Chapter 4
The Early Years: 1934 – 1941

Background

The history of the FDIC cannot be considered apart from changes in economic and banking conditions. The early years of the FDIC's existence were not a period of risk-taking by banks. Caution marked the attitudes of both the supervisory agencies and the industry itself. For their part, the supervisory agencies viewed the events that culminated in the nationwide bank holiday 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 what the FDIC later termed as a policy of keeping banks and banking practices within the bounds of rightful competition.

The attitude of bankers was similarly circumspect. Those who survived the Depression were chastened by that experience. The effect of the Depression experience on the industry was reflected in the subsequent massive liquidity buildup undertaken by banks. By 1937, for example, cash and holdings of U.S. government securities comprised about 52 percent of the industry's total assets, or more than twice the proportion held in 1929. To the dismay of would-be borrowers, banks continued to stress liquidity for many more years.

Legislation enacted in the 1930s to insulate banks from competing with one another too aggressively also restrained bank behavior. The Banking Act of 1933 outlawed the payment of interest by member banks on demand deposits. The Act also authorized the Federal Reserve Board to set a ceiling on time deposit rates offered by member banks in order to forestall ruinous competition among banks. In addition, the 1933 law ordered the separation of investment from commercial banking to be completed by mid-June 1934.

The Banking Act of 1935 similarly incorporated provisions designed to limit bank behavior. The Act expanded the FDIC's supervisory powers and set more rigorous standards for admission to insurance. The 1935 law required the FDIC to prohibit the payment of interest on demand deposits in insured nonmember banks and to limit the rates of interest paid.

While the effects of a still-depressed economy also engendered caution on the part of bankers and regulators, conditions improved from the low point reached in 1933. Unemployment declined significantly, real GNP increased at an average annual compound growth rate of 9.5 percent between 1933 and 1937, and price increases were moderate. The recession of 1937-1938 interrupted this pattern of economic expansion. Owing to the continuous improvement in the banking system that had occurred since the bank holiday of 1933, however, banks were able to meet without difficulty the strains resulting from the decline in business activity that ensued. Following the recession, economic conditions improved once again as real GNP rose and unemployment abated.

Capital Rehabilitation

After the initial admission examinations had been completed, in early 1934 the FDIC shifted the emphasis of its examination function from determining minimal acceptability to the strengthening of weaker banks, particularly in the area of capital adequacy. It was determined that minimal safety required banks to have net sound capital equal to at least 10 percent of deposits. Net sound capital was defined as equity, capital notes, debentures and reserves, less assets classified as worthless or of doubtful value, including bond depreciation. Based upon admission examination findings, all banks not meeting this standard were reexamined during the first six months of 1934.

The same cooperation accorded to banks initially rejected for deposit insurance was given to those banks requiring capital rehabilitation. Of the state nonmember banks admitted to the fund, 35 percent were found to be undercapitalized. Subsequent examinations and rehabilitative efforts reduced this ratio to just 13 percent by the end of 1934. Many other banks recorded significant improvements though they still fell short of the 10 percent standard. For example, 20 percent of the initial applicants had net sound capital of less than 5 percent, but by year-end 1934, only 3 percent were under this level. This improvement in capital was achieved despite the fact that insured nonmember banks wrote off adversely classified assets equal to 20 percent of their total capital. The RFC supplied most of the funds used to offset these write-offs, while the remainder was supplied by local interests and retained earnings.

By the end of 1934, the concept of federal deposit insurance was generally accepted, even by most of its detractors. As one measure that public confidence had been restored, bank runs were no longer a significant problem, although they did not disappear altogether. Local concerns about the solvency of an individual bank still gave rise to occasional bank runs. In some instances, fears were aroused when it was felt that bank examiners had overstayed their “normal” visit to a bank, although these fears were usually groundless.[24]

Safety-and-Soundness Examination Policy

After completing its first two examination tasks – admissions and capital rehabilitation – the FDIC again shifted its examination focus and concentrated on developing permanent examination policies and procedures. The purposes of these examinations were fivefold:

1. Appraise assets in order to determine net worth;
2. Determine asset quality;

[24]Interview with Neil Greensides (former Chief, FDIC Division of Examinations), Washington, DC, August 16, 1983.

3. Identify practices that could lead to financial difficulties;
4. Appraise bank management; and
5. Identify irregularities and violations of law.

In addition to completing and reviewing its own examinations, in 1936 the FDIC began reviewing examination reports of national and state member banks because the FDIC had an insurance exposure for these banks supervised by the Comptroller of the Currency and the Federal Reserve.

Some analysts came to the conclusion that supervisory policies in the 1930s were unduly harsh, and that recessionary periods were not the time to pressure banks to sell depreciated assets and reduce risk. Such practices, it was felt, would lead to a restriction of credit as well as otherwise unnecessary bank liquidations and forced mergers. These concerns had been expressed to the Comptroller of the Currency in 1931, but policy directives at that time were generally ineffective.

A sharp recession had begun in 1937, rekindling these criticisms of bank examination policy, and in 1938 Secretary of the Treasury Morgenthau called for a conference of bank examiners. This time around, policy changes were strictly translated into examination procedures, resulting in more lenient asset valuation techniques. It was agreed that most bonds would be appraised at book value rather than market value, a policy believed to be more reflective of long-term investment quality. Moreover, a larger portion of classified assets were to be included in the capital ratio calculation. These policy shifts caused only a slight increase in aggregate capital-to-assets ratios – 12.8 percent under the new method *versus* 12.6 percent under the old – but the difference at individual banks, particularly marginal performers, could be critical.

The 1938 conference also led to a revision of the nomenclature of asset classification, establishing the four groups that have remained essentially unchanged: (I) not mentioned, (II) substantial and unreasonable risk, (III) loss is probable and (IV) uncollectible (immediate charge-off). Since 1949, categories II, III and IV have been referred to respectively as substandard, doubtful and loss.

The Banking Act of 1935

During the 20 months that the Temporary Federal Deposit Insurance Fund was in operation, the banking situation improved significantly. Attention was shifted to the specific insurance provisions of the 1933 Act. Most of those who had originally opposed deposit insurance legislation apparently had been convinced that the existence of the FDIC was a major contributing factor to the drastic reduction in bank failures. However, various provisions of the original permanent plan were viewed as not being appropriate in the new environment.

The banking industry did not like the potential for virtually unlimited assessments and generally felt that the assessment rate should be set at a relatively low level. Large banks took exception to shifting the assessment base from insured to total deposits, contending that they would be unduly penalized because of the relatively large proportion of uninsured deposits held in larger institutions. State-chartered nonmember banks objected to mandatory membership in the Federal Reserve System as a precondition for retaining deposit insurance coverage.

FDIC recommendations. For its part, the FDIC was faced with a dilemma. Although the bank failure rate had dropped precipitously and the capital rehabilitation program of the RFC and the FDIC had been moderately successful, the banking system was not strong and the prospects for bank earnings were not bright. Additionally, the fears and uncertainties regarding the bank failure rate had not been dispelled by 1934 and indeed would not recede for more than two decades. The FDIC thus was faced with the problems of protecting the earnings of insured banks until capital and reserve positions could be rebuilt while, at the same time, conserving what was by historical standards a modest deposit insurance fund.

During 1934, FDIC staff began drafting what was to become Title I of the Banking Act of 1935. In hearings beginning in February 1935 before the House Committee on Banking and Currency, FDIC Chairman Leo Crowley articulated his plan for the future of federal deposit insurance. The FDIC had calculated that during the period 1865-1934, an annual average assessment rate of about one-third of 1 percent of total deposits would have been required to cover the actual losses on deposit balances in failed banks. However, if certain “crisis” years in which losses were unusually high were eliminated, the necessary rate would have been lowered to about one-twelfth of 1 percent. Adoption of the lower rate was justified on the grounds that many banking reforms and improvements had occurred to strengthen the banking system and prevent bank failures.

In addition to an assessment rate lower than historical experience would suggest, Crowley’s plan consisted of a combination of stricter entrance standards for new banks and expanded authority over the actions of existing banks, expanded powers regarding the handling of failing banks, a reduction in insurance exposure (*i.e.*, retaining the $5,000 insurance coverage rather than the higher limits envisioned in the original permanent plan) and other provisions that would tend to conserve the deposit insurance fund. From a practical point of view, the program advocated by Crowley consisted of attempting to strengthen the banking system, while using every legal means available to conserve FDIC financial resources. This philosophy dominated FDIC behavior until the mid-1960s.

Enactment. By early August, the two houses of Congress resolved their differences on changes in the assessment rate, accepting the rate recommended by the FDIC. A compromise also was reached on the Federal Reserve membership issue. In the final conference report, which was accepted by both houses on August 19, only insured banks with more than $1 million in deposits would be required to join the Federal Reserve System, beginning in 1941. The membership requirement was rescinded altogether in 1939.

The Banking Act of 1935 became effective August 23, 1935. The deposit insurance provisions of the Act, with few exceptions, were identical to the draft legislation prepared by the FDIC. From a financial point of view, one of the most significant revisions to the original permanent plan related to the calculation of assessments levied on insured banks. The 1935 Act provided that assessments were to be based on a flat annual rate of one-twelfth of 1 percent of *total* (adjusted) deposits. The effect of this change was to shift the relative burden of the deposit insurance system to the larger banks while protecting the level of assessment income to the FDIC.

Admissions. The Banking Act of 1935 provided for the automatic admission to insurance under the permanent plan of all banks insured at the close of the temporary funds, except banks which signified, within 30 days, their intention to withdraw from insurance and those banks that had failed to file the required certified statement of deposits and to pay the required assessments.

Thirty-four banks insured under the temporary plan withdrew within 30 days after the close of the temporary funds. One other bank had its insurance status terminated by reason of failure to file the certified statement. Automatically admitted to insurance under the permanent plan were 14,219 banks. Of these, 14,163 were commercial banks insured in the Temporary Federal Deposit Insurance Fund and 56 were mutual savings banks insured in the Fund For Mutuals.

The 1935 Act set more rigorous standards for admission to insurance. In acting on insurance applications from new banks, the FDIC was required to consider the adequacy of the bank's capital, its future earnings prospects, the quality of its management and its usefulness in serving the convenience and needs of the community.

The revised law, moreover, provided that any balances to which an insured bank was entitled, upon termination of the temporary federal deposit insurance funds, were to be credited toward the assessment to be levied under the permanent insurance plan. These balances consisted of the unused portion of assessments collected under the temporary plan. Since investment income of the temporary funds was sufficient to pay all of the operating expenses of the FDIC and cover deposit insurance losses and expenses, insured banks received a credit for the full amount of the assessments they had paid.

Supervisory powers. Insured nonmember banks were required to obtain the FDIC's approval before opening new branches or reducing their capital. The Act required all insured banks to obtain approval before merging or consolidating with noninsured institutions. The FDIC was empowered to require any insured bank to provide protection and indemnity against burglary, defalcation and other similar insurable losses. If an insured bank was found by the FDIC to have continued unsafe or unsound practices, the practices were to be reported to the appropriate supervisory authorities. A bank's insurance status could be terminated if the practices were not corrected.

In order to strengthen the banking system, the FDIC was given the right to make a loan to, or purchase assets from, an open or closed insured bank to facilitate its merger or consolidation with another insured bank, if the merger would reduce the risk or avert a threatened loss to the FDIC. This power, which was first granted on a temporary basis, later was made permanent.

The Banking Act of 1935 required the FDIC to prohibit the payment of interest on demand deposits in insured nonmember banks and to limit the rates of interest paid on savings and time deposits. The FDIC also was required to prohibit insured nonmember banks from paying any time deposit before its maturity, except as prescribed by the FDIC.

In granting these and other regulatory powers to the FDIC, Congress sought to prevent unsound competition among banks. The prevailing philosophy was that unfettered competition in the past had resulted in excesses and abuses in banking as well as other industries. The restrictive powers contained in the Banking Act of 1935 were thus consistent with the tenor of other New Deal legislative programs.

Borrowing authority. The FDIC was authorized to issue notes or other obligations in an amount not to exceed $975 million, and the RFC and the Secretary of the Treasury were directed to purchase up to $500 million of these notes if the funds were needed for the payment of depositors. The FDIC never borrowed under this provision of the Act. The Act also deleted the requirement for initial and subsequent capital subscriptions by insured banks, and the payment of dividends on capital stock held by the U.S. Treasury was eliminated.

Insured-Bank Failures

The Banking Act of 1933 authorized the FDIC to pay up to $2,500 to depositors in insured banks that failed. The only procedure to be used to pay depositors was a Deposit Insurance National Bank (DINB), a new national bank chartered without any capitalization and with limited life and powers. During the period of the temporary deposit insurance plan, January 1, 1934 to August 23, 1935, 24 insured banks were placed into receivership and their depositors paid off through a DINB. The first FDIC-insured bank to fail was the Fondulac State Bank in East Peoria, Illinois, which was closed by the state in May 1934. Mrs. Lydia Lobsiger received the first federal deposit insurance payout, a check for $1,250 dated July 3, 1934. This was the only bank to fail while the $2,500 coverage limit was in effect.

The 1935 Act gave the FDIC the authority to pay off depositors directly or through an existing bank, and once that authority was granted, the FDIC ceased using the DINB for the next 29 years. The DINB provides a vehicle for a slow and orderly payout, and its use in recent years has been confined to situations where only limited banking services were available in the community or where a regular payoff would have been substantially delayed.

In addition to broadening the ways in which a payoff could be effected, the 1935 Act gave the FDIC the authority to make loans, purchase assets and provide guarantees to facilitate a merger or acquisition. This authority had been sought by the FDIC because of its concern that many of the banks that had been granted deposit insurance might not survive, and paying off insured depositors in these banks would be too expensive. In addition, most banking observers felt that there were too many banks in operation and that it would be desirable if the FDIC could facilitate an orderly reduction in their number through increased mergers.

The FDIC handled 370 bank failures from 1934 through 1941, an average of more than 50 per year. Most of these were small banks. Without the presence of federal deposit insurance, the number of bank failures undoubtedly would have been greater and the bank population would have been reduced. The presence of deposit insurance also may have limited the necessity for some banks to merge, and may have indirectly encouraged retention of restrictive state branching laws. Insurance losses totaled nearly $23 million during this period. The FDIC had positive net income in all but its first year of operation, though, and the insurance fund continued to grow. The year-end 1941 fund balance was $553.5 million. This resulted in a ratio of the fund to insured deposits of 1.96 percent, which remains the highest reserve ratio in the history of the FDIC.

The end of 1941 marked the completion of eight years of successful operation of the system of federal insurance of bank deposits. It also marked the close of a period of economic recovery under peacetime conditions, which provided especially favorable circumstances for the establishment of deposit insurance and for improvement in the financial condition of banks.