Chapter 5
War and Recovery: 1942 – 1970

During World II, government financial policies and private-sector restrictions produced an expanding banking system. Total bank assets at the end of 1945 were nearly double the $91 billion total at the end of 1941. Large-scale war financing of the federal government was the primary factor contributing to the rise in bank assets. Banks played a major role in financing the war effort by lending to other bond buyers, by handling the bulk of the war loan campaign sales volume, and by purchasing government obligations themselves. 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 28 insured banks failed in the period 1942-1945. The decline in the number of troubled banks can be ascribed primarily to the highly liquid state of bank assets, the absence of deposit outflows, and vigorous business activity.

As the war drew to a close and ended, the transfer to peacetime conditions raised questions whether the economy would enter another recession or experience disruptive inflation. Many individuals feared that unemployment, declining income and business failures would ensue. However, inflation rather than deflation ensued. The public had a large volume of liquid assets, there was a tremendous demand for goods, and the immediate problem was one of inadequate production rather than of unemployment.

Effects of the War on the FDIC

The participation by the United States in World War II affected both the FDIC and the state banks it supervised, and some of those effects carried on well past the 1940s. The short-term effects included such things as moving some headquarters personnel to Chicago to vacate Washington office space for the war effort. The FDIC also suffered the same personnel shortage felt by many government agencies resulting from military enlistments and transfers to defense-oriented programs. A shortage of examiners meant that the FDIC was unable to fulfill its policy of annual bank examinations. Even after the war, government hiring restrictions and rapid growth of the economy led to a shortfall of qualified examiners, and it was not until 1951 that the FDIC again was able to examine all of its banks annually.

Another temporary effect of the war effort was the transfer to the FDIC of responsibility for the supervision and examination of about 4,000 federal credit unions, though the FDIC did not insure their deposits. Federal credit unions previously had been supervised by the Farm Credit Administration. In 1948, after six years of FDIC supervision, this responsibility was transferred to the Federal Security Agency.

FDIC Chairman Leo Crowley had come to be regarded by President Roosevelt as one of the best administrators, in or out of government, and he accepted numerous wartime responsibilities. While retaining his FDIC post, Crowley held nine separate government positions, including those of Alien Property Custodian and head of the Foreign Economic Administration, the latter a cabinet-level post that included the lend-lease program. Thus, all foreign economic dealings, and assets and authorizations totaling more than $40 billion, were administered from Crowley's FDIC office in the Press Building on Fourteenth Street.

A more lasting effect of the war was a rapid decline in bank capital ratios, due primarily to the growth of banks' assets. However, the same process that led to rapid bank expansion – government financing – reduced the riskiness of bank portfolios. By the end of 1944, cash and U.S. government obligations had grown to 79 percent of bank assets. Between 1934 and year-end 1944, the aggregate capital-to-assets ratio of banks had declined from 13.2 percent to 5.9 percent. Despite the decline in capital ratios, bank examiners were not particularly critical of bank behavior because of the quality and liquidity of bank assets.

Post-World War II Developments

The banking industry had emerged from World War II in very liquid condition and was in a favorable position to finance the spending spree that was poised to occur. Yet, many individuals expressed doubts whether banks were up to the task of resuming their traditional lending function. These concerns proved groundless. In 1947 alone, bank lending increased from 16 percent to 25 percent of the industry's assets. Lending subsequently reached 40 percent of assets in the mid-1950s, and 50 percent in the early 1960s.

This resurgence of lending did not produce a concomitant increase in loan losses. Throughout this period, loan losses remained relatively small. Net charge-offs averaged considerably less than one-tenth of 1 percent of outstanding loans during the 1950s. Several factors accounted for the relatively low level of loan losses during the postwar years. First, banking behavior by present standards continued to be very conservative. In addition, the economy remained strong. Recessions were reasonably mild and short. This was a period of general prosperity, with a secularly increasing real GNP and relatively low unemployment.

Bank lending had increased, but banks were still operating within traditional markets, and risks to the soundness of the banking system and to the deposit insurance fund were minimal, even during recessionary periods. Bank failures that did occur often received a great deal of attention, including Congressional hearings in some instances. This concern was reflected in the strict supervisory posture that prevailed during this period, but most bankers were content to accept tight regulation in exchange for the restraints it placed upon competition among banks and with nonbank competitors.

During the late 1940s and 1950s there were no more than five bank failures in any single year. However, the low incidence of failures was regarded by some as a sign that the bank regulators were overly strict, operating with policies and practices rooted in the banking crises and economic chaos of the 1930s. 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 and, finally last year, no bank failure at all, is to me a danger signal that we have gone too far in the direction of bank safety.

Until about 1960, banks continued to operate in this safe, insulated environment. Then banks gradually began to change the way they operated. The Depression experience ceased to be a dominant influence on bank management. The new generation of bankers who came to power in the 1960s abandoned the traditional conservatism that had characterized the industry for many years. Instead, they began to strive for more rapid growth in assets, deposits and income.

Intensified competition and higher costs of funds put pressure on interest margins, and greater risks were assumed in order to increase portfolio yields. The trend was particularly pronounced among large banks. These banks also began pressing at the boundaries of allowable activities. They expanded into fields considered by some to involve more than the traditional degree of risk for commercial banks. Banks in general had become more susceptible to the effects of business downturns (as reflected in loan-loss rates) and interest-rate fluctuations.

Before the 1970s, banks were not noticeably harmed by the movement toward increased risk-taking. Generally favorable economic conditions enabled many otherwise marginal borrowers to meet their obligations. With the exception of relatively mild recessions, the economy produced high levels of production, employment and income during most of the period.

There were other changes during the 1960s that had an effect on banking. States began to liberalize branching laws. The use of the bank holding company corporate structure was expanded as an alternative form of multioffice banking and as a means to enter new product markets. With the introduction of the large, negotiable certificate of deposit, banks' reliance on purchased money increased. In addition to the bank regulatory agencies having to monitor these developments, federal legislation gave them additional enforcement responsibilities in the areas of securities disclosure, antitrust and consumer protection.

As banking entered the 1970s, it was on a new course that had brought it out of the period of post-war stability and into a period of increasing volatility and change.

Insured-Bank Failures

After 20 insured banks failed in 1942, fewer than 10 banks failed in each of the next 32 years. In 1962, one insured bank failed, but it required no disbursement by the FDIC, the only year in the FDIC's history with no failure-related disbursements. Because most of the banks that failed during the period 1942 to 1970 were small institutions, insurance losses remained low. In just four of these years did losses exceed $1 million, and losses averaged only $366,000 per year.

Financial Operations

The deposit insurance fund continued to grow during the 1940s, surpassing $1 billion at year-end 1946. Because of the highly liquid condition of the banking industry, the legislation passed in the 1930s to reduce risks in many sectors of the economy and the low bank failure rate, many observers felt that a $1-billion fund was sufficient to cover almost any economic contingency. Apparently, Congress also felt that the fund was adequate at that time and legislatively mandated repayment of the original capital subscriptions. The $150 million contributed by the Treasury and the $139 million in capital stock purchased by the Federal Reserve Banks was fully repaid by the end of 1948.

Bankers also had voiced concern that the assessment rate was too high. By 1950 the fund had reached a balance of $1.2 billion, despite the repayment of capital completed two years earlier. Assessment income had been growing at a high rate, reflecting the rapid growth in bank deposits during the war and post-war years. Moreover, because of low interest rates during this same period, bank earnings lagged increases in prices and deposit insurance expenses.

The FDIC was reluctant to support a permanent reduction in the basic assessment rate. There still was concern that accumulated earnings would be insufficient to handle the increased rate of bank failures that many thought would occur during the 1950s. This fear was reinforced by the decrease in capitalization of the banking industry because of low earnings and rapid asset expansion since 1940.

As a compromise, deposit insurance charges were effectively reduced by the Federal Deposit Insurance Act of 1950. Rather than lowering the basic assessment rate, however, the reduction was accomplished through a rebate system. After deducting operating expenses and insurance losses from gross assessment income, 40 percent was to be retained by the FDIC, with the remainder to be rebated in the form of assessment credits to insured banks. This procedure meant that losses were to be shared by insured banks and the FDIC on a 60/40 basis. This procedure tended to stabilize FDIC earnings despite periods of fluctuating loss experience.

From 1934 to 1949, insured banks had paid an assessment rate of one-twelfth of 1 percent, or 8.3 cents per $100 of assessable deposits. As a result of the 1950 Act, the effective assessment rate fell to 3.7 cents per $100. In 1960, the rebate scheme was modified slightly to adjust for a change in the calculation of an institution's assessable deposits, and the rebate proportion was increased from 60 percent to 66-2/3 percent. From 1950 to 1980, the effective assessment rate stayed in the range of 3.1 cents to 3.9 cents per $100 of assessable deposits, except for a slight blip in 1974 (4.4 cents). Higher insurance losses after 1980 soon eliminated the assessment credits, restoring the effective rate to 8.3 cents (see Chapter 6).

The 1950 Act also required the FDIC to reimburse the Treasury for interest foregone on the initial capital contributions by the Treasury and the Federal Reserve Banks. This requirement was the result of an exchange between FDIC Chairman Maple T. Harl and Senator Paul Douglas of Illinois during hearings on the 1950 Act. The exchange went as follows:

> Senator Douglas: ...Mr. Harl, on page 2 [of your prepared statement] you speak of making final payment to the Treasury on August 30, 1948, when you paid the Treasury out in full for the loans [capital] which were advanced. Do I understand that to be your statement?
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> Mr. Harl: We paid them for the money advanced.
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> Senator Douglas: Would that include the interest upon the Government loan which was made?
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> Mr. Harl: It did not. The law provided that there should be no dividend upon the capital stock.
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> Senator Douglas: In practice, the Government has made an advance to the FDIC which has not been repaid; namely, the interest on the bonds which the Government issued, but for which it was not reimbursed.
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> . . .
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> Mr. Harl: ...This Corporation stands ready to reimburse the Government, or anyone else, provided it is legally authorized to do so.
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> Senator Douglas: You are ready to pay the interest, is that right?
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> Mr. Harl: If we have an obligation we are ready to pay it.
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> . . .
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> Senator Douglas: That is a possible source of revenue that I had not thought of. This brief conversation, which I at first thought was going to be unprofitable, might yield the Government as much as $40,000,000. I first thought it was love's labor lost. It may turn out there was gold in "them there hills."[25]

The amount estimated by Senator Douglas was somewhat low. During 1950 and 1951, the FDIC paid approximately $81 million to the Treasury for the interest foregone on the initial contribution of both the Treasury and the Federal Reserve Banks.

An interesting benchmark was passed in 1961 when investment income ($73.9 million) surpassed assessment revenue ($73.4 million) for the first time. This remained so until the late 1980s, when insurance losses had eliminated assessment credits, thus increasing assessment revenue, and depleted the fund's investment portfolio and earnings.

[25] U.S., Congress, Senate, Committee on Banking and Currency, *Hearings before a subcommittee of the Senate Committee on Banking and Currency on Bills to Amend the Federal Deposit Insurance Act*, 81st Cong., 2d sess., January 11, 23 and 30, 1950, pp.27-29.

With the low insurance-loss experience of the 1950s and 1960s, and despite the implementation of the assessment credit program in 1950, the insurance fund continued to grow, reaching $4.4 billion at the end of 1970. The fund's growth rate trailed that of insured deposits, though, and the reserve ratio declined to 1.25 percent by the end of 1970.

There were three increases in the insurance coverage limit during the years 1942 to 1970. Coverage was raised from $5,000 to $10,000 in 1950, to $15,000 in 1966 and to $20,000 in 1969.