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"THE ROLE OF DEPOSIT INSURANCE"

Address of

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Before the

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Madison, Wisconsin

September 5, 1958

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Madison, Wisconsin

Basic Economic Problems

First Year

John H. Wills, Section Leader

Lecture on

The Role of Deposit Insurance

by

Jesse P. Wolcott, Chairman

Federal Deposit Insurance Corporation

Washington, D. C.

September 5, 1958

THE ROLE OF DEPOSIT INSURANCE

This is the eighth year that "the role of deposit insurance" has been included in the course on Basic Economic Problems in the curriculum of your school of banking. During this time different aspects of deposit insurance have been presented, directed more or less toward matters that had particular interest or significance at the time. Back in 1951, when deposit insurance was first included in your course, the theme was "Strengthening the banking system in prosperity." Today it seems appropriate to take as a theme, "Deposit insurance as a stabilizing influence during recession."

For almost a year our economy has been operating at something less than its full capacity. The peak from which the slide started was reached in July or August of 1957, just a little over a year ago. During the past winter and spring many of the measures of economic activity reached a low point from which several of them have moved upward during the summer. These encouraging developments, however, must be extended and accelerated before we can be satisfied that they indicate general recovery.

The past year has been one of severe adjustment for many industries and individuals. With automobile and steel production at almost half of recent peak levels, numerous smaller industries operating below capacity, and unemployment above five million, it has been a time of hardship for many and anxiety for millions more. Yet, in this atmosphere of recession, there has been no concern about the soundness of

our banks or the safety of bank deposits, the major component of our money supply.

Our banking system has not been upset or seriously disturbed by the blows that have hit different parts of our economy. Prepared to adjust to changes in supply and demand relationships without bringing about credit liquidation and monetary deflation, it has helped lay the basis for an early resumption of our economic advance. Many things have gone into the making of this fine record, and we like to think that deposit insurance is one of them.

The recession of the last 12 months is a type of situation in which deposit insurance is particularly helpful. Though deeper in some respects than the recessions of 1948-49 and 1953-54, it has been less severe than the recession of 1937-38, and, of course, is not to be compared with the debacle of 1932-33. During this recession there have been only seven bank failures, four of them of banks insured by the Federal Deposit Insurance Corporation. This period provides an illustration of the Corporation's role in limiting the effects of bank failure in an atmosphere of economic decline.

In three of the insured banks which have failed since the recession began depositors have been paid the amount of their deposits up to \$10,000, and those with deposits in excess of \$10,000 will share in receivers' dividends as these become available. The other insured bank which failed was taken over by a neighboring insured bank, with the financial assistance of the Corporation, thereby assuring each depositor full protection regardless of the amount of his deposit.

Depositors of the three noninsured banks which have failed during the past year have, of course, lacked the protection of the Federal Deposit Insurance Corporation. They stand to lose whatever is not recovered through the respective receiverships; and even if some of them eventually recover the full amount, they will have been deprived of the use of their deposits for varying periods of time. However, it is probable that the very existence of deposit insurance, though not applicable to these banks, has served to limit the impact of their failure. For the insurance enjoyed by depositors of other banks has an insulating quality which averts panicky runs and inspires confidence.

During the last several years a majority of the failures of insured banks have been due to defalcations of various kinds. Presently we are beginning to feel the influence of the deterioration of assets under the impact of adverse business circumstances. Deposit insurance has the responsibility of reducing the impact of bank failures, whatever their cause. However, banks themselves have a particular responsibility in preventing defalcations and other internal abuses which may lead to failure, a responsibility recognized in the fidelity bonds they carry. They also have an obligation, in meeting demands for credit, to make a prudent selection of assets. When insured banks have not made adequate provision against defalcations, or where they encounter losses in their operations severe enough to cause insolvency, the Corporation is obliged to step in to protect depositors. The Corporation has the further responsibility of cushioning the impact of failures due to economic developments beyond the control of individual banks.

Cushioning the impact of bank failures entails more than the psychological factor resulting from the protection we give depositors against loss. It requires also that deposits be made available promptly. In most receivership cases involving insured banks, deposits are available within a couple of weeks, while in assumption cases there is ordinarily no interruption of banking services. It is with good reason that the Federal Deposit Insurance Act specifies that payment of insured deposits shall be made "as soon as possible," even should it be clearly apparent on the date of failure that depositors, in the absence of insurance, would receive full recovery at some future date from the proceeds of liquidation of the bank's assets. The reason for this directive, as I have indicated, is that deposit insurance is intended not merely to protect depositors against loss, but also to restore, up to the insurance maximum, these bank deposits in order that they may continue to play their part in maintaining the flow of goods and services.

Banks are peculiar institutions. They are different from other businesses and industries. Through the creation of deposits they supply by far the major part of our circulating medium. While the issue of money is a function for which the Federal Government is responsible under our Constitution, this function has been in effect largely delegated to our banking system. To permit banks to create deposit money is to invest them with great responsibilities, and these responsibilities become particularly evident in the event of bank failure. If a retail store or a small manufacturing firm fails, employees may be without work and investors may lose their capital, but the impact on the community may be cushioned by employment opportunities

in other enterprises. However, if a bank fails, and especially if it is the only bank in the immediate area, the entire community is affected. It is the responsibility of the Federal Deposit Insurance Corporation to quickly restore deposits made temporarily unavailable by bank failure.

The deposits of the seven banks which have failed during the last year totaled around \$10 million. They could not by themselves be considered to have much economic significance--except, of course, to the individuals directly concerned. But had there been no deposit insurance, the consequences might well have been troublesome. Consider the spark of doubt which might have been ignited in seven widely separated States--Georgia, Kansas, New Hampshire, New Jersey, Ohio, Oregon, and Texas. Sweeping from community to community, and fed by rumor and mounting panic, doubt and fear could quickly have weakened the web of confidence that sustains our banking system. Circumstances such as these, prior to FDIC, contributed to the contraction of recessions into depressions and depressions into panics.

After all, it is confidence that sustains our banking system. If all creditors tried at the same time to collect what was owed to them, our economic system would become hopelessly snarled. Fortunately, this is not likely to happen, for every day in many ways we show our confidence. Every industry has a stake in maintaining public confidence, but none so large a stake as banking. For banks deal in promises, not in goods, and confidence is the essential element in every promise. Federal deposit insurance has done a great deal to foster the confidence that is so vital to the American banking system.

A patient who had to make frequent trips to his doctor would not ordinarily be considered a good medical risk. Nor would a banking system which had to call frequently upon its insurer be considered a prime financial risk. It is therefore important that the Corporation should do whatever it can to minimize the calls upon it as guarantor of deposits. This it can do most directly by promoting strong banks and sound banking. These are responsibilities which it fulfills by withholding insurance from banks which do not meet statutory requirements and by examinations of banks already insured.

The requirements which banks must meet in order to become insured are clearly specified in the Federal Deposit Insurance Act. The Corporation is required to give consideration to the adequacy of the bank's capital, its future earnings prospects, the quality of its management, and its usefulness in serving the convenience and needs of the community. Application of these criteria, made in cooperation with the chartering authorities, has tended to prevent the opening of banks entailing a high risk of failure.

Once banks are insured, the Corporation seeks to reduce its risk by regular examinations. It may terminate a bank's insurance if, after prescribed procedures, it persists in unsafe and unsound banking practices. This ultimate sanction has been used sparingly, as most banks charged with unsafe and unsound practices, or violations of law, cooperate in making corrections. Examinations have come to comprise the bulk of the Corporation's work, and through them the Corporation has exerted considerable influence upon the character of banking.

Notwithstanding the best efforts of the Corporation, along with those of other bank supervisory agencies, banks do fail. Mistakes in judgment are bound to occur so long as we have a changing, growing economy; and to the extent that banks provide credit to keep our economy going, they subject themselves to error and to the possibility of losses severe enough to produce insolvency. The private enterprise system which we extol and support must include as an incident the right to make mistakes, and the decisions of the market must sometimes lead to failure.

As bank supervisors we may be tempted to impose our views of what is proper and correct, and we do carry a heavy responsibility to police insured banks. However, we try never to forget that it is less the job of the Corporation to prevent bank failures than to cushion their impact, and that to attempt to do otherwise by arbitrarily substituting our judgment for that of each of thousands of bankers would violate this Nation's most revered principles.

We noted earlier that the first step in cushioning the impact of the occasional bank failure is to make deposits available promptly. It is possible for the Corporation to do this only because it can, in effect, "stand in" for bank creditors, and can wait for whatever reimbursement may in time be made. This procedure avoids the pressures for hasty liquidation which formerly characterized bank failures. Rights of depositors are transferred either to the Corporation or to a receiver appointed by the State, which then handles whatever assets are acquired in the manner best calculated to preserve values, avoid disruption of markets, and maximize recoveries.

During its nearly 25 years of operation the Corporation has provided funds in order that the deposits of 436 insured banks could be paid to the insured limit or transferred in full to another insured bank. These banks have had about 1,400,000 depositors and total deposits approaching \$600 million. Less than one-half of 1 percent of these deposits have been lost by depositors; and the Corporation has recovered all but about one-tenth of its disbursements in these cases. It is thus evident that when banks have failed, deposit insurance has been highly effective in preventing the destruction of that part of the money supply represented by bank deposits. It has accomplished this with relatively small loss to depositors or to itself.

It is hoped that this experience might be projected into the years ahead. The record has been getting progressively better. In the 25 years before deposit insurance, bank failures averaged about 640 a year. From 1934 through 1942, as we recovered from depression and cleaned up from the banking collapse of 1932-33, failures averaged a little over 50 a year. Since 1942 the average has been about 4 a year, or slightly less than the number experienced during the last 12 months. Naturally, not all of the credit for this improvement can go to deposit insurance. But we do believe that the number of failures during recent periods has been smaller than it would have been in the absence of such insurance.

What about the future? The Corporation, of course, cannot divorce itself from developments in our economy generally. Sometimes it seems that we have entered a new era where depressions are avoided and

bank failures almost eliminated. Yet history has a habit of repeating itself and, taking the long view, we are never far from the reminder that the deposit insurance fund could be called upon to make disbursements for the protection of depositors far in excess of anything we have experienced to date. We have only to recall that the eight States operating deposit insurance plans early in this century, after what appeared to have been a successful beginning, were unable to cope with the banking disorders of the 1920's and early 1930's. Rememberance of things past, however, is not submission to despair but a call to vigilance. If we take the precaution to see that the deposit insurance fund continues to grow at least as rapidly as the deposits it insures, we should be able to meet any situation that is likely to arise.

For the immediate future, there is no reason to expect the experience of the Corporation and the demands made upon it to differ significantly from the recent past. The downward trend in our economy seems to have been reversed, and it appears that we have again prevented a relatively mild readjustment from developing into a severe depression. Banking has been one of the strongest segments of our economy, just as it was in the other two postwar recessions. Bank failures have not caused widespread destruction of our money supply, as in all depressions preceding the establishment of the Federal Deposit Insurance Corporation. By eliminating the historical instability of our banking structure, we have given our system of individual liberty and competitive business enterprise an opportunity to demonstrate its flexibility and responsiveness to changing conditions and changing times. The role of deposit

insurance, then, is to act as a stabilizing influence on banking and thus to contribute to business stability. We are determined that the Federal Deposit Insurance Corporation shall do its job well.