The FDIC Podcast – A Look Back at Bank Failures and Deposit Insurance in the U.S. (Part One)

BRIAN SULLIVAN: Hey, welcome back to the FDIC podcast, where we talk about our banks and your money. I'm Brian Sullivan at the Federal Deposit Insurance Corporation. In the next two episodes, we're going to go back in time to remember some of the recent and not so recent financial crises, and how we came out of those and what that means for us today.

We can't talk about this history without going back to the Great Depression, before there was an FDIC, before people's bank deposits were insured, and before folks had the same level of confidence in their banks as they do today. Recall from your history class, back in the day, the run on the nation's banks and how President Franklin Roosevelt called a bank holiday in March of 1933.

> **PRESIDENT ROOSEVELT:** It needs no prophet to tell you that when the people find that they can get their money, that they can get it when they want it for all legitimate purposes, the phantom of fear will soon be laid. People will again be glad to have that money where it will be safely taken care of and where they can use it conveniently at any time. I can assure you my friends, that it is safe to keep your money in a reopened bank than it is to keep it under the mattress.

BRIAN SULLIVAN: You can reasonably say that in his more than 35 years at the FDIC, Art Murton has seen it all. He joined the agency back in 1986 as an economist, and over the years has had a front row seat for all the ups and downs in the banking and financial sectors. Today, Art Murton is the Deputy to the FDIC Chairman for Financial Stability, and he joins us. Art, welcome.

ART MURTON: Thank you, Brian. It's a pleasure to be here.

BRIAN SULLIVAN: So, Art, let's start at the beginning way back in the '30s, nearly 90 years ago during the Great Depression when the FDIC came into being.

ART MURTON: Yes, following the stock market crash of 1929 in the next few years, over 9,000 banks failed in the U.S. and in fact, 4,000 banks failed in the few months before President Roosevelt took office.

BRIAN SULLIVAN: Calamitous!

ART MURTON: It was, it was. And, as you heard, the president declared a bank holiday to restore confidence in the banking system and following that, Congress created the FDIC to provide federal deposit insurance.

BRIAN SULLIVAN: **So, w**hat's the idea behind that? Just so, I mean, people kind of understand that their deposit are insured, but what's the foundation of that.

ART MURTON: Well, the idea is that if people know that their deposits are guaranteed and protected by the FDIC, they won't feel the need to run on the bank when there are concerns about possible problems, because they know that their money is safe. And that mitigates or prevents the runs on the banks that they had seen in the years prior to that.

BRIAN SULLIVAN: And to be clear, they don't pay the premiums on that insurance policy, right?

ART MURTON: No, no, the banks paid for deposit insurance. And in fact, when the system was started to set up a fund to protect the deposits, the FDIC borrowed money from both the Federal Reserve and the Treasury Department and paid those loans back over the next 15 years.

BRIAN SULLIVAN: Just to capitalize the insurance fund?

ART MURTON: Seed money for the funds. Exactly.

BRIAN SULLIVAN: I see.

ART MURTON: I'm also going to talk today, not just about the FDIC but also another agency that was created in 1934 to ensure the deposits of what are called savings and loans. And it's probably worth distinguishing between what the FDIC insures, commercial banks, and what the Federal Savings and Loan Insurance Corporation insured…

BRIAN SULLIVAN: FSLIC!

ART MURTON: Exactly…Savings and Loans. Commercial banks were essentially depository institutions that took in checking accounts, offered checking accounts to, to their customers and made loans to businesses. Savings and Loans were place where people put their savings accounts and Savings and Loans took those funds and lent them out in the form of mortgages to homeowners…for people to buy their houses. So there were two systems of federal deposit insurance created in the early thirties. And I should just note that several decades later, a third deposit insurance system was established to ensure that deposits of credit unions…

BRIAN SULLIVAN: ...the National Credit Union Administration.

ART MURTON: Correct.

BRIAN SULLIVAN: Well, we talk about the FDIC today. We don't talk about FSLIC. What happened there?

ART MURTON: Well, we'll get to that.

BRIAN SULLIVAN: Okay. So here we are. We finally have a national system of deposit insurance, whether in a commercial bank or in these Savings and Loans that had to stabilize.

ART MURTON: It did. It did stabilize the situation. But along with creating those agencies, there were also some limits placed on risk taking because deposit insurance was actually controversial. A number of people thought it was a bad idea, including most of the bankers at the time who felt that it would lead to excessive risk taking because if the depositors were protected, they wouldn't care whether their banks were safe or not, and how the bankers lent their money. And so, it might create more risk in the system. So, there were some measures put on to try to control that risk.

BRIAN SULLIVAN: So, I gather for a period of time, everything was okay?

ART MURTON: It was, it was, really for the next few decades. But it's probably worth mentioning that some of those controls on, on the risk taking were things like caps on the rates that banks could pay for deposits. So, there was a limit on how much banks could pay depositors.

BRIAN SULLIVAN: In interest?

ART MURTON: Exactly. So, for example, on your checking account, they could pay no interest and on savings accounts, it was limited. There was a cap on it.

BRIAN SULLIVAN: Now, why would the government care how much interest banks pay their customers? You would think that that's a market decision.

ART MURTON: Exactly. But the concern was that if banks could compete with one another by paying higher rates to attract deposits, they would then have to lend that money out at higher rates, presumably for riskier loans. And that risk would build up in the system and you'd have problems again.

BRIAN SULLIVAN: Is that why we don't get very much interest on our deposit accounts today?

ART MURTON: That's probably a different story and one that might take a little more time.

BRIAN SULLIVAN: Okay. Well, so in controlling the interest that banks could charge or pay, rather, to their depositors, was there any concern that, that there was not enough or too much competition in the banking space?

ART MURTON: Right. At that time there was concern that there had been too much competition. Some people referred to it as 'ruinous competition.' So there, the idea was perhaps to limit the ways in which banks could compete, not just through deposit rates, but also geographic restrictions on how many banks could be in a given geographic location, how many branches they could have, and the idea was to limit competition so that you wouldn't get the, again, the risk-taking,

BRIAN SULLIVAN: So, there was a time in this country's history where you could be a bank in Texas, but that bank couldn't also be a bank in Pennsylvania.

ART MURTON: That's correct. That's correct.

BRIAN SULLIVAN: And these days you can be a bank anywhere.

ART MURTON: That's right. So, as you mentioned, market forces developed that, you know, led to broader and broader geographic expansion.

BRIAN SULLIVAN: Well, did any of these caps on interest or geographic restrictions and up harming the system in the end?

ART MURTON: Well, I don't know if it harmed it, but I might mention just how banks adapted to that. So, they could not compete with one another through deposit rates obviously, but what they tried to do was compete in other ways. So, they might offer a better loan rate if you had deposits at the bank or banks often put in more branches to make it more convenient for their depositors, because remember this was before ATMs. So, the way people got their money was by going to the branch of the bank.

BRIAN SULLIVAN: Branch locations. Right.

ART MURTON: And also, the banks competed by providing essentially gifts for placing deposits. The classic example of that is toasters. When you opened a deposit account, you would get a toaster. And you know, in terms of restrictions or branching, there was a period in the sixties and seventies when the regulators, including the FDIC Board had to approve new establishment of new branches and so the concern was you didn't want to have too many in one area. And so, the staff would have to recommend to the Board whether to approve and an obvious way to analyze that would be to look at how far apart these two locations were. And, but there are other considerations such as how easy it is to get from one place to another? Are there hills? Are there rivers, valleys, et cetera? So, at that time, the staff of the FDIC, when it presented the case to the Board for approval, it used papier-mâché models of the topography to, to allow the Board to help make that decision.

BRIAN SULLIVAN: To illustrate whether or not there was too much concentration or not enough for, or how difficult it was to cross a creek to get to the bank?

ART MURTON: Exactly that. I mean, that's essentially what passed for data visualization in those days.

BRIAN SULLIVAN: It sounds so anachronistic that you'd be using paper mache models or models of any kind to define where one bank branches versus another bank branch. At some point in time, though, the federal government seemed to relax its restrictions on competition. What happened?

ART MURTON: Well, I think market forces forced some changes. So, for example, as interest rates rose in the late sixties and early seventies, people wanted a better return on their deposits and so within the banking industry, the *NOW Account* was created that acted like a checking account, but paid a rate of interest…that was created by a small savings bank in Worcester, Massachusetts.

And then outside the banking industry, the Money Market Mutual Funds arose and they offered a product that acted pretty much like a checking account, but also paid a rate of interest. Now they did not have federal deposit insurance but they were safe because they invested in safe instruments like treasuries. And Money Market Funds, mutual funds, became quite popular and there was a concern that they could draw funds away from the banks…commercial banks and Savings and Loans.

BRIAN SULLIVAN: Right, well they weren't insured but they sure acted like a checking account in most every other respect, right?

ART MURTON: That's right. That's right. So that led to some pressure to ease some of the restrictions on banks. And of course, money market mutual funds became very popular and, uh, you know…and they experienced problems in 2008 and again last year.

BRIAN SULLIVAN: We'll get to that. Right. But again, they were not insured.

ART MURTON: That's correct.

BRIAN SULLIVAN: Okay. So, Art, after the creation of the FDIC and FSLIC for the Savings and Loans out there, there's this period of calm and stability in the banking sector, very few bank failures…everything's going pretty good, right? Were there any signs of trouble during this period of time?

ART MURTON: Well, not yet, but there were some who had concerns about that stability. And in fact, in 1963 at the dedication of the FDIC's new headquarters at the time, two blocks west of the White House, the Chairman of the House Banking Committee gave the keynote speech. And in that speech, and I will quote from it, he said, "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."

BRIAN SULLIVAN: Well, pardon me for, you know, thinking that's nonsense. Am I wrong here? You're the economist here. Tell me, is our bank failures, can they be sometimes a good thing? I don't know.

ART MURTON: I think his concern was that the rules were too restrictive and that they impeded the ability of banks to serve their communities and support the economy and that it may be a limit on economic growth.

BRIAN SULLIVAN: So, I guess coming out of something like the Great Depression and all these controls that are put on the bank, controls like how much interest they can pay their depositors and where they can operate, thought to be too restrictive and maybe we needed a little "thinning of the herd," so to speak?

ART MURTON: Yes, well, yes. And, you know, after that, after the early '60s and going into the late '60s and early seve'70s, the economy changed or experienced inflation and higher interest rates. If people remember, there was high rates of inflation in the 1970s and that put pressure on the economy and on the financial system and the banking system. And something needed to be done to address the high rates of inflation. And if you'll recall in 1979, Paul Volcker became the Chairman of the Federal Reserve. And his main initiative was to try to combat inflation by raising interest rates to, to calm down the economy, in order to bring inflation and the expectations of inflation under control.

BRIAN SULLIVAN: Yeah, well, I guess few people these days know what inflation is or high interest rates either, right? So, we've been operating under low inflation, low interest rates for so long.

ART MURTON: Yeah. To give you an example, my first job out of college, I received, and my colleagues received, two cost-of-living adjustments per year, and they were not insignificant.

BRIAN SULLIVAN: Goodness gracious! Well, so in the 50 years or so after the Great Depression, again still a period of relative calm and stability, but then we go into the 1980s and something happened. What happened?

ART MURTON: Well, as I said, the high interest rates, and the reaction to that, created severe problems for certainly the Savings and Loan industry and, eventually problems for the commercial banking industry as well. And, you know, I might quote from the Chairman of the FDIC in 1983. The FDIC put out a study that was called "The First 50 Years," documented the first 50 years of the FDIC. And in the introduction to that, the Chairman of the FDIC said, "We hope the need for deposit insurance will never again be as great as it was in the 1930s. Nevertheless, as the FDIC embarks on its second half century, the challenges at hand are greater than at any time in the past four decades."

BRIAN SULLIVAN: Hmm. Ominous sounding.

ART MURTON: It was. And so perhaps maybe I can talk about the, what happened to the Savings and Loans.

BRIAN SULLIVAN: Yeah. Well, the S&L Crisis, you know, just blew up and, and people were harmed.

ART MURTON: That, that's right. So, if you think about what a Savings and Loan balance sheet looked like back then, they made essentially 30-year mortgages. They loan money out for 30 years at fixed rates and they took in deposits. But as I said, interest rates were rising, the cost of their deposits and the means of attracting funds was going up. So, what happened was they were paying more to attract deposits than they were earning on the loans.

BRIAN SULLIVAN: Yeah. It just doesn't work out.

ART MURTON: Right. They were upside down as people refer to it. So that created huge losses in the Savings and Loan Industry. And I think it's fair to say that people would agree that the policy response to that was in some ways misguided. So, the idea, some of the measures were to allow the, try to give the Savings and Loans expanded powers to get into types of lending that they had no experience in, in order to help grow out of their problems. That was one of the ideas. They changed accounting rules so that the losses that were on the books were not apparent through the accounting that they were allowed to employ. And then, in terms of capital, the buffer that absorbs losses for banks and Savings and Loans, they were allowed to use capital instruments that really were not available to absorb losses. So, in a sense, it was way of delaying the recognition of these losses and allow the losses to grow over the years.

BRIAN SULLIVAN: So, they just kept digging the hole deeper. And then they started going out of business in droves, right? What happened to the insurance fund that was set up to protect people who their money into the Savings and Loans?

ART MURTON: That's right. Good question. The, so at first, they, they raised the premiums that Savings and Loans paid, but they, the industry was too weak to fully bear the cost of that. They tried some stop gap measures such as issuing bonds, 40-year bonds, borrowing money in the market to, to shore up the FSLIC…

BRIAN SULLIVAN: **…s**tealing from Peter to pay Paul, it sounds like.

ART MURTON: That's a good way to put it. And then finally it was recognized that something had to be done, something more meaningful. And so, when in 1988, when the first President Bush took office, one of his first announcements was that they were going to address the Savings and Loan problem. And they started looking for solutions and, you know, of course an obvious question is how are you going to pay for those losses? And at the time there was a senior White House official who floated an idea for paying for them. And he suggested that there be essentially, you levy a premium on depositors to, to bring in funds to pay for it. And the Chairman of the FDIC at the time, Bill Seidman, didn't think that was a good idea and.

BRIAN SULLIVAN: He was a salty character, wasn't he?

ART MURTON: He was. And in fact, he referred to that plan publicly as the "reverse toaster plan." So, of course, this White House official wasn't very happy about that and he spent the next few years trying to encourage Chairman Seidman to leave office early, before his term was up. And it turns out that Chairman Seidman had a ranch in Arizona, and he liked to go out there and ride his horses, and one time he was riding, and he had a horrible accident. He was thrown from his horse. He lost a great deal of blood. His life was in jeopardy. And the story is, and it may be apocryphal, is that when he woke up in the hospital the first thing he said was, "tell so-and-so I'm not leaving!"

BRIAN SULLIVAN: Oh, my goodness! Well, the Savings and Loan crisis ultimately had to be resolved by the creation of the Resolution Trust Corporation. They came in to clean up the mess.

ART MURTON: That's, right. The Congress in 1989, passed what is known as FIRREA. I won't go into the acronym, but it essentially abolished FSLIC. It made the taxpayers pay for the losses. So, the taxpayers had to pony up over a hundred billion dollars and it created what you referred to, the Resolution Trust Corporation, which was an agency, a temporary agency, set up to handle hundreds and hundreds of failed Savings and Loans. And then once it was finished with that, go out of business.

BRIAN SULLIVAN: At this point, we're going to bring this to a close and continue our walking down memory lane with Art Murton in our second in a two-part series of podcasts on the History of Recovery. Art, thank you so much for joining us for Part One.

ART MURTON: You're welcome, Brian. It was my pleasure!