FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

NEWS RELEASE

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"FDIC 1975: SOURCE OF STRENGTH WITHIN THE AMERICAN BANKING SYSTEM"

Address by

Frank Wille, Chairman
Federal Deposit Insurance Corporation

before the

Eighteenth Bank Presidents'
and
Senior Officers' Policy Seminar

of the

Western Independent Bankers

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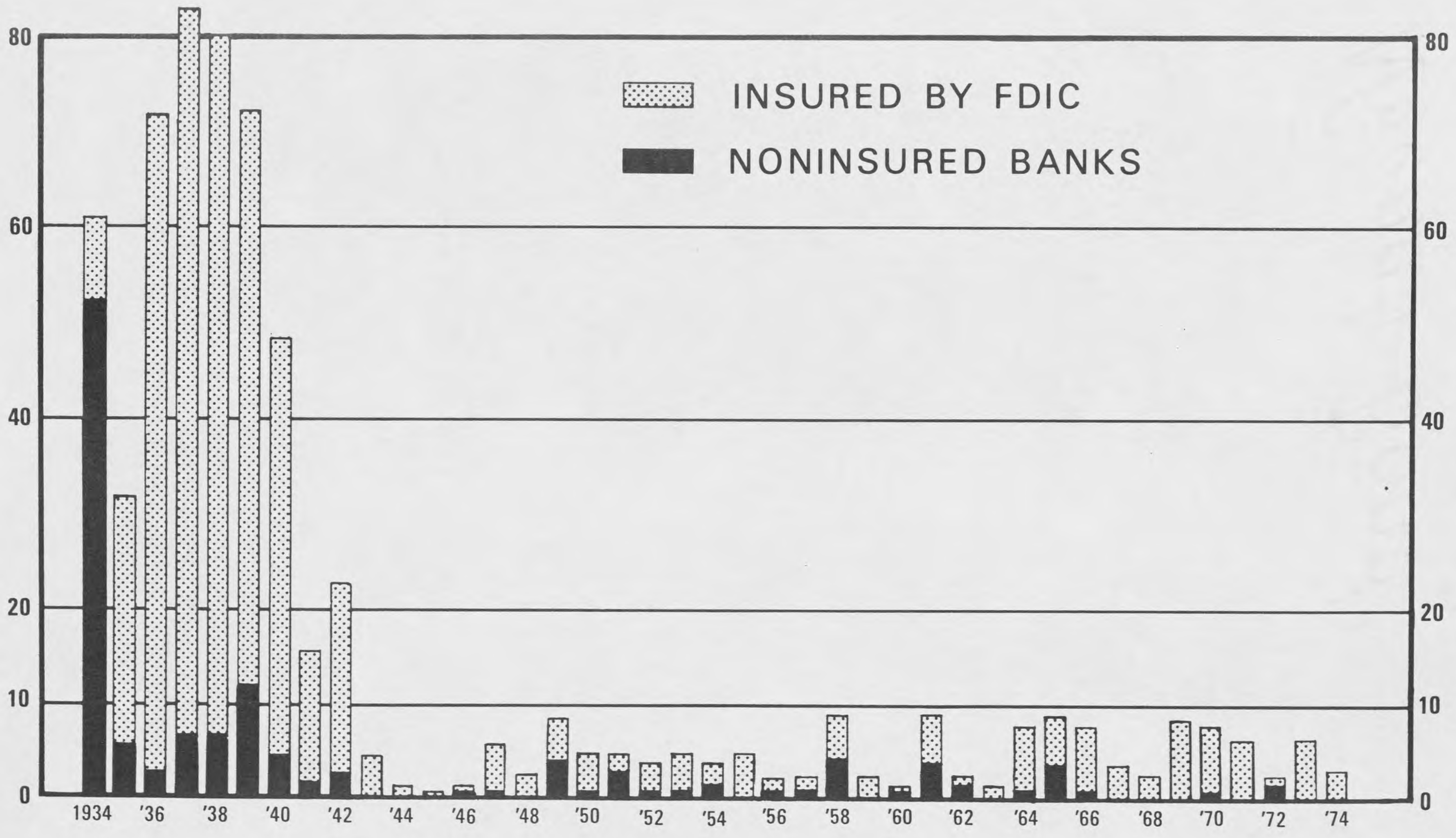
What made 1973 and 1974 such troubled years for the banking industry in this country was not economic instability or the wide range of pressures confronting the nation's 14,500 banks, but rather a noticeable loss of public confidence in the financial system as a whole -- a loss of public confidence sparked by the two largest bank failures in FDIC history and fanned by speeches, news items, magazine articles and books that questioned the basic soundness of that system. This publicity has given prominent play to the size of the banks that failed, the liquidity problems of a number of fair-sized banks, the recent upsurge in bank loan losses, the magnitude of some foreign exchange losses, the gloomy outlook for the economy and the implications of an extended recession for bank borrowers and bank profits in 1975. Inevitably, such discussions turn to the financial ability of the FDIC to absorb the bank failures that have occurred and the adequacy of its trust fund in coping with a variety of contingencies in the future. My purpose today is to discuss some of the relevant issues, and I will focus on the financial capacity of the FDIC to deal with a number of large bank failures in the future, even if these should occur within a limited period of time. Let me state at the outset my conviction that much of what has been said in the popular press about the vulnerability of the banking system is exaggerated and badly out of balance in its perspective. I would concede, however, that over the past ten years the degree of risk in the American banking system has increased and that large banks are by no means immune to either mismanagement or mistake. Nonetheless, I consider the present level of risk well within tolerable limits for the American banking system as a whole. I further believe that FDIC is soundly based with sufficient financial resources available to it for any realistically foreseeable situation.

Let us turn to our actual experience. In 1974, there were four bank failures that required disbursements from the FDIC. One of these institutions, Franklin National Bank in New York, was the largest insured bank ever to fail, with slightly more than $1.4 billion in deposits the day it closed. A second failed bank, American Bank & Trust, Orangeburg, South Carolina, held deposits of approximately $112 million, while the other two banks were much smaller institutions. In 1973, six insured banks failed, only one of which was of significant size -- United States National Bank in San Diego with about $930 million in deposits. Actually, the number of bank failures in both 1973 and 1974 was about average for the period since the early 1940s, as shown in Chart I.

Many of the doubts concerning the FDIC's ability to deal with a number of large bank failures focus on the fact that the deposit insurance fund is but a small fraction of the total deposits insured by the FDIC. This is factually correct, but it has always been the case and is nothing new. Except for the start-up years when the FDIC fund was

BANK FAILURES, 1934-74



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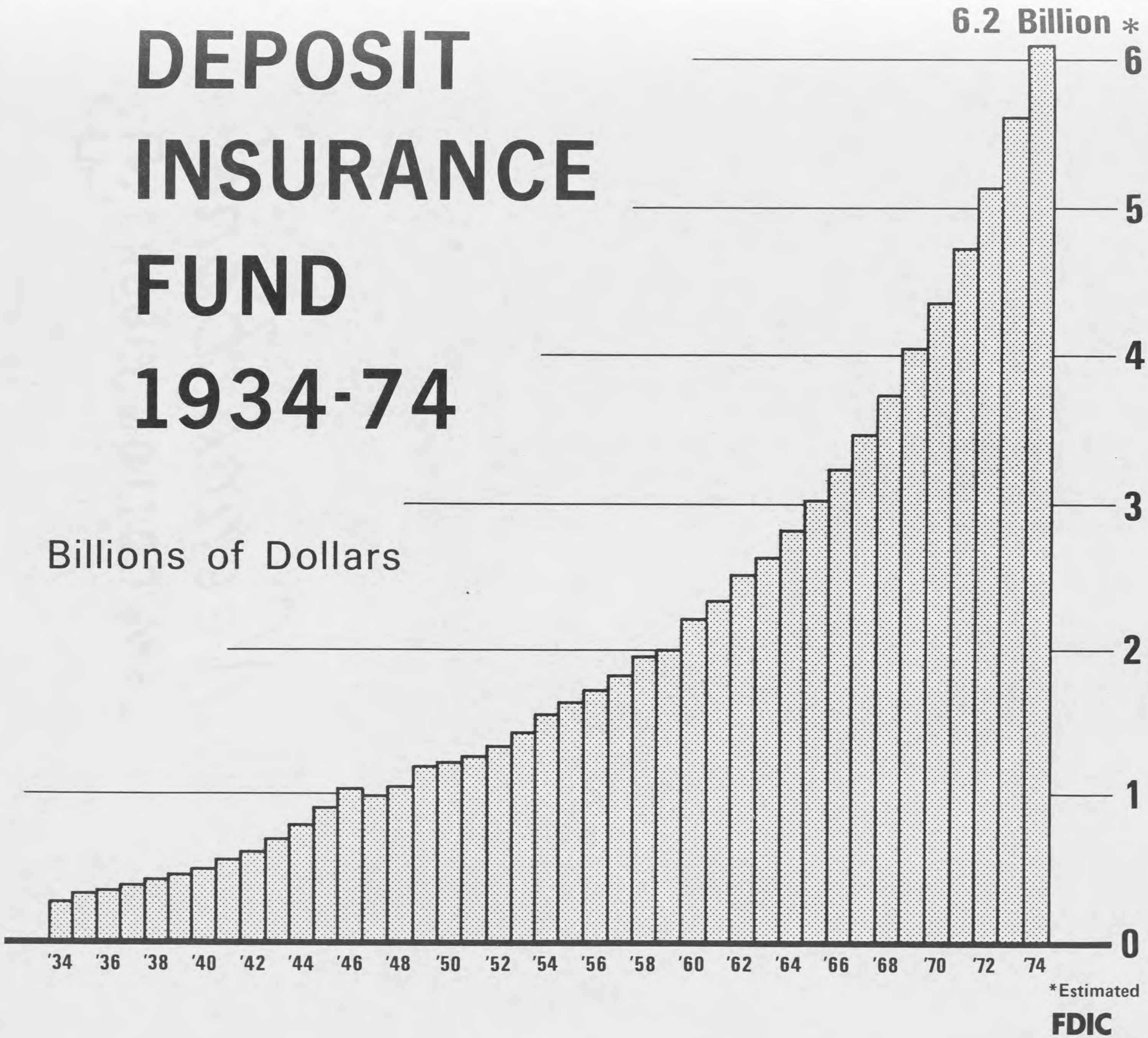
first being set aside, it has ranged between 1.2 percent and 2.0 percent of all insured deposits, and while insured deposits have been growing at a relatively rapid rate in recent years, so has the deposit insurance fund itself, which now totals $6.2 billion, as shown in Chart II.

The more relevant comparison is not between the level of the deposit insurance fund and the total of insured deposits in the banking system, but the relationship between the FDIC's annual income and its accumulated insurance fund and other financial resources on the one hand, and its actual disbursements and loss experience in the 508 insured banks which have either failed or required FDIC financial assistance between January 1, 1934 and year-end 1974.

FDIC's gross income each and every year will soon exceed $1 billion, with its administrative and operating expenses taking only about $60 million, or 6 percent of that amount, per year, as shown in Chart III. All of that amount, in addition to the principal amount in the FDIC's trust fund, could be made available for insurance purposes in any given year. Beyond that, the Corporation may by law call upon the United States Treasury for an additional $3 billion any time this is needed for FDIC purposes -- an authority the FDIC has never found it necessary to use in its 41-year history.

By contrast, the FDIC disbursed only $1.337 billion between January 1, 1934 and year-end 1974 to pay depositors up to the insured


DEPOSIT
INSURANCE
FUND
1934-74
Billions of Dollars
6.2 Billion *
6
5
4
3
2
1
0
'34 '36 '38 '40 '42 '44 '46 '48 '50 '52 '54 '56 '58 '60 '62 '64 '66 '68 '70 '72 '74
*Estimated
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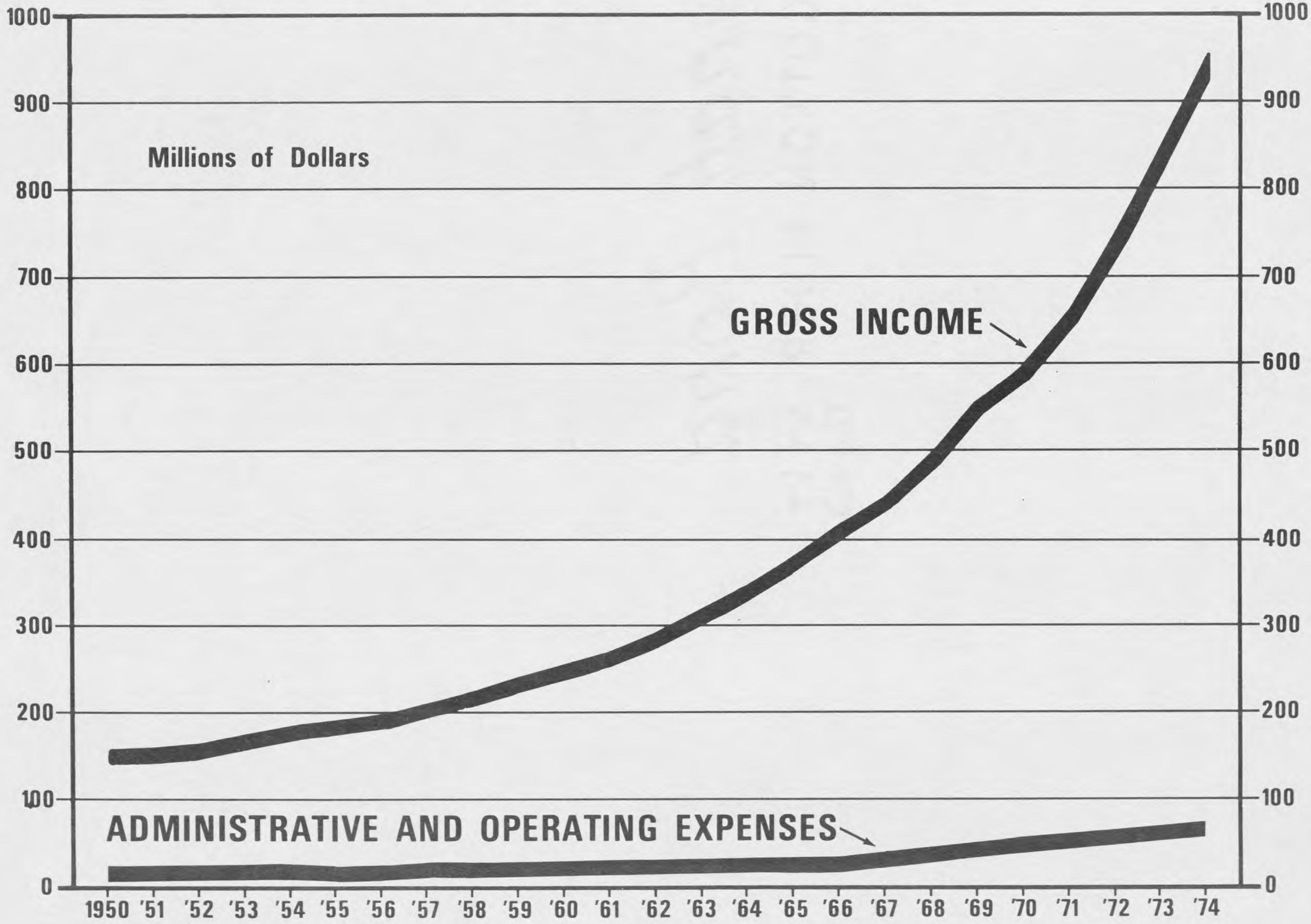
GROSS INCOME COMPARED TO OPERATING EXPENSES

FEDERAL DEPOSIT INSURANCE CORPORATION, 1950-1974



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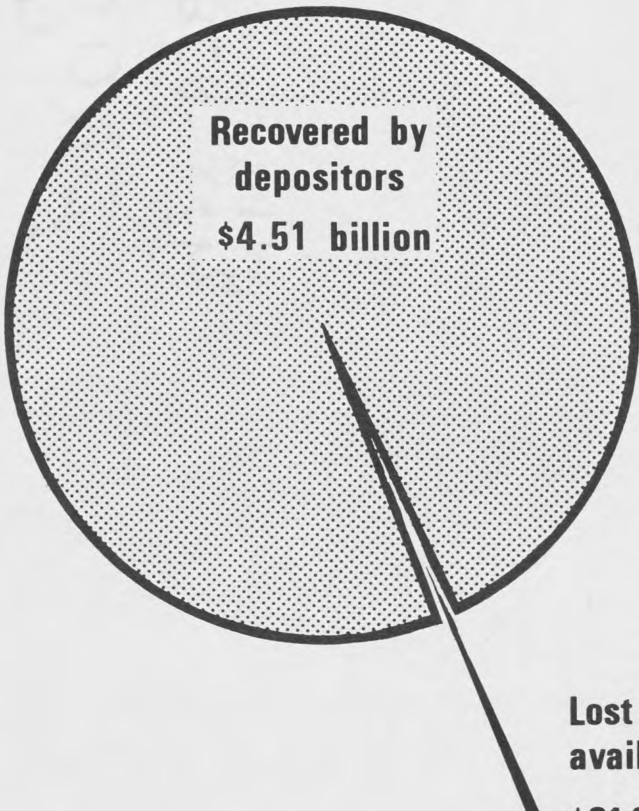
limit, facilitate deposit assumptions by a healthy bank or prevent an impending failure in those 508 failures and near-failures. The likely loss on all of these disbursements is currently estimated at $227 million -- about 5 percent of the $4.5 billion in total deposits held by these same banks. Furthermore, the 3,300,000 depositors in those banks who were helped by FDIC protection have suffered a loss, on average, of less than 1/2 of 1 percent of that deposit total -- borne entirely by depositors with more than the FDIC-insured amount on deposit on the day of failure, most of whom are corporations, institutions or public bodies. Chart IV.

One should keep firmly in mind the relationships between these figures because the experience of 41 years indicates better than any words of mine the geometric protection afforded by FDIC's resources: $4.5 billion in deposits, protected by an initial FDIC outlay equal to one-third that amount, with an estimated loss to FDIC of only 5 percent of that deposit total and an average depositor loss of less than 1/2 of 1 percent. To look merely at the $9.2 billion in resources currently available to FDIC and assume that only bank deposits of equivalent amount can be protected is obviously wrong, and a great disservice to public confidence in a banking system with obviously greater deposit totals. The $1 billion Bank of the Commonwealth, for example, was saved from failure in 1972 by an FDIC disbursement of only $35.5 million, a disbursement on which we are unlikely to suffer any net loss at all.

DEPOSITS AND LOSSES IN INSURED BANKS REQUIRING FDIC DISBURSEMENTS, 1934-74

TOTAL DEPOSITS

$4.532 billion



DISBURSEMENTS BY FDIC

$1.337 billion

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The same point can be made looking solely at the 1973-1974 experience when FDIC disbursements were required in ten bank failures, including the two largest in its history. These ten banks held total deposits, at the time they failed, of approximately \$2.5 billion in the aggregate. FDIC disbursed \$580 million, or less than one-fourth of that deposit total, to pay \$20,000 per account to depositors of three of the banks and to facilitate deposit assumptions by healthy banks in the remaining seven cases. The net loss to FDIC from all ten failures is currently estimated at \$157.8 million (\$150 million of which is attributable solely to the failure of United States National Bank in San Diego). Approximately 1 million depositors were protected in full for the amounts they had on deposit in these ten banks and the only depositor losses likely to be suffered will be borne entirely by 140 account holders in the three banks which were paid off. They had only \$1.4 million on deposit in excess of the \$20,000 insurance limit then in effect, and if our usual experience in collecting assets is any guide, most of these "excess" depositors will be made substantially whole as liquidating dividends are paid.

Since the FDIC had gross revenues in those two years, net of operating expenses, of \$1.8 billion and disbursed only \$580 million to protect depositors, it can be argued that FDIC financially could probably have handled twenty additional bank failures of the same aggregate deposit size as the ten that failed without even touching one penny of the accumulated principal of the FDIC trust fund or the $3 billion on call at the Treasury.

Some of the concern about the FDIC's financial capacity to handle its insurance responsibilities if additional large banks go down arises from a failure to distinguish between the funds FDIC lays out or disburses right after a bank failure and the FDIC's ultimate net loss with regard to the same failure. As the figures I have just used make clear, the two are very different, and the disbursements -- although considerably larger than FDIC's ultimate net loss -- are at most a temporary impediment to the Corporation since the bulk of these disbursements are usually recovered promptly from asset collections in the first few years of a given receivership.

Now that the general insurance limit has been doubled to $40,000 per account, has FDIC's capacity to handle the bank failures that may come along been effectively cut in half? The answer is "Clearly no" and the reason is that deposit accounts between $20,000 and $40,000 in size do not add significantly to the total deposits insured at the $20,000 limit. We estimate, for example, that before the insurance ceiling was raised, the insured portion of total deposits in FDIC banks was around 56 percent and that this figure was raised only about 7 percentage points by the insurance changes which Congress made last year. Moreover, if most of the bank failures in the future are handled through deposit assumptions by a healthy bank, rather than statutory payoffs up to the insurance limit, just as they were in 1973 and 1974, the impact of the new ceilings is likely to be felt, not by FDIC in its disbursements and net losses, but by those handful of "excess" depositors who fail to get all their money back when FDIC determines to pay off up to the insurance limit rather than assist a deposit takeover by a healthy bank.

The FDIC's record of providing depositors a high degree of protection with only moderate and manageable disbursements and losses to itself is impressive, even with the unusual experience of several large bank failures in recent years. This record has been achieved in part because the FDIC has considerable flexibility in dealing with failing bank situations. As my remarks up to this point have implied, the FDIC has two principal methods which it uses to protect depositors in failed banks which it insures: (1) the direct payoff of insured deposits up to the statutory ceiling, and (2) assisting a sound bank to take over the deposits and other liabilities of the failing institution.

In deposit payoff cases, immediately following closure of an insured bank by the Comptroller of the Currency in the case of a national bank or by the State Bank Supervisor in the case of a State-chartered bank, the FDIC sends its claim agents to the bank to begin preparations for the payment of insured deposits. The claims presented by depositors together with the records of the bank are used to determine the total amount of deposits held by each depositor. From this total, any matured loan owed by the depositor to the bank may be deducted, and the net amount that is eligible for deposit insurance is then paid by the Corporation. In the past five years, payment of insured deposits has usually begun within five to seven days following the closure of the bank, regardless of its size. Since 1934, almost three-fifths of all bank failures have resulted in statutory payoffs, although that proportion has been much lower in recent years. The aggregate deposits in all such banks when they failed was approximately $400 million.

The FDIC is also authorized to assist financially in the takeover of a failing bank or the assumption of its deposit liabilities by another insured bank whenever the FDIC determines that its risk or its likely loss will thereby be reduced. This assistance may take various forms: the FDIC may purchase the assets or grant a loan secured by the assets of the failed bank (the result of which is to balance with FDIC cash the liabilities assumed less the assets found acceptable to the takeover bank), it may agree to indemnify the takeover bank against loss by reason of the transaction, or it may take a short-term capital note from the assuming bank to provide it with temporary capital to support its suddenly expanded deposit base. Sometimes all three forms of assistance are necessary -- as they were in our resolution of the Franklin National Bank failure last

October. Without exception in recent years, the Corporation's willingness to use this method of dealing with a failed bank has been encouraged by the agreement of the takeover bank to pay a healthy premium, or price, for the overall transaction -- $89.5 million, for example, in the case of Crocker's takeover of the deposits and offices of United States National Bank; $125 million, for example, in the case of European-American's takeover of the deposits and offices of Franklin National Bank; and $5.6 million, for example, in the case of Southern Bank and Trust Company's takeover of the deposits and offices of American Bank & Trust. This premium, of course, provides an additional cushion for loss in the liquidation of the failed bank's assets over and above the net capital of the bank, if any, the day it closes. In that sense, the premium serves to minimize FDIC's net loss, but it also enhances the possibility of an eventual recovery by the failed bank's subordinated noteholders and shareholders. Two out of every five bank failures have been handled in this way since 1934, but the current ratio is much higher (seven of the ten bank failures in 1973 and 1974 were handled this way). The aggregate deposits in all failed banks that have ended up being assumed by some healthy bank totalled $3.1 billion as of the end of 1974.

The Corporation has also had authority since its early days to organize and operate for two years a special type of bank called a "deposit insurance national bank," when this appeared desirable to provide limited banking services to a community deprived of banking services because of a bank failure. A deposit insurance national bank is organized as a nonstock company, and managed by an executive officer appointed by the FDIC Board of Directors. The Corporation provides funds necessary to begin its operations and to cover its operating losses, if any. Such a bank begins business with deposits limited to the total amount of the insured deposits in the bank that failed, and normally it performs only limited banking functions unless authorized by the Comptroller of the Currency to offer a broader range of banking services. When such a bank is organized, the FDIC will attempt to transfer its ownership to private hands within the two-year period authorized by law, and Federal law requires the FDIC to offer such stock first to the shareholders of the bank that failed. If the stock offering is not successful, the law requires that the bank be closed, and the FDIC then assumes its assets and obligations, liquidating both as in a normal receivership.

A deposit insurance national bank is only rarely created these days. The most recent example occurred two months ago when such a bank was organized to provide limited banking services on the site of a small minority bank in Kansas City, Missouri. This was the first use of these statutory provisions since 1964, when two such banks were established.

The Federal Deposit Insurance Act was amended in 1950 to provide FDIC with additional authority to deal with distressed banks before actual failure. Section 13(c) of the Act authorizes the FDIC to provide specified forms of assistance to an open and operating insured bank only after a finding that (a) but for the contemplated assistance, the bank is in danger of closing and (b) the continuation of that bank as an independent entity is "essential to provide adequate banking service in the community." The Corporation has used this authority on only three occasions since. The first occasion was in 1971 when the FDIC took a $1.5 million capital note from a small minority bank near Boston, Massachusetts. The second time was the following year when FDIC entered into a capital note agreement with the $1 billion deposit Bank of the Commonwealth, Detroit, Michigan, under which $35.5 million was eventually taken down. In both cases, the banks involved were forced to agree to significant restrictions on their activities and their managements while FDIC funds were at risk. Last September, the FDIC provided short-term liquidity assistance under this same section to American Bank & Trust, a nonmember bank, to prevent its failure before a satisfactory purchase and assumption transaction with a sound bank could be arranged.

When the condition of an insured bank deteriorates to the point where failure seems likely -- despite efforts at correction and despite efforts to merge it without financial or other assistance from the Corporation, the FDIC conceives its mission to be not to prevent the failure at whatever cost, but to protect depositors and maintain public confidence in the banking system as a whole despite the failure. In most cases of impending failure, the FDIC will first seek to determine if a deposit assumption transaction with FDIC assistance can be worked out with a healthy bank and still meet the statutory criteria set forth in Section 13(e) of our Act. Such a transaction provides full protection to all bona fide depositors, even if their accounts are over the $40,000 insurance limit, and otherwise minimizes disruption of banking services to the community. However, even if the statutory standards are met, the circumstances may be such that a deposit assumption is not feasible, desirable or even possible. Where extensive fraud or misconduct is apparent, the FDIC may decide that the indemnities that would have to be given to an assuming bank as protection against unknown or undetermined liabilities of the failed bank involve too much risk to the Corporation, even allowing for the premium which the assuming bank might be willing to pay for the overall transaction. In unit banking states which do not permit multibank holding companies, and in other states with restrictive branching laws, there may be very few banks eligible under state law to be acquiring banks and none of them may be able to get the necessary approvals for such a transaction -- because of their size relative to the failed bank, or because of their own condition, or because of their existing competitive position in the market. If a deposit assumption cannot be arranged in accordance with the FDI Act, the most likely alternative FDIC will follow in the case of a closed bank is to pay off the insured deposits up to the statutory ceiling.

The comments I have made thus far will not answer all the fears that have been expressed in recent months. That is because even the most skeptical observers of the American financial scene concede that our deposit insurance system has worked smoothly in the past. Their concern is for the future. The ultimate question they raise is whether the FDIC could cope with a wave of large bank failures or a general banking emergency. While I have indicated my belief that FDIC has adequate financial resources to handle even within a single year bank failures several times the combined magnitude of United States National Bank, Franklin National Bank and American Bank & Trust, a massive breakdown of our entire banking system, which I do not believe is even remotely possible, could be a different story. Were that nonetheless ever to happen, or were the FDIC ever to exhaust the funds available to it for insurance purposes, I have no doubt that Congress would act promptly to provide the FDIC with such additional borrowing authority or funds as might be needed to honor the Government's commitment to insured depositors.

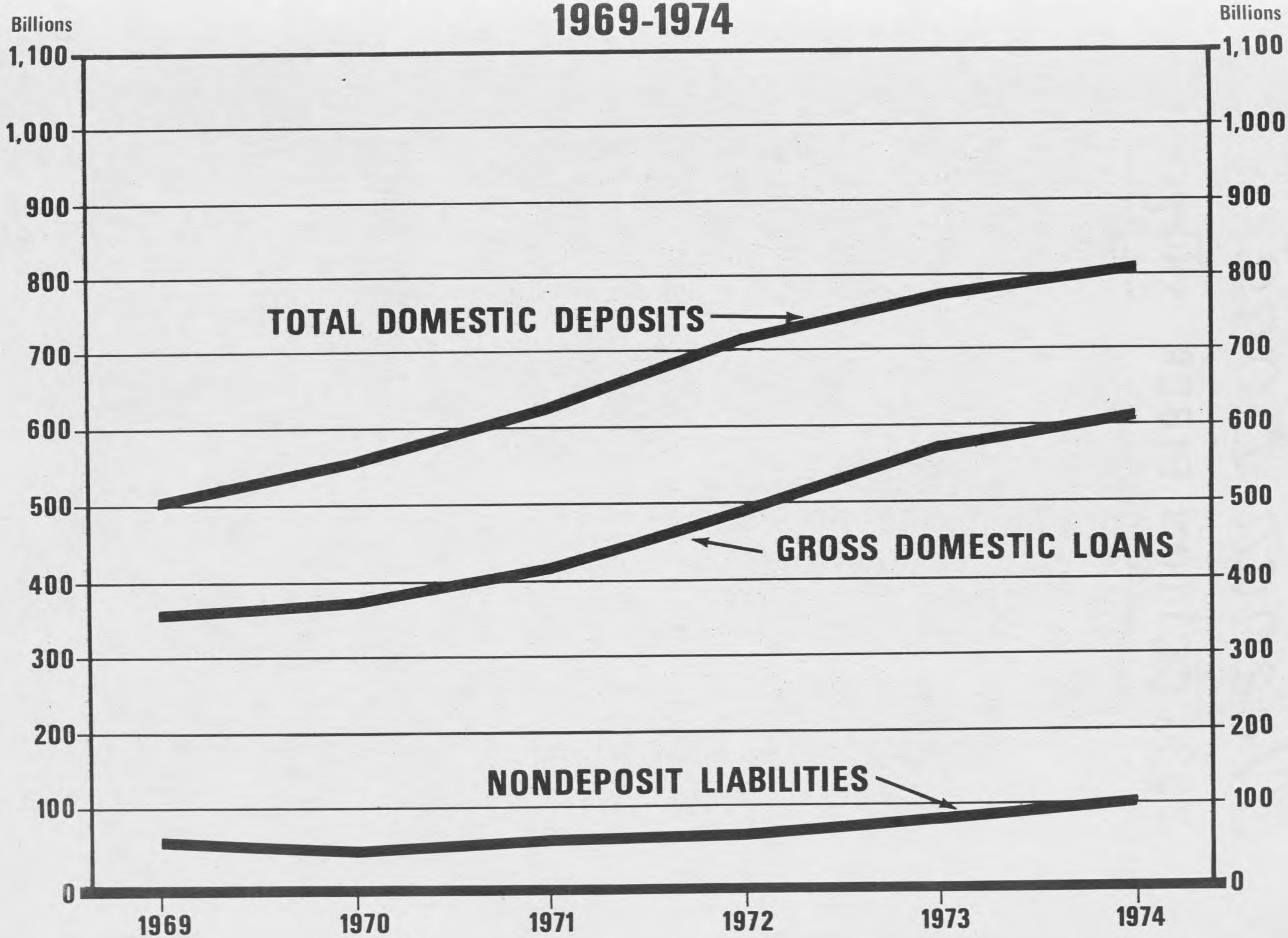
There are many reasons why I do not regard a breakdown of our banking system as being even remotely possible, despite the duration of the economic recession in which we currently find ourselves. In the first place, no one is predicting anything resembling the Great Depression of the early 1930s. That traumatic period was associated with a drastic and sustained decline in the money supply of the country, and I have no doubt that appropriate steps will be taken by the Federal Reserve or the Congress to prevent such a decline from ever occurring again. In the second place, it has been FDIC's experience over the years that, generally speaking, banks fail not because of economic conditions alone, but because these conditions may aggravate preexisting problems within the banks themselves, such as poor management policies, poor earnings, poor controls, self-serving, unsound or illegal practices, and the like. And banks which have significant problems in these respects remain a distinct minority of American banks. Thirdly, the banking system as a whole has a much greater ability to withstand adversity than many people realize.

We have been told, for example, that bank earnings and bank capital have not kept pace with the rapid growth in bank assets and bank liabilities. We have been told that bank loan losses have gone up substantially and that the red ink may flow more heavily in 1975 than ever before. We have been told that banks have a $12 billion exposure in loans to the hard-pressed REIT industry and that more and more of them are becoming nonincome-producing with every passing day. Each of these statements may be true, but they present a very distorted impression of the vulnerability of the American banking system if they are viewed independently of other relevant information.

The total domestic assets of the nation's insured banks now exceed $1 trillion. Domestic loans aggregate about $600 billion. These figures should be kept constantly in mind as exposures and loan loss estimates are discussed. Chart V shows how deposits, loans and non-deposit liabilities at domestic offices of all insured banks have gone up over the past five years. Loan levels are indeed up, by about $250 billion, but deposit levels are also up, by about $200 billion, the difference reflecting mostly the increase in nondeposit liabilities. Yet total capital accounts, including loan loss reserves, have also gone up substantially and now approximate $78 billion. Chart VI, which displays the total capital accounts, including capital notes and debentures, of insured commercial banks shows that the aggregate figure stood at about $45 billion in 1969. In mid-1974, the figure was almost $70 billion. But the most interesting line on Chart VI is the one that is barely visible at the bottom -- representing that "substantial increase" in loan losses we've heard so much about. With an estimated loan loss figure for 1974 of something around $2 billion, actual loan losses still represent a very small portion of the total capital accounts available to absorb such losses in the nation's commercial banks. Loan losses could increase significantly in 1975 without materially affecting that basic relationship.

Chart VII contrasts net loan losses in all insured banks with net operating income, both expressed as a percentage of total capital accounts.

DOLLAR GROWTH IN BANKS
1969-1974



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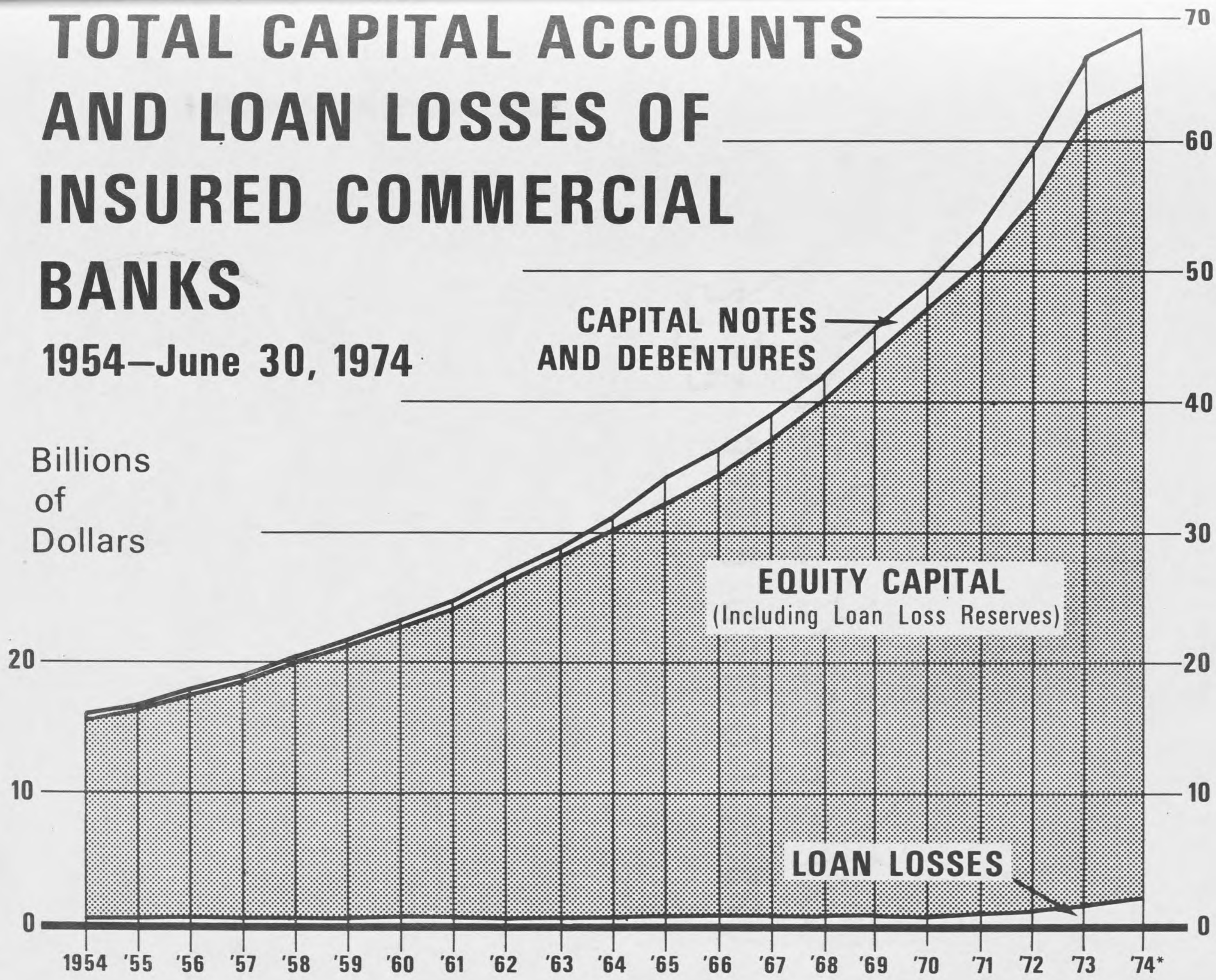
TOTAL CAPITAL ACCOUNTS AND LOAN LOSSES OF INSURED COMMERCIAL BANKS

1954—June 30, 1974



*1974 Loan Losses Figure Estimated

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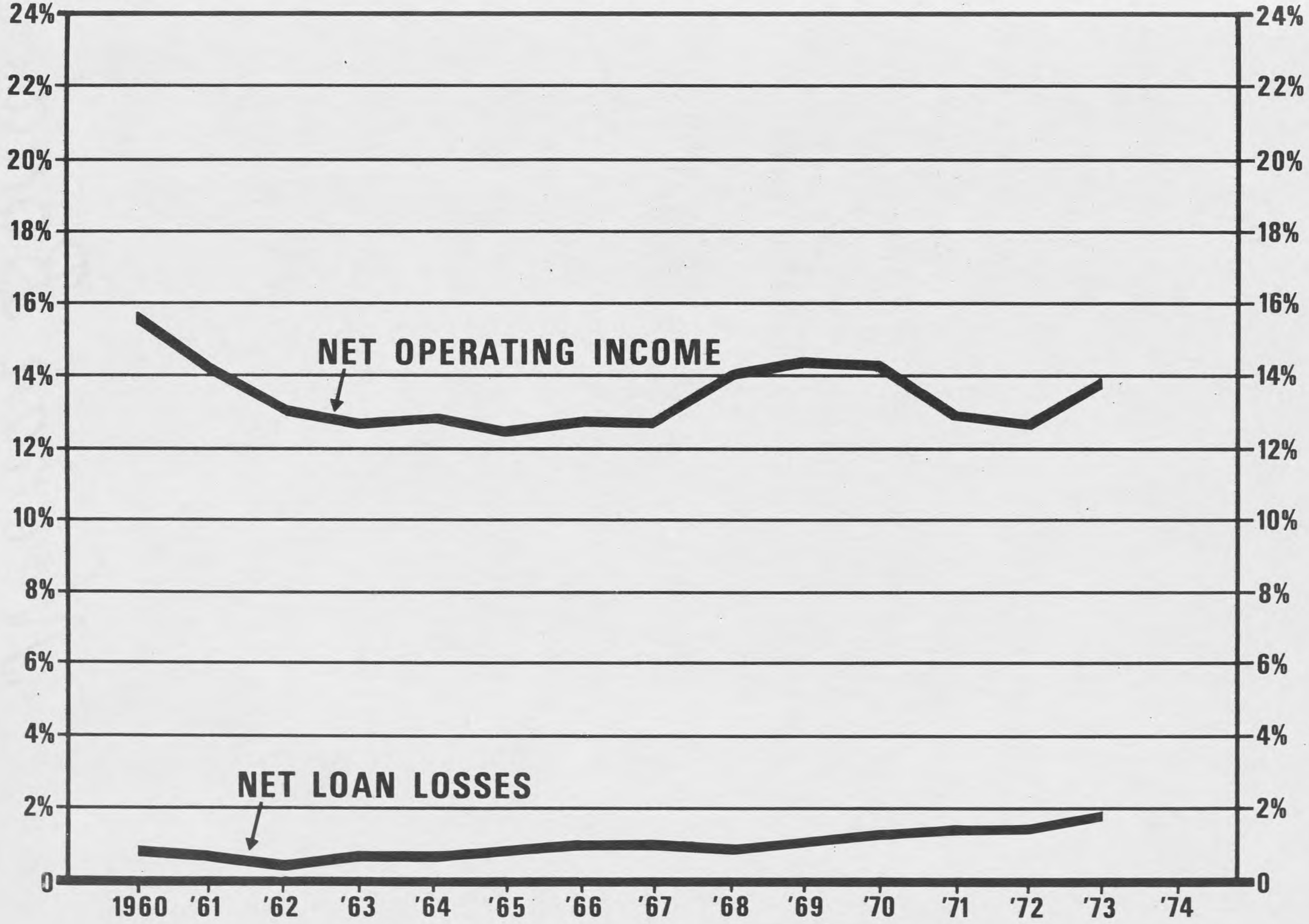
Again, the relationship between the two would indicate that even if there were a significant increase in net loan losses within the system as a whole, that increase could be easily absorbed within net operating income. Chart VIII, which is derived from individual examination reports, shows that at least as to nonmember commercial banks, the percentage level of classified loans has not changed materially over the past six years. Only about 3 percent of the aggregate loan portfolios of nonmember commercial banks is classified, with "Doubtful" and "Loss" classifications remaining remarkably stable at about 1/2 of 1 percent of total loans.

These charts may help explain why we at the FDIC are not expecting any dramatic increase in the annual number of bank failures in the system as a whole. Obviously, however, particular banks will not always reflect the averages presented by these industry-wide statistics. And that brings me to bank examination and supervision, the fourth major reason I see no significant deterioration coming in the American banking system.

At the FDIC, only about 200 people are currently engaged full-time in the liquidation activities that follow a bank failure. As Chart IX indicates, ten times that number are employed in our Division of Bank Supervision, including some 1,600 field examiners who periodically examine the nation's 8,800 nonmember banks. The Comptroller of the Currency has about 2,200 examiners for the nation's 4,700 national banks and the Federal Reserve another 600 for the nation's 1,070 State member

NET LOAN LOSSES AND NET OPERATING INCOME AS A PERCENTAGE OF TOTAL CAPITAL ACCOUNTS-ALL INSURED BANKS



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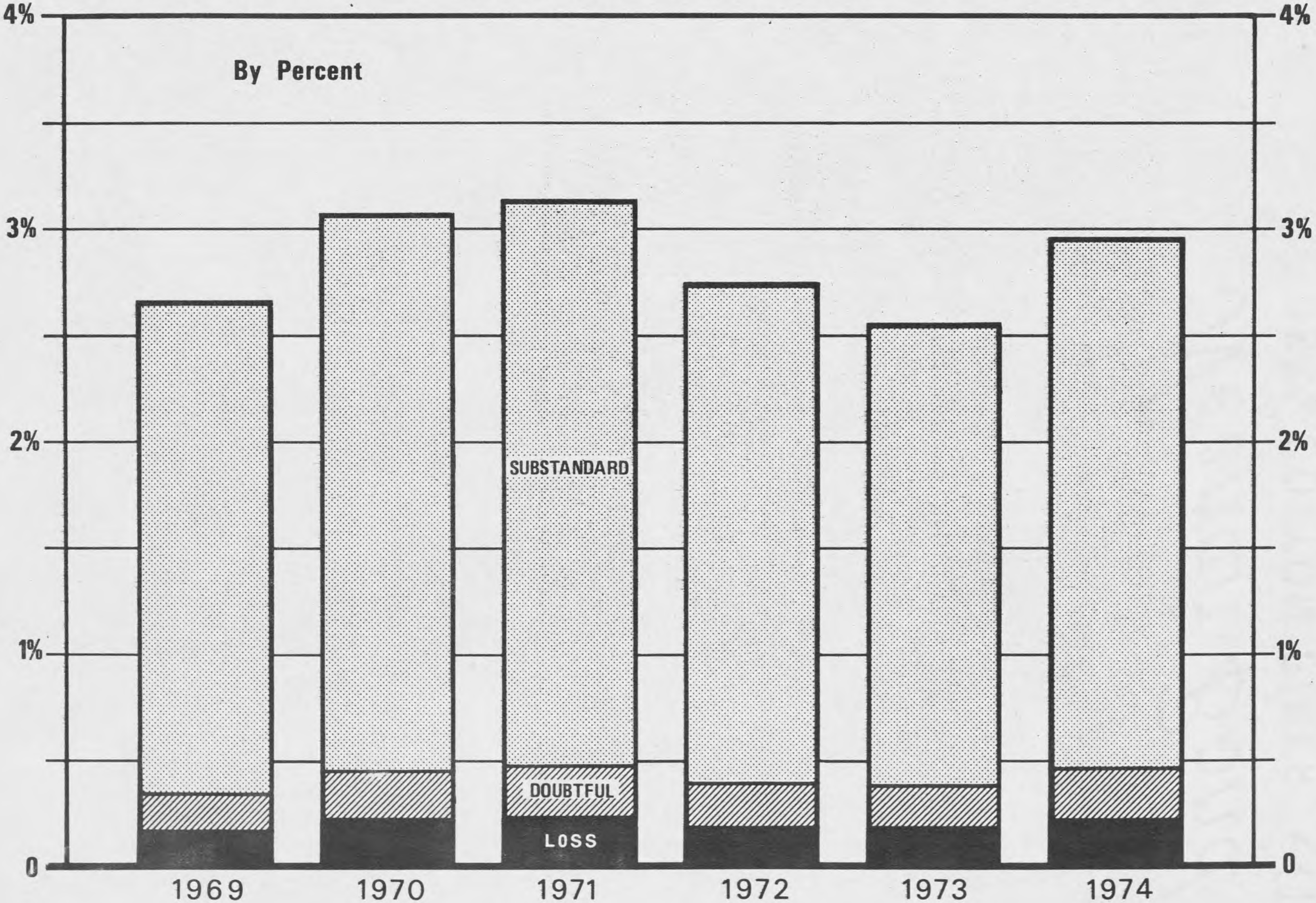
LOAN CLASSIFICATIONS TO TOTAL LOANS
INSURED STATE NONMEMBER COMMERCIAL BANKS – ALL U.S.



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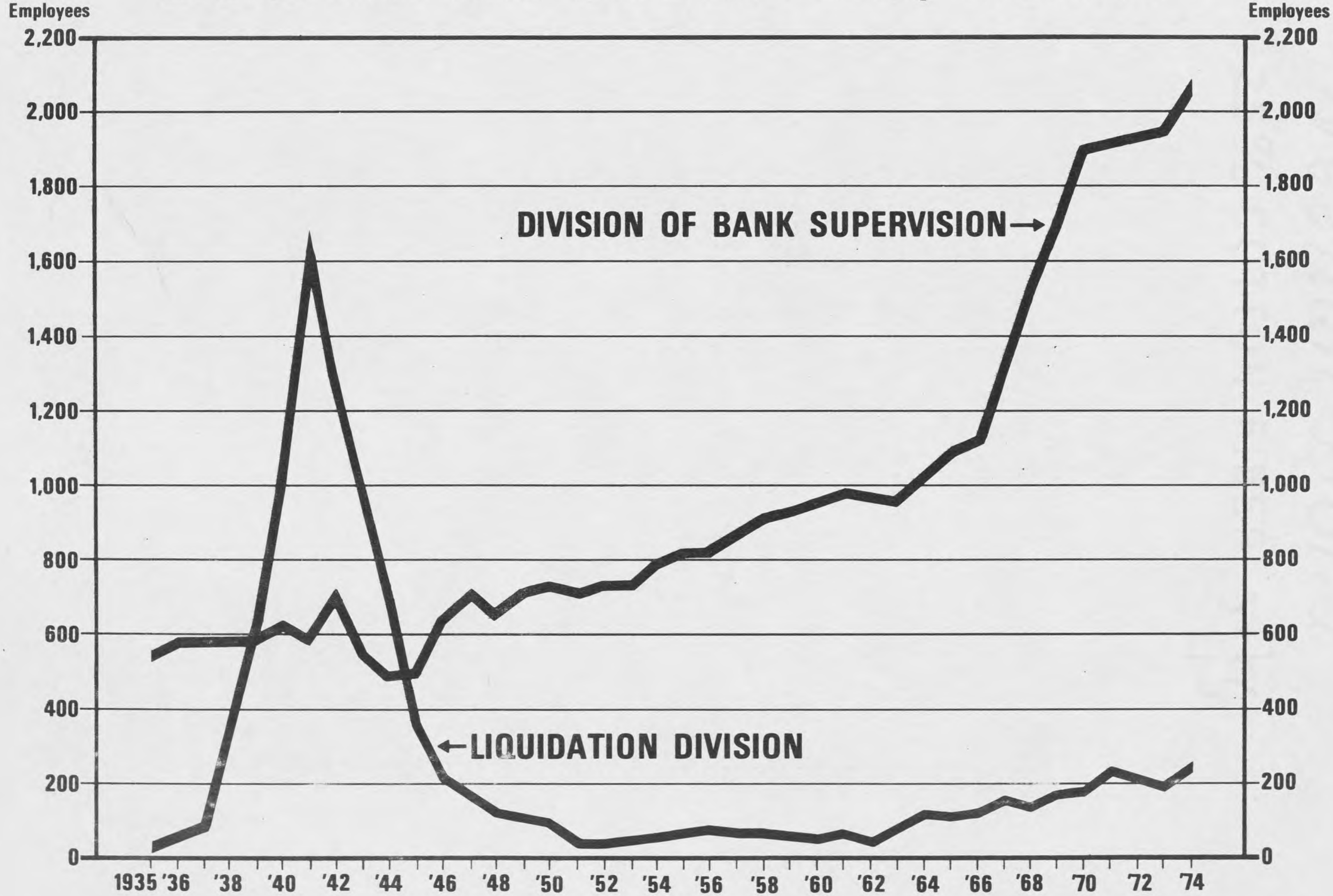
FDIC BANK SUPERVISION AND LIQUIDATION EMPLOYEES, 1935-74



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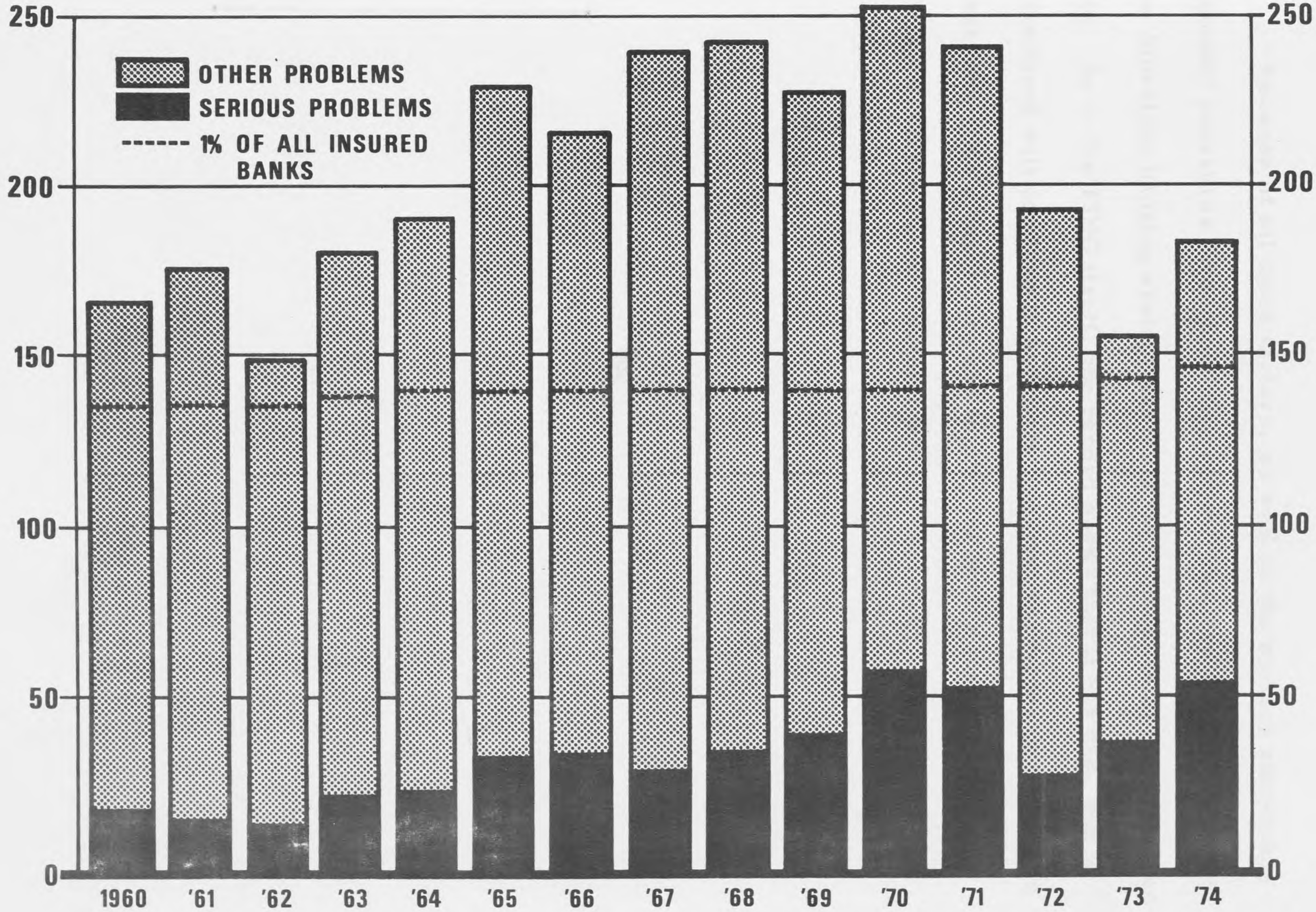
banks. An additional 1,800 examiners from State banking departments assist the Federal Reserve and the FDIC in examining and supervising State-chartered banks. Obviously, the bulk of all bank regulatory personnel is engaged in the preventive work so necessary to public confidence, rather than in the post-failure work required by the deposit insurance program. The essential purpose of all this manpower is to evaluate the condition and performance of individual banks and the character, capabilities and practices of their managements. Wherever possible, they encourage voluntary correction of unsafe, unsound or illegal practices. When necessary, more formal and forceful corrective action can be taken.

With 14,500 bank managements of varying degrees of competence in the country, it is predictable that at any given point in time at least some will present special cause for supervisory concern. Such banks are invariably placed on special "watch" lists or "problem bank" lists so that the agencies with jurisdiction over them can monitor developments more closely. Typically, they are subjected to more frequent examinations and visitations than other banks, they may be subjected to special capital requirements or loan write-offs, and they may be restricted as to future expansion plans. In the majority of cases, corrective action taken under supervisory pressure removes them from such special lists within two years. Only a few will end up as bank failures largely because bank supervisory efforts are successful with the vast majority of banks appearing on these lists.

The FDIC's list of problem banks includes, at any given point in time, those insured banks which in our judgment may involve the FDIC in a cash disbursement if corrective action is not forthcoming. It covers national banks and State member banks, as well as nonmember banks. But it is well to remember that banks on the list may differ from one quarter to the next as problems within a listed bank are overcome and their names removed. The number of banks on the FDIC problem list at year-end 1974 was up somewhat over the total number on the corresponding list the year before but, as Chart X shows, the increase was not at all alarming and it was well within the range of our historical experience over the past 15 years for both serious and less serious problems. While banks can fail without having been previously on a "problem" or "watch" list, as for example when embezzlements or irregularities occur, the present list shows no unusual indications of problems and no reason to expect any different rate of bank failures in the future than we have had in the past. Moreover, every bank regulatory agency has been alerted by the experience of the last few years to the fact that significant problems can develop in large banks as well as medium-sized banks and small banks. Their vigilance and growing sophistication should help keep the rate of failure in large banks to a minimum in the years ahead.

NUMBER OF PROBLEM BANKS, 1960-74



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Because of all these factors, as well as the obvious slackening of liquidity pressures throughout the system, I believe the basic strength of the American banking system warrants the confidence of the American public. As to the FDIC itself, the record shows that it has had, and in all likelihood will continue to have, the financial resources necessary to protect the nation's depositors and to play its part in maintaining the public's confidence in our financial fabric.