Remarks
by
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When I glimpsed the Bank of England on the way here this morning, I was reminded just how great a contribution that institution has made by inventing many of the practices in finance that are now used around the world. The Bank of England was founded in 1694, almost a century before the United States became a nation, when a group of merchants agreed to lend 1.2 million pounds sterling to King William III at eight percent, in return for a monopoly on bank notes and the right to receive deposits. Over time, the Bank of England would also invent the role of a central bank.

By contrast, we in the United States did not establish an enduring connection between our banking system and our federal government until 1864 -- 170 years after the Bank of England was created. We did not create our own central bank until 1913.

With the Federal Deposit Insurance Corporation (FDIC), however, the United States created the oldest system of national deposit insurance in the world. Because I believe strong national systems for resolving failed financial institutions can make international coordination more effective, today I will talk about the FDIC's experiences in resolving two banking crises in the United States as a case study of the issues associated with the failures of financial institutions. I will also contrast that case study with another case study: the considerably less successful effort at dealing with savings and loan insolvencies in the United States in the 1980s and early 1990s.

The FDIC was created in 1933 to halt a banking crisis. Nine thousand banks -- a third of the industry in the United States -- failed in the four years before the FDIC was established. The failure of one bank would set off a chain reaction, bringing about other failures. Sound banks frequently failed when large numbers of depositors panicked and demanded to withdraw their deposits -- leading to a "run" on a bank. As depositors began withdrawing their cash in amounts larger than the bank could sustain, banks suspended operations and states across the country declared moratoria on bank transactions. The banking system of the United States was on the verge of collapse.

The behavior of depositors was not irrational. They had learned from hard experience that if they kept their money in a bank, it might not be available when they needed it, and they might lose a large portion of it as well. As a general practice, between 1865 and 1933 before the creation of the FDIC, depositors of national and state banks were treated in the same way as other creditors -- they received funds from the liquidation of the bank's assets after those assets were liquidated. The time taken at the federal level to liquidate a failed bank's assets, pay the depositors, and close the books averaged about six years -- although in at least one case, it took 21 years. From 1921 through 1930, more than 1,200 banks failed and were liquidated. From those liquidations, depositors at banks chartered by the states received, on average, 62 percent of their deposits back. Depositors at banks chartered by the federal government received an average of 58 percent of their deposits back.

Given the long delays in receiving any money and significant reductions in deposits when banks failed, it was understandable why anxious depositors would withdraw their savings at any hint of problems. With the wave of banking failures that began in 1929, it became widely recognized that the lack of liquidity that resulted from the process for resolving bank failures contributed significantly to the economic depression in the United States.

To deal with the crisis, the government of the United States focused on returning the financial system to stability by restoring and maintaining the confidence of depositors in the banking system. When it created the FDIC, the United States Congress addressed that problem in three ways: it created an agency to insure deposits, it gave that agency bank supervision responsibilities, and it gave that agency special powers to resolve failed banks. I will briefly discuss each of these three in turn.

First, the FDIC was established to insure bank deposits, initially up to $2,500. If a bank failed, its depositors were guaranteed to receive that much of their money from the government, in many instances within days.

In 1934, coverage was raised to $5,000. With that increase, 45 percent of the deposits in the banking system were covered by insurance. By providing the public with an assured source of liquidity, federal deposit insurance restored confidence in the banking system, insulated banks from runs and panics, and stabilized the financial system. The year after the FDIC was created, nine insured banks failed -- and total deposits in the banking system increased by 22 percent.

Today, we insure deposits of up to $100,000 at just under 11,500 institutions. With $27 billion in reserves, our Bank Insurance Fund (BIF) insures about two-thirds of the deposits at its member institutions. With just under $9 billion in reserves, our Savings Association Insurance Fund (SAIF) insures about 95 percent of the deposits of the thrift institutions that belong to it. Our insured institutions pay premiums to the funds based on the total amount of their insured deposits and the level of risk they present to the insurance fund. This risk is measured by their capital levels and the supervisory ratings they receive from bank examinations.

Second, the FDIC supervises state-chartered banks that are not members of the Federal Reserve System -- today this is just over 6,300 banks. Without a strong supervisory system, which in the United States includes three federal regulators, granting insurance on deposits would be an even riskier business for the guarantor of a deposit insurance system, which in our case is the U.S. government.

Third, the FDIC acts as the receiver responsible for resolving any potential failure involving one of the 11,500 insured institutions. Its extraordinary powers as receiver enable it to act quickly when a bank fails. These powers were enhanced in 1989 during the midst of our recent banking crisis.

We do not have to return to the 1930s for evidence that the FDIC's ability to act quickly stabilizes the banking system of the United States during times of crisis. In 1991-- just six years ago -- the New York Times described events when a large regional bank called the Bank of New England was failing: "Frantic depositors pulled nearly $1 billion out of the bank in two days; small savers trooped through the lobbies with their money in wallets, bulging envelopes and briefcases, and money managers yanked out multimillion-dollar deposits by remote control with computer and telex orders. Yet as soon as Washington stepped in, with the Federal Deposit Insurance Corporation taking over the bank on Sunday, the panic subsided," the Times concluded. The Bank of New England case underscores how rapidly public confidence in a financial institution can evaporate. It also underscores the importance of having a bank regulatory authority who can move quickly to address a bank failure. Bank of New England customers had doubts about their bank -- but the doubts were not contagious. A run on the Bank of New England did not spread into a general banking panic, with depositors at other banks also demanding their funds, despite the fact that nearly 1,200 banks had already failed in the United States in the 10 years leading up to the Bank of New England's failure.

Against that background, it is useful to look more closely at the nature of the FDIC's role as receiver, how that role is important in promoting liquidity after bank failures, some of the lessons we learned from our recent crisis, and why a special approach to resolving bank failures is better than handling them through bankruptcy proceedings.

Turning to the FDIC's role as receiver, we generally use one of three techniques in resolving a bank that fails. The first technique permits the FDIC to pay depositors their insured deposits using money from insurance reserves. The FDIC then liquidates the failed institution's assets and replenishes the insurance funds with the proceeds. Typically, when using this technique, the FDIC issues checks to depositors for the amounts of their insured deposits within three days of a bank's failure -- note I said in "days," not "weeks" or "years." The roles of insurer and receiver are two roles we play in one process: as insurer, the FDIC pays depositors of failed institutions from its insurance funds, which also provides the working capital for the resolution of failed bank assets. Then, as receiver, the FDIC liquidates the assets of the failed institution to replenish the insurance funds.

The second technique allows the FDIC to sell an institution that has failed, or parts of the institution, to a purchasing institution, which would assume the liability for the deposits of the failed institution. Generally, such a sale is carried out by the FDIC during a weekend, so depositors and customers have no interruption of banking service -- once again we are talking about days.

Using the third technique, the FDIC can provide financial assistance to keep an institution open and serving its community. That is what the FDIC did when Continental Illinois National Bank -- then the seventh largest bank in the United States -- failed in 1984.

From 1980 through 1994, during our banking crisis, the FDIC used the first technique -- paying depositors from our insurance funds and then liquidating assets to replenish the funds -- in 297 bank failures. We sold 1,184 failing banks to other institutions, sometimes with loss sharing arrangements. We also provided financial assistance to keep 136 failing banks open. We have not used this latter technique for several years, however, and are much less likely to use it in the future because of a change in the law in 1991 requiring the FDIC to use the least costly method for resolving a bank failure. This requirement is intended to introduce greater incentives for shareholders and large creditors of insured banks to impose more discipline on the management of insured banks to operate safely and soundly.

When appointed receiver, the FDIC assumes an obligation to all creditors of the receivership with the responsibility to recover for them the maximum amount possible on their credits as quickly as it can. When the FDIC pays off insured deposits, it becomes a creditor of the receivership for the amount of advances made to insured depositors. As assets of the receivership are liquidated, proceeds are periodically distributed as dividends to creditors, including the FDIC, on a pro rata basis. To promote the rapid return to liquidity of creditors, including depositors, the FDIC is able to declare “advance” or “accelerated” dividends based on an estimate of recoveries using its substantial insurance reserves.

Thus the FDIC seeks to assure stability in the financial system by guaranteeing the liquidity of insured deposits and the consequent liquidity of the banking system in times of stress.

The FDIC also returns assets of failed banks as quickly as possible to the private sector, which encourages greater market discipline in the economy and more rapid economic recovery. The 1,617 banks that failed or received financial assistance from the FDIC between 1980 and 1994 held nearly $320 billion in assets. That level of exposure for the financial system to insolvencies did not result in catastrophe in part because the FDIC was able immediately to return approximately $240 billion of those bank assets -- or about 75 percent -- to the private sector. Over time, the FDIC sold the bulk of the remaining assets, with only $4.3 billion in assets of failed banks to liquidate as of year-end 1996. Because the FDIC as receiver was able to resolve bank failures quickly, providing liquidity to local and regional economies, and promoting their recovery from recessions, it helped the U.S. economy return to its current robust health.

A good example of where the FDIC acting as receiver assured liquidity in the context of multiple bank failures arose in Texas, one of our major banking markets. In just three years -- 1987 to 1990 -- 473 banks in Texas failed or received FDIC financial assistance to stay open. They held nearly 26 percent of total bank assets in the state. Of these 473 banks, only 15 involved direct payouts to depositors for insured deposits. In the other 458 failures and assistance transactions, 384 banks were sold to acquirors and 74 were kept open with FDIC assistance to continue serving their communities.

Another example was our state of New Hampshire, which suffered from both a collapse of the local real estate market and the economic recession of the early 1990s. On October 10, 1991, seven of the banks in New Hampshire were closed, including six of the state's ten largest banks. The seven failed banks held 28 percent of banking assets in the state. More than three quarters of those assets were sold by the FDIC to local acquirers immediately upon closure.

The FDIC's rapid response to bank failures allowed the economies of these states to recover more quickly than would otherwise have been possible. In contrast, the United States also has experience with what happens when the widespread failures of financial institutions are not handled quickly or effectively -- which occurred during the collapse of our savings and loan industry in the 1980s.

The problem of the savings and loan associations began with rising interest rates. Until the 1980s, those institutions were by law generally limited to the business of accepting short- term deposits from the public and lending the funds for long-term home mortgages, with the maximum interest rates for deposits also limited by law. When interest rates began to climb in the late 1970s and early 1980s, the ceilings on the interest rates for deposits were phased out, and savings and loan institutions found themselves earning low interest rates on their loans long after they had to start paying high interest rates for their deposits. Over time, many institutions became insolvent -- far more than the old savings and loan insurance fund -- a fund not managed by the FDIC -- had the resources to liquidate. By one estimate, it would have cost that fund approximately $25 billion to close financial institutions that were insolvent in early 1983 -- four times the reserves that it actually held at that time. The problem was exacerbated by the fact that savings and loan associations in the United States were regulated unevenly and ineffectively by an agency that has subsequently been replaced.

In 1986, the reserves for the old savings and loan insurance fund were estimated to be negative $6.3 billion. By 1989, there were 517 insolvent savings and loan associations being kept open because no insurance reserves were available to resolve the failures. To clean up the problem, Congress ultimately had little choice but to establish a special government corporation to resolve the insolvent thrift institutions. Over all, Congress voted more than $132 billion to pay the direct costs of resolving savings and loan failures in the 1980s and early 1990s. The FDIC was also given the responsibility for managing a new Savings Association Insurance Fund, which the Congress passed legislation last year to capitalize fully using assessments on the thrift industry.

From the savings and loan crisis, the regulators in the United States learned that strong and effective supervision of depository institutions is essential to a sound system of government- sponsored deposit insurance and the rest of the safety net. Without such supervision, the insurer is faced with writing a blank check for losses. Without strong supervision, deposit insurance and the broader safety net simply become a public resource that risk takers can exploit. We also learned the importance of closing or transferring the obligations of insolvent, insured financial institutions promptly to keep the losses in the banking system to a minimum. Finally, we learned that a strongly capitalized deposit insurance fund is essential (1) to effective bank supervision so that problems in institutions can be addressed quickly, (2) to assuring liquidity in times of financial stress, and (3) to facilitating economic recovery by returning the assets of failed financial institutions to the private sector as soon as possible.

For more than two years, economists and other analysts at the FDIC have been systematically analyzing the bank and savings and loan association failures that occurred in the United States from 1980 through 1994 to draw specific lessons from the experience. Part One of our study -- focusing on lessons for future supervision of financial institutions -- was discussed with outside experts at a symposium earlier this year and will be published in a few months. Part Two of our study -- on how our role as receiver evolved during the banking crisis and what we have learned for the future -- will be the subject of a symposium later this year, with analyses and conclusions to be published in 1998.

It is our hope that all of us can learn from these historical studies.

Despite the FDIC’s success during the banking crisis, a small number of observers have recently proposed eliminating the FDIC as receiver and shifting that function to the bankruptcy system. Could the bankruptcy system have acted as quickly as the FDIC did in our recent banking crisis? The answer is clearly no, an answer substantiated by U.S. bankruptcy statistics.

From 1982 through 1995, only 491 companies in the United States successfully emerged from bankruptcy proceedings under Chapter 11, which gives companies protection from creditors while they reorganize. The average length of time for a company to emerge from this process was 17.2 months -- although it took one company more than 82 months, or almost seven years.

Moreover, for Chapter 7 proceedings -- which applies to liquidation of companies -- the process ranged from two to four years. Given a wave of regional bank failures or one large institution failure, such a delay in providing liquidity could have devastating effects on individual communities, regions, or even the financial system of an entire country. In addition, the delay in returning failed bank assets to the private sector could have a significant impact on the speed at which the economy recovers from a recession and returns to economic growth.

Governments have long recognized that they have a responsibility to maintain stability and liquidity in the financial markets. It is instructive to note that the Bank of England -- at only 26 years of age -- played an essential “rescue” role by buying 4.2 million pounds sterling of the stock of the collapsed South Sea Company when speculative mania in that government- sponsored enterprise collapsed in 1720. The Bank of England, one of our hosts today, has repeatedly been a key factor in stabilizing the financial markets in the United Kingdom since that time, and in working with U.S. and other bank regulators to assure international stability.

In conclusion, as we consider how to plan for the insolvency of an international financial institution, our experiences in the United States have taught us that we will be more effective at assuring stability and liquidity in the banking system if we have a structure in place for dealing with financial crises.

While it is true that addressing an insolvency that in significant ways crosses national boundaries, as well as different legal regimes, means a formal structure cannot soon be put in place, such a conclusion should not deter us from formalizing the kinds of international cooperation that is necessary to act together quickly and effectively. Moreover, having clear mechanisms in place for resolving domestic financial institution insolvencies will, I believe, enhance our ability to set up a more effective, albeit informal, international structure. Finally, we need to study domestic systems, like ours in the United States, and develop international standards for addressing insolvency issues.

As Cervantes’ Don Quixote told Sancho Panza: “Forewarned, forearmed -- to be prepared is half the battle.” The answer then to the question: “Will we be ready the next time?” is “yes” -- if we learn from our individual past experiences and if we engage in a coordinated effort to build on those experiences by implementing international standards and mechanisms for addressing financial institution insolvencies.

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