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BANK OF

CLEVELAND

ANNUAL REPORT 1985

Our 1985 Annual Report examines the March 1985 crisis of privately insured savings and loan associations in Ohio, outlines the history of the event, and discusses its short- and long-term effects. The crisis was a very important incident in the Fourth Federal Reserve District during the past year, and eventually proved to be the forerunner of private deposit insurance disturbances elsewhere in the United States. As of this writing, the importance of the questions raised by the crisis has generally diminished outside the Fourth District, but the unsettled condition of some financial institutions and markets elsewhere creates an ongoing possibility that those questions could become important once again.

THREE
The President's Forward

FIVE
Unfoldings in Ohio: 1985

TWENTY·FIVE
Directors

TWENTY·SIX
Comparative Financial Statements

TWENTY·EIGHT
Officers

Karen N. Horn, *President*

While 1985 provided the Federal Reserve System with many challenges, the events surrounding the closing of 70 privately insured savings and loan associations (S & Ls) in Ohio were unique for the Federal Reserve Bank of Cleveland.

Federal banking supervisory and regulatory agencies, including the Federal Reserve, generally do not have direct supervisory responsibility for state-chartered, nonfederally insured depository institutions. However, because of the Federal Reserve's concern with financial markets, the Federal Reserve Bank of Cleveland was an active participant in the resolution of the March 1985 Ohio S & L crisis. Throughout the crisis, the Federal Reserve Bank of Cleveland assisted the state of Ohio and the federal supervisory and insurance authorities in solving many problems. The 1985 Annual Report essay, "Unfoldings in Ohio: 1985," discusses the events surrounding the crisis, the Federal Reserve's involvement, and some of the issues raised by the crisis.

My most lasting impression of the crisis is how quickly depositors' confidence plummeted at the privately insured institutions. The Federal Reserve Bank and commercial banks shipped currency to institutions that were experiencing heavy withdrawals, but cash alone was not enough to restore confidence. The further public confidence fell, the more difficult the problem became to solve. Without depositors' confidence, even the best-capitalized financial institution can be severely affected.

The scenes of the crisis were constantly shifting and were far-flung. The problem began in Cincinnati at Home State Savings Bank. The action soon shifted to Columbus, where the Governor and state legislature grappled with legislative solutions to the crisis. Cleveland was the site of discussions and negotiations among state officials, bankers, and thrift industry representatives. When it became clear that federal insurance would be a part of the solution, the focus of attention became the Federal Home Loan Bank Board, the Federal Savings and Loan Insurance Corporation, and the Federal Deposit Insurance Corporation, all in Washington, D.C. The events of March dominated the news in Ohio and also had a brief impact on world financial markets.

Containing and solving the crisis required the cooperative efforts of many individuals. The employees of the Federal Reserve Bank of Cleveland worked many long hours, and we received a great deal of support from the entire Federal Reserve System. Every Federal Reserve Bank in the System sent bank examiners to Ohio to assist in the examinations required to qualify the closed S&Ls for federal deposit insurance. Employees of the Federal Reserve System demonstrated creativity and responsiveness, and proved that they have the knowledge and skills to deal quickly and effectively with complex, emergency situations. Throughout this period, the Federal Reserve Bank of Cleveland worked closely with the Federal Home Loan Bank of Cincinnati. We shared information and staff in a cooperative effort to deal with problems and to fashion solutions.

The Bank also benefited greatly during 1985 from the collective experience and judgment of its outstanding group of Directors. Their broad-based experience and judgment helped guide the Bank through a year of many accomplishments. I extend my special appreciation to the Directors who completed terms of service in 1985: John W. Kessler and Lewis R. Smoot, Sr. of our Cleveland Board; Clement L. Buenger of our Cincinnati Board; and A. Dean Heasley and Robert S. Kaplan of our Pittsburgh Board. The Bank also will miss the services of Milton G. Hulme, Jr., the Chairman of our Pittsburgh Board, who passed away on August 5, 1985.

Finally, I want to take this opportunity to extend a personal thank you to the officers and staff of the Federal Reserve Bank of Cleveland. I am grateful for your efforts and dedication during the Ohio S&L crisis and throughout the year.

Sincerely,

Karen N. Horn

Karen N. Horn
President
April 11, 1986

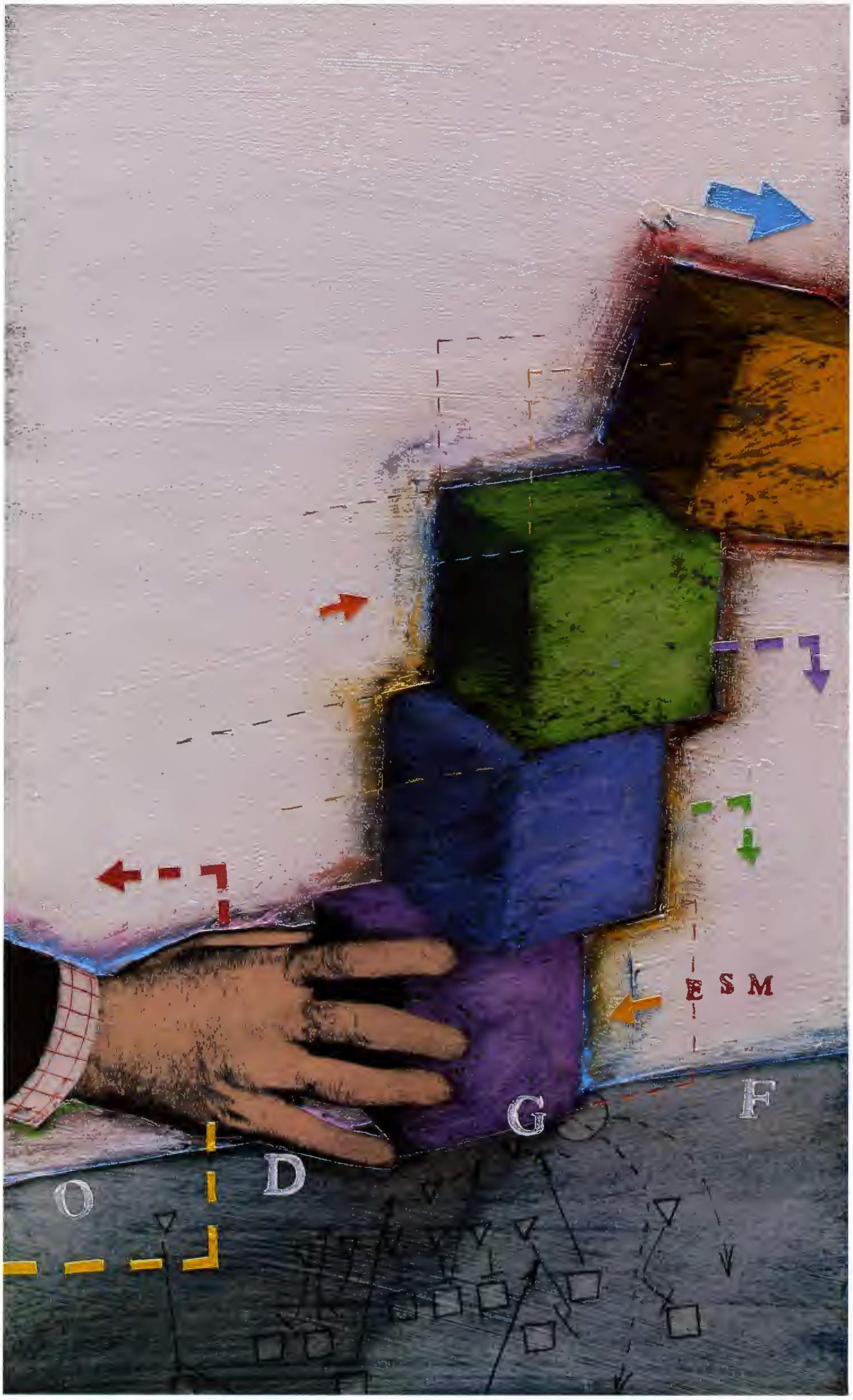
HISTORY—ESM Government Securities, Inc., a Fort Lauderdale, Florida, government securities dealer, closed its doors forever on March 4, 1985. As a result, Home State Savings Bank of Cincinnati, Ohio, immediately faced approximately $145 million of potential losses on its dealings with ESM. Those losses exceeded the combined value of Home State's capital, plus the total $130 million of deposit insurance assets available for statewide use in the Ohio Deposit Guarantee Fund (ODGF).

Home State was the largest member of ODGF, which was an independent, private, mutual deposit insurance fund chartered under Ohio law.[1] Most of the ODGF's funding came from deposits made by insured savings and loan associations equal to two percent of their insured deposits. These two percent deposits were reported as assets by the insured institutions in their statements of condition. Apart from Home State, the ODGF insured approximately $3.6 billion worth of deposits on a statewide basis. Home State had $672 million worth of deposits insured by ODGF and had reported assets of $1.439 billion (December 31, 1984). However, $670 million of these assets actually were claims for securities lent to ESM. By March 11, 1985 it became apparent that all remaining assets of the ODGF would have to be used to cover the losses of Home State. This would deplete the entire ODGF insurance fund and would inflict losses on each of the remaining 68 savings and loan associations that were members of ODGF.

Later, it became clear that loss of the two percent deposits that these member institutions had made with ODGF would also exhaust the net worth and render technically insolvent at least six of the 68 institutions. Approximately one-third of the composite net worth of the 68 ODGF-insured institutions would also be eliminated. Thus, instead of reassuring depositors as to the safety and availability of their deposits, the ODGF emblem became a signal to many Ohio savings and loan depositors that funds should be withdrawn as quickly as possible.[2]

1. The ODGF covered 70 institutions, two of which were Home State and its Dayton, Ohio, affiliate. Apart from Home State, there were 68 other ODGF-insured institutions.

2. The ODGF emblem prominently displayed the legend "All deposits guaranteed in full."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During the week of March 4-8, 1985, runs developed at Home State, with net withdrawals of approximately $154 million.[3] Home State offices were scheduled to open on Saturday, March 9, but its officers decided not to reopen after Friday, March 8. A conservator for Home State was appointed on Sunday, March 10. Runs began at some other ODGF-insured institutions on Monday, March 11. By Thursday, March 14, extensive runs were reported at six Cincinnati-area ODGF-insured institutions. Moderate runs were also reported at approximately six other Cincinnati-area institutions, at scattered locations throughout southern Ohio, and as far north as the Columbus area.

3. For purposes of this essay, a "run" is defined as a loss (net withdrawal) of more than one percent of total deposits per banking day that cannot be explained by seasonal or other factors unrelated to depositors' confidence.

The daily deposit outflows at the seven most affected Cincinnati-area institutions were as follows: March 11, $6 million; March 12, $13 million; March 13, $23 million; March 14, $60 million. The runs were limited to ODGF-insured institutions and never materially affected deposit flows at federally insured savings and loans, credit unions, or commercial banks in Ohio during the critical two weeks in mid-March 1985.

In an attempt to allay the fears of depositors at ODGF-insured institutions, a bill was enacted on March 13 authorizing establishment of a new Savings Association Guarantee Fund ("ODGF-II"), to be funded by a new levy on ODGF-insured institutions equal to one percent of insured deposits. The new deposit with ODGF-II was expected to raise approximately $40 million and was to be combined with an emergency loan of $50 million of state funds. By Friday, March 15, when the remaining ODGF-insured institutions met in Columbus to organize and fund ODGF-II, it was too late: the ODGF-insured institutions already were closed, and the confidence of many depositors already was lost.

Governor Richard F. Celeste proclaimed a mandatory, 3-day closing of all ODGF-insured institutions shortly after dawn on Friday, March 15. Two ODGF-insured institutions in eastern Ohio, which previously had been unaffected during the crisis, remained open for business. However, runs developed at both institutions, and they closed in the early afternoon in response to direct requests from the Governor's office.

During the weekend of March 15-17, bankers met with state officials at the Federal Reserve Bank of Cleveland to consider proposals for purchases of ODGF-insured institutions. Those meetings were arranged with the hopes that a solution to the crisis would emerge by Monday, March 18, and that the closing proclamation would not have to be extended. Those hopes were not realized. Neither the state officials nor the bankers had access to enough information about the current condition, and particularly about the quality of assets, of the ODGF-insured institutions to make reasonably informed proposals for the purchase of any or all of those institutions. The out-of-state bankers, in particular, might have been willing to pay premiums for the right to enter Ohio, but not without a guarantee from the state against loss, and only with sufficient knowledge of the asset portfolios of the ODGF-insured institutions. The lack of a state guarantee and of sufficient knowledge of the asset quality of the ODGF-insured institutions also had been an insurmountable obstacle to the sale of Home State a week earlier.

As a result of the failure to find a solution, the closing proclamation was extended for another two days, through Tuesday, March 19. By now, the lack of viable proposals for the sale of ODGF-insured institutions made it difficult to assume that many of them could reopen promptly. A prompt reopening would require that they either obtain their own federal deposit insurance or reopen under the umbrella of another institution's federal deposit insurance. By March 18, moreover, it was clear to state officials that federal deposit insurance had to be an essential element of any lasting solution to the crisis.

The Ohio legislature helped resolve the crisis by enacting emergency legislation during the night of March 19-20. Governor Celeste and the bipartisan leadership of the state legislature assured the general public that ODGF-insured institutions were sound or would be made sound with the assistance of the state of Ohio, that they would eventually reopen fully, and that they would be converted to federal deposit insurance. At 3 a.m. on Wednesday, March 20, Governor Celeste signed into law the act that specified conditions under which an ODGF-insured institution could reopen for business. On March 20, a few institutions reopened with federal deposit insurance. The emergency act authorized partial reopenings for limited withdrawals not in excess of $750 per month per depositor's account, which was later increased to $1,000 per month. On Thursday, March 21, a few ODGF-insured institutions partially reopened for limited withdrawals. By Monday, March 25, 59 of the 68 ODGF-insured institutions, other than Home State, were open for at least partial withdrawals.

The generalized loss of depositors' confidence in the formerly ODGF-insured institutions began to abate after the weekend of March 23-24. Apart from longer-than-normal lines of customers on the first day or two of the partial reopening of some institutions, the difficult atmosphere that prevailed during the preceding two weeks disappeared.

Extensive efforts by state, Federal Reserve, Federal Deposit Insurance Corporation (FDIC), and Federal Home Loan Bank examiners soon began to confirm that a substantial majority of ODGF-insured institutions were fundamentally sound and could have viable futures. Federal Reserve examiners played a key role in this effort; approximately 60 examiners from the Federal Reserve Bank of Cleveland and 100 examiners from all the other Federal Reserve districts participated in this review. After March 22, the bulk of the qualifying

examinations for federal deposit insurance were conducted by Federal Home Loan Bank examiners. During the last two weeks of March 1985, 26 of the ODGF-insured institutions reopened fully, having qualified, with minor changes in financial structure, for federal deposit insurance. Most of the rest that required no state financial assistance reopened fully during April 1985.

Resolving the problems of Home State and approximately 20 other ODGF-insured institutions that were in poor financial condition required two more months of supervisory effort. This amount of time was required, in part, by the lack of knowledge of their current financial condition. Some ODGF-insured institutions clearly were in worse condition than at the time of their last state examinations prior to March 1985. Also, when it became clear that out-of-state bank holding companies could become a part of the solution to the crisis, state officials then required more time than previously expected to discuss and debate the implications of altering the nature of competition in Ohio banking markets.

On May 21, the legislature enacted a law that authorized out-of-state acquirers of Home State, and other ODGF-insured institutions with a minimum aggregate amount of $400 million of deposits, to operate those institutions under a commercial banking license. Chase Manhattan Corporation acquired six ODGF-insured institutions with total deposits in excess of $450 million and received an Ohio commercial banking license. Chemical New York Corporation, parent of Chemical Bank, submitted what appeared to be the winning bid for Home State, but American Financial Corporation, Cincinnati, parent of Hunter Savings Bank, outbid Chemical by $5 million on the seventh and final day allowed for consideration of bids on Home State from Ohio institutions. Meanwhile, Home State's depositors had no access to their funds, not even for limited withdrawals, until June 14, when the 33 offices of Home State were reopened.

As of this writing, one small formerly ODGF-insured institution ($58.6 million of deposits at year-end 1984) still has not reopened fully, but all other ODGF-insured institutions, including Home State, were fully open by January 3, 1986. Forty-four ODGF-insured institutions eventually received full or conditional approval for federal deposit insurance. Twenty-five institutions, including the two Home State entities, were merged into or acquired by other institutions and disappeared as independent savings and loans. The smallest ODGF-insured institution was authorized to reopen while applying for Federal Savings and Loan Insurance Corporation (FSLIC) insurance. Of the merged institutions, Chase Manhattan acquired six, and Home Savings of America, Los Angeles, California, acquired four.

During the crisis, some federal bank supervisory officials believed that failure to contain the loss of thrift institution depositor's confidence in Ohio would have adverse consequences in other states with private deposit insurance plans. In fact, the March 1985

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Ohio crisis did have serious repercussions for depositors' confidence in private deposit insurance funds in other states. During March and April 1985, supervisory officials in other states with private deposit insurance funds made public statements resisting the idea that "the Ohio problem" could spread to their states because, they said, the circumstances in Ohio were unique. Ripples from the crisis eventually reached another state (Maryland), and the crisis was a principal factor in persuading officials in four states (Maryland, Massachusetts, North Carolina, and Pennsylvania) to require federal deposit insurance to protect their own institutions. The Ohio crisis thus emphasized the importance of federal deposit insurance, which proved to be a stable bulwark against a more generalized loss of retail depositors' confidence.

BACKGROUND—As the March 1985 crisis unfolded, ODGF-insured institutions then included a large number of small institutions, most of which were conservatively managed, as well as a small number of much larger institutions, most of which were aggressively managed. Ohio savings and loan industry leaders organized the ODGF in 1957, with the original purpose of providing deposit insurance protection for institutions that were considered too small to require or, in some cases, even to qualify for federal deposit insurance. Later, as the ODGF-insured institutions grew, it became convenient for some of the larger institutions to maintain the ODGF as their only deposit insurer. ODGF insurance was superficially less expensive than federal deposit insurance. This was because the ODGF-insured institutions could (and did) report their two percent deposits with the ODGF as assets, while federally insured institutions must report their deposit insurance premiums as current expenses. Also, operating within the ODGF enabled its members to take advantage of a less-binding set of restrictions on the powers of savings and loans than would have been possible under the supervisory structure of federal deposit insurance.

For example, three ODGF-insured institutions offered 10 percent for passbook savings accounts, while federal regulations limited the interest payable on such accounts at FSLIC-insured institutions to 5.5 percent. Five other ODGF-insured institutions, including Home State, were offering passbook rates of at least 8 percent when the March I985 crisis began; 33 more ODGF-insured institutions were offering at least 5.75 percent. Thus, 41 of 70 ODGF-insured institutions were offering more than the maximum interest rate for FSLIC-insured institutions for passbook savings accounts. This competitive edge had enabled some of the largest ODGF-institutions to expand and, in some cases, to take imprudent risks.

One interesting question is raised by the March 1985 Ohio crisis: should depositors who had the advantage of the extra returns offered by ODGF-insured institutions have had the same protection as depositors whose federally insured institutions were prohibited from offering comparable returns? Eventually, customers of all but three of the ODGF-insured institutions received 100 percent availability of their deposits within six months after the crisis began. Complete availability of deposits was achieved at two of those three institutions by year-end. It may be said that the depositors of ODGF-insured institutions were exempted from the discipline of the marketplace by receiving the benefits of federal deposit insurance, after the fact, without having paid directly or indirectly, the *costs* of federal deposit insurance. Another interesting question raised by the crisis is whether or not shareholders should suffer the discipline of the marketplace. Most ODGF-insured institutions were mutual institutions, but several were stock institutions. With the exception of Home State and two other stock institutions placed in receivership in July 1985, shareholders of ODGF-insured institutions emerged from the crisis enjoying the benefits of the same, free, federal deposit insurance as depositors.

After the closing of Home State, the Federal Reserve Bank of Cleveland began to monitor depositors' activity at virtually all the ODGF-insured institutions. The purpose of this activity was to be certain that up-to-the-minute, accurate information about runs


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always was available so that decisionmakers would not have to rely on rumors. Subsequently, to acquire more information, the state requested that the Reserve Bank provide on-site examiners to quickly evaluate the underlying financial condition of ODGF-insured institutions. Examiners from the Federal Reserve Bank of Cleveland played a key role by helping to provide vital information to state and federal officials.

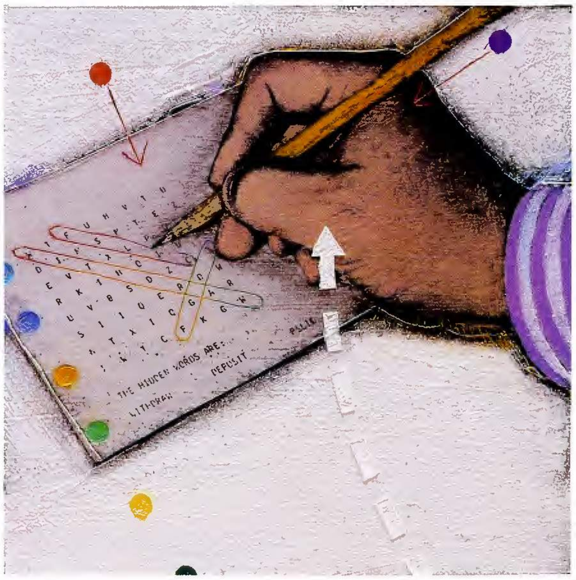
Another role of the Federal Reserve Bank was to provide all the currency that ODGF-insured institutions requested. The Reserve Bank made 174 currency deliveries to Home State offices between March 6 and 8, and 77 currency deliveries to the other ODGF-insured institutions between March 14 and 29. Also, commercial banks, particularly in the Cincinnati area, were cooperative in providing currency shipments to the ODGF-insured institutions. The Reserve Bank made daily telephone calls to all ODGF-insured institutions to make certain that they would have sufficient currency on hand to meet any foreseeable runs. As the withdrawals increased, however, state officials and representatives of the ODGF-insured institutions expressed the reasonable concern that a prolonged effort to finance the runs would cause sound ODGF-insured institutions to suffer serious financial damage, along with the insolvent institutions.

Once Home State closed, a variety of new problems quickly arose. For example, until adequate information became available, the supervisory authorities often had to make decisions based on assumptions that later proved false. It was reasonably clear early on, even prior to March 9, that Home State was insolvent, but no one had a reasonably accurate estimate of the extent of Home State's insolvency until April 1985, when potential out-of-state purchasers, particularly Chemical Bank, examined Home State's books and submitted estimates to the state of Ohio regarding the assistance required to reopen the institution.

Consequently, throughout March and April, plans to reopen Home State had to be constantly reevaluated and revised as more information became available. This lack of knowledge extended, with similar consequences, to many of the other 68 institutions besides Home State. If enough of them were insolvent, then their losses might exceed the resources of ODGF-II, which was the remedy that the state initially proposed. In fact, later examination of data provided to the Ohio Superintendent of Savings and Loans indicated that nine ODGF-insured institutions, in addition to Home State, were insolvent on the basis of generally accepted accounting principles. Another five institutions had net worth equivalent to less than 0.6 percent of assets. When the loss of those institutions' original two percent deposits with the ODGF was taken into account, all five of the low-net-worth institutions, plus two more, were insolvent. In all, 16 of the remaining 68 ODGF institutions were insolvent under generally accepted accounting principles, once loss of the original two percent deposits with the ODGF was taken into account.

If federal deposit insurance was to be the answer for the ODGF-insured institutions, it became clear that they would have to meet the minimum net worth and other requirements for FSLIC insurance. Many of the ODGF-insured institutions seemed unlikely to be able to meet these requirements on their own. In any event, the process of qualifying for federal insurance clearly was going to require additional time for thorough financial examinations. Also, additional time clearly was going to be required for raising new capital and for making structural changes necessary to comply with federal deposit insurance requirements.

As the confidence of depositors in ODGF-insured institutions deteriorated after March 4, 1985, the range of options available to state officials to deal with the crisis narrowed. At the same time, the need to achieve some form of containment of the crisis grew as the possible repercussions for national and international financial markets became more worrisome. The news of the Ohio moratorium caused the dollar to decline approximately two to three percent in the foreign exchange markets on Monday, March 18, 1985. The decrease in the value of the dollar followed national publicity on the Governor's proclamation of the moratorium, not publicity on the runs that preceded the moratorium. Also, the price of gold increased three percent and the price of silver increased five percent that day.



Ohio residents immediately were aware of the runs at ODGF-insured institutions because of coverage by Ohio newspapers, radio, and television. National news media, however, did not report the runs in Ohio until Friday, March 15, *after* the emergency closing was proclaimed. The national news media probably considered runs on small thrift institutions in Ohio unimportant until the entire ODGF system was closed. After all, bank failure was nothing new — 120 commercial banks were closed in 1985 (most of them without runs of any kind) — but a banking or thrift institution moratorium was a novelty.

4. In May 1985, the Maryland private deposit insurance fund covered 102 institutions with $7.2 billion of deposits.

It is worth noting that, in Maryland, much more time has been required than in Ohio to formulate a lasting solution to the crisis of privately insured thrift institutions. Those institutions in Maryland succumbed on May 14, 1985 to the same problems that enveloped Ohio in March. As of this writing, approximately $1.15 billion of depositor's funds in Maryland still are subject to limitation on withdrawal. Some of those withdrawal limitations have been in effect since May 14. The principal reason for the continuation of the crisis on a comparatively large scale in Maryland is that Maryland had more large, privately insured institutions than Ohio.[4] Also, some of the real-estate transactions in which the large, privately insured, Maryland thrift institutions were engaged were at least as complicated and speculative as the financial transactions between Home State and ESM. In any case, the underlying problems in Maryland were similar to those in Ohio.

At the peak of the runs on ODGF-insured institutions (March 11-14), it was not clear to the general public whether the state would or would not reimburse depositors' losses, because state officials stopped short of making outright commitments of state resources to protect depositors from loss. Statements intended to calm depositors did not calm them. It is fair to observe that, after the ODGF-insured institutions were closed, depositors probably heard and believed the information they wanted to hear and believe, and ignored information that contradicted their beliefs. The lack of accurate, current information on financial conditions of the ODGF-insured institutions at the onset of the crisis hampered public officials in their attempts to describe the true financial condition of those institutions to the public, and contributed to depositors' confusion. To illustrate the public's confusion, some customers who withdrew funds from Home State before March 8 redeposited those funds in other ODGF-insured institutions after March 11.

As the crisis unfolded, federal supervisory and insurance authorities, Ohio officials, and officials of some other states constantly had to reassess their objectives, commitments, and abilities to protect depositors. By March 18, provision of 100 percent protection to depositors by the state of Ohio became the underlying assumption and premise for the events that followed. Up to $151 million of nontax receipts of the state initially were committed to the reopening of the ODGF-insured institutions.[5] Part of those funds eventually might be regained from legal actions against those involved in the collapse of Home State, or recovered from reimbursements to loss reserves. Approximately $22 million of these state funds were appropriated for the Savings and Loan Assurance Corporation, which provided assistance to seven ODGF-insured institutions during 1985. The remaining $129 million of state funds were allotted to the reopening of Home State.

5. Sections 4 and 5 of Article VIII of the Ohio constitution prohibit the use of tax receipts for private purposes, including payments to depositors of state-chartered banks.

OUR ROLE—In addition to its other roles, the Federal Reserve Bank of Cleveland assured the integrity of the payments mechanism. As previously discussed, the Reserve Bank arranged emergency shipments of currency to ODGF-insured institutions, provided limited coordination for the activities of the federal bank supervisory authorities, provided meeting space for state officials and bankers to consider proposals for the purchase of ODGF-insured institutions, and gathered and analyzed current information on the ODGF-insured institutions. In those roles, the Federal Reserve Bank of Cleveland acted as a facilitator in the containment and eventual resolution of the crisis.

PAYMENTS MECHANISM—The closing of the 70 ODGF-insured institutions was unique in recent Federal Reserve experience because of the large number of institutions closed simultaneously and because of uncertainty about whether, when, and under what conditions they would reopen. The closing required the Federal Reserve Bank of Cleveland to make numerous decisions affecting the processing of negotiable orders of withdrawal (NOW drafts) drawn on the ODGF-insured institutions and the processing and settlement of automated clearinghouse (ACH) items. The Reserve Bank, in dealing with the situation, was guided by both its responsibility to maintain the integrity of the payments system and its role as a collecting bank and clearinghouse.

Governor Celeste's March 15 closing order, later extended through March 19, made the reopening of ODGF-insured institutions contingent on further orders of the Ohio Superintendent of Savings and Loan Associations. The closing order appeared to prevent the ODGF-insured institutions from opening for a banking day. The Federal Reserve Bank of Cleveland, by analogy, applied to the NOW drafts the standard procedures used for depository institutions that close on local holidays that are not observed by the Reserve Bank.

Accordingly, the Reserve Bank did not charge correspondent banks' accounts for NOW drafts drawn on the closed ODGF-insured institutions. On March 19, the Reserve Bank determined that it would give written notice to institutions sending items to it for collection that it currently was unable to collect NOW drafts drawn on ODGF-insured institutions and that it would return all such drafts coming into its possession until the institutions on which they were drawn reopened. The returned NOW drafts were stamped, "Unable to Present at This Time."

The Reserve Bank determined that the March 15 closing of all ODGF-insured institutions was a suspension of payments pursuant to the rules covering ACH debits and credits. Accordingly, after March 15, the Reserve Bank did not make settlement for any ACH payments received from or destined to the closed institutions. The Reserve Bank did not return ACH transactions initially because it was not certain how long the ODGF-insured institutions would be closed. The Reserve Bank wanted to do everything reasonable to assist the depositors of these institutions and to encourage continued confidence in the payments system. Moreover, it was clear that a precipitous return of the ACH transactions would have inconvenienced depositors if the institutions reopened within three days.

Following the March 18 extension of the closing of ODGF-insured institutions, the Reserve Bank determined that ACH debits and credits settling on or after March 18 would be returned. This action was necessary under the Reserve Bank's operating letters and reflected concern that ACH payments soon to be made by the Department of the Treasury would not be received by the depositors of ODGF-insured institutions if those institutions remained closed.

As April 1 drew near, with automatic, direct deposits of social security payments destined for closed institutions via the ACH network, the Reserve Bank's staff worked closely with the staff of the Board of Governors of the Federal Reserve System and the Treasury to find alternatives for delivery of the ACH payments. The Treasury did not have sufficient time remaining to modify its files so that checks could be issued in lieu of April direct social security deposits. Consequently, contingency plans were established to deliver Treasury payments electronically to other fully open depository institutions.

Every closed ODGF-insured institution agreed with the contingency plan, but it was not implemented. On March 23, the Ohio Superintendent of Savings and Loans authorized all ODGF-insured institutions to receive ACH debits and credits. The Superintendent's action enabled the Reserve Bank to reinstate immediately all ACH service for ODGF-insured institutions. The Superintendent's decision to allow the flow of ACH items to resume assured that social security and other Treasury payments would be deposited in the normal way.

LENDER OF LAST RESORT—Because the ODGF-insured institutions generally were liquid, the peak amount of Cleveland Reserve Bank advances to those institutions was only $44.9 million during the Thursday-to-Wednesday period ending March 27,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1985. The Reserve Bank was prepared to advance substantially more, if necessary, in accordance with established procedures for advances in unusual circumstances.

In reviewing the actions of the Reserve Bank in its role as the lender of last resort during the March 1985 Ohio crisis, a fundamental distinction must be made between the provision of liquidity support to depository institutions, and the guarantee of the solvency of depository institutions or of full repayment to depositors. Providing liquidity is the traditional lending function of the Federal Reserve Banks. In the United States, guaranteeing solvency, however, is not a function of the Federal Reserve Banks.[6]

The Federal Reserve Banks stand ready to provide liquidity assistance to all types of depository institutions through extensions of credit secured to the satisfaction of the Reserve Banks, with due regard to the soundness of the assets presented as collateral. Reserve Banks are not ordinarily prepared to act as either a liquidator of assets or as a risk-assuming lender for the purpose of providing deposit insurance or a guarantee of solvency. Other agencies or instrumentalities of the federal government, such as the FDIC, FSLIC or, during the 1930s, the Reconstruction Finance Corporation traditionally have performed such a guarantor's function for financial institutions.[7]

On occasion, however, Federal Reserve Banks might extend credit to an insolvent institution, but such credit would be extended only for the purpose of facilitating an orderly closing or merger of the institution. The Reserve Bank would establish two conditions: first, the advances must be adequately secured, with due regard to the soundness of the assets presented as collateral, and, second, the appropriate supervisory authority (in this case the state of Ohio) must have arranged, or be in the process of arranging, a solution to the problems of the insolvent institution. Thus, the Reserve Bank would extend credit while expecting the indebtedness to be assumed, or repaid, by a legal successor of the insolvent institution.

6. Many foreign central banks either make capital contributions to particular enterprises or allow financial institutions to remain consistently indebted to the central bank. A Federal Reserve System committee, in addressing this point, noted that, in the United States, banks in recent decades have not been and should not be permitted to remain continuously in debt to the Federal Reserve (1971).

The Federal Reserve Bank of Cleveland was willing to make advances to ODGF-insured institutions that were solvent, or, if insolvent, then with satisfactory assurances that a capable legal successor would be found. Concerns regarding the designation of an acceptable legal successor were increased, and the overall problem of lending was complicated enormously, by the lack of accurate and timely information about the underlying financial condition of the ODGF-insured institutions, particularly Home State. Prior to March 15, 1985, the Federal Reserve Bank of Cleveland did not know which institutions were solvent or insolvent. In those circumstances, it was crucial that the Reserve Bank examine the collateral presented by ODGF-insured institutions with great care because it was possible that the collateral would have to be liquidated.

7. Some states, including Ohio, indirectly have achieved the effect of state guarantees of obligations of financial institutions, not by pledging the full faith and credit of the state for that purpose, but by chartering state-owned corporations supported by streams of revenues, other than tax receipts, that could issue such guarantees.

In order to obtain a large amount of collateral of acceptable credit quality from ODGF-insured institutions in the most rapid time possible, the Reserve Bank undertook a statewide field warehousing effort. Federal Reserve examiners were instructed to select mortgage loans covering real property in Ohio and adjacent states for which the institutions had original loan documents. Those documents were placed in sealed spaces (field warehouses) leased to the Reserve Bank at the premises of the ODGF-insured institutions. Federal Reserve examiners supervised the field warehouses. Later, as borrowings from the Reserve Bank were repaid, the mortgage loans used as collateral were released, and the field warehouses were closed. As soon as was practical, the mortgage loan collateral was brought into the Reserve Bank and the Reserve Bank's lien on the collateral was recorded formally. Thus, eventually all the field warehouses were closed.

Despite the intricate legal and policy questions raised by the circumstances of the March 1985 Ohio crisis, the Federal Reserve Bank of Cleveland was able to remain within the boundaries of traditional lending practices authorized by statute. It did this while still providing all the currency and other financial assistance that was required to enable ODGF-insured institutions to cope with depositor's demands.

ENDNOTE—Many of the issues raised during the March 1985 Ohio crisis are not resolved definitively at this writing. However, the experiences of that crisis, viewed in light of the history of prior banking crises in the United States, already tend to suggest some answers to most of the principal questions.

The decision to close all ODGF-insured institutions reflected several concerns regarding the public safety and welfare. After all, the runs in Ohio were spreading rapidly between March 11 and March 14, and sound and unsound institutions alike were affected. The volume of withdrawals at the most severely affected institutions was doubling or tripling daily, and the loss of confidence was spreading beyond the Cincinnati area. The closing of all ODGF-insured institutions also had at least three consequences: First, during the closing there was time to assess the situation and to remedy the inadequacy of information. Second, the increasing pace of withdrawals was stopped altogether and financial damage to many ODGF-insured institutions that later proved to be in sound condition was prevented. Third, the Governor and the legislature gained an opportunity to consider and prepare more sweeping reform proposals than state officials previously had considered.[8]

8. For comparison, Jesse Jones, then chairman of the Reconstruction Finance Corporation, noted that the bank holiday proclamation of March 6, 1933, provided comparable opportunities for Federal officials to gain control of the developing banking crisis and to propose sweeping reforms of the banking system. Congress became convinced of the need for action during the holiday and voted for the Emergency Banking Act on March 9, 1933, without debate.

One lesson derived from the March 1985 Ohio crisis is that prompt, effective responses to public concerns are necessary to contain a crisis of confidence in the banking system. Another lesson is that several ingredients were required for a prompt, effective response in the Ohio situation. Accurate information and understanding of the extent of the problem, the ability to commit the state's resources, and a decision to do so were essential to assuring depositors of protection from loss. In the early stages of the March 1985 Ohio crisis, none of these ingredients was present.

Federal Reserve Bank of Cleveland Directors

As of March 1, 1986

Cleveland

Chairman and
Federal Reserve Agent
W. H. KNOELL
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Chief Executive Officer
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Pittsburgh, Pennsylvania

Deputy Chairman
E. MANDELL DE WINDT
Chairman of the Board
Eaton Corporation
Cleveland, Ohio

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Chief Executive Officer
Mellon Bank
Pittsburgh, Pennsylvania

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Chief Executive Officer
Independent State Bank of Ohio
Columbus, Ohio

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Columbus, Ohio

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Chief Executive Officer
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and President
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Chief Operating Officer
Standard Oil Co. of Ohio
Cleveland, Ohio

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First-Knox National Bank
Mount Vernon, Ohio

Cincinnati

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Chief Executive Officer
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Middletown, Ohio

SHERRILL CLELAND
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Marietta, Ohio

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Executive Vice President and
Chief Executive Officer
Harlan National Bank
Harlan, Kentucky

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Dayton, Ohio

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Owner, Dunreath Farm
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Chief Executive Officer
National City Corporation
Cleveland, Ohio

Pittsburgh

Chairman
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Chief Operating Officer
National Intergroup, Inc.
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Butler, Pennsylvania

LAWRENCE F. KLIMA
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The First National Bank
of Pennsylvania
Erie, Pennsylvania

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Former Vice Chairman
Aluminum Company of America
Pittsburgh, Pennsylvania

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Chief Executive Officer
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Uniontown, Pennsylvania

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Senior Vice President-
Finance and Chief
Financial Officer
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Pittsburgh, Pennsylvania

MILTON A. WASHINGTON
President and
Chief Executive Officer
Allegheny Housing
Rehabilitation Corporation
Pittsburgh, Pennsylvania

Comparative Financial Statement

For years ended December 31

Statement of Condition

	1985	1984
Assets		
Gold certificate account	$ 635,000,000	$ 617,000,000
Special drawing rights certificate account	270,000,000	302,000,000
Coin	32,826,806	34,730,126
Loans and securities:		
Loans to depository institutions	153,376,400	1,202,000
Federal agency obligations bought outright	480,954,538	464,506,387
U.S. government securities:		
Bills	4,993,731,997	3,933,137,910
Notes	3,954,442,018	3,612,081,955
Bonds	1,445,438,895	1,270,765,897
Total U.S. government securities	10,393,612,910	8,815,985,762
Total loans and securities	11,027,943,848	9,281,694,149
Cash items in process of collection	431,748,745	193,118,962
Bank premises	28,367,930	27,639,546
Other assets	660,983,418	422,751,603
Interdistrict settlement account	215,098,992	707,143,437
TOTAL ASSETS	$13,301,969,739	$11,586,077,823
Liabilities		
Federal Reserve notes	$11,341,421,849	$10,124,974,843
Deposits:		
Depository institutions	1,125,625,795	882,847,789
Foreign	9,600,000	10,350,000
Other deposits	43,575,363	24,114,558
Total deposits	1,178,801,158	917,312,347
Deferred availability cash items	434,129,847	189,147,400
Other liabilities	133,616,285	146,723,933
TOTAL LIABILITIES	$13,087,969,139	$11,378,158,523
Capital accounts		
Capital paid in	$ 107,000,300	$ 103,959,650
Surplus	107,000,300	103,959,650
TOTAL CAPITAL ACCOUNTS	$ 214,000,000	$ 207,919,300
TOTAL LIABILITIES AND CAPITAL ACCOUNTS	$13,301,969,739	$11,586,077,823

Income and Expenses

	1985	1984
Current income		
Interest on loans	$ 2,106,227	$ 2,863,929
Interest on government securities	964,682,089	939,311,393
Earnings on foreign currency	14,566,789	15,021,379
Income from services	36,425,345	34,310,795
All other income	498,154	459,292
Total current income	$1,018,278,604	$ 991,966,788
Current operating expenses	58,961,748	55,450,346
Cost of earnings credits	8,534,049	9,195,430
CURRENT NET INCOME	$ 950,782,807	$ 927,321,012
Profit and loss		
Additions to current net income		
Profit on foreign exchange transactions	$ 77,442,770	
Profit on sales of government securities	5,627,610	2,779,521
All other additions	5,239	3,801
Total additions	$ 83,075,619	$ 2,783,322
Deductions from current net income		
Loss on foreign exchange transactions	$ -0-	$ 31,382,265
All other deductions	434,824	395,929
Total deductions	$ 434,824	$ 31,778,194
Net additions or deductions	$ 82,640,795	($ 28,994,872)
Assessments by Board of Governors		
Board of Governors expenditures	$ 4,902,500	$ 5,637,400
Federal Reserve currency costs	10,450,559	9,137,397
Total assessments by Board of Governors	$ 15,353,059	$ 14,774,797
NET INCOME AVAILABLE FOR DISTRIBUTION	$1,018,070,543	$ 883,551,343
Distribution of net income		
Dividends paid	$ 6,349,649	$ 6,177,578
Payments to U.S. Treasury (interest on Federal Reserve notes)	1,008,680,244	874,781,466
Transferred to surplus	3,040,650	2,592,300
Total distributed	$1,018,070,543	$ 883,551,343

Federal Reserve Bank of Cleveland Officers

As of March 1, 1986

KAREN N. HORN
President

WILLIAM H. HENDRICKS
First Vice President

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Senior Vice President & General Counsel

RANDOLPH G. COLEMAN
Senior Vice President

JOHN M. DAVIS
Senior Vice President & Director of Research

LESTER M. SELBY
Senior Vice President & Secretary

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Senior Vice President

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CREIGHTON R. FRICEK
Vice President

JOHN W. KOPNICK
Vice President

EDWARD E. RICHARDSON
Vice President

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Vice President & Associate General Counsel

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Vice President

MARK S. SNIDERMAN
Vice President & Associate Director of Research

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Assistant Vice President

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Assistant Vice President

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JILL GOUBEAUX CLARK
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LAWRENCE CUY
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Assistant Vice President & Economist

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Assistant Vice President

ROBERT J. GORIUS
Assistant Vice President

NORMAN K. HAGEN
Assistant Vice President

DAVID P. JAGER
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Directing Officer

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Directing Officer

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Assistant Vice President

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Assistant Vice President & Assistant General Auditor

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Assistant Vice President

EDWARD J. STEVENS
Assistant Vice President & Economist

WALKER F. TODD
Assistant General Counsel & Research Officer

ANDREW W. WATTS
Assistant General Counsel

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ROSCOE E. HARRISON
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DAVID F. WEISBROD
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LOIS A. RIBACK
Assistant Vice President

ROBERT B. SCHAUB
Assistant Vice President

Columbus Office

CHARLES F. WILLIAMS
Vice President

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