FDIC Press Release

FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON 25, D. C.

OFFICE OF PUBLICATIONS
AND INFORMATION
Phone EXECUTIVE 3-8400
Extensions 226-7

PR-5-58

ADVANCE -- FOR RELEASE UPON DELIVERY
May 16, 1958

BANK CAPITAL AND DEPOSIT INSURANCE

Address of

Jesse P. Wolcott, Chairman

Federal Deposit Insurance Corporation

Before the 67th Annual Convention

of the

Illinois Bankers Association

Chicago, Illinois

May 16, 1958

BANK CAPITAL AND DEPOSIT INSURANCE

For more than twenty-five years now it has been my lot to participate in discussions of banking problems. In the Congress of the United States, as a member of the House Banking and Currency Committee, I have had the privilege of listening to a great many practical bankers as well as professional experts in the field present their views. Thus, my own thinking as regards banking has developed and taken shape under very able instruction.

That the subject of bank capital has been the central theme from time to time throughout these discussions should not be surprising, I suppose. Almost irrespective of the issue that claims attention at the outset of a discussion with respect to banking, there seems inevitably to be a drift in the direction of the bank capital problem. At this point virtually all of the basic questions in the banking field seem to come to focus.

From the very beginning of my interest in banking matters, I have been impressed with the mercurial character of the bank capital problem and the tremendous difficulties that beset our efforts to come to grips with it. Easy enough to grasp is the fact that stockholders invest money in a bank by acquiring shares, contributing to the surplus, or allowing their earnings to remain in the undivided profits account. The balance sheet reflects these transactions in the capital accounts. But an understanding of the bank capital concept calls for something more than a knowledge of accounting practices.

To stay in business a bank requires a volume of assets that exceeds the total amount of its liabilities--principally deposits--by a substantial margin. Stemming in its origins from the contributions of the owners, this margin--more commonly known as bank capital--provides depositors with protection against losses that occur for one reason or another. Thus, when a bank finds that some of its assets have turned out to be bad, the losses are charged off against the accounts that comprise the capital. Viewed in this light, bank capital is the margin of protection against losses that keeps the bank in business and protects the depositors.

This simple and straightforward concept of bank capital, although it might appear to many of you experienced bankers to be sophomoric, has

served me well on many occasions, and it continues to do so. It furnishes guidance as I work with the bank capital problems from day to day in the Federal Deposit Insurance Corporation. As might be expected, however, the subject takes on new complexities as time goes on and my views become oriented and projected in terms of new dimensions. Today I shall endeavor to share some of these viewpoints and dimensions with you.

All of the supervisory authorities--the Federal Deposit Insurance Corporation included--are deeply concerned with bank capitalization. The adequacy of the capital accounts presents a problem to the authorities in the case of an individual bank. Bank capital adequacy also is a problem to the authorities when they seek standard tests or criteria for guiding their decisions on this subject.

But today, because of the obligations we all have, and in which I am sure we all share a proportionate responsibility, it is my intention to discuss and stress an aspect of this subject which can never be over emphasized, namely, the relationship between bank capitalization and the deposit insurance fund. Owing to this relationship the Federal Deposit Insurance Corporation has an interest in bank capitalization that sets it somewhat apart from the other bank supervisory authorities. It is from this point of view that I shall develop my discussion.

Consideration of the relationship between bank capital and deposit insurance reveals first of all the mutuality of purpose between the capital in the banking system--made up of the capitalization of each individual bank--and the deposit insurance fund. The purpose, of course, is the protection of depositors. If bank capital and the deposit insurance fund serve the same purpose, then we are confronted with the question: Why isn't one or the other superfluous? And if neither is superfluous, what then should be the division of labor between them in achieving the common objective?

As background for developing answers to these questions, it may be helpful to recall some of the early history of Federal deposit insurance legislation. Everyone, I believe, who had a hand in preparing this legislation envisaged the immediate problem as one of restoring depositors' confidence in the banking system and maintaining it thereafter by such means as would cause a minimum of disturbance to the established pattern of our economy. In the first place, there was a consensus that most banks were reasonably well managed although many of them had experienced serious capital attrition. With the return of more or less normal times it was felt that most of them would be able to absorb the losses incidental to their operations without any assistance. Also, there was an assumption that banks insured by the Federal Deposit Insurance Corporation would continue to remain strong and well managed institutions. Presumably their capitals would be sufficient for meeting difficulties that might arise in any but the most unusual circumstances. Thus, the deposit insurance fund was viewed as a second line of defense, whereas bank capitalization together with good management was viewed as the necessary first line of defense.

By way of contrast, let us speculate for a moment on what might have been the result twenty-five years ago if the Congress had not been largely of the sentiment that the capitalizations of individual banks could be depended upon to protect the bulk of them most of the time. Two points stand our rather clearly. In the first place, it seems to me that bank management would have been drastically circumscribed if there had not been widespread confidence in the ability of banks to take care of their own troubles by means of proper capitalization. Secondly, it also seems quite clear that the deposit insurance fund would have been accumulated at a greatly accelerated rate if there had been any serious doubt as regards the basic strength of the banking system.

A few minutes ago I raised the question regarding the division of labor between the deposit insurance fund and the capitalizations of the insured banks in protecting depositors and maintaining the stability of the entire banking system. Comparison of these two magnitudes, the total capitalizations of all insured banks and the aggregate insurance fund, provides an immediate answer to the question about the necessary division of labor.

Parenthetically, let me tell you that I learned long ago that every speechmaker should present a few statistics--but certainly not too many--if he expects to gain any credit for being knowledgeable and modern.

Here are the figures that I want to bring to your attention: All insured banks have about $18 billion of capital that serves as a margin of protection for depositors. By way of contrast, the deposit insurance fund held by the Corporation totals about $1,800,000,000. In other words, the fund equals about one-tenth of aggregate bank capitalization. When these figures are placed side by side, it is obvious that the banking system itself must shoulder most of the burden involved in protecting depositors.

Now to be sure, for the purposes of this discussion I am simplifying a complicated picture of relationships that exist between bank capital and the deposit insurance fund. In addition to the capital accounts banks have very substantial reserves calculated to absorb losses that may exist in their portfolio of assets. As a matter of fact we know that the insured banks have accumulated almost $2 billion of valuation reserves for their loans. Likewise, the Federal Deposit Insurance Corporation has elements of strength in addition to the fund. The law gives the Corporation $3 billion of borrowing power at the United States Treasury. To be sure, these are important details in the picture but they do not alter the fundamental relationship between the deposit insurance fund and bank capital or the role of either in maintaining the stability of our banking system.

That responsibility for absorbing practically all of the ordinary losses growing out of day-to-day operations has been left with the insured banks should be no cause for surprise. This, you may recall, has been inherent in the deposit insurance system since its inception. Owing to the

fact that the deposit insurance fund amounts to less than one percent of the deposits in the insured banks, it follows that the fund does not have a great risk-carrying capacity. The fund was designed to be effective chiefly by stamping out banking troubles singly, as they arise, and thereby preventing the multiple growth of banking disorders to catastrophic proportions.

Deposit insurance has been provided with some technical means for reducing the potential demands that may be imposed upon the fund. In the first place, this type of insurance, like any other, will work only if obviously gross risks are excluded at the outset. This means that banks applying for deposit insurance must be rigidly screened to determine acceptability--just as individuals are subject to physical examination for life insurance. Such a screening process tends to focus on capitalization, not only because this is a vital element in reducing the risks which may be imposed upon the deposit insurance fund with the admission of the applicant to insured status, but also because it is one of the more objectively determinable elements. Others, such as the quality of the management and the prospects for the area to be served by the bank, are much more difficult to measure. Secondly, by means of bank examinations, the Federal Deposit Insurance Corporation is informed from time to time with respect to the condition of the insured banks.

Not only does the examination process furnish the information necessary for the Corporation to evaluate changes in its risk exposure, but in addition, the groundwork is laid for a remedial effort. By means of education and persuasion the staff of the Corporation is constantly engaged in an effort to bring about improvements in banking operations. With the cooperation of the bankers, this positive and constructive effort is probably our most effective tool for making deposit insurance work. Finally, the Corporation has no alternative but to follow a rigorous policy of eliminating unsafe and unsound banks from the deposit insurance system. The deposit insurance fund cannot afford to protect depositors in banks that are chronically unhealthy.

The statutory maximum coverage of $10,000 per depositor provided by Federal deposit insurance is further evidence that the fund should not be expected to carry the risk inherent in the full protection of all bank deposits. In the insured banks, the capital margin together with the deposit insurance fund protects deposits both within and outside of the statutory maximum coverage. However, the responsibility for protecting deposits in excess of the statutory maximum--regardless of how desirable it may be for the Federal Deposit Insurance Corporation to do so--rests solely upon bank capitalizations. That the deposit insurance fund now is too small to assume full responsibility for all deposits cannot be emphasized too strongly, in my opinion.

Bank capitalization has other responsibilities in addition to being the sole protection for excess deposits. For example, the continuity of banking services during periods of economic adversity can be maintained

only if there are strong, well managed and adequately capitalized banks in existence. Such banks must be prepared to accommodate the deposit increases resulting from the flight of funds from less well fortified banks in the course of financial storms. Often it has been necessary in bad times for these well managed and strongly capitalized banks to assume liabilities and engage in salvaging the assets of failed or failing banks as part of their day-to-day work. Many of you, I am confident, have memories of the inadequate banking services that developed as an outcome of the great depression. There were bankless towns as well as many communities in metropolitan areas that were not well served with banking facilities. Strong and well capitalized banks can do much to prevent such situations from developing.

By now perhaps some of you are beginning to wonder whether I believe that deposit insurance can make any really significant contribution either to the banking system or to the protection of depositors. Let me respond to your misgivings by raising two questions: Is the deposit insurance fund really as small as it appears to be? Does its contribution to the protection of depositors weigh in amount only as a very small fraction of aggregate bank capitalization? The answer to both of these questions is definitely "no". The dollars making up the deposit insurance fund are high powered for purposes of protection because they are extremely mobile. They can be moved to the point of need promptly when trouble arises. There they may be used to take the place of weak assets in banks experiencing difficulties or to pay off depositors immediately and thereby maintain their confidence in the banking system. This is a condition that is essential for the support of business activity required to sustain the economic life of a community.

Bank capital, on the other hand, cannot leave the institution to which it pertains. In contrast to the resources of the insurance fund, bank capital lacks mobility. Furthermore, even when the deposit insurance fund is used to acquire the assets of a failing bank--unless the items prove to be worthless--the dollars are not entirely consumed thereby. In these circumstances a portion of the fund is invested for a longer or shorter period in assets the bulk of which may be expected to return to cash under an orderly liquidation process. Losses there will be, of course, but experience has demonstrated that by adhering to sound procedures in managing a liquidation, these losses can be greatly minimized. Thus, the deposit insurance fund revolves through a cycle from cash to the assets acquired from a failing bank and then back to cash again. So there is a built-in self-replenishment feature.

Nevertheless, even when account has been taken of these special attributes which lend unusual potency to the resources of the deposit insurance fund, the fact remains that troubles in only a few of the larger insured banks--or even one of the few giants--would completely exhaust or so decimate the entire fund that it would become virtually ineffective. Constant vigilance on the part of the various supervisory authorities (including the Federal Deposit Insurance Corporation) as provided by the

examination procedure is the primary shield against such misfortunes.

By coping with banking difficulties promptly, the deposit insurance fund can forestall liquidation of bank assets that occurs inevitably when depositors make unreasoned demands for their funds. Demands of this nature force even good banks literally to tear themselves apart. In any community asset values can be sustained only when there is not an abnormal amount of property forced on the market for sale. The panic demands of depositors leveled at banks when they seek to withdraw funds trigger a chain reaction that causes these same banks to liquidate good assets and to restrict their credit operations. These restrictions in turn force borrowers to liquidate and at times and on terms that wholly disregard the continuity of business operations. The Federal Deposit Insurance Corporation is able to mitigate or avoid troubles of this nature.

It is entirely within the capabilities of the deposit insurance fund to prevent the forced liquidation of assets when a bank gets into difficulties. To mention a few of the tools available, the protection of depositors may be accomplished by facilitating the assumption of the deposit liabilities of the bank in trouble by another one that is stronger and better capitalized, by the immediate payment of all insured deposits, or by using the Corporation's authority to make a subordinated deposit and thereby to alleviate the pressures temporarily impinging on an individual bank. Any of these procedures makes forced liquidation unnecessary. The business community, accordingly, is stabilized when depositors find that they have access to their funds and there is no unreasoned pressure for the liquidation of assets. Furthermore, banks that are not in trouble benefit directly and immediately from the by-product effect of sustaining the asset values in their portfolios.

So now let me repeat for purposes of emphasis that the deposit insurance fund does relieve bank capitalizations from many of the heaviest pressures that hitherto have made the burden almost impossible to carry. The fund can be expected to put out the brush fires of banking disorders that tend to break out among the weakly situated banks. Carrying this analogy a step forward, by keeping these brush fires under control, major conflagrations can be avoided. Finally, the deposit insurance fund provides a mechanism for an orderly liquidation of assets obtained from failed banks.

What, then, does all this have to do with bank capital and deposit insurance? In my opinion, this is the heart of the matter. There is a mutuality between the size of the deposit insurance fund and the aggregate amount of bank capital that up to now has not been stressed sufficiently. Deposit insurance has worked because it does not have to do the entire job--bank capital carries a good share of the load. With the background of banking troubles in the 1920's and the collapse of the system in the early 1930's, banks now would require much larger capital accounts if it were not for the existence of the deposit insurance fund. Conversely, an insurance fund of the present magnitude would not do the job if bank

capitalization were any narrower than it is. The aggregate capital of banks and the dollars in the deposit insurance fund are linked together in a ring of mutual dependence. Viewed in terms of depositor protection, neither capital nor the fund is superfluous--they are inter-related and inter-dependent.

To sum up, then, we need strong, well capitalized banks to the end that all deposits--not only the portion within the maximum of insurance coverage--are protected, to insure the continuity of banking services, and to provide the banking leadership needed when weak banks fall by the wayside. It is a fact that the deposit insurance fund and bank capital have different attributes. While not substitutable dollar for dollar, they are complementary. The capital funds of the banking system must be sufficient to cut down the risk exposure of the insurance fund to manageable proportions. Moreover, well capitalized banks must be widely distributed throughout the system so that the Corporation may stretch its resources when necessary by calling upon stronger institutions to assist in maintaining the continuity of the banking system and to help with the salvaging of weak banks. Finally, by nurturing public confidence in banking, the Corporation can minimize losses from forced liquidations associated with panic runs. The deposit insurance fund and the capital of the insured banks are dedicated to a common objective, but the two are so interconnected that one cannot be successful without the success of the other.