

How Safe is Your Money?
FDIC-Insured Deposits in Troubled Economic Times

Remarks Before Selected Guests
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I saw a cartoon the other day that showed a man with a mask over his face pointing a gun at a bank teller. The teller said, "Sorry. We're low on cash. I'll have to call the FDIC." And the gunman responded, "I *am* the FDIC!"

As is the case with all humor, I am afraid there is a grain of truth to the cartoon. More than 1,100 banks have failed or required "assistance" since 1985, draining \$22 billion from the Bank Insurance Fund. Out of roughly 12,000 banks with deposits insured by the FDIC, almost 1,000 are considered "problems". After watching the turmoil and costs of the S&L crisis escalate, we now hear that the insurance fund for banks has been all but depleted.

The obvious question is: *How safe is your money?*

A key feature that sets banks apart from other deposit-taking institutions, and something that we monitor very carefully, is federal deposit insurance. I would like to share with you this morning some thoughts and information on the current situation in the banking industry and on deposit insurance to help you answer the question, "How safe is your money?" for yourself. I will be glad to entertain comments and questions as we go along, as well as afterwards.

But let me tell you my conclusion up front. Despite what we have heard about the decay of the banking industry, despite what we have been told about the deposit insurance system, and *especially* despite what we have witnessed in the S&L industry, there are no safer financial assets than qualifying deposits at FDIC-insured banks, plain and simple.

Since January 1, 1934, when the FDIC began operations, not one depositor has lost a penny of insured funds from an FDIC-insured account. In fact, from 1985 to 1990, the period with the most bank failures since the 1930s, more than 99 percent of *uninsured* deposits have been fully protected in bank failures.

I would like to touch on four things this morning. First, how did the situation evolve to where it is today? Second, why is the situation in banking different in nature and size from the S&L debacle? Third, how can you make an informed decision about the health of your bank? And fourth, what happens if your bank fails?

The Road to Ruin

First, a little history. Bank failures were once a familiar feature on America's financial landscape, beginning in 1809 with the failure of Farmers Bank of Gloucester, Rhode Island. By the turn of the century, the failure rate topped 80 banks per year. The average climbed to nearly 600 institutions per year in the generally prosperous 1920s. In the early 1930s, the Depression pushed the average number of bank failures to 2,300 per year. At the height of the panic in 1933, 4,000 banks closed their doors.

To restore health to the nation's financial system, Congress created the predecessor to today's Bank Insurance Fund. The Fund was initially capitalized by contributions of \$150 million from the Treasury and \$139 million from the Federal Reserve System, all of which was repaid in the 1940s. Premiums contributed by banks have provided the Fund with virtually all of the resources it has needed to cover the costs of protecting insured deposits at failed institutions for the more than half century since the creation of the FDIC.

Deposit insurance was a simple idea, and it worked. Insurance restored confidence in the banking industry, prevented bank runs, and protected small depositors. The number of bank failures fell sharply, to just a few each year by the end of the 1940s, and stayed low until the mid-1980s.

The original legislation insured accounts to \$2,500. Initially, only deposits at Federal Reserve member banks were covered, but by 1939 all banks were allowed to participate. It took Congress only six months to figure out that it had stumbled across something that voters liked, and it doubled the coverage to \$5,000.

The limit stayed there until 1950, when it was boosted to \$10,000. In 1966, it jumped to \$15,000, in 1969 to \$20,000, and in 1974 to \$40,000. In 1980, with little debate, the Senate passed an increase in the limit to \$50,000, as part of the bill that deregulated interest rates. The House version had no such provision. Yet, acting on behalf of the U.S. League of Savings Institutions, which believed that more insurance would help S&Ls compete with banks, Representative St. Germain persuaded the conference committee to raise the limit to \$100,000. No one ever voted on the increase.

That was the last nail in the coffin of the Savings and Loan industry. S&Ls, of course, used to make money by borrowing short and lending long. That was fine as long as short rates stayed below long rates. The problem was that the inflation of the late 1970s and early 1980s drove the short term rates that S&Ls paid depositors above the long-term rates they had locked in on mortgages, wiping out most of the industry's capital.

Had there been no deposit insurance, that would have been the end of it. Institutions with little or no capital would have been unable to attract deposits and would have gone out of business with minimal cost to the S&L insurance fund. But because deposits were insured, S&Ls were able to continue to attract money and essentially "double their bets": "Heads, I win" (my capital is restored). "Tails, you lose" (the taxpayer picks up the pieces).

A Different Dilemma

In contrast, the problems in commercial banking stemmed from restrictive regulations, which made banks vulnerable, and from increased competition from both inside and outside of the industry, which exploited this vulnerability. For example, when agriculture went bust in the early 1980s, banks in the heart of farm country that were prohibited from expanding geographically, failed alongside their customers.

The size of the problem is quite different, too. The S&L industry deteriorated so severely before Congress finally stepped in that not only was the insurance fund insufficient to meet losses, but the industry lacked the financial strength to recapitalize the insurance fund. As a result, taxpayers will be tapped for \$150 billion or more.

The banking industry, on the other hand, earned net income of nearly \$19 billion last

year, up from \$16 billion the year before, and had \$230 billion in capital at the end of the year. But aggregate numbers can be misleading. There are a large number of sizable institutions in serious financial trouble. The key difference with the S&L situation is that the Bank Insurance Fund lacks liquidity, not solvency. Even the worst projections show borrowing requirements of the Fund far below the total capital of the industry and foresee a return to liquidity in the 1990s. And, no taxpayer money will be needed by the Bank Insurance Fund.

What is most relevant for our discussion, however, is that even in the case of S&Ls, no insured deposits have been lost and the full faith and credit of the United States stands behind the Bank Insurance Fund.

Picking a Winner

But as I said, there are troubled institutions. And, suppose that you wanted to avoid the inconvenience of being involved with one. How can you spot trouble if you are not a CPA? Here are three easy factors that you can check by looking at a company's latest annual, or in some cases quarterly, report. The first is capital. At the end of this year, new capital guidelines will go into effect, requiring banks to have equity capital of 4.0 percent and total capital of 8.0 percent. These measures are also referred to as Tier I and Tier II capital, and they are adjusted to some extent for the riskiness of the institution's balance sheet. Clearly from a depositor's standpoint, the higher the capital ratios, the better.

The second measure to look for is the market value of a share of stock, compared with its book value. Most failed banks see the market price of their stock fall below the book value before it is too late for depositors to avoid getting caught. And third, one factor many failed institutions had in common was excessively rapid growth in a major component of their balance sheet or of the institution itself. There are exceptions, of course, but generally speaking, steady growth is sound growth.

Perhaps not all failed institutions waved these three flags before they sank, and certainly not all institutions that do wave them are in danger of failing. But knowing that your deposits are with a strong company that financial markets regard highly and that grows steadily may provide an extra margin of comfort.

In the Event of Failure

Finally, what if your bank does fail? The first thing to remember is that, by law, your insured deposits will be returned to you in short order. If history remains an accurate guide, even uninsured deposits will be returned.

But what are insured deposits? I have made a copy of the updated pamphlet from the FDIC titled, "Your Insured Deposit", which explains the conditions under which deposits are insured. First, they must be at an institution that displays the official bank or the official savings association sign, which you can find on the front door and at each teller window. Second, they must be deposits--other creditors and shareholders are *not* protected by deposit insurance--but they can be any kind of deposit. Third, deposits at separate institutions are insured separately; they are not lumped together. Finally, coverage is for \$100,000, including accrued or anticipated interest or earnings. Deposits maintained in different categories of legal ownership are separately insured, so that it is possible to have more than \$100,000 insurance coverage in a

single institution if the funds are owned and deposited in different ownership categories. The pamphlet explains these rules, and shows how accounts can be configured to achieve maximum protection.

When the FDIC closes an institution, it usually becomes the "receiver"; that is, it assumes the task of liquidating the bank's assets and settling its debts, including claims for deposits in excess of the insured limit. The FDIC uses one of three methods to carry out its function as receiver: (1) the *purchase and assumption transaction (or merger)*, in which all deposits are assumed by a healthy bank, (2) *deposit payoff*, in which the FDIC directly pays depositors by check, usually beginning within a few days of the bank's closing, and assists in filing claims for uninsured deposits, and (3) *deposit transfer*, in which insured deposits are transferred to an agent bank in the area, from which they are available for immediate withdrawal. The exact course of events is somewhat different in each case, but as the pamphlet explains, insured deposits are completely protected regardless of the method of liquidation.

The Economy to the Rescue

Before we turn to your thoughts, let me just say that to the extent that the strength of the economy affects the health of the banking industry, recent developments have been positive. The Conference Board announced yesterday that consumer confidence jumped sharply in April, after a large improvement in March. Sales of domestically-made cars rose to their highest level since the end of last year in the mid-May selling period. Housing construction is up 40-50 percent from a year ago--a telltale sign of economic recovery. And, consumer spending topped its pre-recession peak some months ago and has continued to expand to new highs.

The consensus is still for a weaker-than-usual recovery from the recession, but if inflation and interest rates stay relatively low, as also seems likely, the new expansion could prove to be a durable one. This, more than anything lawmakers or policymakers can do, would promote a swift resolution to the present difficulties facing the Bank Insurance Fund.