institutions;

(3) The criterion in appraising the quality of assets is not maturity but soundness in terms of the ability of the obligor to service his obligation and meet his contract;

(4) It is tacitly assumed that the central bank will rediscount assets not on the basis of maturity and the ability of the paper to con-

form to so-called commercial loan standards, but on the basis of the soundness of the assets as measured by the ability of the obligors to meet the terms of their contracts, and will rediscount those assets on the basis of reasonable appraised values rather than of current market values.

These principles represent the application to bank supervisory practices and to central banking operations of the principles embodied in the Banking Act of 1935 and in the revised Regulation A of the Board of Governors of the Federal Reserve System.

Insofar as the Federal Deposit Insurance Corporation was concerned, these principles had been applied to the appraisal of loans since the joint examiners' conference held in Washington in September 1934.

<u>Limitations on bank examinations and bank supervision</u>. It is the task of the supervisor to establish the general policies governing the examiners' work, to develop rules and standards of sound banking, and to determine what corrective measures, if any, should be adopted in individual cases. It is the job of the examiner to appraise the assets of the bank, determine the capital position of the bank, to check the conformity of the bank's operations with law and regulation, and to assist in the development of corrective programs where necessary.

Appraisal of assets requires skill and judgment on the part of the examiner. Such skill and judgment come only after training and experience. The examiner deals with particular cases in individual loans. He works under considerable pressure and has little or no opportunity to sit back and view the scene with a broad perspective. He, therefore, must be supplied with standards to be used as guides in making his appraisals and analyzing the position of the bank. Those standards must be relatively simple and objective. The examiner cannot be expected to vary his standards with changes in economic conditions and to exert pressure for expansion or restriction of credit. Dealing with individual cases as he does his efforts at credit control will impinge upon the extension of a loan to John Jones. Substitution of the judgment of an examiner or of a low salaried government official for that of the banker in extending individual loans and lines of credit does not provide a solution of the problem of economic instability. It is also incompatible with a system of private enterprise. Bank supervision cannot be substituted for bank management but can serve only as a check on ill-conceived and unethical banking practices and policies. The examiner and the supervisor can insist only that credit extensions shall be on a reasonably sound and disinterested basis and that individual banks shall not expose themselves to undue concentration of risk. A reasonably sound basis is one which provides reasonable assurance that the obligor can service his obligation. A disinterested basis is one which assures that the banker will deal with his customers at arm's length and will not try to act in a dual capacity.

Just as the central banking system should operate with some flexibility so is it desirable to have some flexibility in supervisory policy as expressed in the review of examinations made and the programs of correction determined upon. It is important that the supervisor should guard against optimism in times of business prosperity and pessimism in times of business depression. The supervisors should not insist upon liquidation of criticized assets during periods of depression or financial strain. Sound banking policy and sound supervisory policy require the setting aside each year of a part of income to take care of losses which may arise and the prompt writing off of losses as they occur or as ascertained. Such a policy may be effected through the use of valuation allowances or other accounting procedures rather than by forced liquidation or sale of assets. The present policy of the Corporation is to require banks to recognize their losses by adjustments in their accounts and to leave actual liquidation of the assets to discretion of the bankers except where violations of law are involved.

In the past most of the banks' losses have been incurred through liquidation under adverse economic pressure forced by deposit withdrawals and by inadequate rediscount facilities. If the central banking system does not adhere in the future to the principle of rediscounting sound assets at reasonable values the commercial banks will not be able to meet demands under severe strain and our improved supervisory standards will not have contributed to stability to any significant degree.

Deposit Insurance as a stabilizing factor. At the present time insurance coverage is limited to a maximum of $5,000 for each depositor. This covers more than 98 percent of the accounts in the banks but only 45 percent of the deposits. If the primary purpose of deposit insurance is to aid in providing security for the masses of the population with small and moderate incomes, then the $5,000 limitation is adequate. If, however, the primary aim of deposit insurance is to protect the country's customary means of payment and to guarantee it against shrinkage as a result of runs and bank failures, then the limitation of insurance coverage to $5,000 is not adequate. Nearly three-fourths of the demand deposits of individuals and business enterprises are in accounts with balances of more than

$5,000, and it is these balances which are used in making the bulk of the payments involved in production and trade.

In small communities, where the banks are small and insurance coverage under the $5,000 limitation is very high, the present law does provide nearly complete protection of the active currency of the community. In the industrial centers and large cities, however, which are dependent for their currency upon the large banks and the accounts of large business enterprises, the present limitation provides only meagre protection for the community's circulating medium.

The protection afforded deposits in large accounts, however, actually is considerably greater than would be indicated by the $5,000 limitation. This is due to two factors: (a) the fact that many holders of deposits with balances above $5,000 are either protected by pledge of security or legal preference or become aware that a bank is in difficulties and draw out their deposits prior to suspension; and (b) the tradition of some years standing, intensified by experience in the recent crisis that the government cannot afford to permit any large bank to fail. The protection offered in this way, however, is uncertain and may not prevent the stress of a period of business recession from generating a banking panic with its disastrous effects upon the volume of production and upon the flow of income in the community.

Elimination of bank runs. It has long been believed that many bank suspensions are caused by rumors spread among depositors, and thus that many banks in sound condition have been forced to close because of runs. It is assumed, furthermore, that such runs are made primarily by the large number of holders of small accounts who are not acquainted with the character of the bank management and who are for this reason especially susceptible to the influence of rumors. Deposit insurance, even when limited to $5,000 for each depositor, should eliminate such runs. It has in fact eliminated runs so far as the appearance of long lines of people waiting at the doors of a bank is concerned.

However, the analysis of deposits in closed banks made by the Board of Governors of the Federal Reserve System indicates that it is primarily the holders of large accounts rather than the holders of small accounts who withdraw their deposits most rapidly when loss of confidence occurs. Withdrawals of deposits by the holders of large accounts are less spectacular than those by holders of small accounts since they are made by drawing checks for deposit in another bank or more probably, merely by depositing current receipts in a new account in another bank and paying current expenses from the old account. It is only when adverse clearing house balances accumulate that the officials of banks realize that a "silent run" is in progress.

Extension of deposit insurance to cover all liabilities. Bank failures may be attributed primarily to one of the two following general factors, or to the combination of the two: first, internal factors such as mismanagement and defalcation, and second, external factors such as adverse business conditions resulting in inability of borrowers from banks to meet their obligations and in the withdrawal of balances to meet payments due in other parts of the country. If a bank is in difficulties because of mismanagement the holders of large accounts will usually know something about the situation prior to the time the bank is forced to close and tend to draw down their deposit accounts to the $5,000 balance which is insured. If a bank is in difficulties because of adverse business conditions in the community in which it operates, it is likely to suffer an adverse balance of payments due to the fact that depositors are using their balances to pay for supplies purchased from other sections of the country.

When deposit withdrawals occur, regardless of whether they are due to the fear of depositors that the bank is incapably managed or to the necessity which depositors face of making payments to other parts of the country, the banks from which the withdrawals are made find it necessary either to dispose of assets or to borrow and to pledge assets as collateral for such borrowings. Borrowing or disposal of assets, however, becomes difficult in times of regional or national business depression when adverse economic circumstances are affecting the value and saleability of the assets which the banks have. The market situation which makes it difficult to sell assets and thus induces borrowing by the banks also makes it necessary for the banks to pledge to support such borrowing collateral in amounts far in excess of the amounts borrowed.

The insuring of all direct liabilities of the banks would increase the ability of banks to liquidate assets by transferring them to other banks or to the central bank. The insurance of the Corporation would afford protection to the lending institution. Such an extension of the insurance principle would increase confidence in the workability of the assumption upon which our entire supervisory and central banking policies is based, namely that liquidity of bank assets is to be found not in their disposal in the open market nor in the enforced liquidation of borrowers but in the transfer of sound assets from institutions which need to convert them into cash to institutions with excess cash resources or to the central bank.

The extension of insurance to cover all liabilities of banks raises certain questions and problems. Full insurance will maintain confidence in the banking system only if confidence is felt in the ability of the Federal Deposit Insurance Corporation to fulfill its obligations. As of December 31, 1938, the total capital account of the Corporation amounted to $402 million. In addition, the Corporation has a borrowing power of approximately $1 billion. The total funds available to the Corporation, therefore, are about $1.5 billion. As previously pointed out, the assessment rate is low. The capital position of the banks is weaker than ever before. Although our banking system has been set up with a view to increasing its flexibility and ability to convert assets into cash under strain, the system has not yet been put to the test. Furthermore, it is not known what the effects may be psychologically or otherwise upon our business and financial practices of the increased bearing of risk by an agency of the Federal Government. One thing is true; if the Corporation or any other agency were to assume all of the banking risks which management and private ownership are unable to assume, the authority of that Corporation or agency would have to be extended and strengthened. A strict policy would have to be instituted of moving promptly, except during periods of adverse economic conditions, to eliminate from insurance, or to liquidate, or to reorganize any bank which fell below a certain minimum standard of condition, as determined by its capital ratio and the quality of its assets.

Cost of increased insurance coverage. The experience of the Corporation to date does not indicate that increased coverage would increase the cost of insurance materially.

Bank deposits are given protection at the present time to a far greater degree than is commonly realized. In the insolvent insured banks which have been placed in receivership, or reorganized and merged with financial aid of the Federal Deposit Insurance Corporation, deposits were protected to the following extent:

In 1935	85.2%
1936	93.4
1937	98.2
1938	99.6

Surveying the situation as we know it to exist, it does not appear that the coverage will be much lower in the insolvent banks which will have closed or merged by the end of 1939.

In periods of depression banks will have borrowed heavily and will have pledged substantial amounts of their sound assets to secure such borrowing. The pledged assets, therefore, will not be available to protect the remaining depositors and the Federal Deposit Insurance Corporation from loss in the event of failure. To insure against loss the borrowings which would otherwise be protected by pledge of assets, therefore, would hot materially increase the losses of the Corporation. On the contrary, complete control of the assets of the insolvent bank should permit the Corporation as sole creditor to liquidate the assets under the most favorable circumstances thus securing maximum returns. Receivership costs should also be reduced.

Branch banking as a factor in stability. Supervision is an attempt to obtain assurance that the banks' affairs are properly and honestly managed and that the banks are kept in a sound condition. The existence of deposit insurance is a recognition of the fallibility of human judgments and institutions with its consequent more or less occasional failures.

One suggestion for reducing or eliminating bank failures is the extension of branch banking on a nation-wide scale or at least a broad geographic scale, with a relatively few large banks controlling the banking resources of the country. It is claimed that in this way risks will be diversified, strain of adverse balance of payments materially reduced if not eliminated and more competent management secured. Many studies have been made attesting to the shortcomings of our many small, weak and independent banks and the virtues and strength of our large banks. Many of the studies have concluded that an extension of the geographic scope of branch banking is the proper solution of our banking difficulties. The merits or demerits of branch banking will not be discussed here but a review of some of the results of investigations into the basic assumptions underlying most discussions of branch banking should be of interest.

Large versus small banks. When Federal insurance of deposits became effective in 1934 more than 7,000 banks not members of the Federal Reserve System were insured. These banks were generally the small banks of the country. More than half of them had deposits of less than $250,000 each. Seven-eighths of them had deposits of less than $1,000,000 each. If the small bank was inherently weak and uneconomic here was a real problem. The energies and resources of the Corporation were thrown into the study of the problem and the devising of programs for strengthening or eliminating these weak uneconomic institutions. Findings to date may be summarized briefly as follows:

(1) The small banks have a better capital position than the large banks;

(2) The quality of assets of the small banks appears to be on a par with the quality of assets of the large banks;

(3) The small banks have maintained a greater proportion of their assets in loans than have the large banks;

(4) The small banks show consistently better net earnings in terms of assets than do the large banks;

(5) In the performance of their particular jobs the managements of small banks do not appear to be sufficiently inferior to the managements of the large banks to give cause for great worry over the small banks;

(6) The rates of losses sustained on loans and on securities by operating national banks over a period of 20 years (1918-1937) have been no higher for country banks than for city banks;

(7) Small banks have not had the rediscount and borrowing facilities of the large banks due in part to their inability to operate as well as the large banks in accordance with the principles of the commercial loan theory of banking, and in part to their inability or refusal to join the Federal Reserve System and the inability of the Federal Reserve System to make its facilities available to the many small nonmember banks. The shortcomings in the rediscount facilities of the Federal Reserve System which arose from an adherence by that System to the commercial loan theory

of banking have already been pointed out;

(8) In the past, supervisory standards appear to have been applied more strictly to the small banks than to the large banks, so that weak small banks were closed more promptly than were large banks in a comparable condition;

(9) A higher proportion of small banks than of large banks have failed. However, at least part of the difference was due to the heroic efforts of government agencies to keep the large banks from failing and part was due to the fact that banks in agricultural regions - the smaller banks - were under severe adverse pressure for 13 years, while the banks in industrial, commercial and financial regions - the larger banks - were subject to pressure for less than two years in the early 20's and for only three years in the early 30's. Studies are now under way to appraise, among other factors, the extent to which banks of different sizes failed when located in similar geographic and economic areas, in places of comparable size and economic characteristics and when subject to approximately similar competitive situations. These studies are not complete. The results should prove interesting;

(10) The embarrassment of a few large banks through adverse circumstances could involve greater loss to the Corporation and to the public and contribute more to the instability of our economic institutions than could suspension of all of the so-called weak, uneconomic, small banks put together.

<u>Branch banks versus unit banks</u>. Returning again to the question of branch banking, we have found the following:

(1) The capital ratios of the branch systems are lower than those of the unit banks:

(2) The proportion of substandard assets is higher in the branch banks than in the unit banks;

(3) Branch banks show lower net earnings per $100 of assets than do the unit banks;

(4) The managements of branch banks do not appear to be superior to those of the unit banks;

(5) Sufficient evidence has not been presented to support the contention that branches are operated more economically than are unit banks of comparable size.

Many of the branch banks whose data were included in the analysis are relatively small banks and others are those restricted to city-wide branch banking. Further analysis of the findings is necessary, therefore, before they can be accepted. The only purpose in raising the question here is to indicate that the case for branch banking has by no means been proved.

<u>Conclusion.</u> Deposit insurance and bank supervision reflect an effort to secure safety for depositors and effectiveness in the operations of our banks. Whether consciously or not they also represent an effort on

the part of the public to preserve through the pooling of depositors' risks the best features of our system of a large number of independent banks. The purpose of deposit insurance is to avoid or minimize losses to depositors. The purpose of bank supervision is to keep banks sound. These objectives can be achieved but not without effort.

The rate of assessment for insurance is about one-third the rate of losses the depositors experienced over a 70-year period. The rate of losses must be kept at a level greatly reduced from that of the past if safety through a self-supporting insurance system is to be maintained. A reduced rate of losses can be achieved only through sound banking and an effectively functioning central banking system. Our traditions indicate that soundness can be achieved only through good management and good supervision. If supervision is weakened or turned from its basic purpose of maintaining soundness, it will be necessary to obtain additional funds in order to be prepared to meet losses which on the basis of past experience may average considerably higher than the present rate of assessment. If the bankers and the depositors are not prepared to meet this cost effective supervision must be maintained or the United States Treasury must bear the financial burden, in effect giving subsidy and relief to the bankers even as they are given to the farmers and to those on relief. To attempt to weaken our system of deposit insurance and bank supervision without recognizing the need, and making adequate provision in advance, for assumption of financial responsibility is to invite the ultimate socialization of banking in this country. However, the most skillfully administered system of deposit insurance and the most admirable system of bank supervision cannot prevent a collapse of our banking system in the absence of an effectively functioning central bank.

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