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BIGGER IS NOT ALWAYS BETTER

Address of
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When a bank of any significant size fails, we in the bank regulatory business have come to expect questions about the safety and soundness of other institutions, Congressional or legislative inquiries as to the general effectiveness of bank examination and supervisory techniques, and a spate of publicity that runs the gamut from accurate and perceptive to the ill-informed, the irresponsible or even the politically motivated. Bankers brace themselves for additional regulations and restrictions depending on the facts and circumstances of a particularly messy bank failure, and articles about FDIC and FSLIC insurance coverage have a sudden surge in popularity.

These reactions, I might add, do not depend at all on whether the bank which failed was a national bank or a state bank, or on the examining agencies that might have had jurisdiction, or even on the geographic location of the bank's offices. With enough notoriety and publicity, those of us elsewhere in the country will experience some of the fallout from the failure of a San Francisco National or a United States National, just as those on the West Coast will feel the repercussions of a failure in Detroit, Sharpstown, Eatontown or Wakefield. Whether new regulations evolve or not, the nation's banks under existing law will feel the financial effect of a significant bank failure in their net assessments for deposit insurance and will probably also experience more intensive examination scrutiny in one or more areas of their operations. Like it or not, therefore, the nation's supervisors and the nation's banks are all affected by any significant failure that occurs within the banking system.

Over the last ten years, the FDIC has had a comparatively active time as the insurance agency for deposits placed with the nation's banks. During that period, 55 closed insured banks required FDIC disbursements as compared with 25 closed insured banks in the preceding ten-year period. From the vantage point of my position as Chairman of the FDIC and in view of the largest bank failure in FDIC history last October 18, I hope I may be excused if I offer this morning a few comments of my own on the general subject of bank failures and the supervision of problem banks.

First of all, we should keep our sense of perspective about the frequency of bank failures in the United States. There are 14,300 insured banks in the United States today -- a number which has been increasing recently at the rate of about 150 banks per year as new banks are chartered to serve an ever-larger number of Americans. Even during the past ten years, only five or six banks have failed, on the average, each year, with the number ranging from one bank failure in 1972 to the nine that failed in 1969. Using any of these figures, only an infinitesimal fraction of the total number of insured banks in the country fail in any given year. The fact that actual bank failures continue to be so uncommon is undoubtedly one reason, but not the only reason, of course, why they receive the publicity they do when they occur. At the same time, the reverse side of the coin, though seldom mentioned in the press, should give bank supervisors and insured banks a significant degree of satisfaction: that is, that except for this infinitesimal fraction, the remaining banks in the nation are either well managed or, if they are not well managed, they seem to be effectively supervised so as to prevent actual failure.

Secondly, our banking system and the federal deposit insurance program itself assume that from time to time some banks in the system will be forced to close. No other nation has as many depositaries as we do, yet we continue to believe that the decentralized system this produces is worth saving and we continue to charter each year a large number of new groups who seek to enter the banking business. Most of us see both economic and social value in having numerous sources of financial service and in continually replenishing that supply as banks merge out of existence, fail or become complacent in serving the needs and convenience of the public. We may argue about the number of units which will best serve the American people, but I doubt that many of us seek or wish to encourage a financial structure composed solely of a relatively few multibillion dollar banks or bank holding companies. We should, on the other hand, recognize that any system in which several thousand insured banks compete to serve the American people entails a calculated risk of failure, the effects of which federal deposit insurance seeks to minimize but was never intended to eliminate. Occasional bank failures, in short, are part of the price we have agreed to pay for a banking system of several thousand units.

I doubt, for example, that with this structure we can ever eliminate the risk of bank failure caused by the outright embezzlement or conversion of bank funds for personal gain by a dishonest bank officer acting alone or with others. In every such case I know of, it has been the bank supervisory agencies, through their examination process, that have first discovered such misconduct, and it is they which have had the unpleasant but necessary burden of forcing a bank out of business when the bank's capital is depleted by such activities. Two out of every five bank failures in the country over the past ten years have fallen into this particular category.

Thirdly, bank supervision today is focused not on preventing bank failures but on maintaining a competitive and innovative banking system, responsive to the changing financial demands of the times. We recognize that public confidence is an essential ingredient in any workable banking system, but we have rejected the kind of stultifying regulation that would undoubtedly be necessary if we were even to attempt to eliminate all bank failures other than those caused by criminal misconduct. In the process, we would reduce the most ably managed and innovative banks to the level of the most mediocre and unimaginative; we would have to substitute a supervisor's judgment for that of 14,300 bank managements as to the proper and prudent business risks to be taken under a wide variety of banking conditions; and in the end we would undoubtedly fail in our purpose because we lack the brainpower necessary to write such regulations and the manpower necessary to enforce them. Responsible supervisors instead seek to contain within tolerable limits to the system as a whole, rather than to eliminate altogether, the day-to-day risks involved in banking today, as banks offer new services, adapt to new technology, face new competition and offer the more traditional services over ever-wider geographic areas. In determining the tolerable limits of such risks, none of us should ignore the lessons of the past but we must also recognize that the name of the game today is competition and service, not the protection of institutional safety and solvency or the protection of bank managements against the effects of their own business decisions and policies. Is our present rate of bank failures within tolerable limits for our banking system as a whole? My answer to that question is "undoubtedly, yes."

Fourthly, I believe the real success story in bank supervision lies in the problem banks that do not fail -- a category which is thirty or forty times more numerous than those which do. These banks all require individualized attention from every supervisory agency which has them, and the attention given is usually totally disproportionate to the size of the bank and the overall responsibilities of the agency involved. To your credit, the supervisory measures taken result, in a substantial majority of all cases, in the removal of the bank from problem status within two years of its first identification as a problem. The measures taken can include repeated conferences with bank management, one or more meetings with a bank's board of directors, frequent examinations, restrictions on the bank's expansion plans, requirements for loan write-offs, the reversal of questionable accounting practices, insistence on new capital and more formal action when management proves to be dilatory or recalcitrant. Where state-chartered banks are involved, the lead in such matters is generally taken by state bank supervisors, although there are occasional differences between state and federal agencies as to the severity of the problems presented by a particular bank or the timing of specific action. Overall, I consider the cooperation between state banking departments and the FDIC as to state nonmember banks in problem status to be excellent. But this particular success story is one which can never be fully reported without unnecessary damage to the reputation of banks which are still open and operating and presently in sound condition.

My remarks to this point are not meant to suggest that there is little we can learn from a closer look at some of our more significant recent bank failures or problem bank cases. There are, in fact, a number of characteristics worth noting which may be helpful both to you and to the FDIC in the future.

First, if there ever was a day when problem banks or actual bank failures were confined to relatively small banks, this is no longer the case. In 1963, the average size of the 159 insured banks on FDIC's year-end problem list was just under \$8 million. At year-end 1973, this same average for approximately the same number of banks was just under \$28 million. The largest bank on the 1963 list had total deposits of slightly over \$180 million, while only two other banks had total deposits of more than \$50 million. The 1973 list had 15 banks on it in the "over \$50 million" category.

In the 20-year period between 1943 and 1963, no insured bank larger than $17 million in total deposits failed. In the last ten years, six insured banks larger than $17 million in total deposits have failed, the largest of which was, of course, United States National Bank, San Diego, last October 18. The four largest failures in FDIC history have all occurred in the past ten years (Public Bank, Detroit, 1966, total deposits $93.0 million; Sharpstown State Bank, 1971, total deposits $66.8 million; Birmingham-Bloomfield Bank, 1971, total deposits $57.5 million; and United States National Bank, 1973, total deposits $932.0 million). In addition, the $40 million-deposit San Francisco National Bank failed in 1965 and the $1.028 billion-deposit Bank of the Commonwealth, Detroit, would have failed in 1972 but for the short-term infusion of $35.5 million in capital funds by the FDIC early the same year. By itself, the fact that larger banks than before are showing up among the casualties and problems of the nation's banking system is not surprising in view of the growth in deposits generally and in the persistence of the nation's inflationary trends. What is perhaps surprising is that an increasing number of banks in the size categories over $100 million are included among them. In short, "bigger" is not always better, and we supervisors will ignore that truism at our peril.

Second, one-man domination was evident in four of these five recent bank failures and also in Bank of the Commonwealth. In most cases the dominant chief executive also controlled, through family and friends, a majority of the voting stock and the election of directors to whom he was supposed to be legally and actually accountable. As a practical matter, he was free to act without significant policy restraints set by an active and independent board of directors.

Third, each of the banks exhibited extraordinary deposit growth over a relatively short period of time and in only two cases was even a minor portion of this growth attributable to merger. Two years after it opened, San Francisco National Bank reported more than $55 million in deposits. Eight years after it opened, Public Bank, Detroit, passed $120 million in deposits. Sharpstown State Bank jumped from $10 million in 1967 to more than $82 million three years later. Birmingham-Bloomfield Bank went from $11 million in deposits in 1965 to slightly more than $105 million less than four years later. United States National Bank added more than $450 million in deposits between year-end 1970 and the date it closed, with less than $80 million of this attributable to mergers in 1971 and 1972. Bank of the Commonwealth added almost $700 million in deposits in the four and one half years immediately after Donald Parsons took control, with only $93 million of this attributable to merger. Much of this growth occurred in the volatile time deposit category which subsequently presented severe liquidity problems to the banks as CDs matured and were not renewed. Most of them ended up being heavy borrowers to meet their liquidity needs, and this frequently intensified an adverse earnings position.

Fourth, the management of each of these banks exhibited clear self-serving tendencies, which were manifested most commonly in a variety of loan transactions, the aggregate of which was disproportionate to the total volume of loans and to the bank's total capital and reserves. In individual cases, other forms of self-dealing were also evident prior to failure.

Fifth, the capital of each bank was clearly inadequate in view of its rapid deposit growth, the volume and severity of its classified assets and its need for a cushion to absorb possible liquidity losses and, in some cases, deficit earnings.

Sixth, the management of each bank had been the subject of severe supervisory criticism on repeated occasions prior to failure (or in the case of Bank of the Commonwealth, prior to FDIC assistance), even though the magnitude of the bank's problems may not have been fully recognized at the time. I mention this here because management deficiencies in one area of operations frequently accompany management deficiencies in other areas of a bank's operations.

Obviously, there were more specific problems, usually in the loan portfolio, which contributed to the eventual failure of each of these banks and to Bank of the Commonwealth's request for special FDIC assistance. Public Bank, for example, had massive loan problems caused by its excessive purchase of unsecured home improvement loans under unfavorable terms from two dealers, in one of whom a bank director was financially interested. San Francisco National Bank experienced crippling losses in its loan portfolio coupled with poor judgment and dishonesty on the part of its managing officer. Birmingham-Bloomfield Bank and Bank of the Commonwealth, in addition to heavy loan losses, both suffered from a securities account which was woefully out of balance with respect to maturity and credit quality. Yet these other common characteristics I have mentioned may constitute special warning flags, regardless of the size of bank, even before a failing condition is identified. And as we all know, the earlier a serious problem bank is identified, the more likely it is that a program of corrective action can be undertaken in time to be successful.

Along these lines, FDIC personnel have been working intensively on a computer project which may assist all bank supervisors in the identification of possible problem banks even before examination schedules are established or definitive reports of examination are received. In its current phase, the FDIC's Financial Trend Analysis program utilizes data routinely submitted to the Corporation, such as reports of condition and of income, and calculates a number of financial ratios selected by our examination personnel which may be helpful in spotting trends that may be of supervisory interest or concern. The program can quickly print out a list of those banks having values for these selected ratios above or below any level specified by the examiner. Thus, the printout can list all banks with capital ratios below a specified cut-off point like 5%, or loan-to-asset ratios above a certain percentage, or banks whose earnings have declined, or banks with almost any other balance sheet or income ratio one can think of. We now routinely send to each of our Regional Directors, following each call report, a list of the state nonmember banks in his region with ratios he considers worthy of note.

We view this as only a first step in the application of analytical techniques and computer power to matters of bank supervision. Our next step, now under way, is to assess the usefulness of these various financial ratios in measuring the condition of a bank. That is, of the many possible measures of capital adequacy or liquidity which supervisors have traditionally used, are some better indicators than others of the true position of the bank? Of the various measures of bank efficiency and profitability, are some more reliable than others? Our results to date are tentative, but if confirmed by further analysis, they may lead us all to reconsider the financial data we now consider important. It appears, for example, that the capital measure adopted by the Comptroller's Office in recent years, the ratio of loans to capital, is more useful than the traditional capital to assets ratio in distinguishing problem from nonproblem banks.

We are assessing these ratios not only individually but, using sophisticated statistical techniques, are trying to see which combination of financial ratios gives us the most useful overall picture of the bank. Thus, we are trying to develop a classification system which will tell whether a particular institution, previously unclassified, may have become a "problem bank" since it was last examined. We then hope to determine if, on the basis of financial ratios, a way can be found to predict the likelihood that a particular bank will develop into a problem bank one, two, or three years hence so that supervisory attention can be concentrated on that bank earlier than it is today.

We also hope, as this program proceeds, to refine our present methods of identifying whether, and to what degree, a particular bank is atypical when compared to a relevant sample of other banks.

Our preliminary work on the classification and prediction models has met with some success. We have been able to classify by statistical methods a group of problem and nonproblem banks pretty much in accord with the way our examination staff evaluated these banks. This, of course, represents no advance in supervisory effectiveness, but it is a necessary step in the development of a reasonably reliable early warning system. Identifying the future problem bank a couple of years before it reaches that status in regular examinations is also showing some positive results, and we are encouraged enough by our progress to have arranged to classify all state nonmember banks by this system as of their December 1973 financial ratios to see which ones may loom as potential problem banks in the years ahead. While we cannot depend on this system at the present time, even as a screening device, the information we develop in our examinations over the next few years should help us to refine the system and increase its reliability.

While programs such as this may help to flag particular banks for special supervisory attention, they are no substitute for the careful evaluation work of examiners reviewing the loan portfolios and internal controls of individual banks where any problems they have are most apt to be found. But as we grapple with an ever-larger banking system, bank examiners and bank supervisors alike should reach out for any computer application that will maximize the amount of time examiners can actually spend on this crucial evaluation work. Many of you are in the forefront of these developments within your own departments and I know that almost all of you are emphasizing the analytic requirements of a bank examiner's work in your examiner training programs. All of this is a good sign for the future.

The failure of large banks always raises questions about the soundness of the nation's banking system and about the FDIC's capacity to withstand the losses that such failures may entail, and I should close with a word about each.

As a whole, the banking system of this country is well managed, financially strong, responsive to changing needs and resilient in the face of adversity. The relative handful of banks in difficulty are in that spot because their managements misuse the freedom and discretion which is entrusted to them in a system of more than 14,300 units. Effective supervision restores at both Federal and State levels 95 percent of such banks to sound condition and all of us strive to improve our performance with respect to the balance. The American banking system, in short, is alive and well and deserves the confidence of the American people.

The FDIC itself reflects that strength. The deposit insurance fund now stands at $5.8 billion, exclusive of the statutory call which the Corporation has upon the United States Treasury. The annual income of the Corporation, after our administrative expenses are deducted, is almost $800 million and is available, along with the principal of the insurance fund, for any losses that might occur in the same year. Our loss experience has been low -- about $100 million all told for the 500 bank failures that preceded United States National Bank -- and not even the most extreme assumption as to the final outcome of that receivership will materially affect the financial strength of the Corporation. I am confident, moreover, that with your cooperation and diligence, as well as the Comptroller's, we can keep the large bank failure a rarity in United States banking history.