RESEARCH ACTIVITIES OF THE FEDERAL DEPOSIT INSURANCE CORPORATION

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Donald S. Thompson, Chief
Division of Research and Statistics
Federal Deposit Insurance Corporation

Delivered before the Advisory Conference on Research in Finance
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In common with most research conducted by administrative agencies the research of the Federal Deposit Insurance Corporation reflects primarily the activities and problems of the Corporation and, as in the case of any young organization, the circumstances surrounding the Corporation's origin. In our research we seek to maintain closest possible contact with the operating divisions of the Corporation and constantly to gear our work to the experience and operations of the Corporation.[1/]

You are all familiar with the banking history which brought Federal insurance of deposits into existence and with the general situation at the time insurance became effective.

Under the original law the Corporation was charged solely with the duty of paying off depositors in closed insured banks and of liquidating closed banks of which it might be appointed receiver. The failure and loss record of the immediate past, the breakdown of previously existing systems of State deposit insurance, and the problems of

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1/ I wish to state at the outset that, while I shall deal primarily with the activities of the division of which I happen to be the head, a considerable amount of research, properly defined, is carried on in and by the other divisions of the Corporation as an incidental part of their operations.

rehabilitating the weak banks admitted to insurance, convinced officials of the Corporation that changes were necessary in the Federal deposit insurance system if that system was not to constitute an unwarranted financial burden upon the banks or the Federal Government.

Early research of the Corporation. The Division of Research and Statistics, accordingly, was created for the purpose of providing analysis and information to assist officials of the Corporation in the administration of the Temporary Insurance funds and in the establishment on a permanent basis of the deposit insurance system. There was a great gap in our knowledge of the operations of banks not members of the Federal Reserve System, most of which had been admitted to the insurance fund. The Comptroller of the Currency had been publishing available data relating to these banks but the data lacked comparability and homogeneity, and were in a form which greatly limited their usefulness. The Corporation immediately set about to secure more comprehensive and reliable data regarding this group of banks. This activity has increased our knowledge of our banking system and provided bankers, supervisors, and students with improved tools for analysis.

Probably the two most important contributions of our research during this period were: (1) analysis of the experience of previously existing systems of State deposit insurance or guaranty; and (2) analysis of the bank failure record, and of loss experience in the closed commercial and mutual savings banks.

Previous systems of State insurance or guaranty of deposits. Earlier systems of State deposit insurance failed because of, (1) an inadequate distribution of risk through restriction to a given State generally lacking in economic diversification; (2) operation of the principle of adverse selection, poor banks becoming insured with many of the good banks avoiding the systems by becoming national banks; (3) absence of supervisory standards and authority; and (4) (and most obvious) lack of financial resources.

Our studies do not support the oft-repeated charge that these systems encouraged bad banking. The errors and the failures were the result not so much of ineptitude of bankers generated and fostered by deposit guaranty but of the optimism with which new countries or new businesses are generally developed. I might add at this point that our experience to date has indicated that if deposit insurance contributes to bad banking it does so because of the growing belief on the part of many bankers that with such a system they do not need to provide as much capital as they otherwise would.

Losses to depositors in suspended commercial banks. A survey of losses to depositors in banks during the 70 years preceding the establishment of deposit insurance revealed that losses to depositors in suspended commercial banks amounted to about one-third of 1 percent per annum of deposits in all active commercial banks. Losses on those deposits which would have been insurable had the present plan of insurance been in operation were estimated to be about one-fourth of 1 percent per annum of total deposits in all commercial banks. More banks have now been liquidated and we have recently revised our estimates. We now estimate the average annual rate of losses to depositors at about one-fifth of 1 percent, compared with our earlier estimate of one-third of 1 percent, and losses on insurable deposits at about one-seventh of 1 percent, compared with our original one-fourth of 1 percent. The figures are summarized in the following table:

	Amounts per $100 of deposits in active banks	
	Revised estimates 1865-1939	Original estimates 1865-1934
Average losses per year in suspended commercial banks:		
On total deposits	$0.20	$0.32
On insurable deposits	0.15	0.24

Elimination of losses incurred during years of banking crises gave us an annual rate of loss on total deposits of about one-twelfth of 1 percent of deposits in all commercial banks and a rate of loss on insurable deposits of about one-fourteenth of 1 percent.

Our studies, coupled with the actual operating experience of the Corporation during the first year of its existence, led to the incorporation in the Banking Act of 1935 of, (a) an annual rate of assessment of one-twelfth of 1 percent; (b) standards for admission of banks to deposit insurance; and (c) supervisory authority for the Corporation, particularly with regard to insured banks not otherwise subject to Federal supervision.

Principles underlying permanent system of deposit insurance. As the deposit insurance system is now constituted the amount or rate of income is not the most essential part of that system. Continued improvement in the condition of our banks and in the functioning of our banking system are more essential. It is important that income and resources of the Corporation should be adequate to meet requirements, but preventive measures for dealing with potential failures are far more necessary for the effective functioning of our banking system. It is perfectly clear that our present rate of assessment of one-twelfth of 1 percent would not be adequate to cover losses if they were to recur in as great volume and severity as in the past.

It is inevitable that there will be bank failures just as there are failures in any other business. In order that the low rate of assessment will not operate to weaken the deposit insurance system and, consequently, the entire banking system, bank owners must assume a greater share of the risks of their business by investing more private capital, particularly in the case of inadequately capitalized banks. It is necessary that bank management be more enlightened and more effective than in the past, and that the structure, instruments, and practices of bank supervision be strengthened and improved.

These objectives can be attained only by concerted effort on the part of both bankers and supervisors aided by unremitting research.

As is the case of any insurance system, the Federal deposit insurance system as now constituted assumes the continued existence of a functioning banking system and is set up to absorb losses arising out of a normally functioning system. It cannot handle a general banking collapse, although it is our hope that our operations can contribute toward preventing another collapse. The Corporation does not provide liquidity; it insures solvency. Liquidity in our present banking system may be obtained only through adequate borrowing and rediscount facilities.

We do not believe that bankers can operate on the assumption that they must individually and unaided be prepared to meet any and all contingencies which may conceivably arise. The very existence of the Federal Reserve System and the Federal Deposit Insurance Corporation is testimony to the inability of banks to operate under such an assumption.

Establishment of permanent plan of insurance. Establishment of the permanent plan of deposit insurance, embodying the principles just outlined, resulted in a reorientation of the research activities of the Corporation. The research of the Corporation was focused upon:

(1) Problems of deposit insurance;

(2) Problems and principles of bank supervision;

(3) Studies relating to bank operations;

(4) Studies relating to the effects of economic fluctuations upon banks and bank operations.

Deposit insurance. Research on deposit insurance covers such questions as (1) insurance coverage by type of deposit, class of bank, size of bank, and type of bank; (2) the nature of the deposit structure of closed banks, particularly any difference from that of operating banks; (3) losses in closed insured banks; and (4) income from assessments.

To what extent does present coverage actually protect depositors? Which depositors are not fully protected? How effective may this protection be in preventing bank runs in the event of serious economic dislocation? What are the conditions and circumstances which lead to loss of confidence in banks and to what extent can deposit insurance prevent such loss of confidence? What changes and modifications may be necessary to deal with possible new situations or conditions? What would be the effect of increase in insurance coverage to $10,000? to $25,000? to all deposits? to all liabilities? To what extent would such changes increase the Corporation's losses and the cost of insurance? These are the more important questions the answers to which we are seeking.

Bank supervision. Our research on bank supervision covers, among other aspects, the history of supervision itself and the history of the development of various standards and practices. It deals with standards of bank capital, valuation of assets, rules with regard to quality of assets, control of chartering, regulation of interest on deposits, the structure of bank supervision itself, and the role of supervision in the banking and economic systems.

To illustrate some of our work in this field I should like to deal briefly with the problem of valuation of assets and with rules regarding the quality of assets. The Corporation observed that many apparently weak banks admitted to insurance had subsequently become relatively sound, due in large part to the improvement in the quality and value of their assets which accompanied the recovery in business and in financial values. We also observed that a number of banks which had been closed in 1932 and 1933 had since paid out not only 100 percent of all creditors' claims but also substantial amounts to stockholders. We also observed, in the revision of our estimates of depositors' losses, that the liquidation experience of banks closed in the 30's and liquidated subsequent to the banking holiday was considerably better than the experience of earlier years had led us to anticipate. It appeared, therefore, that many of the appraisals of assets made during the crisis of the 30's were not borne out by subsequent developments. We observed also during the brief period of our existence that fluctuations of prices in the bond market had appeared to affect seriously the capital position of many banks.

It became apparent that viewed as a whole the conventional supervisory system of valuing of assets was not consistent. Assets which had no ready market generally were valued at their face. Assets equally sound, or perhaps even sounder, which had a ready or organized market, were valued in examinations at market prices as of a particular day, sometimes below their face, even though no question may have existed with respect to the soundness of the assets or the likelihood of the contracts being honored by the obligors. The particular valuations taken were thus a matter of accident. As a consequence, the Corporation at an early date urged abandonment of market as a criterion for determining the value of securities considered to be of proper investment quality for banks and the substitution therefor of book value, or acquisition cost less amortization of premiums.

The adoption of book values on securities of investment quality requires the establishment of rules for the determination of investment quality. What securities are proper for banks to acquire and hold? What losses should banks anticipate on holdings of securities of given grades? What reserves should bank supervisory authorities require banks to set up against their security portfolios? How significant are market prices as indicators of quality of securities available for investment? These questions led to the participation by the Corporation with other Federal bank supervisory agencies, other Federal agencies, numerous private organizations, and the National Bureau of Economic Research, in the study of behavior of bonds, a project which was described to you in the sessions yesterday.

Banking operations. Our studies of bank operations deal with analysis of statements of assets and liabilities, with analysis of our examinations and with analysis of the earnings, expenses, and disposition of profits of banks. In this phase of our work we seek to obtain a better conception of the manner in which our banking system operates, how it adapts itself to changing conditions and practices, and what are the conditions essential to the maintenance of sound, healthy institutions.

Part of the work has been aimed at specific problems such as the importance of exchange charges in bank earnings, and the effect of possible wholesale railroad receiverships and reorganizations upon the banks. A considerable part of it, however, has been frankly empirical.

What are the measurable characteristics of profitable banks as compared with unprofitable banks? How do small banks differ in structure and operation from large banks? Are small banks weaker than large banks? If so, how much and why? At the time of establishment of deposit insurance it was generally believed that the small banks constituted one of the weakest parts of our banking structure.

Our findings to date indicate that, as compared with large banks, small banks have stronger capital positions, better earnings, as good assets, make proportionally more loans, and have about as effective managements.1/ The apparently heavier failure record of the small banks appears to be as much a matter of geography and economics as of size. The small banks were for the most part in agricultural regions which were under severe adverse pressure for 13 years, whereas the large banks were generally in the industrial and financial areas under adverse pressure for less than two years in the early 20's and for only three years in the early 30's. Our banking structure also failed to provide the small country banks with as good borrowing and rediscount facilities as was provided our city banks.

1/ Certain exceptions to these generalizations occur in the group of banks with deposits of less than $100,000.

These defects of structure may explain in part the growth of Federal farm credit activities.

What are the average rates of loss on different types of assets among different classes or groups of banks? This question obviously is important to the insurance corporation and to bank supervisors seeking to have banks maintain adequate reserves and adequate capital margins.

Why do banks earn such divergent rates of interest on their loans? The range in 1939 was from an average of 2 percent to one of 20 percent. Special inquiries addressed to nearly 300 of the banks which show high rates of earnings on their loans reveal that for the most part they do essentially a sales finance and personal finance business. They are also the institutions whose loan volume has been well maintained and which report very satisfactory profits.

Consumer financing is assuming increased importance in the eyes of bankers. As you know, a special staff of the National Bureau of Economic Research has devoted more than a year to intensive research in the field. Earlier sessions of this conference and previous conferences have dealt with the subject. Many schemes and plans have been submitted to bankers to engage in the consumer financing business. Moot questions have been those of risk, rates of interest, and of operating costs.

The work of the National Bureau of Economic Research has thrown considerable light on risks and rates of interest. The pioneering work of the Russell-Sage Foundation has also contributed much to our knowledge of interest rates on consumer loans. From the viewpoint of the banks it is important to know what rates are fair and proper in order to give the borrower the accommodation he needs, and at the same time to provide a margin to cover costs and losses and to permit a reasonable profit. Little is known about operating costs in this field. Such information is vital both to bankers and to bank supervisors in dealing with the extension of the consumer loan business of banks.

We hope to be able to cooperate with the National Bureau in the analysis of relevant operating figures of personal finance companies, sales finance companies, Morris Plan banks, other industrial banks, and of commercial banks classified according to the extent to which they are engaging in consumer financing. We hope from these studies to know more than at present about operating costs and rate differentials necessary to the successful conduct of the consumer financing business.

The effect of economic fluctuations upon banks. Finally, we are endeavoring to measure some of the effects of economic instability upon banks and upon the incidence of bank failures. We must know how banking crises are generated, how the initial impulses start and accumulate into great forces, and at what places our structure is most likely to break down. When adverse economic circumstances again threaten we must be prepared to deal with them and to suggest those structural and operating changes necessary to prevent breakdown.

Conclusion. If I were to sum up our research in one sentence, I would say that it was aimed at finding out everything we could about the kind of a banking system we have and the manner in which it operates, of course, with special reference to problems of deposit insurance and bank supervision, and to assist in the formulation of general principles and policies underlying the work of the Corporation. The banking system is so complex and of such varied aspects as to defy definition and easy comprehension. It has been studied the most and misunderstood the most of any part of our economic system. The conflicts generated as a result of preoccupation with particular facets of problems of banking remind me of the

" . . . . six men of Indostan
To learning much inclined,
Who went to see the elephant
(Though all of them were blind),
That each by observation
Might satisfy his mind."

As you may remember each one came into contact with a different part of the subject and reached a conclusion different from that of each of the others.

"And so these men of Indostan
Disputed loud and long,
Each in his own opinion
Exceeding stiff and strong,
Though each was partly in the right
And all were in the wrong!

"So, oft in ~~theologic wars~~ (banking and finance)
The disputants, I ween,
Rail on in utter ignorance
Of what each other mean,
And prate about an elephant
Not one of them has seen!" 1/

1/ John G. Saxe, "The Blind Men and the Elephant", with changes in the last verse, as indicated.