Bank failures

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Public interest in bank failures has been renewed recently as a number of multimillion dollar banking firms have been declared insolvent. Legislators, who share the concern, have asserted that "the existing structure of regulation of banking institutions under Federal law . . . is incapable of insuring the safe and sound operation of the commercial banking system of the nation."[1] Regulators have responded with increased bank surveillance and with "early warning systems" to guard against further failures.

When banks fail, investors and sometimes depositors sustain losses; society bears some costs as well. However, the dollar magnitude of such losses is far less than one might expect, and the actual amount of losses sustained is to some extent dependent upon the manner in which regulatory authorities dispose of the failed bank. Yet the mechanics of handling bank failures remain a mystery to most people.

Historical background

Waves of bank failures have recurred throughout American history. During the panic of 1893 nearly 500 banks suspended operations, out of only 9,500 banks then in existence. During the monetary crisis of 1913, 105 banks failed and in each of the next two years, over 150 banks failed.

In the 1920s an average of 588 banks failed each year.[2] Between 1930 and 1933, the last four years prior to the establishment of the Federal Deposit Insurance Corporation (FDIC), 9,100 banks suspended operations in this country—an average of 43 banks per *week*. During these four years depositors sustained losses of $1.3 *billion*. These failures prompted extensive legislation aimed at preventing a recurrence of such disastrous numbers of insolvencies. Banks were barred from paying interest on demand deposits and from engaging in certain activities, such as stock underwriting, on the grounds that these practices had proved excessively risky. While the wisdom and effectiveness of these restrictions has been questioned, the establishment of the Federal Deposit Insurance Corporation in 1933 did indeed bring about the long sought-after stability in the banking system. By guaranteeing the safety of depositors' funds, federal deposit insurance effectively put an end to banking panics. A potential insolvency at one bank no longer threatened deposits at other banks in the same economic region, putting an end to the domino effect which had always plagued American banking.

Federal deposit insurance, however, does not stand as the only bulwark against banking panics. Monetary and fiscal policies of the government are aimed at preventing economic depression, whether due to severe contractions of the money supply or to other causes. The ability and willingness of the Federal Reserve System to provide liquidity to the banking system also helps to insure that the public will not lose faith in bank deposits as a safe and sound means of holding money balances.

The effectiveness of federal deposit insurance in reducing numbers of bank failures is readily seen. During the first four years of FDIC experience, only 249 banks failed, of which 180 were insured. Losses to depositors of insured banks were only $717,000, while losses to depositors of uninsured banks were $6.7 million and losses to the FDIC were just under $9 million. The establishment of deposit insurance thus has had two effects. First, the number of failing banks has been

[1] U.S. Senate, A *Bill to Establish a Federal Bank Commission. . .* , S. 2298, 94th Congress, 1st Session, 1975, p. 2.

[2] Data on bank suspension prior to 1934 are not wholly comparable with data from later years. Some suspended banks subsequently reopened.

Table 1
Basic data on frequency and disposition of bank failures, by year, 1934-1976

	Number of failed banks		Deposits in failed banks		Failure rate (per 10,000 banks)		Disposition of insured failed banks	
Year	Insured	Noninsured	Insured	Noninsured	Insured	Noninsured	Deposit payoff	Purchase and assumption
			(thousands)					
1934	9	52	$ 1,968	$ 35,364	6.4	287.8	9	0
1935	26	6	13,405	583	18.3	32.4	24	2
1936	69	3	27,508	592	48.9	16.6	42	27
1937	77	7	33,677	528	55.2	40.1	50	25
1938	74	7	59,684	1,038	53.7	41.8	50	24
1939	60	12	157,772	2,439	44.3	135.3	32	28
1940	43	5	142,430	358	32.0	58.8	19	24
1941	15	2	29,717	79	10.4	23.5	8	7
1942	20	3	19,185	355	15.0	25.3	6	14
1943	5	0	12,525	0	3.8	0.0	4	1
1944	2	0	1,915	0	1.5	0.0	1	1
1945	1	0	5,695	0	0.8	0.0	0	1
1946	1	1	347	147	0.7	14.5	0	1
1947	5	1	7,040	167	3.7	12.8	0	5
1948	3	0	10,674	0	2.2	0.0	0	3
1949	5	4	6,665	2,552	3.7	55.6	0	5
1950	4	1	5,513	42	3.0	14.5	0	4
1951	2	3	3,408	3,056	1.5	46.2	0	2
1952	3	1	3,170	143	2.2	16.0	0	3
1953*	4	1	44,711	390	3.0	17.6	0	2
1954	2	2	998	1,950	1.5	37.3	0	2
1955	5	0	11,953	0	3.8	0.0	4	1
1956	2	1	11,330	360	1.5	22.5	1	1
1957*	2	1	11,247	1,255	1.5	23.5	1	0
1958	4	5	8,240	2,173	3.1	125.3	3	1
1959	3	0	2,593	0	2.3	0.0	3	0
1960	1	1	6,930	1,035	0.8	28.4	1	0
1961	5	4	8,936	1,675	3.8	123.8	5	0
1962	1	2	3,011	1,220	0.8	64.9	0	1
1963	2	0	23,444	0	1.5	0.0	2	0
1964	7	1	23,438	429	5.2	36.5	7	0
1965	5	4	43,861	1,395	3.7	152.1	3	2
1966	7	1	103,523	2,648	5.2	42.6	1	6
1967	4	0	10,878	0	3.0	0.0	4	0
1968	3	0	22,524	0	2.2	0.0	0	3
1969	9	0	40,134	0	6.7	0.0	4	5
1970	7	1	54,821	423	5.2	54.1	4	3
1971	6	0	132,152	0	4.4	0.0	5	1
1972	1	2	20,480	79,304	0.7	97.1	1	0
1973	6	0	971,296	0	4.3	0.0	3	3
1974	4	0	1,575,832	9	2.8	0.0	0	4
1975	13	1	339,574	1,004	9.0	38.3	3	10
1976	16	1	864,859	800	11.1	36.4	3	13

*"Disposition of insured failed banks" and "Number of insured failed banks" do not agree because some insured failed banks subsequently reopened.

reduced dramatically. Second, for banks with deposit insurance, the risk of financial loss has shifted from depositors to the FDIC's insurance fund, accumulated from premiums paid by insured banks. To understand how the FDIC shifts risk from depositors to itself, it is necessary to understand what happens when a bank fails. A discussion of general provisions governing bankruptcy proceedings will help to clarify the role of the FDIC.

Bankruptcy in general

Bankruptcy is a legal proceeding in which a financially distressed firm is placed under the supervision of a court. The court appoints one or more trustees to oversee the operations of the firm during adjudication. Any creditor failing to receive timely repayment of amounts due him may sue to initiate bankruptcy proceedings against the debtor firm. Firms owing amounts in excess of their abilities to repay may themselves file for bankruptcy to obtain protection from their creditors pending resolution of their indebtedness. In a typical bankruptcy proceeding, creditors present their claims against the failed firm. If the creditors can agree to a debt restructuring, usually involving extended debt maturities as well as some debt "forgiveness," the firm may continue in operation. Otherwise, the assets of the firm are liquidated and the creditors are compensated from the proceeds.

The determination of how much each creditor is paid becomes crucial. Most creditors share in the liquidation proceeds in proportion to their financial claims on the firm. These are called "general creditors." Some creditors are able to establish a prior claim to the liquidation proceeds. Called "preferred creditors," they must be paid in full before any distribution can be made to the general creditors. The benefit of establishing a credit preference is evident (lawsuits over assertions of preferences are common), making the validation of preferences one of the most important aspects of bankruptcy proceedings.

Bankruptcy in banking

Like any other business, a bank can voluntarily place itself in bankruptcy or can be sued by creditors who are refused repayment. These events rarely occur, however, because the banking industry is subject to extensive public regulation. In particular, a bank can be placed in receivership (the equivalent of bankruptcy) by a regulatory authority, but only by the authority issuing its charter.[3] This is an important distinction between banks and other commercial businesses since in banking the chartering agency, which represents neither the business itself nor creditors of that business, has the power to force the firm into bankruptcy proceedings.

Fairly wide latitude is granted to bank supervisors in determining whether a bank should be placed in receivership. If a bank is insolvent, if its capital is impaired, if it is engaging in practices that are likely to result in substantial financial loss to depositors, or if it is about to engage in such practices, the supervisor is justified in taking control of the bank and placing it in receivership. A bank is insolvent when its assets, even though liquidated in an orderly and prudent manner, would not suffice to pay off its noncapital liabilities. A bank's capital is "impaired" when charges against the capital account (e.g., to write off losses or uncollectable debt) exceed the sum of contingency reserves, undivided profit, and surplus. Because of supervisors' wide latitude, a bank is usually closed long before it actually defaults on its debts.

Once a bank is declared insolvent, it is taken over by regulatory authorities and closed to all business. The Comptroller of the Currency or state bank supervisor places the bank in the hands of a court with jurisdiction in such matters (usually a federal district court). The court appoints and oversees a receiver, whose job is to examine the books and accounts of the bank and to verify assets and liabilities. The receiver is also responsible

[3] The Federal Reserve and the Federal Deposit Insurance Corporation, although they are both heavily involved in bank supervision and regulation, lack the legal power to close a financially distressed bank.

for collecting interest and principal due on outstanding loans and investments. Public notice is given, usually for about three months, for all creditors of the failed bank to present proof of their claims. The receiver judges the validity of all claims presented.

A large body of case law exists dealing with preferences in bank failures.[4] Most transactions with a bank arise out of a debtor-creditor relationship. For example, one who deposits money with a bank is a creditor, and the bank stands as a debtor to him. In order to establish a preference in a bank failure case, one must demonstrate that his relationship with the bank was not simply that of a creditor, but rather that the relationship was one of principal and agent or that the bank was acting in a trust capacity. Banks often act as agents for municipal governments or other political subdivisions in the collection of taxes. The political units thereby achieve the preferred status of a principal with respect to the tax deposits rather than that of a creditor. Another situation establishing a preference occurs when money is deposited in a bank with the express stipulation that the funds are to be used to purchase certain securities. The bank then acts as the agent for the depositor, and his claim on the bank takes priority over that of other depositors. Pledging assets to secure deposits also establishes a preference. Depositors who are not preferred creditors are merely general creditors of failed banks. General creditors share *pro rata* in all liquidation proceeds, but only *after* preferred and secured creditors have been compensated.

At federally insured banks, the Federal Deposit Insurance Corporation relieves depositors of financial risk by entering into the bankruptcy proceedings. When an insured bank fails, the FDIC guarantees to each depositor the amount of his account, up to the current insurance limit (now generally $40,000). The FDIC then becomes subrogated to the rights of depositors to the extent of insurance payments; that is, each depositor's claim to liquidation proceeds passes to the FDIC for the amount by which the FDIC reimbursed the depositor. The FDIC then becomes a general creditor of the failed bank and shares in liquidation proceeds *pro rata* with other general creditors.

Claims of capital investors in failed banks rank below those of general creditors. There are three classes of capital investments: capital notes and debentures, preferred stock, and common stock. In order to be exempt from interest rate ceilings and reserve requirements, capital notes and debentures must be explicitly subordinated to all deposits. They are also, therefore, subordinated to all creditors' claims that rank on a par with deposits. Thus, holders of capital notes of a failed bank will not receive any recovery on their investment until all preferred and general creditors recover the full amount of their investments.

If any funds remain after holders of capital notes have been paid off in full, stockholders may receive something. In cases in which the failed bank had both preferred and common stock outstanding, preferred stockholders have priority.

The Federal Deposit Insurance Corporation thus plays a key role in settling depositors' claims against failed banks. In fact, in the vast majority of failure cases, the Corporation is appointed receiver for the failed bank and for failed national banks must be appointed receiver. Regardless of the method of disposition chosen, substantial monetary outlays on the part of the FDIC will normally be required.

Disposing of failed banks

The FDIC has several options for disposing of failed banks. Unlike other business failures, which can be wound up only by a debt restructuring or by a liquidation, bank

[4] Most state banking laws do not deal specifically with preferences. Among Seventh District states only Iowa makes explicit the order of payment of creditors of failed banks. Section 524.1312 of the Iowa Code specifies that, in the event that liquidation proceeds are not sufficient to pay off all creditors in full, the order of distribution is, first, all costs of the receiver; second, all preferred claims (in full or *pro rata* if proceeds are not sufficient to compensate all preferred creditors); third, depositors; fourth, all other general creditors; fifth, holders of capital notes and debentures. The Iowa code thus elevates depositors above other general creditors.

failures can be handled in five distinct ways: (1) by "purchase and assumption"; (2) by "deposit payoff"; (3) by chartering a Deposit Insurance National Bank; (4) by providing financial aid; (5) by reorganizing. Only reorganizing does not involve the FDIC.

Purchase and assumption. The FDIC is empowered to dispose of failed banks by arranging a merger with a sound bank (which may be newly chartered for that express purpose). In a "purchase and assumption" negotiations are entered into between the FDIC and sound banks interested in acquiring the business of the failed bank. Acquiring banks must assume all deposit liabilities of the failed institution and may choose to assume other liabilities as well. In the typical case the assuming bank acquires all matured liabilities with the exception of long-term debt. Contingent liabilities are usually not assumed.[5]

The assuming bank will acquire some, but not all, assets of the failed bank. Many of the failed bank's assets will not be sound, making them undesirable for purchase. If the bank failed through defalcation, some assets may be fictitious. Undoubtedly, some loans will have been classified.[6] Typically, therefore, the assuming bank will acquire a smaller dollar amount of assets than liabilities. The difference is made up by a cash payment from the FDIC to the acquiring bank.

Potential assuming banks bid competitively for the opportunity to acquire the sound and ongoing business of the failed bank. Each competing bank submits a bid to the FDIC, which includes a promise to pay to the Corporation a specified sum of money, called a "premium," if the bid is accepted. Usually the FDIC will accept the bid that carries the highest premium. The premium is "paid" in the form of a lower cash advance from the FDIC. That is, the FDIC pays out to the winner of the bidding enough cash to make up the difference between liabilities assumed and assets taken plus premium. In this transaction the FDIC gains title to all the assets not specifically selected by the assuming bank (hence the term, "premium," in that the FDIC gains title to certain assets without any corresponding liabilities). The size of the premium and the FDIC's ability to collect interest and principal on the assets it receives govern the chances that the failed bank's stockholders will recover their investment.

In addition to administering the exchange of assets and liabilities and paying the cash advance, the Corporation sometimes makes long-term loans to beef up the assuming bank's capital position.

Deposit payoff. The FDIC is seen most clearly in its role as guarantor of deposits when a bank failure is handled by the liquidation or "deposit payoff" method.

When a failed bank is paid off, the FDIC (assuming it has been appointed receiver) assesses the validity of depositors' claims against the failed bank. Secured or preferred depositors, such as political subdivisions, are paid first out of the failed bank's assets. Other depositors who have valid claims receive the value of their deposits from the FDIC, up to the insured maximum. Usually, the FDIC disburses funds in the form of deposits in another bank. If a depositor has received a loan from the failed bank, the amount of the loan may be offset against his deposit.

In exchange for paying depositors the value of their deposits, the FDIC acquires legal claims against the failed bank's assets and becomes a general creditor of the failed bank in the depositors' stead.

As the assets of the bank are liquidated, creditors are compensated from the proceeds. The FDIC shares *pro rata* with other general creditors, such as depositors whose accounts exceeded the insurance maximum, suppliers of business forms or office equipment, and similar other parties to whom the bank owes money.

[5] For an exhaustive definition of contingent liabilities, see Glenn G. Munn, *Encyclopedia of Banking and Finance*, 7th edition, 1973, pp. 222-3. In general, contingent liabilities are obligations not expected to fall due. Some examples in banking are letters of credit, acceptances, accommodation endorsements, liabilities resulting from pending or possible litigation, and futures contracts to deliver foreign exchange. Matured liabilities are those whose incurrence is definite and accomplished, such as deposits, capital notes, and rental charges for space and equipment.

[6] Classified assets are those a bank examiner believes unlikely to repay all interest and principal.

Deposit Insurance National Bank. Infrequently, the FDIC sets up a new bank in place of the failed bank for a temporary time, normally two years. Chartered in effect by the Comptroller of the Currency, with no capital, the bank is titled Deposit Insurance National Bank (DINB) and is automatically granted deposit insurance. The bank makes no loans, holds only U.S. Treasury securities or other securities guaranteed as to principal and interest by the U.S. government or cash assets, and conducts basically a payments business only. All insured deposits in the failed bank are transferred to accounts in the Deposit Insurance National Bank.

Failures handled as DINBs are classified as deposit payoffs, since depositors can withdraw the amount of their deposits. This method is used only where no other banking facilities are available in a community, in the hope that local people will be encouraged to organize a permanent bank for themselves. The FDIC can, if it wishes, sell the business of the DINB by accepting bids to capitalize the bank.

Financial aid. A bank may become insolvent before any actual default on obligations occurs. The FDIC is empowered to make long-term loans to a distressed bank if the FDIC and the chartering regulator agree that continuance of the insolvent bank is necessary to the economic well-being of the community or is desirable because the demise of the bank would bring about excessive concentration of banking resources. Such loans, coupled with close supervision and perhaps mandatory changes in operating personnel and procedures, can help restore a distressed bank to a sound condition. The most notable occurrence of this type of assistance involves the Bank of the Commonwealth of Detroit, which has received loans totaling $35.5 million from the FDIC.

Reorganization. State banking laws and the National Bank Act provide that a failed bank can be reorganized, presumably with reduced capital and other liabilities to reflect the reduced market value of its assets. Intervention by the FDIC is not required.

Reorganization is especially useful when liquidation of the bank will result in large losses for all classes of creditors. To invoke such a procedure, therefore, requires the concurrence of creditors holding claims to a large fraction of the bank's nonequity liabilities, typically 75 or 80 percent.

Of the five methods of disposing of failed banks, legal reorganization is used least frequently—virtually never. Financial aid is used more often to prevent actual failure than to dispose of a failed bank. Deposit Insurance National Banks are used infrequently and are really only an alternative means of paying off depositors. The great majority of failed banks are handled either by purchase and assumption or direct payoff.

The FDIC seemingly has gone through cycles in which it preferred first one method of dealing with failures and then another. From 1934 to 1944 both payoff and assumption methods were extensively used. Between 1945 and 1954, however, every bank failure was handled as a purchase and assumption transaction. Then, from 1955 through 1964, almost all failures were paid off. Since 1965 both payoffs and assumptions have been used.

Data on numbers of bank failures are understated, just as numbers of business bankruptcies are also understated. Besides the possibility of financial aid from the FDIC to keep a distressed bank afloat, emergency mergers are sometimes consummated before the acquired bank actually fails. Occasionally, the merger takes place with the blessings of the federal bank regulatory agencies but without any financial assistance. The most prominent example of this occurred in 1975, when the Security National Bank of Hempstead, New York, was acquired by Chemical Bank. Had the merger not taken place, Security, with deposits of $1.3 billion and assets of $1.7 billion, would have become the second largest bank failure in U.S. history.

In other cases, the FDIC has used direct financial assistance to facilitate mergers. In 1975 the FDIC assisted in the merging of a newly organized bank with the Palmer First National Bank and Trust Company of Sarasota, Florida, after receiving assurances that such assistance was necessary to bring about the acquisition and to avert the failure of Palmer First National. These are but two instances in which failures have been preempted by mergers. It is not known how many insolvencies have been prevented this way.

Normally, the FDIC chooses the method that minimizes the loss to the insurance fund. The distribution as well as the total amount of losses to creditors are strongly influenced by the method chosen by the FDIC. It is possible that one method—usually deposit payoff—may result in a somewhat smaller loss to the insurance fund while generating much larger losses to other creditors than any alternative method. However, when a large bank fails, the FDIC is under great pressure to handle the case by a purchase and assumption. Although possibly more costly to the insurance fund, a purchase and assumption guarantees that depositors, whether fully insured or not, will suffer no losses.

What do bank failures cost?

Regardless of the distribution of losses among creditors, bank failures impose costs upon society. Resources must be devoted to what is essentially the unproductive task of disposing of the failed bank, collecting interest and principal from the failed bank's assets, and compensating creditors of the failed bank—tasks performed by the receiver and by the FDIC as insurer. Labor and other resources may be idled if the bank's demise results in a lack of credit in the community. If the payoff route is chosen, deposits are not immediately available to depositors. Thus, there is an opportunity cost due to the temporary sterilization of working capital. This cost does not arise in purchase and assumption cases. Those resources that had been allocated to businesses that failed (i.e., to defaulting debtors of the failed bank) and that could have been channeled to more productive uses represent wealth that, aside from any liquidation value that may remain, is permanently lost to society. The potentially most important social cost of bank failures is that they might lead to a rapid contraction of the money supply, possibly inducing a period of economic depression. This is the cost that is the primary concern of bank regulation and deposit insurance. Finally, chronic failures might lead to a loss of faith in the payments mechanism. If people become disenchanted with "bank money," they will be induced to hold more currency. The fact that most money is presently held in the form of demand deposits at commercial banks indicates that people generally prefer this form of money. Thus, the occurrence of a situation in which people are driven by uncertainty to hold more currency and less demand deposits than usual would impose a social cost.

Even when bank failures do not result in net losses to society, they bring about transfers of wealth among individuals. Wealth has been transferred from creditors of banks—stockholders, other investors, and sometimes uninsured depositors—to debtors of banks—those whose failures to repay their borrowings brought about the insolvency. Under theoretically ideal conditions—accounting practices that correspond exactly with economic and financial theory and instantaneous liquidation of a failed business—the dollar amount of wealth transfers from bank creditors to bank debtors will exceed the overall cost to society. This is true because bank debtors receive a net benefit from the amounts they borrowed and never repaid. Under real-world conditions, the estimates will likely diverge even farther. The major creditors of failed insured banks, in dollar terms, are depositors, the FDIC, bondholders, and stockholders. Estimating losses to these creditors will give a good indication of the upper bound of the cost to society from bank failures.

Depositors. According to FDIC data,[7] 99.6 percent of the amount of deposits in banks failing from 1934 to 1976 has been paid or made available to depositors. Since in deposit assumption cases all deposits are immediately available, losses to depositors arise only in deposit payoff cases. The vast majority

[7] *Annual Report of the Federal Deposit Insurance Corporation, 1976*, tables 125 and 127.

of deposits in paid-off banks has already been made available to depositors, mostly by direct payments from the FDIC (i.e., a demand deposit in another bank), but partly through offset against outstanding loans, through security or preference, or through the proceeds of asset liquidation. The FDIC expects eventually to repay about 96 percent of deposits in failed banks handled as deposit payoffs, leaving a loss of less than $20 million over the entire 1934-76 period. Thus, even though large deposits are not fully covered by deposit insurance, depositors of insured banks cannot be said to have sustained major losses from bank failures. On the other hand, losses in the form of opportunity costs (interest foregone while deposits are unavailable) may be quite large but are extremely difficult to calculate.

FDIC. The Federal Deposit Insurance Corporation estimates that, based upon all its activities undertaken to protect depositors of failed banks, its total loss from banks failing between 1934 and 1976 will be just over $285 million. This loss covers not only disbursements in payoff and assumption cases but also amounts advanced to protect assets, net losses on purchases of assets from operating banks, defaulted principal on loans made to operating banks to avert failure, and other similar expenditures. Thus, it is obvious that federal deposit insurance operates to shift the burden of risk from depositors to the Federal Deposit Insurance Corporation's insurance fund.

Bondholders. Long-term capital notes and debentures are securities that have become relatively popular only in recent years. Thus, most losses to bondholders have occurred in the decade of the 1970s.

Stockholders. Recoveries by stockholders are infrequent. The FDIC last published a study of stockholder recoveries in its 1958 Annual Report. The overall finding was that in only 91 out of a total of 436 failures did stockholders recover any part of their investment.

The method used by the FDIC to dispose of the bank influences the likelihood of recoveries by stockholders. Stockholder recoveries are less likely in payoff cases because the class of general creditors is augmented by uninsured depositors. In purchase and assumption cases stockholders have on occasion received stock in the continuing bank, especially when two failing institutions were merged into a single sound bank or when a failing bank was merged into a newly chartered bank. In a few other scattered cases, stockholders of assumed banks also recovered a small fraction of their investment.

It would appear that everyone seems to come out at least as well off when the deposit assumption route is chosen as when the FDIC pays off depositors directly. If so, why does the FDIC ever use the payoff method?

There are several reasons. An assuming bank requires indemnification against legal actions that may arise as a result of the closing of a bank. In certain cases the uncertainty surrounding a bank failure may be so great that such indemnification could prove expensive in terms of legal and court costs. In unit banking states finding a suitable merger partner can be quite difficult since the failed bank cannot be operated as a branch. Thus, the assuming bank, if it were not newly chartered, would have to be quite close by. Then, too, the FDIC could estimate that the total cost of paying off depositors could be less than arrranging a merger. Even in the assumption cases, the FDIC is saddled with some assets of the failed bank, normally the worst credit risks. Negotiation costs can be avoided if the FDIC takes over the entire portfolio. And all the purchase bids received by the Corporation could turn out to be negative numbers!

Basically, while the FDIC was instituted to protect depositors in case of bank failures, it has a responsiblity to dispose of failed banks with minimum cost to itself.

Estimating losses in the 1970s

Losses are incurred by depositors only in payoff cases. Some failures handled as payoffs in the 1970s have involved banks whose depositors were fully insured. In other payoff cases, the percentage recovery by general creditors (and therefore that of uninsured depositors) is known. In those payoff cases where the ultimate status of depositors' recoveries is not known, losses to depositors are estimated at 3½ percent of total deposits. This figure is slightly higher than historical average losses in payoff cases.

Losses to bondholders are estimated from information supplied by the Federal Deposit Insurance Corporation. The assumption is made that bondholders of failed banks will lose the entire principal amount of their investments. No component is included for lost interest.

Losses to the FDIC are the Corporation's estimates.

Losses to stockholders are the most difficult to estimate. The ratio of the market value of common stock to the book value of equity for banks and bank holding companies whose equities are widely traded can be formed and applied to the book value of equity for banks that failed. Applying the ratio to book value of equity two years before failure should correct for the large losses sustained by failing banks prior to their closing. The assumption is made that stockholders lose the entire amount of their investment in banks that fail. Data on stockholders' equity are taken from the December Report of Condition two years prior to failure.

Several banks failing in recent years have been owned by bank holding companies. Since the banks comprised the bulk of the holding companies' assets, in all probability those holding companies will also file for bankruptcy. Because some of the holding companies themselves had long-term bonds outstanding, it is reasonable to assume that holders of those bonds will suffer losses. Since they are as yet unknown, these losses are not included in Table 2 but could easily exceed $100 million.

Losses to the four major categories of creditors of failed banks totaled over $673 million for the seven years, according to the estimates in Table 2. Of this sum 60 percent represents losses to stockholders and another 31 percent represents losses to the FDIC. Depositors' losses are less than 1 percent of the total amount lost. Thus, it appears that federal deposit insurance accomplishes its major goal: insulating depositors from loss in the case of bank failure.

Losses to debtholders, insignificant before 1973, are beginning to take on sizable proportions. This reflects both the increasing popularity of debt capital and the greater size of the banks that have failed in recent times. Since 1973 nearly 9 percent of total losses have been incurred by holders of capital notes and debentures. Franklin National Bank of New York had an especially large volume of capital notes outstanding, accounting for the large loss to bondholders in 1974.

Losses to the FDIC tend to be considerably larger than losses to depositors except in the years in which the deposit payoff

Table 2
Estimated losses due to bank failures

		Disposition:		Estimated losses to creditors				
Year	Number of failures	Deposit payoff	Purchase and assumption	Depositors	Debtholders	Stockholders	FDIC	Total
						(thousands)		
1970	7	4	3	$ 585	$ 0	$ 8,572	$ 825	$ 9,982
1971	6	5	1	3,541	0	31,124	1,215	35,880
1972	1	1	0	713	0	1,863	4,000	6,576
1973	6	3	3	0	15,000	56,097	150,269	221,366
1974	4	0	4	0	29,600	167,243	4,100	200,951
1975	13	3	10	1,138	2,600	49,103	35,045	87,886
1976	16	3	13	649	7,038	88,191	15,308	111,186
Total	53	19	34	$6,626	$54,246	$402,193	$210,762	$673,827

technique was relied upon most heavily. Thus, in 1970 and 1971 losses to depositors exceeded losses to the FDIC. The FDIC's largest expected loss resulted from failures in 1973. Interestingly, the FDIC's losses expected from 1974 failures, including Franklin National Bank, should be quite small, while losses to stockholders will be extremely large.

Thus, despite public and legislative concern that an inordinately large number of banks have failed in recent years and that society has paid a heavy price in lost wealth, the evidence shows that bank failures are still relatively rare events and losses are borne, not by depositors, but by capital investors and the federal deposit insurance fund. Since insured banks themselves contribute insurance premiums out of their earnings, one can justifiably conclude that the banking system is fully capable of safeguarding the 'stock of bank money against all but the most drastic contingencies. Protecting against such extreme contingencies, however, is properly the province of monetary and fiscal policy.

Moreover, that losses in bankruptcies be borne by capital investors is fitting. Indeed, stockholders and bondholders should be fully aware of the risks they take in making investments in banks or in any other firm. Since they enjoy whatever return their investment brings, they should properly bear the risks.

Summary

- Two important legal distinctions separate bank failures from other business failures. In banking, the chartering authority, which is neither a creditor of nor an investor in a bank, is empowered to declare the firm insolvent; in other businesses, only creditors or the firm itself can initiate bankruptcy proceedings. While but two means of resolving a bankruptcy proceeding are available for most businesses, five methods can be used in banking. The two most commonly used methods are deposit payoff (liquidation) and purchase and assumption (merger into a sound institution).

- Deposit insurance operates to reduce the number of bank failures and to minimize the financial impact of failures on small depositors. The FDIC accomplishes this by inserting itself in the legal proceedings between depositors and the failed bank, substituting a guaranteed reimbursement of the insured amount of an account for an uncertain claim against the assets of the failed bank.

- Because of its prominent role in disposing of a failed bank, the FDIC is typically appointed receiver. The Corporation then serves in two roles: as guarantor of deposits, the FDIC is potentially a general creditor of the failed bank; as receiver, the FDIC is responsible for evaluating assets and liabilities and validating claims and preferences.

- Bank failures generate costs, part of which can be thought of as wealth transfers and part of which represent net wealth losses to society. Wealth is transferred from creditors of banks to debtors of banks.

- Estimates of losses to creditors of banks that failed from 1970 to 1976 reveal that stockholders and the Federal Deposit Insurance Corporation bear the brunt of the costs, accounting for 91 percent of all losses sustained.