Chapter 1
Introduction

The Federal Deposit Insurance Corporation has served as an integral part of the nation's financial system for 50 years. Established by the Banking Act of 1933 at the depth of the most severe banking crisis in the nation's history, its immediate contribution was the restoration of public confidence in banks. While the agency has grown and modified its operations in response to changing economic conditions and shifts in the banking environment, the mission of the FDIC over the past five decades has remained unchanged: to insure bank deposits and reduce the economic disruptions caused by bank failures.

Background

At the time of its adoption in 1933, deposit insurance had a record of experiments at the state level extending back to 1829. New York was the first of 14 states that adopted plans, over a period from 1829 to 1917, to insure or guarantee bank deposits or other obligations that served as currency. The purposes of the various state insurance plans were similar: to protect communities from the economic disruptions caused by bank failures; and to protect depositors against losses. In the majority of cases the insurance plans eventually proved unworkable. By early 1930, the last of these plans had ceased operations.

At the federal level, deposit insurance had a legislative history reaching back to 1886. A total of 150 proposals for deposit insurance or guaranty were made in Congress between 1886 and 1933. Many of these proposals were prompted by financial crises, though none was as severe as the crisis that developed in the early 1930s. The events of that period finally convinced the general public that measures of a national scope were needed to alleviate the disruptions caused by bank failures.

From the stock market crash in the fall of 1929 to the end of 1933, about 9,000 banks suspended operations, resulting in losses to depositors of about $1.3 billion. The closure of 4,000 banks in the first few months of 1933, and the panic that accompanied these suspensions, led President Roosevelt to declare a bank holiday on March 6, 1933. The financial system was on the verge of collapse, and both the manufacturing and agricultural sectors were operating at a fraction of capacity.

The crisis environment led to the call for deposit insurance. Ultimately, the force of public opinion spurred Congress to enact deposit insurance legislation. The Banking Act of 1933, which created the FDIC, was signed by President Roosevelt on June 16, 1933.

By almost any measure, the FDIC has been successful in maintaining public confidence in the banking system. Prior to the establishment of the FDIC, large-scale cash demands of fearful depositors were often the fatal blow to banks that otherwise might have survived. Widespread bank runs have become a thing of the past and no longer constitute a threat to the industry. The money supply both on a local and national level has ceased to be subject to contractions caused by bank failures. The liquidation of failed bank assets no longer disrupts local or national markets and a significant portion of a community's assets are no longer tied up in bankruptcy proceedings when a bank fails.

The Early Years

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 banking 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 declined.

The FDIC handled 370 bank failures from 1934 through 1941. 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.

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.

The Period 1942-1972

During World War 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 depression 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.

The banking industry was in a favorable position to finance the spending spree that was poised to occur. Banks had emerged from World War II in very liquid condition. 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. 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.

Conservative banking practices and favorable economic conditions resulted in few bank failures during the late 1940s and 1950s. However, the low incidence of failures was regarded by some as a sign that the bank regulators were overly strict. 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 a 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.

The trend toward aggressiveness and risk taking 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.

There were other changes during the 1960s that had an impact on banking. States began to liberalize branching laws. The bank holding company vehicle was developed as an alternative form of multi-office 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.

Until the mid-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.

The Period 1973 — Present

Bank behavior has continued to undergo significant changes during the past ten years. Bank reliance on purchased money has increased, even for moderate-sized banks. Demand balances have become less important and, in the case of the household sector, most of these now pay interest. Cheap deposits, in general, have become scarce. Banks have entered new product markets, geographic expansion possibilities have broadened and traditional banking services are now being offered by financial and commercial conglomerates. While these changes have enabled banks to remain competitive, particular aspects of bank behavior, such as the growing dependence on purchased money, have made the industry more vulnerable to adverse economic conditions.

The performance of the economy over the past 10 years has not been very strong. The first of two major recessions during the decade occurred in 1973-1975. The severity of the recession contributed to a substantial increase in commercial bank loan losses and an increase in both the number of problem banks and bank failures. It was during this period that the FDIC encountered the first large bank failures. The 1973-1975 recession led to substantial real estate loan problems. In many instances these persisted well beyond the onset of economic recovery and, as a result, the bank failure rate remained comparatively high, peaking in 1976 at 16, the highest number since 1940.

The mid-1970s also were characterized by other special problems. Repercussions were felt throughout the economy as a result of the rapid increase in oil prices that began in 1973, and the subsequent role of U.S. banks in recycling petrodollars. The oil price shock contributed to a rising inflation rate and new highs in interest rates in 1974.

While the banking industry did not fully recover from the effects of the recession until 1977, the following year brought renewed pressures on the industry. In 1978, interest rates on securities markedly surpassed the rates payable by depository institutions for savings and time accounts. Deposit growth slowed, particularly at thrifts, as alternative investment instruments and yields became relatively attractive.

In 1979 and early 1980, inflation burst upward, along with interest rates. The rise in interest rates was spurred not only by inflationary pressures, but also by a change in Federal Reserve monetary policy in October 1979. The resultant high interest

rates, in combination with an unduly heavy emphasis on fixed-rate, long-term lending, caused severe problems for the thrift industry.

In addition to the stresses produced by high interest rates, financial institutions had to cope with the changes engendered by the passage of banking deregulation legislation in 1980. The Depository Institutions Deregulation and Monetary Control Act, the most sweeping banking reform package enacted since 1933, mandated the elimination of interest rate ceilings by 1986. Other provisions of the Act liberalized lending powers of federal thrifts and preempted some state usury laws. Two years later, in 1982, Congress passed the Garn-St Germain Depository Institutions Act, which took deregulation even further and gave the regulators more flexibility in dealing with failing institutions.

A severe recession in 1981-1982 placed further strains on the banking industry. The recession arrived at a time when bankers were willing (and may even have felt forced) to take additional risks in order to maintain interest margins in the face of rising liability costs. The lure of lending to growth industries had led some banks to excessive loan concentrations in fragile industries. An oil surplus and the resultant decline in prices, for example, caught many bankers who had invested heavily in independent oil and gas development companies that suddenly were no longer viable.

Recession-related factors, in combination with high and volatile interest rates and deregulation, caused loan charge-offs to increase by more than 50 percent in 1982 alone. The number of problem banks also increased sharply. In 1982, the number of bank failures hit 42, a new post-World War II high. Moreover, despite the turnaround in the economy during the first half of 1983, there were 27 commercial bank failures during this period.

These developments have had a major impact on the FDIC. There is a greater sense of bank exposure and risk of failure that exists not just among those who regulate and follow banks, but among the general public as well. The FDIC has had to adjust its bank supervision practices, as well as dramatically increase its liquidation work force. Changes in the complexity and size of the banking industry over the past decade have presented the FDIC with challenges and problems as formidable as those faced by the FDIC during its first decade.

This book chronicles the history of the FDIC during its first 50 years. Chapter 2 focuses on the antecedents to federal deposit insurance. The events that led to the passage of the Banking Acts of 1933 and 1935 are discussed in Chapter 3. The financial and internal operations of the FDIC are detailed in Chapter 4. Inasmuch as the handling of failures and bank supervision have encompassed the FDIC's primary areas of responsibility, each of these areas is covered separately in Chapters 5 and 6, respectively. Some final thoughts on the occasion of the FDIC's 50th anniversary are offered in the Epilogue.

On June 16, 1933, President Franklin Roosevelt signed the Banking Act of 1933, a part of which established the FDIC. At Roosevelt's immediate right and left were Sen. Carter Glass of Virginia and Rep. Henry Steagall of Alabama, the two most prominent figures in the bill's development.

Photo: Wide World Photos