FDIC POLICY TOWARD BANK FAILURES

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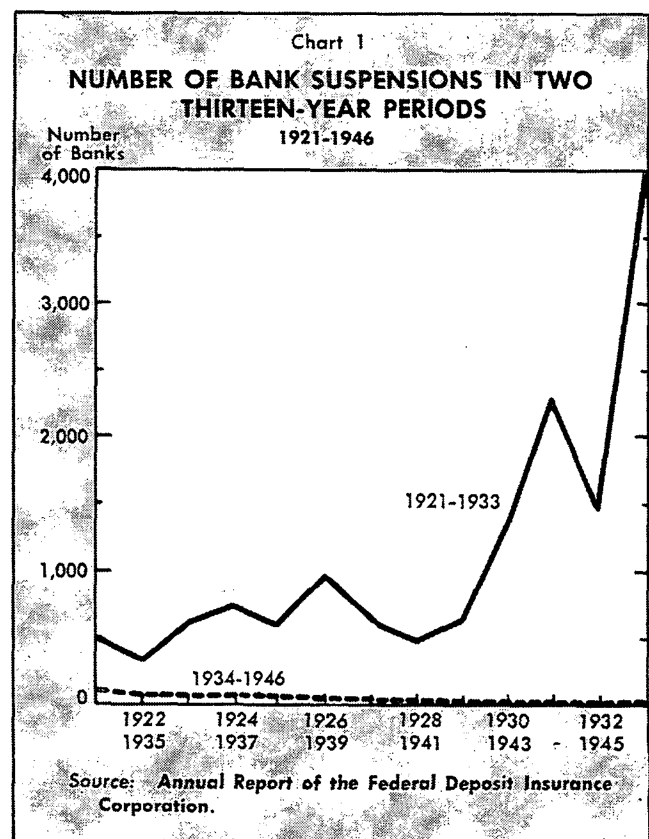
The marked increase in the number and size of banks that have failed in recent years has focused attention on the problems connected with bank failures and the appropriate aid bank regulatory agencies should provide to banks in distress. Since this aid is designed to maintain public confidence in the banking system, there is a need for greater public understanding of policies toward banks with serious problems. Special attention is given in this article to the activities of the Federal Deposit Insurance Corporation in providing assistance to insolvent banks. The different forms this assistance has taken over the years, as well as current FDIC policy as revealed in two recent large bank failures, are examined. Special problems relating to large bank failures raise questions concerning the adequacy of the size of the deposit insurance fund, the constraint this fund places on FDIC decisions, and the coordination and cooperation among bank regulatory agencies necessary to minimize the impact of bank failures. These issues will also be discussed.

The prevention of wholesale bank failures has been the expressed intent of Congress since the establishment of the Reconstruction Finance Corporation and the enactment of the Glass-Steagall bill in 1932. These emergency measures were followed by the passage of the Banking Act of 1933, which was intended to be a permanent answer to the problem of widespread bank failures (over 11,000 banks failed between 1921 and 1933, nearly half of these after 1930). The Act established a national deposit insurance system under the FDIC. This was an important element in the fight to restore confidence in the commercial banking system and resulted in a precipitous decline in the number of failures after 1933, as shown in Chart 1. Over the years deposit insurance has helped to strengthen the banking system and has served as a stabilizing influence on the economy.

The mandate given the FDIC by Congress in 1933 was quite clear. Its purpose was to "purchase, hold, and liquidate . . . the assets of banks which have been closed; and to insure the deposits of all banks." This prescribed order of duties supports the proposition that "the primary function of deposit insurance is, and always has been, protection of the circulating medium from the consequences of bank failures. That insurance also serves the purpose of guarding the small depositor against loss from bank failures cannot be denied, but this function is of secondary importance" [3, p. 194]. Deposit insurance provides a safety mechanism against a sudden decline in the money supply through bank fail-



Source: Annual Report of the Federal Deposit Insurance Corporation.

ures (see box insert). Rather than simply replacing deposits of failed banks, deposit insurance reduces the incidence of failure by assuring the public that bank deposits are safe—thereby preventing runs that can topple even sound banks.

The Federal Deposit Insurance Corporation was established to assist in the protection of the nation's money supply. Though the Corporation's *raison d'etre* is widely accepted, its operating methods have been a controversial issue. The regulatory agencies in general and the FDIC in particular, charged with carrying out Congressional statutes, must decide which of their powers gives the greatest support to the banking system. The choice of methods employed by the FDIC has resulted from consideration of the financial status of the banks in question, different interpretations of Congressional intent, and Congressional inquiry itself. This choice has been a difficult one—one that has caused debate in the past and will undoubtedly continue to do so in the future.

The FDIC has four alternative procedures that may be followed in assisting a failed or failing bank. These alternatives are:

1. DIRECT PAYMENT OF INSURED DEPOSITS: Acting as receiver of the bank's assets and making direct payments to insured depositors;

2. DEPOSIT ASSUMPTION: Facilitating a merger with a healthy institution or replacement by a new organization with new ownership and management through loans and/or purchase of assets, thereby protecting all deposits;

3. DIRECT LOANS: Supplying direct financial aid in an effort to correct deficiencies to allow the bank to continue in operation;

4. DEPOSIT INSURANCE NATIONAL BANK: Operating a Deposit Insurance National Bank for a maximum of two years prior to a deposit payoff or deposit assumption.

The first two methods of operation have been authorized since the establishment of the Corporation and have been, by far, the most commonly used. While the maximum deposit insurance protection has been increased from time to time (from $2,500 in 1933 to the present $40,000), legislators have taken the position that "it should never be the policy of Congress to guarantee the safety of all deposits in all banks" [9, p. 2]. Under the direct payment to depositors method this mandate is maintained. If a bank is closed by the appropriate state or Federal authority and placed into receivership for liquidation of assets, the insured deposits are paid up to the maximum allowed by law. On the other hand, extension of advances to other banks to assume the deposit liabilities of a failing bank protects depositors in full. It has been recognized, however, that the deposit assumption method has additional benefits not available through deposit payoffs. In some cases, the continuation of banking services to the community and minimizing the impact of the failure may be vital considerations.

FDIC Activity and Congressional Supervision

When distress situations occur, the FDIC has attempted to safeguard the public's trust in banking largely through a varying policy of direct deposit payoffs and deposit assumptions via mergers. Table I outlines FDIC assistance to failed banks since 1946. It shows that FDIC officials avoided the direct payment of insured deposits between 1946 and 1954. Corporation officials felt that such procedures, with the loss of some depositors' funds and an interruption of banking services, did not provide the support needed to maintain confidence in the banking system. Instead, mergers (usually consummated with financial aid from the Corporation) were the exclusive method used over this period.

Congress challenged the Corporation's avoidance of the direct payment method through receivership in 1951 [10]. The contention was that the FDIC had insufficient evidence in some cases to base a decision on whether or not the assumption of assets by a healthy bank would reduce the risk or avert a loss to the Corporation's insurance fund as required by law. Some legislators argued that the FDIC did not know the full extent of its liability in all such cases, and therefore it may be preferable for banks to be placed into receivership and direct payments on all insured deposits be made. The Corporation, nevertheless, continued its established policies until 1955, when four deposit payoffs were experienced.

The methods used to assist distressed banks have undergone Congressional scrutiny periodically since 1956, reaching full force in 1965. Seven banks failed in 1964—all being placed into receivership and only the insured deposits paid. The direct concern of legislators this time, however, was not 100 percent insurance protection versus limited protection. Instead, the adequacy and quality of Federal banking supervision, examination, and interagency cooperation became the main subjects of Congressional inquiry.

Of immediate concern to the Senate Committee on Government Operations [11] was the growing number of abuses by bank management that had been prime factors in the increasing incidence of

THE IMPACT OF BANK FAILURES ON THE MONEY STOCK

To understand how bank failures can result in a sudden decline in the money supply, it is first necessary to recognize three factors accounting for changes in the stock of money:[1] (1) "high-powered money" (H), (2) the ratio of commercial bank deposits to bank reserves (D/R), and (3) the ratio of deposits to currency held by the public (D/C). High-powered money is defined as the amount of currency held by the public plus bank vault cash plus reserves held as deposits with the Federal Reserve—the latter two components making up member bank reserves. One dollar of high-powered money held as bank reserves can support several dollars of deposits under a fractional reserve banking system. A change in the total of high-powered money will result in an equal percentage change in the stock of money, other things equal (namely D/R and D/C).

The effects on the money stock of changes in the deposit/currency and deposit/reserve ratios are interdependent. The magnitudes of these ratios are determined by decisions of the public concerning the composition of their cash balances and bank liquidity decisions, respectively. Requirements imposed by law affect reserves held by banks and the relative desirability of currency and deposits—thereby influencing these decisions. In addition, the payment of interest and services offered by banks affect the D/C ratio, while the public's desire to change the composition of cash balances held may have an impact on the D/R ratio. A decision to hold a larger proportion of cash balances in currency and less in deposits alters the aggregate amount of the money supply as well as its composition. Under fractional reserve banking, a withdrawal of deposits from the system reduces total bank reserves, which, unless otherwise replaced, forces a multiple contraction of earning assets and deposits. The lower the deposit/currency ratio, the smaller the fraction of high-powered money in the form of bank reserves and, therefore, the smaller the money stock. The formula connecting these factors with the money stock is useful in viewing the consequent impact of a downward shift in the public's desired deposit/currency ratio: $M = H[D/R(1 + D/C)]/[D/R + D/C]$. Since D/R is significantly greater than unity, a reduction in D/C will result in a decline in M (assuming H constant).

The public cannot determine the aggregate level of either deposits or currency. It can, however, determine the **ratio** of deposits to currency as long as convertibility between the two is maintained. Since a shift in this ratio can have a multiplicative impact on the total money supply, an examination of the variables determining its magnitude is essential. In a study of the demand for currency in the United States [1], Phillip Cagan found that the expected net rate of interest paid on deposits and expected real income per capita have been major determinants of the demand for currency relative to deposits.

While Cagan's results show that the deposit/currency ratio increases proportionally with expected real income, of greatest interest at present is the relation between this ratio and the net rate of interest paid on deposits (interest paid explicitly or implicitly through free services minus service charges and expected losses). The D/C ratio varies positively with changes in the net rate of interest on deposits—i.e., as the net expected rate paid on deposits declines, so does the deposit/currency ratio. During periods when expected losses on deposits from bank suspensions are high, the net rate of interest paid on deposits may become negative (the depositor may even lose all of his funds). Under such conditions, it is only normal for the public to wish to hold the more desirable (less expensive) form of money—currency. If the withdrawal of deposits occurs on a large scale, the bank may be forced to dump many of its assets on the market to meet its liquidity needs unless additional high-powered money is acquired to meet the currency demands of the public.

Some bank failures, unless neutralized, can lead to massive withdrawals of deposits and the creation of liquidity problems for other banks—regardless of their financial position. It is the responsibility of Federal banking agencies to **neutralize** bank failures and maintain public confidence in banking to prevent indiscriminant runs on banks that may have serious consequences for the nation's money supply.

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[1] Much of this discussion is from [2].

bank failures. Investigation of several banks involving dishonesty on the part of bank officials revealed a lack of interagency cooperation. The cause of the failure of the San Francisco National Bank in January 1965, for example, was not revealed to the FDIC or the Federal Reserve System until the bank was placed in receivership—over seven months following the finding of illegal actions by bank management. The FDIC, charged with supervising the bank in receivership and making payments to depositors, and the Federal Reserve, responsible for making funds available to member banks in times of financial stress (over $9 million to San Francisco National), were precluded from entering a joint effort to rehabilitate the bank prior to its closing. The

Table I

INSURED BANK FAILURES, DEPOSIT PROTECTION, AND FDIC DISBURSEMENTS

1946-1975

Year	Banks Placed in Receivership (FDIC Receivership)*	Banks' Deposits Assumed	Banks Receiving Direct Loans From FDIC	FDIC Disbursements in Deposit Payoffs ($ Thousands)	FDIC Disbursements in Deposit Assumptions ($ Thousands)
1946	—	1	—	—	265
1947	—	5	—	—	1,724
1948	—	3	—	—	269
1948	—	4	—	—	2,552
1950	—	4	—	—	3,182
1951	—	2	—	—	1,884
1952	—	3	—	—	1,340
1953	—	2	—	—	5,039
1954	—	2	—	—	902
1955	4(4)	1	—	4,459	2,343
1956	1(1)	1	—	2,981	463
1957	2(1)	—	—	1,056	—
1958	3(1)	1	—	2,801	231
1959	3(1)	—	—	1,856	—
1960	1(1)	—	—	4,799	—
1961	5(5)	—	—	6,191	—
1962	—	—	—	—	—
1963	2(2)	—	—	19,247	—
1964	7(5)	—	—	12,471	—
1965	3(3)	2	—	11,383	456
1966	1(1)	6	—	732	14,339
1967	4(4)	—	—	7,864	—
1968	—	3	—	—	5,053
1969	4(4)	5	—	7,652	18,552
1970	4(4)	3	—	26,691	19,696
1971	5(3)	1	1	53,739	109,245
1972	1(1)	—	1	16,105	—
1973	3(3)	3	—	16,781	167,748
1974	—	4	1	—	173,201
1975	3(3)**	10	—	N.A.***	N.A.***

* One bank placed into receivership of state bank authorities in 1957; two each in 1958, 1959, 1964, and 1971.

** Deposit insurance national banks were formed by the receiver of two closed banks.

*** FDIC disbursements in 1975 in connection with its insurance responsibilities totalled $305.6 million.

Note: Deposit payoff figures are for Dec. 31 of respective year plus estimated additional disbursements for the respective banks.

Source: **Annual Report of the Federal Deposit Insurance Corporation**, annually.

members of the Senate committee concluded that cooperation and liaison among the Federal banking agencies were absolutely vital to the public interest.

Legislation designed to aid the regulatory agencies in protecting banks from criminal acts and gross mismanagement followed with the passage in 1966 of the Financial Institutions Supervisory and Insurance Act, which provided cease and desist powers and provisions for removal of officers and directors. An increase in the number of problem banks, plus the limited use of the newly provided supervisory powers spurred another Banking and Currency Committee investigation in 1971.

In his statement before the Committee [8, pp. 10-11], Frank Wille, Chairman of the FDIC, outlined the Corporation's procedures and priorities concerning failing banks. Mr. Wille emphasized that the Corporation had no say in the closing of insured banks—this was the responsibility of its chartering authority: the Comptroller of the Currency in the case of national banks or the appropriate state authority in the case of state banks. It is mandatory, however, that the Corporation serve as the receiver of all national banks and serve as receiver of state banks when appointed. When this happens, the FDIC Board of Directors generally determines whether the deposit payoff or deposit assumption procedure should be followed. The second method is utilized, however, only when the prospective cost to the Corporation is less than the cost through the deposit payoff alternative. A prerequisite to a deposit assumption, of course, would be an existing or newly organized bank that is willing to enter into such a transaction and that is acceptable to the appropriate chartering authority as well as to the FDIC.

The Corporation added new scope to its operations in 1971 when it used, for the first time, the direct loan authority granted in 1950. At that time, the Corporation was authorized to provide direct financial assistance to an insured operating bank in danger of closing whenever, in the opinion of the FDIC Board of Directors, the continued operation of such a bank was essential in providing adequate banking service in the community. Even in this case, assistance is withheld if individuals responsible for the bank's poor condition will benefit financially or if it appears that assistance may be required over a prolonged period.

This authority has been used only three times —July 1971, January 1972, and August 1974—and then only with rigid constraints. In the first two cases, the Corporation required that existing shareholders, not the FDIC, bear the existing loss potential on the bank's assets. The FDIC also prohibited dividends from being paid, required new officers and directors to be subject to FDIC approval, and further restricted each bank's activities. In the most recent case, direct assistance was granted to keep the bank going for three weeks until a deposit assumption could be arranged.

The fourth alternative method for protecting depositors, the organization of a deposit insurance national bank, was utilized twice during 1975. Section 11 of the Federal Deposit Insurance Act authorizes the FDIC to transfer all the insured and fully secured deposits in the closed bank to the new bank. Those funds are then available to their owners to the same extent as they were in the closed bank. Deposit insurance national banks can remain in existence a maximum of two years, during which time the FDIC can make a public offering of stock in the new bank. Through this procedure, the Corporation hopes to encourage local communities to consider the establishment and capitalization of a new bank before a final disposition of assets and transfer of deposits from the insolvent bank.

Congressional interest in the FDIC's role in recent years, however, has shifted away from the *method* that the Corporation uses to handle the protection of depositors' funds to the question of the Agency's role in the *prevention* of bank failures. The Corporation has not escaped criticism on its depositor insurance methods during this period, though. The Hunt Commission Report expressed the view that the dominant criterion used by Federal insurance agencies in meeting claims should be the needs and welfare of the community involved, not the minimization of payouts from the insurance fund [6, p. 73]. The Commission's report suggested the need for a reevaluation of deposit insurance legislation. This important issue had clearly been subjugated in legislative priorities, however, to the prevention of bank failures. Increasing emphasis has been placed on the Federal regulatory agencies' responsibilities in preventing bank failures. These agencies have long sought to promote sound banking through examinations wherein management and financial conditions are evaluated. In the course of these

examinations, attempts are made to discover and correct unsafe or unsound practices or violations of law and regulations before such practices prove fatal to the bank.

Congressional and regulatory attention has shifted to detection of bank problems at an early enough date to prevent failures. Congress and the financial community have come to expect bank regulators to step in and salvage a bank in trouble either as a corporate entity or as a party to a merger. The *number* of bank failures is not the Corporation's concern, however. The Federal Deposit Insurance Corporation's primary function has been the protection of the banking system from the *consequences* of bank failures—i.e., the creation of problems for otherwise healthy banks and destabilizing influences on the nation's money supply. Former FDIC Chairman Frank Wille interprets the Corporation's mission to be one of minimizing the impact of a bank failure.

> When an insured bank, despite efforts at correction, progresses to the point where actual failure appears likely, FDIC . . . conceives its mission to be not the prevention of failure at whatever cost but the protection of depositors and the maintenance of public confidence in the banking system as a whole despite the failure. We seek, in other words, a 'soft landing' which minimizes the impact of a bank failure in a community . . . [12].

But how does the Corporation presently feel this responsibility is best carried out? For this answer it is best to look to recent experience.

Two Recent Failures Examination of recent FDIC policy and procedure in handling bank failures is quite revealing. The largest failures in U. S. history, as well as the most publicized in recent years, have been those experienced by U. S. National Bank of San Diego (USNB) and Franklin National Bank, New York. Criminal charges have been filed in both instances alleging improper or illegal actions by top management. Each case reveals that conscious efforts were made to misrepresent the true financial conditions of the banks and to deceive regulatory authorities.

The failure of U. S. National Bank of San Diego on October 18, 1973, at the time the largest bank in U. S. history to collapse ($934 million in deposits), was the subject of a hearing before the Bank Supervision and Insurance Subcommittee of the House Banking and Currency Committee. At that time, Mr. Wille pinpointed the steps taken by the Corporation incident to the transfer of certain assets and liabilities to Crocker National Bank, San Francisco. Of particular interest to the Subcommittee were the FDIC's involvement with USNB since its identification as a problem bank and the Corporation's consideration of the alternative methods available to it to protect the bank's depositors and other creditors.

In the last few weeks before USNB was closed, during which time the FDIC began preparations in the event the bank did fail, Corporation personnel went to San Diego for the purpose of obtaining specific and detailed financial information to be utilized in discussions with banks interested in acquiring USNB's offices and banking business. Concurrently, reviews of the Comptroller's examination reports, provided to the Corporation, were started in order to measure the FDIC's insurance risk. Estimates were that an insurance payoff in this case would necessitate an initial FDIC outlay of approximately $700 million and would result in the immediate loss of the use of nearly $230 million to the approximately 3,300 depositors whose deposits exceeded the $20,000 insurance limit in effect at that time. In the judgment of the FDIC Board of Directors and outside bankers involved in consultation, such action would have shaken public confidence in the nation's entire banking system, with especially severe repercussions in California. Considering such a payoff to be the last resort, the Corporation also rejected direct assistance to USNB because the statutory requirement that the continued operation of the bank was essential to provide adequate banking service in the community could not be substantiated. It was also felt that USNB's controlling stockholder, responsible for many of the bank's difficulties, would benefit financially from the assistance.

The Corporation began to formulate a transaction proposal that it hoped would transfer substantially all the banking business of USNB at a sufficiently high price to satisfy the requirement, as interpreted by Congress and the FDIC, that the merger would minimize the loss to the Corporation's insurance fund. It was recognized that if this could not be arranged the payoff method would be implemented. Serious discussions were begun with three major California banks that expressed an interest in acquiring USNB. In order to insure competitive bidding, the remaining four banks in the state capable of assuming nearly $1 billion in liabilities were also contacted. Two of these decided not to participate in the bidding for internal reasons, while the other two confronted serious antitrust problems. After consultations with the Antitrust Division of the De-

partment of Justice, it was decided these last two banks would be contacted only if no acceptable bids were obtained from the other three banks.

Once it became obvious that the failure was imminent, the FDIC took steps necessary to guarantee an efficient, expedient solution. Negotiations on a purchase and assumption proposal among the three banks and the Corporation were agreed upon. In case the bidding did not realize a premium that would conform to statutory requirements, a contingency plan for a payoff was drawn. Mr. Wille's statement before the Subcommittee was, therefore, careful to emphasize that the Corporation, after careful consideration of all available alternatives, chose to meet its obligations through the method that was of greatest benefit to the public *within* statutory constraints.

Within three hours of the closing of USNB by the Comptroller and the FDIC being named as receiver, bids were accepted and analyzed as to their sufficiency, and court approval to the proposed acquisition was granted. The next morning all of USNB's offices reopened at their usual business hours as branches of Crocker National Bank. The threat of destabilizing and disruptive influences on the American banking system was thus averted.

When Franklin National Bank ($1.7 billion in deposits) failed in October 1974, it captured the distinction of becoming the biggest bank failure in U. S. history. Once the twentieth largest bank in the country, Franklin's failure resulted from a series of poor management decisions. Banking analysts generally agree that the bank's lack of earning power, combined with relatively high loan losses, large losses in foreign exchange transactions, and heavy reliance on the use of short-term borrowings in the money market to back relatively long-term loans, made its failure a foregone conclusion. Of the 65 banks in its size category ($1 billion to $5 billion in deposits), Franklin ranked last in earnings power with a return on assets of only .23 percent. Massive withdrawals of deposits (53 percent of total deposits) followed the announcement of large foreign exchange losses in May 1974. Only heavy borrowings from the Federal Reserve System kept the bank afloat until Comptroller James Smith determined the bank to be insolvent and appointed the FDIC as receiver.

Following the USNB precedent of a year earlier, the Corporation immediately accepted bids from several New York banks and named European-American Bank and Trust Co. as the winner in the bidding to assume all of the deposit liabilities and certain assets of Franklin with FDIC assistance. The next morning Franklin's 104 branches in the New York area opened for business as usual as branches of European-American. The apparent ease with which the deposit assumption was completed was, in fact, the end result of five difficult months of contractual negotiations with potential buyers. During this period, the FDIC attempted to insure competitive bidding by more than one bank on a contractual basis acceptable to all parties.[1] The restriction placed on the use of the deposit assumption method was the decision not to contribute cash assistance exceeding the $750 million estimated necessary to pay off all insured deposits. If terms of sale resulting in a smaller payout from the deposit insurance fund could not be arranged, the deposit payoff method would have been followed.

During the time of negotiations, it became apparent that the assisted sale of Franklin would not be possible without a coordinated effort among the banking agencies. The Comptroller of the Currency constantly monitored Franklin's financial condition while the Federal Reserve advanced the bank nearly $1.75 billion through its discount window in an effort to seek an efficient solution to the crisis.[2] Interagency cooperation may, in fact, have advanced to the stage where the System was "buying time" for the best solution possible, as Mr. Wille implied.

> Where widespread public reaction to a precipitous bank failure is possible, and time is needed to work out a more orderly solution, either the Federal Reserve or the FDIC may be willing to advance funds to the bank on a short-term, secured basis [12].

FDIC concern for the level of uninsured deposits and the interruption of banking services within a community has clearly made the direct payoff of insured deposits an undesirable alternative in the case of large banks. Consideration of the impact a bank failure has on the financial community (in Franklin's case both national and international in scope) has become of major im-

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[1] For a detailed disclosure of the FDIC's participation in the solution to the Franklin problem, see [13].

[2] Federal Reserve advances were subsequently assumed by the FDIC and will be repaid largely through liquidation of Franklin assets held by the FDIC.

portance to the regulating authorities.[3] It is entirely conceivable that a policy of minimizing the shock waves of a bank failure in the economy may eventually come into direct conflict with the requirement that a deposit assumption be shown to minimize a threatened loss to the Corporation insurance fund. This potential conflict certainly calls into question sole reliance on the comparison between direct liabilities of the FDIC under the deposit payoff and deposit assumption techniques as the basis for choosing between these methods. This comparison has become necessary due to great concern in the past with the absolute size of the insurance fund and its ability to cover excessive bank failures. Since the impact on the insurance fund has served as a constraint on the Corporation's attempts to give maximum support to the nation's money stock, examination of this restriction seems in order.

Adequacy of the Insurance Fund Kenneth Scott and Thomas Mayer, in an article [7] based upon research undertaken for the Hunt Commission, argue that insurance assessment rates have forced banks to bear substantially more of the costs of bank failures than they have generated. Acknowledging that banks should be expected to cover losses attributable to fraud, misconduct, and "normal" managerial failure, they present evidence supporting their contention that assessment rates have been sufficiently high to generate a large surplus over what is needed to cover these losses.

> The only justification for such rates is the contingency for failures due to gross perturbations in the economy attributable to the conduct of national fiscal and monetary policy. Deposit insurance for this fourth category of failures seems fully warranted on macroeconomic grounds as a safeguard against sharp and unplanned contractions in the money supply. The cost of this category of coverage, however, should be borne directly by the federal government as the party responsible—and not placed on banks . . . and their customers [7, p. 900].

If this view is accepted, there would be little need for regulators or legislators to look upon a potential exhaustion of the insurance fund as a disaster. If the concept of the "adequacy" of the fund were altered to exclude the contingency for failures resulting from the conduct of stabilization policy, assessment rates could be lowered to correspond with the experience of failures resulting from bank practices. A major practical problem of implementing such a program, however, would be in distinguishing bank failures attributable to stabilization policy from other causes. Past losses and disbursements have largely been attributable to the first three causes of failures. From this experience the accumulation of funds for insurance purposes may have been excessive.

The argument for increased Government support of the insurance fund is not needed, however, to draw attention to the facts that the present fund is substantial, has never been threatened by depletion, and presently has a potentially unlimited source of additional funds. The U. S. Treasury stands behind the FDIC in case the insurance fund is threatened. With a present reserve of approximately $6.7 billion, the Corporation also has what amounts to a blank check on the Treasury. It can draw another $3 billion immediately and after a short delay can obtain any additional amount if needed. Although 527 insured banks have failed since the Agency was established, additional Treasury funds have never been used. Through 42 years of operation, the FDIC has incurred losses of $247 million, including estimated losses on active cases—approximately 3.7 percent of the present fund.[4] This loss experience suggests the Corporation has protected the insurance fund in an extremely capable manner. Minimization of the loss to the insurance fund may interfere, however, with the primary function of deposit insurance—the stabilization of the money supply—a responsibility it shares with the Federal Reserve System.

FDIC and the Fed: A Common Bond The Federal Reserve, through the conduct of monetary policy, attempts to maintain the domestic money supply at levels consistent with the financial health of the nation's economy. Through its dis-

[3] If, in fact, we have 100 percent deposit insurance for large banks, the question arises whether the same protection should be afforded small banks on equitable as well as competitive grounds. For a discussion of the need for review of present deposit insurance legislation, particularly concerning large bank failures, see [4] and [5]. The latter argues that 100 percent deposit insurance would eliminate the conflict in social goals that arises when considering whether a large bank should be allowed to fail. Optimal resource allocation suggests that inefficient firms, regardless of size, must be allowed to fail. The stabilization goal, on the other hand, suggests that large bank failures should be prevented lest they lead to runs on other banks and to a reduction in the money supply. Complete protection for depositors (but not stockholders) would retain the disciplinary impact potential failure has on bank management but, at the same time, would serve to insulate the money stock from the hazards of large bank failures. Since the FDIC usually protects all deposits, eliminating the insurance ceiling *de jure* as well as *de facto* would remove the uncertainty that large depositors now face. Such a policy would also eliminate the potential conflict between the objectives of minimizing the destabilizing impact of a bank failure and minimizing the cost to the deposit insurance fund.

[4] The trend toward large bank failures may have further implications for the adequacy of the insurance fund, however. If one of the largest banks in the country were to fail, initial FDIC cash outlays would likely exceed the present level of the fund. This would be the case even if liquidation of the bank's assets held by the Corporation resulted in a zero loss to the fund. Under such circumstances, Treasury assistance would presumably be required in the interim.

count mechanism and as supervisor of a large number of commercial banks, the Fed has acknowledged responsibility to provide funds on a secured basis to solvent but temporarily illiquid banks. The purpose of this "lender of last resort" function is to insure the viability of banks experiencing short-term liquidity problems—thereby protecting the public's confidence in banking, thus preventing runs on bank deposits and destabilizing impacts on the money supply. Deposit insurance has a similar rationale. By minimizing the risk of deposit loss from bank failure, deposit insurance limits the potential cost of holding money in the form of deposits. This discourages the withdrawal of deposits that, if widespread, can cause a sharp reduction in the money supply.

The distinction between a temporarily illiquid bank and an insolvent one provides the Federal Reserve a benchmark with regard to which the decision to employ its lending function may be made. Our system of bank supervision and review usually provides the regulatory authorities with the information necessary to pass on the financial conditions of individual banks. Once it is determined that a bank cannot remain viable, the problem of how its operations and liabilities should best be handled arises. The FDIC disposes of those necessary failures in a manner that, while in the public's best interest, gives maximum support to the circulating medium.

Regulatory Review There is a recognized need for bank examiners and analysts to keep up with trends and innovations within the banking industry. The banking agencies' capabilities in meeting their examining responsibilities are dependent on obtaining enough information to reveal the true condition of each bank. This places great importance on the supervisors' investigative skills. Regulators have expressed a need for greater attention to the safeguards to bank soundness and stability. This concern joins the continuing goals of promotion of competition in banking and adaptation of the banking system to meet changing needs for credit as the focus of regulation.

The Federal banking agencies, charged with supervising the country's commercial banks, have acknowledged that current examination procedures may be inadequate to the task of dealing with the sophisticated policies of today's banks. A move toward continuous monitoring rather than single examinations is, therefore, underway. In addition, an extensive review of the entire regulatory process in banking has been initiated by Congress and will, undoubtedly, receive further attention in future years.

Public confidence—the very foundation of the banking system's existence—is based, fortunately, on more than just the banking agencies' capacity to "bail out" banks in trouble. For in some cases, whether because of fraudulent actions by bank officials or the inability of regulators to correct management deficiencies, *banks must be allowed to fail.* Public confidence in the banking industry is based on the belief that banking authorities can assure stability through a coordinated program of regulation and supervision designed to limit bank failures only to unavoidable cases and to *efficient disposition of those banks that do fail.*

Summary Recent experience has revealed extensive coordination and cooperation among Federal banking authorities in the handling of failing banks. This is both encouraging and crucial to the effort to support the banking system. This interagency cooperation has made it possible for banking authorities to lend maximum support to the nation's money supply in those cases where a bank failure cannot be avoided. Adhering to a policy of minimizing the shock waves to the rest of the financial community, the FDIC has recently shown a decided preference for the deposit assumption method where statutory requirements can be met. But what will happen if the method that is in the public's best interest comes into conflict with the constraint that the assumption route may only be used if it minimizes the loss to the Corporation's insurance fund? What would have been the impact on the economy had USNB or Franklin National been placed in receivership and only the insured deposits paid off? It is doubtful that the degree of confidence in the banking system would have remained as high as it did had thousands of depositors lost millions of dollars in uninsured deposits. Yet it is clear what action the FDIC is required to take if such a conflict occurs. The concern for the effect individual failures have on the insurance fund could, under current legal requirements, eventually force the Corporation to resort to a large deposit payoff that may damage the public's trust in banking and the regulatory authorities' ability to support the nation's money supply. If the latter continues as the objective of deposit insurance, a reevaluation of insurance legislation appears necessary to resolve the problems raised by large bank failures.

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