Chapter Two -- 1933 - 1979

The next several years were marked by caution on the part of both banks and regulatory agencies. The supervisory agencies viewed the panic of 1933 as a banking, rather than a monetary, phenomenon. The prevailing philosophy was that unfettered competition in the past had resulted in excesses and abuses in banking. Consequently, the supervisory agencies followed a policy of what the FDIC later termed keeping banks and banking practices within the bounds of "rightful competition."

The attitude of bankers was similarly circumspect. Bankers who survived the Depression were chastened by that experience. Banks took few risks as the banking industry began a massive liquidity buildup. By 1937, for example, cash and holdings of U.S. government securities comprised about 52 percent of the banking industry's total assets, or more than twice the amount held in 1929. To the dismay of would be borrowers, banks continued to stress liquidity for many more years. In the eight-year period from 1934 through 1941, the FDIC handled 373 bank failures; most of them were small banks.

During World War II, government financial policies produced an expanding banking system. Total bank assets at the end of 1945 were nearly double the $91 billion at the end of 1941. Large-scale war financing by the federal government was the primary factor contributing to the increase in bank assets. Banks financed the bulk of the war-loan sales campaign, including the purchase of government obligations for their own portfolio. At the end of 1945, holdings of those obligations accounted for 57 percent of total bank assets.

Loan losses were practically nonexistent during the war years, and bank failures declined significantly. Only 29 insured banks failed from 1942 to 1946. The decline in the number of failed banks was due to the highly liquid state of bank assets, the absence of deposit outflows, and vigorous business activity. Conservative banking practices and favorable economic conditions also resulted in few bank failures during the late 1940s and 1950s. The low incidence of failures was regarded by some as a sign that the bank regulators were too strict. Years later, in a speech marking the dedication of the headquarters building of the FDIC in 1963, Wright Patman, then-Chairman of the House Banking and Currency Committee, declared:

> . . . I think we should have more bank failures. The record of the last several years of almost no bank failures . . . is to me a danger signal that we have gone too far in the direction of bank safety.[2-1]

[2-1] Wright Patman, as quoted in *Federal Deposit Insurance Corporation: The First Fifty Years*, (Washington, D.C.: Federal Deposit Insurance Corporation, 1984), 7.

Banks continued to operate in a safe, insulated environment until the 1960s, when changes began to occur. The new generation of bankers was not affected by the experiences of the Great Depression. They abandoned the traditional conservatism that had characterized the industry for many years. They began to strive for more rapid growth in assets, deposits, and income.

Until the mid-1970s, the generally favorable economic conditions enabled many otherwise marginal borrowers to meet their obligations. With the exception of periods of relatively mild recession, the economy produced high levels of production, employment, and income.

The first of two major recessions during the 1970s occurred from 1973 to 1975. The severity of that recession contributed to a substantial increase in commercial bank loan losses and an increase in both the numbers of problem banks and bank failures. During that period, the FDIC encountered the first large bank failures. The recession led to substantial real estate loan problems. It is important to note that those problems often persisted well beyond the onset of economic recovery. As a result, the bank failure rate remained comparatively high, peaking in 1976 at 16, the highest number of failures since 1942. The six largest banks requiring FDIC disbursements are listed on table 2-1. Table 2.2 lists the number all bank closings per year since the inception of the FDIC in 1934 until 1970.

Table 2-1

Six Largest Banks Requiring FDIC Disbursements 1934 - 1979 ($ in Thousands)

Date	Name of Institution	Total Assets	Transaction Type
10/74	Franklin National Bank, New York, New York	$3,656,000	Purchase and Assumption Agreement
10/73	United States National Bank, San Diego, California	$1,266,000	Purchase and Assumption Agreement
1/72	Bank of the Commonwealth, Detroit, Michigan	$1,257,000	Open Bank Assistance Agreement
3/78	Banco Credito y de Ahorro, Ponce, Puerto Rico	$713,000	Purchase and Assumption Agreement
2/76	Hamilton National Bank, Chattanooga, Tennessee	$412,000	Purchase and Assumption Agreement
6/76	Farmers Bank of the State of Delaware, Wilmington, Delaware	$370,000	Open Bank Assistance Agreement
Source: Federal Deposit Insurance Corporation: The First Fifty Years.			

Table 2-2

*Bank Closures** *1934 - 1979* *($ in Thousands)*

Year	# of Failures	Total Deposits ($)	Total Assets ($)		Year	# of Failures	Total Deposits ($)	Total Assets ($)
1934	9	1,968	2,661		1957	2	11,247	1,253
1935	26	13,405	17,242		1958	4	8,240	8,905
1936	69	27,508	31,941		1959	3	2,593	2,858
1937	77	33,677	40,370		1960	1	6,930	7,506
1938	74	59,684	69,513		1961	5	8,936	9,820
1939	60	157,772	181,514		1962	1	3,011	N/A
1940	43	142,430	161,898		1963	2	23,444	26,179
1941	15	29,717	34,804		1964	7	23,438	25,849
1942	20	19,185	22,254		1965	5	43,861	58,750
1943	5	12,525	14,058		1966	7	103,523	120,647
1944	2	1,915	2,098		1967	4	10,878	11,993
1945	1	5,695	6,392		1968	3	22,524	25,154
1946	1	347	351		1969	9	40,134	43,572
1947	5	7,040	6,798		1970	7	54,806	62,147
1948	3	10,674	10,360		1971	6	132,058	196,520
1949	5	6,665	4,886		1972	1	20,480	22,054
1950	4	5,513	4,005		1973	6	971,296	1,309,675
1951	2	3,408	3,050		1974	4	1,575,832	3,822,596
1952	3	3,170	2,388		1975	13	339,574	419,950
1953	4	44,711	18,811		1976	16	864,859	1,039,293
1954	2	998	1,138		1977	6	205,208	232,612
1955	5	11,953	11,985		1978	7	854,154	994,035
1956	2	11,330	12,914		1979	10	110,696	132,988
					Total	**566**	**$6,049,012**	**$9,235,787**
					Average	**12.3**	**$131,500**	**$200,778**

*Table does not include four open bank assistance transactions but does include eight failures where no money was disbursed from the FDIC.

Source: FDIC, *1994 Annual Report*.

While the banking industry did not recover fully from the effects of the recession until 1977, the following year brought renewed pressures on the industry. The second major recession began in 1978 when interest rates on securities markedly surpassed the rates payable by depository institutions for savings and time accounts. Deposit growth slowed, particularly for thrift deposits, as alternative investment instruments and yields became relatively attractive. In 1979 and early 1980, inflation burst upward, along with interest rates. A change in Federal Reserve monetary policy in October 1979 also contributed to the rise in interest rates. The resulting high interest rates, in combination with an unduly heavy emphasis on fixed-rate, long-term lending, caused severe problems for the thrift industry.

Early Resolution Practices. To pay the insured deposits, FDIC was originally required to create a Deposit Insurance National Bank (DINB). A DINB is a national bank chartered without any capitalization and with limited life and powers. During the period of the temporary deposit insurance plan, which ran from January 1, 1934, through August 23, 1935, the FDIC placed 24 insured banks into receivership. Their depositors were paid by the FDIC through DINBs.

The Banking Act of 1935 gave the FDIC authority to pay off depositors directly or through an existing bank, and once that additional authority was granted, the FDIC ceased using DINBs for the next 29 years. In the 1960s through the early 1980s, the FDIC used DINBs only five times, the last time for the 1982 failure of Penn Square Bank, N.A., Oklahoma City, Oklahoma. The DINB essentially provided a vehicle for a slow and orderly payoff, and its use was confined to situations when the bank's failure would have severely limited banking services in the community or when a regular payoff was not practical.

In addition to broadening the ways in which a payoff could be effected, the Banking Act of 1935 gave the FDIC the authority to make loans, purchase assets, and provide guarantees to facilitate mergers and acquisitions. The FDIC sought this authority because of its concern that many of the insured banks might not survive, and paying off the depositors in those banks would be detrimental to the insurance fund.

Beginning in 1935, the FDIC had two options for handling bank failures: payoffs or assumptions. When banks were paid off, depositors received direct payments from the FDIC up to the insurance limit. Uninsured depositors had claims on the receivership for the uninsured portion of their deposits, along with the claims of other general creditors. The FDIC also held a claim on the receivership because it had provided the money to pay the insured depositors. In those transactions, uninsured depositors frequently did not receive the full amount of their receivership claims. Those that did receive portions of their claims usually received them several years later, at the termination of the receivership, resulting in loss of foregone interest on the deposits.

Assumption transactions involved the transfer of the deposits of the failed bank to a healthy institution. In assumption transactions all depositors, both uninsured and fully insured, received all of their funds in the form of deposits in the acquiring bank. Once the FDIC began using the assumption transaction, the decision about which procedure would be used depended primarily on whether a potential, interested acquirer existed. Most payoffs occurred in states that did not permit or severely restricted branching; acquisitions could not be easily effected in those states.

Improved economic conditions in the late 1930s and during World War II significantly reduced the number of bank failures. Beginning in the mid-1940s, the FDIC ceased paying off banks. The assumption method provided a more flexible method of liquidating the affairs of an insolvent bank than conducting a payoff. Depositors were fully protected, there was no break in banking services, and the community did not suffer economically.

Between 1935 and 1956, the FDIC's procedures for merging failing banks did not involve premerger closings or the establishment of receiverships. Acquiring banks assumed all of the deposits of the failing banks and an equivalent amount of sound assets. Any shortfall in sound assets was made up by cash. In early assumption transactions, the FDIC determined the volume of a failing bank's sound assets and made a demand loan to the failing bank for an amount equal to the difference between deposits and sound assets. The loan was collateralized by the remaining assets. The FDIC would demand payment on the loan and foreclose on those remaining assets. The proceeds from the foreclosed assets would be used by the FDIC to repay itself for the cash advance, plus interest. Any excess cash went to the stockholders of the merged-out bank.

After several years in which the FDIC used loans to carry out assumption transactions, it became apparent that legal complications related to bank borrowing limits and collateral foreclosure procedures could be averted. Instead of lending to failing banks, the FDIC could purchase assets from them. This technique became the usual procedure for facilitating mergers, eventually becoming known as a purchase (of assets) and assumption (of deposit liabilities) transaction, or P&A.

The FDIC shifted back to using payoffs in the 1950s. In 1951, during confirmation hearings on the appointments of members of the FDIC Board of Directors, the FDIC's resolution practices came to the attention of some U.S. senators. The senators argued that the FDIC's policy of providing 100 percent *de facto* insurance to depositors, as occurred in P&A transactions, went beyond the level of protection originally intended, and the FDIC's decisions did not reflect any substantial analyses or cost calculations. Thereafter, the FDIC began to use a cost test in resolving failing banks.[2-2] P&As were used only when the FDIC could determine that they were less costly than paying off depositors and liquidating the bank's assets. As a result, payoffs became more common. Between 1955 and 1958, there were nine payoffs and only three assumption transactions.[2-3] From 1959 through 1964, there were 19 payoffs and no assumptions.

[2-2] The FDIC began using a cost test 31 years before one was explicitly inserted in the Federal Deposit Insurance Act by the Garn-St Germain Depository Institutions Act of 1982. A "least cost" test, more stringent than the 1982 version, was introduced with the passage of the Federal Deposit Insurance Corporation Improvement Act of 1991.
[2-3] In addition to the closings, Del Rio National Bank, Del Rio, Texas, was placed in receivership on June 20, 1957; it was restored to solvency with no funds distributed from the FDIC and reopened on July 3, 1957.

By the mid-1960s, the FDIC modified its procedures recognizing the advantages of having a bank closed by the Comptroller of the Currency or the state,[2-4] creating a receivership, and effecting a P&A transaction out of the receivership. P&A transactions eliminated the need for the stockholder approvals required in deposit assumptions and, in certain instances, reduced the potential exposure for the acquiring bank and for the FDIC. By 1968, the FDIC had developed an explicit bidding process for handling closed bank P&As, and that was the way most bank failures, including practically all of the larger ones, were handled during the next 15 years.

Through the years, deposit insurance coverage increased as inflation rose, with the exception of the 1980 increase which was more in recognition of the sizable amounts of large certificates of deposit that were being held due to a high interest rate climate. Table 2-3 shows the pertinent dates of the deposit insurance coverage increases.

Table 2-3

Increases in the Deposit Insurance Coverage Limit

Year of Increase	New Coverage Amount
Beginning	$2,500
1934	$5,000
1950	$10,000
1966	$15,000
1969	$20,000
1974[2-5]	$40,000
1980	$100,000
Source: Federal Deposit Insurance Corporation: The First Fifty Years.	

In 1950, the FDIC sought legislation to provide assistance to banks, through loans or the purchase of assets, to prevent their failure. Through passage of the Federal Deposit Insurance Act of 1950, Congress gave the FDIC this "open bank assistance" authority, but imposed restrictive language relating to the circumstances under which it could be given. The FDIC did not use the authority until

[2-4] Throughout most of its history, the FDIC did not have the authority to close banks. That authority rested with the Office of the Comptroller of the Currency in the case of national banks and with the state banking departments in the case of state chartered banks. Generally, the FDIC has worked closely with the primary supervisor in resolving failing banks. The FDIC's attainment of closure authority is discussed later in this study.

[2-5] In 1974, the insurance limit for time and savings accounts held by state and political subdivisions (that is, public funds) was increased to $100,000; in 1978, this same limit was extended to Individual Retirement Accounts (IRAs) and Keogh Accounts.

1971, when it provided assistance to Unity Bank and Trust Company, Boston, Massachusetts. The FDIC used this authority three other times in the 1970s.

Early Asset Disposition. As the predecessor to the FDIC's Division of Resolutions and Receiverships, the New and Closed Bank Division supervised seven receiverships in 1935 with a staff of 25 employees. It also was involved with 26 other liquidations for which the FDIC had not been appointed receiver, but was a major creditor by virtue of having paid off insured deposits.

The failure of several banks within a short period of time—or even a single large bank failure—created a sudden demand for experienced liquidators. Some personnel were retained from the failed banks, and many other clerical personnel were hired locally on a temporary basis. The FDIC also relied heavily on locally hired liquidation specialists to assist its permanent staff.

The personnel requirements fluctuated widely from year to year and were dictated by the number, size, complexity, and duration of active receiverships. In the early 1940s the division employed more than half of all the FDIC personnel, topping 1,600 in 1941. In the early 1950s, by comparison, as few as 32 liquidation personnel were required, as the number of failures had declined in the post-World War II period. The number of personnel remained relatively unchanged in 1960 at 38 people, but rose to 175 by 1970. By the end of the decade, the division's staffing had more than doubled to 432.

In its first seven years of operation, the FDIC handled an average of 50 failures annually. As a result, the failure-related assets acquired by the FDIC increased, peaking at $136 million in 1940. Over the next three decades, failures averaged fewer than five annually, but those banks generally were larger than banks that had failed in the early years. The volume of assets in liquidation, which was only $2 million in 1952, did not again reach the 1940 level of $136 million until 1971. FDIC liquidation activity escalated dramatically in the 1970s. The volume of assets in liquidation reached $2.6 billion in 1974. By the end of the decade, the volume had decreased somewhat to a total of $1.9 billion, still well above the pre-1970 totals.

During the 1950s and 1960s, the FDIC would "offset" the amount a borrower owed on all delinquent loans against that person's deposit balance, thereby reducing the overall payment to the depositor and ensuring that the FDIC collected a higher, if not full, amount on the loan. For performing loans, the FDIC often withheld offsetting deposits pending individual negotiations. Usually, the result was that deposits and loans were "netted" against one another so that only the remaining balance was paid by or owed to the FDIC. This method worked to the FDIC's benefit because the FDIC was able to reduce its initial outlay of funds for payoff cases.

An **Offset** was used in a bank failure when a customer who had a delinquent loan also had a deposit account in the bank. The customer's deposit funds were applied to the delinquent loan reducing or "offsetting" the balance owed. Offsets worked to the advantage of a customer with deposits over the insurance limit. Loans and deposit accounts could be offset, making the deposit account fully insured. Deposit funds of a customer with a current loan would be **Withheld** until payment arrangements could be made. Both Offsets and Withholdings were used only where mutuality (loans and deposits in the same name) of the two accounts existed.

The offsets and withholding method of collection, however, had an adverse effect on local communities. Depositors could not use their funds until decisions could be made about offsets. In addition, once decisions were made, the failed bank's customers often had less liquidity than they had before. The issue received considerable attention in 1963 when the Chatham Bank of Chicago, Chicago, Illinois, failed, and the payoff had significant repercussions for the local community. As a result of that failure, the FDIC changed its policy so that it offset only delinquent loans or officers' and directors' funds against potential liability, and it stopped the practice of offsetting or withholding all mutual loans and deposits. Depositors with funds over the insurance limit retained the right to offset those amounts against loans to the failed bank. That strategy usually worked to the depositors' advantage because, although they owed the full amount of their loans, they would probably collect less than full value on uninsured funds in the absence of the offset or netting arrangement.

Beyond the offset issue, asset collection practices in the early years were fairly simple and straightforward. Borrowers were instructed to pay according to the original terms of the note. If payments could not be met, a reduced payment amount was negotiated. Compromises, write-offs, and loan sales were not part of standard procedures.

From time to time, the FDIC's liquidation portfolio included some rather unusual assets. Throughout the years, the FDIC had interests in oil tankers, shrimp boats, and tuna boats, and experienced many of the pitfalls facing the maritime industry. An oil tanker ran aground; a shrimp boat was blown onto the main street of Aransas Pass, Texas, by a hurricane; and the tuna boats were idled when Mexico prohibited fishing in its waters and confiscated the tuna nets. Other unusual liquidation assets have included taxicab fleets; a coal mine that was on fire the day the bank was closed; lame thoroughbred race horses; thousands of art objects, including an antique printing of the Koran; and a collection of stuffed wild animals. In one instance, a bank failed because its president was illegally diverting bank funds to finance production of a motion picture. When the bank failed, the FDIC acquired the completed but unedited film and the movie distribution rights.

Owned assets require active FDIC management when, for one reason or another, their sale cannot be arranged quickly. FDIC asset managers have been called upon to operate hotels, motels, apartment complexes, office buildings, golf courses, ski resorts, restaurants, and other assorted business. This can necessitate additional investment by the FDIC and the development or acquisition of specialized expertise. Asset managers have had to purchase machinery to protect citrus orchards from freezing weather, as well as acquire beehives for pollination of almond trees. The FDIC also found itself in possession of an abandoned gold mine in Idaho. A buyer could not be found until the FDIC had transformed the property into a successful tourist attraction.