Problems in the Banking Industry

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by

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Problems in the Banking Industry

What seems to be the problem in the banking industry? This question has been echoed from thousands of Americans all across the United States; and with good reason. During 1984, more banks failed than in any year since the Great Depression. The startling number of failed banks was 79, with the last one of the year coming on December 22, 1984, in Sandwich, Illinois. The highest number previous to this was 84 failures in 1937. But even these numbers are a long way from the 4,000 or so banks which failed in 1933, when there was no insurance system set-up to help the insured depositors. The recent rash of bank failures reflects not only the existence of trouble spots in our economy -- including agriculture, energy and real estate -- but also the incapacities of some bankers.

While one can look at the failures in 1984 which number 79 and gasp, there are some comforting notes to this year's failures. The majority of the failed banks were small institutions. Seventy-five percent of the failed banks had deposits of $30 million or less. The total deposits of failed banks in 1984 was $2.9 billion, which is a great deal below the total deposits of $5.4 billion in 1983, and $9.9 billion in 1982. The largest bank failure in 1984 was the failure of the Girod Trust Company in San Juan, Puerto Rico which had deposits of $258 million.

The past year's bank failures had relatively little effect on the overall financial system, and few depositors lost any money. At the
beginning of 1984, there was great concern that loans to developing
countries may go bad, which would put a real damper on the banking
system. Fortunately, the "international debt crisis" never quite
materialized. The biggest scare the banking system received in 1984
was when the Continental Illinois National Bank and Trust Company of
Chicago, Illinois, was threatened by a run on deposits. At the same
time, Continental Illinois was in the face of huge problem loans to
energy companies. It was at this point in time that the Federal Deposit
Insurance Corporation and the Federal Reserve System decided to step
in and were forced to pump in additional capital to keep the bank afloat.

Despite the fact that the United State's economic recovery is in
its third year, many banks are still struggling to stay alive. The
Federal Deposit Insurance Corporation keeps a list of so-called problem
banks which numbered 817 at the end of 1984. This record number
includes major banks as well as small banks. The record previously was
380 on the list in 1976. While you might get the idea that the banking
system is in total chaos as a result of the events of the past few years,
many market analysts believe that the strength of the banking system has
improved significantly in recent months due to the fact that the nation's
biggest banks seem to be in sounder condition.

Referring back to the "international debt crisis" mentioned earlier,
there were no bank failures in 1984 due to a country-debt problem. Many
analysts attribute this fact to an easing of the third world debt crisis.
To reduce the likelihood of sudden defaults, many banks are forming agree-
ments between large debtor nations and the banks, or better yet, are
renegotiating their old agreements to make them more flexible. Without
undermining the seriousness of the "international debt crisis", efforts
are being made to help and reduce what some consider to be the catastrophic results which could follow a rash of debtor country defaults.

The biggest problem for United States bankers would have to be the loans to the once-booming domestic energy and agricultural sectors, and also real estate in a minor way. A surprising fact is that many failures have occurred in what are called the "sun belt" states. There were five bank failures in Nebraska, Oklahoma and Oregon; six in California and Texas; seven in Kansas; and eleven in Tennessee. It has been reasoned that bankers in areas that have been more prosperous have not yet learned how to deal with problems, while bankers in less prosperous states have grown-up dealing with adversities and know how to survive.

It is difficult to attribute any bank failure to one specific factor, yet in some cases the basic problem is pretty obvious. An example of a bank which failed mainly because of farm loans is the David City Bank of David City, Nebraska. Roger M. Beverage, Nebraska's director of banking and finance had this to say about the bank, "The bank had been struggling in a down agricultural economy, and this factor was paramount in causing its insolvency." The Community Bank and Trust Company of Enid, Oklahoma failed mainly because of loans to the energy sector, and the Heritage Bank in Anaheim, California failed largely because of loans to real estate developers.

Banking officials have indicated that imprudent practices have played a role in some bank failures. Among these imprudent practices would be loans to friends and associates, and also illegal practices, such as fraud and embezzlement. A good example of imprudent practices playing a part in a bank failure can be seen by looking at the failures in Tennessee this past year which number eleven in total. Most of the failures in Tennessee
were related to the collapse of the United American Bank in Knoxville.
The bank was owned by Jacob F. Butcher, who along with his brother Cecil
Hilque together had interests in 27 banks with assets of $3 billion.
Mr. Butcher has since been indicted for bank fraud.

An important positive point to note here is that under pressure
from regulators and investors, the nation's biggest banks have been
rebuilding their reserves against loan losses and at the same time,
increasing the levels of their stockholder's investments. The end result
of this action is that there is a larger cushion between possible loan
losses and the depositor's money.

This paper will give a history of the banking system in the United
States and hopefully explain why we are in the situation we are today,
and the events leading up to our current position. The system of banking
followed today is the result of many years of trial and error. And while
the banking industry today is not without flaws, it has much to be proud of.

Between the years 1921 and 1929 an average of more than 600 banks per
year failed. Because the closings frequently involved small town, rural
banks, many of which were thought to be poorly managed and weak, they evoked
hardly any concern at all. Many people even felt that the banking system
would become more efficient by weeding out the "bad apples".

During the last months of 1930, a flood of bank failures set off
widespread attempts to convert deposits to cash. What many banks were
forced to do to meet the deposit withdrawals was to contract credit and
sometimes even liquidate assets. While this action reduced the amount of
cash that was available to the public, the public was still placing addi-
tional cash demands on the banks. As you can see, this becomes a vicious
cycle which is hard to break. Banks which were unable to meet the with-
drawals were forced to close, which put even more of a panic into the public. The process described above is what was known as a bank "run", and they became quite common in the early 1930's.

The Federal Reserve actually did little to help with the liquidity problems the banks were facing during this period. The Federal Reserve System did have its reasons for keeping an arms-length distance from the whole situation. Due to the common belief mentioned earlier that bank failures are the result of bad management, many people felt that the Federal Reserve had no place to step in and take corrective action. Another point here is that the majority of the failed banks in 1930 were not members of the Federal Reserve, and therefore the Federal Reserve should not have to take responsibility for them.

Bank failures prior to 1930 had most frequently been in the agricultural area, but things were changing. It was during the year 1930 that one of the largest banks in the nation failed, the Bank of the United States. Along with the increased number of bank failures in the year 1930, there was an even greater increase in the amounts which depositors were losing. Bank failures declined significantly in the early months of 1931 as there was an easing of liquidity measures, but unfortunately this was short-lived. Banks were once again scrambling to meet demand withdrawals in March and June as the number of failures again rose. During the last six months of 1931 this cycle continued and banks were finding themselves in grave trouble. As a result, the end of 1931 found that approximately 2,300 banks had shut their doors. Now, compare this number to the average number of failures from 1921-1929, and it is no wonder that so many people became so alarmed. The losses that the depositors faced in 1931 alone exceeded the losses for the entire
period between 1921 and 1929.

In October of 1931 a group of bankers in the private sector organized the National Credit Corporation whose purpose was to grant loans to banks experiencing difficulties. When the Corporation failed soon after it had begun, business leaders made their appeal to the Federal Government for some type of assistance. It was the Hoover Administration which was in office at the time and they responded to the business leaders appeals by first creating in January of 1932 the Reconstruction Finance Corporation which was to be a new major federal lending agency. The second thing the Hoover Administration can take credit for is the Glass-Steagall Act of February 27, 1932. This Act made the special circumstances under which member banks could borrow from the Federal Reserve more lenient.

The purpose of the Reconstruction Finance Corporation was to make advances to banks, and it well achieved this goal. In the time span of one short year, the Reconstruction Finance Corporation approved close to $900 million in loans which assisted over 4,000 banks which were struggling to remain open. The number of assisted banks may have even been considerably higher except for the fact that Congress ordered the Reconstruction Finance Corporation to publicly disclose the names of borrowers starting in August of 1932. Naturally, the banks were not anxious to be seen on this list as it was a sign of weakness and could even lead to a run on the bank. As a result, some speculate that the number of assisted banks could have been substantially higher, if it had not been for the stipulation of disclosure of the names of the assisted banks. The two measures put into action by the Hoover Administration only temporarily helped the banking system.

Banking conditions were once again looking grim around the winter of
1932-1933. Although no one can be quite certain as to a specific event or factor which forewarned of the events which took place in this period, there seemed to be a general uneasiness with respect to banking conditions. In the election of 1932, Franklin D. Roosevelt was elected and there was great concern expressed over the rumor of his plan to devalue the dollar. These rumors prompted an increase in speculative holdings of foreign currencies, gold and gold certificates.

The panic really started when there was suddenly a great demand for withdrawals in selected parts of the country. Bank holidays were declared by one state after another due to their inability to fulfill the demand withdrawals. The peak of the panic occurred during the first three days of March in 1933. There were many visitors in Washington, D.C. to witness the inauguration of Franklin D. Roosevelt. Little did they know, but they were in for a real shocker when they arrived at their hotels. The visitors were informed that checks drawn on out-of-town banks would absolutely not be honored. On March 4, 1933, which was Inauguration Day, a bank holiday was declared by every state in the union. President Roosevelt found himself in a jam already and proclaimed a nationwide bank holiday to begin on March 6, 1933, and to last for four days.

The new Administration had to work diligently and hastily to not only legalize the holiday, but more importantly to stand the nation's banking system back up on its own two feet as well. On March 9, 1933, Henry B. Steagall who was the Chairman of the Committee on Banking and Currency presented the Administration's bill to the House and then the Senate. Needless to say, the bill known as the Emergency Banking Act was passed on both accounts.

The Emergency Banking Act was of vital importance to the stabilization
of America's economy at the time. Not only did the Act legalize the bank holiday, but it also established guidelines for the reopening of banks at the end of the declared holiday. Under the Emergency Banking Act, the Reconstruction Finance Corporation was endowed with additional powers to aid the banks which were experiencing difficulties. The Act also permitted the issuance of Federal Reserve Bank Notes, backed by United States government securities to provide for an ample amount of currency. Federal Reserve Banks were allowed to forward the new currency to its member banks without requiring an outlandish amount of collateral.

As long as things were moving along smoothly, the President decided to extend the holiday. Plans for reopening the banks were announced during President Roosevelt's first "fireside chat" on March 12, 1933. The reopening of member banks in the twelve Federal Reserve Bank cities would be on March 13th, and member banks in the 250 other cities with clearing-houses would be reopening on March 14th. After these two feats were accomplished, then the reopening of licensed member banks in other localities could take place. Unfortunately, there were some banks which were never able to reopen. These number approximately 4,000, which did not reopen because of the bank holiday, or because of the compound effect of the events of the previous months. As a result of the Emergency Banking Act, public confidence in the banking system was starting to rekindle.

The Banking Act of 1933 by Congress chartered the Federal Deposit Insurance Corporation as an independent agency of the Federal Government. The Corporation first opened for business on January 1, 1934. Following a banking crisis that saw literally thousands of banks close, it was at the height of the Great Depression.
There were many unsuccessful attempts to establish deposit insurance protection on a national basis during the years 1886-1933. Unfortunately, it took the catastrophic Depression of the 1930's to finally convince the nation that positive measures on a national basis were definitely needed to protect depositors against the disastrous losses associated with bank failures.

The restoration of public confidence in banks was the Federal Deposit Insurance Corporation's first and most important task. In addition to the insurance protection the Corporation provides, a bank supervisory program was instituted which helps to reduce the risks to the Federal Deposit Insurance Corporation's insurance fund by the development of safe and sound banking practices. The direct result was a dramatic decrease in the number of bank failures and the prevention of most losses or freezing of deposit funds when a bank failure occurs. The protection that the Federal Deposit Insurance Corporation provides to bank depositors continues to provide a very important stabilizing influence on the economy.

Perhaps by looking at statistics, this dramatic decrease in the number of bank failures before and since the establishment of the insurance system can be seen more clearly. During the years 1900-1919, an average of eighty-two banks failed each year. During what most people consider to be the roaring twenties, this number rose to an average of 588 per year. The number of failures leaped to an average of 2,277 per year in the Depression years of 1930-1933. While all along people sensed the need for something to be done, it took some 4,000 banks to close their doors in 1933, for President Roosevelt to put his pen to paper and sign the Banking Act of 1933, which established the Federal Deposit Insurance Corporation.

After the introduction of deposit insurance on January 1, 1934, there
was a sharp decline in the number of bank failures. From 1934-1942, failures averaged only 43 per year. Compare this number to the 4,000 which failed in 1933 alone, and there remains little doubt in your mind that the Banking Act of 1933 accomplished what it had set out to do.

The Federal Deposit Insurance Corporation began insurance operations in 1934 with $289 million of initial capital provided by the United States Treasury and the Federal Reserve Banks, and had the authority to borrow up to three times that amount. The Corporation was able to pay back this money in 1948, after paying $81 million in interest. Through these years the Corporation had laid the groundwork for the setting of a safe and sound insurance fund which in December of 1983 amounted to $15.4 billion. Also important to note here is that the Corporation has the authority to borrow up to $3 billion from the United States Treasury in the case of an emergency, but the need to take advantage of this has not arisen.

The insurance fund gets its income from two principal sources. These are assessments on insured banks and interest income. The 1933 Act levied an assessment for insurance at a rate equal to one-half of one percent of annual assessable deposits. Half of the assessment was paid immediately with the remainder subject to call. The Banking Act of 1935 reduced the annual assessment to one-twelfth of one percent of average total deposits. This rate still serves as the basis of the assessment, but the effective amount was significantly modified in 1950. During 1950 a law was enacted that directed sixty percent of banks' assessments remaining after the Corporation has deducted insurance losses and expenses be made available to banks as a credit against future
assessments. This credit was increased by law in 1961 to sixty-six and two-thirds percent, and then returned to sixty percent in 1980, when the insurance coverage was raised to $100,000. Since 1961, the effective net assessment rate has ranged between 1/30th and 1/13th of one percent a year on average total deposits.

The Congress in 1980 further amended the Federal Deposit Insurance Act to authorize the Federal Deposit Insurance Corporation's Board of Directors to make adjustments to the assessment credit within certain limits generally to maintain the insurance fund at no less than 1.1 percent and no more than 1.4 percent of total insured deposits.

The Federal Deposit Insurance Corporation's other source of income is from investments. Since 1961, income from the Federal Deposit Insurance Corporation's holdings of United States Government securities has exceeded income from assessments.

In general, a depositor's checking, savings, and other types of deposit accounts are insured in total up to $100,000 in each commercial and mutual savings bank which is insured by the Federal Deposit Insurance Corporation. If you have a Keough Plan Retirement Account or an Individual Retirement Account, you are provided with a separate $100,000 coverage. Separate federal entities usually insure deposits in most savings and loan associations and shares in most credit unions.

Coverage for accounts held by individuals and businesses applies to checking accounts and to savings accounts or time accounts, or to any combination of such accounts, in each insured bank. A depositor is able to obtain more coverage by opening accounts at other insured banks, but your coverage does not increase if you open like accounts at different branches of the same bank. There are ways for individuals to maximize deposit
insurance to protect more than $100,000 on deposit in one institution. The trick is to use separate accounts, which can each be insured for up to $100,000.

For example, a husband and wife can have a total of $500,000 in insured savings by having two individual accounts, a joint account, and two revocable trust accounts. In the trust accounts, the wife would be the trustee for the husband, and the husband would be the trustee for the wife. With the increasing risk of bank failures, it is wise to make sure that all of your money will be insured.

Most people today take it for granted that their deposits are insured, and many times this is the case. To cite figures, as of December 31, 1982, 97 percent of all commercial banks in the United States, and 75 percent of all mutual savings banks, were protected by federal deposit insurance. The Federal Deposit Insurance Corporation estimates that about 99.8 percent of depositors accounts are fully protected. This data was obtained in periodic surveys of the number and size of deposit accounts in insured banks.

Deposit insurance is required by law for all member banks in the Federal Reserve System. These include national banks chartered under federal law by the Comptroller of the Currency and state-chartered banks that voluntarily obtain membership in the Federal Reserve System. State-chartered banks that are not members of the Federal Reserve System are required in most states by law or policy to carry federal deposit insurance and these account for approximately 62 percent of all insured banks. As of 1978, branches of foreign banks were eligible to obtain federal deposit insurance, and in some cases the Congress of the United States required that these branches become insured.
Since the Federal Deposit Insurance System came into existence in 1934, no deposit with $100,000 or less has lost a dime, because they were federally insured. Depositors in insured failed banks have realized full recovery of their accounts up to the insurance limit. Although recoveries on the uninsured portion will vary from case to case, from January 1, 1934, through December 31, 1982, depositors have recovered 99.8 percent of their total deposits, and this figure includes the uninsured portion of their deposits.

On January 1, 1934, when federal deposit insurance first became effective, the coverage was limited by law to $2,500 per depositor. The Federal Deposit Insurance Corporation raised the coverage to $5,000 on July 1, 1934, and then to $10,000 by the Federal Deposit Insurance Act of 1950. Several changes in the law followed, and the amount of coverage went from $10,000, to $15,000, to $20,000, to $40,000, and finally on March 31, 1980 it was put at where it stands today -- $100,000.

Typical problems in troubled banks arise from taking unnecessary risks in lending or borrowing activity; lax supervision of department managers by top directors and/or officers; unduly concentrated lending portfolios without enough diversification; bad luck in foreign exchange or international operations which is usually caused by insufficient care taken to minimize risk; overly aggressive growth and profit maximizing strategies that involve excessive risk; self-dealing transactions or loans to friends, relatives, or businesses owned by bank insiders; embezzlement, theft, or fraudulent misappropriation of funds; even losses on bad checks, endorsements or guarantees. Banks have a great deal of power over spending, investing, and business growth potential. Their main weaknesses stem from losses or the misuse of funds, whether it be by serious error, negligence, selfish
and irresponsible greed, or the dishonest diversion of bank funds to illegitimate or unsound purposes.

Supervision by the Federal Deposit Insurance Corporation and other federal and state agencies has undoubtedly reduced the likelihood of bank failures, but just what happens when the unthinkable does occur? Like any business enterprise in a free economy, banks are subject to risks and uncertainties. In the event that a bank is closed by its chartering authority, the Federal Deposit Insurance Corporation is ready to take action immediately. The Federal Deposit Insurance Corporation acts as soon as the bank's chartering authority -- the state, or the Comptroller of the Currency in the case of a national bank -- closes the institution.

It is important to note that the Federal Deposit Insurance Corporation does not close banks as many people think they do; they are present to insure them and act as receiver when an insured bank fails. There are three types of liquidity methods used in handling a failed bank. These methods are: 1) paying off the insured depositors by the Federal Deposit Insurance Corporation, 2) having the deposit liabilities assumed by another bank, and 3) having the insured deposit liabilities transferred to another bank. By far the most popular method used today is the deposit assumption. To give a clearer idea of these three methods, an example of each follows.

The Corporation is often able to arrange a deposit assumption, in which another bank, either new or existing, takes over many of the assets of the failed bank and assumes its deposits. On January 21, 1984, the Board of Directors of the Federal Deposit Insurance Corporation announced that the deposit liabilities of City and County Bank of Jefferson County, White Pine, Tennessee had been assumed by Merchants and Planters Bank of Newport, Newport, Tennessee. The failed bank had two offices which reopened on Monday,
January 23, 1984, as branches of the assuming bank. The failed banks' depositors automatically became depositors of the assuming bank.

Tennessee Commissioner of Banking, William C. Adams closed the City and County Bank of Jefferson County on January 20, 1984, and the Federal Deposit Insurance Corporation was named receiver. Mr. Adams cited heavy loan losses as a major contributor to the banks' demise. There were 5,600 accounts in the failed bank, and the deposit assumption made it unnecessary for the Federal Deposit Insurance Corporation to embark on a payoff. Deposit assumption also prevents possible financial loss to the owners of deposits which exceed the insurance limit of $100,000.

Merchants and Planters agreed to pay the Federal Deposit Insurance Corporation a purchase premium of $345,000 in addition to assuming about $22 million in deposits and other liabilities. The assuming bank also agreed to purchase the failed banks' installment loans and certain other assets. The Federal Deposit Insurance Corporation also cash advanced the assuming bank $8.2 million and retained assets of the failed bank with a book value of about $13 million.

The Federal Deposit Insurance Corporation usually exercises its authority to approve a deposit assumption whenever it determines that such a transaction will reduce the potential loss to the Corporation. Mainly due to the premium paid by Merchants and Planters, the Federal Deposit Insurance Corporation arrived at a deposit assumption decision. As stated before, deposit assumption is the method for liquidating a failed bank that is used most frequently, providing there is a bank willing to take on the assumption. A deposit assumption usually takes less than three days, and often there is not even the slightest interruption of banking services.

The next method of liquidating a failed bank is the transfer of the
insured deposits to another new or existing bank. This method was observed when the Seminole State National Bank of Seminole, Texas, was closed on March 16, 1984, by Acting Comptroller of the Currency H. Joe Selby and the Federal Deposit Insurance Corporation was named receiver. The same day the bank was closed, the Board of Directors of the Federal Deposit Insurance Corporation approved the transfer of insured deposits of the failed bank to Seminole National Bank, Midland, Texas.

Deposits up to $100,000 in Seminole will immediately be available to their owners. Customers with interest-bearing accounts in Seminole will still earn interest, and checks drawn on Seminole accounts will still be honored. Insured Seminole depositors were permitted to continue services with Seminole National for an eighteen month period, and were encouraged to visit the bank in the near future to discuss future plans. Mr. Selby cited substantial deterioration in the quality of the bank's loan portfolio, which it was unable to remedy as the main reason for its problems. The losses eventually exhausted the bank's capital funds, which resulted in its insolvency.

Seminole State National Bank held insured deposits in 5,800 accounts amounting to $41.3 million. Seminole National paid the Federal Deposit Insurance Corporation a premium of $2.3 million for the right to receive the transferred deposits. Seminole National's administration of the deposits transferred to it was funded by a cash payment equivalent to the amount of the deposits transferred which was paid by the Federal Deposit Insurance Corporation. In addition, Seminole National will purchase Seminole's installment loans and certain other assets which totalled $19.7 million.

Seminole State National Bank held approximately $705,000 in deposits that exceeded the $100,000 insurance limit. The owners of these deposits
will share proportionately with the Federal Deposit Insurance Corporation and any other general creditors, based on the estimated present value of assets to be liquidated, equal to 55 percent of their uninsured claims. The Federal Deposit Insurance Corporation made prompt advance payment the next week to the uninsured depositors, and other creditors based on this estimate. If the actual collections exceed this estimate, then the creditors will receive additional payments on a pro rata basis. If the actual collections turn out to be less than the estimated 55 percent, then the Federal Deposit Insurance Corporation insurance fund will absorb the difference.

The advance of funds to the uninsured creditors which was used in the Seminole State National Bank failure is a new feature of the insured deposit transfer approach. The purpose of the deposit transfer is to avoid the unintended effect of protection to uninsured depositors and the general creditors that occurs when a failed bank is merged with another institution. People who have deposits over the insured amounts should not expect to be fully protected, especially when there are ways for them to distribute their deposits in such a way as to be fully protected. The Federal Deposit Insurance Corporation Board believes the deposit transfer coupled with the advance, if used as a matter of policy consistently, will treat depositors in all failed banks in an equitable fashion and minimize the adverse effects of a closing on the uninsured creditors and the community.

In the case of the Seminole State National Bank, the Federal Deposit Insurance Corporation determined that handling the failure through a transfer of insured deposits to another bank, rather than through a merger, represented the most cost-effective procedure to them.

Although it is too early to tell if the modified payoff plus advance transaction employed in this case will be used in the future, the Federal
Deposit Insurance Corporation could be changing its general procedures for handling bank failures.

If either of the previously presented arrangements cannot be made, the Federal Deposit Insurance Corporation will pay off all depositors up to the insured maximum as soon as possible. A direct payoff begins within a few days of a bank's closing. Deposit amounts in excess of the limit are usually treated the same as other general debts of the bank and their owners share pro rata in the appropriate portion of the proceeds realized from the liquidation of the bank's assets.

An example of a direct payoff can be observed by looking at the case of the Stewardship Bank of Portland, Portland, Oregon. The bank was closed on June 8, 1984, by Oregon Superintendent of Banks, John B. Olin and the Federal Deposit Insurance Corporation was named receiver. The Board of Directors of the Federal Deposit Insurance Corporation announced that they would begin paying off insured depositors of the bank early in the next week.

There were approximately $5.4 million deposits in the Stewardship Bank in 1900 accounts. As an estimate, the Federal Deposit Insurance Corporation said that all but $220,000 of the bank's deposits were within the federal insurance limit of $100,000 or were otherwise secured. The owners of the uninsured deposits will share proportionately with the Federal Deposit Insurance Corporation in the proceeds realized from liquidation of the bank's assets. In this case, as in the Seminole State National Bank case, the Federal Deposit Insurance Corporation made a prompt advance payment to uninsured depositors based on the estimated present value of the assets to be liquidated, which was equal to 55 percent of their uninsured claims. The Federal Deposit Insurance Corporation's decision to
pay off the uninsured depositors and make an advance payment to them was made after no bids were received for a normal purchase and assumption transaction.

These three examples cited should make clear the three methods which the Federal Deposit Insurance Corporation uses when liquidating failed banks. In 1950, Congress bestowed additional authority on the Federal Deposit Insurance Corporation. They became able to make loans, purchase assets, or deposit funds in any insured bank which has closed or is in danger of closing, if continued operation of the bank is considered essential to the banking needs of the community. This authority offers more flexibility in handling potential failure cases and is not used very often. Under section 13(c) of the Federal Deposit Insurance Act, the Corporation is authorized to take direct action to reduce or avert a threatened loss to the Corporation and arrange a merger of a failed or failing insured bank with another insured bank. Sometimes these powers are available for insured banks whose stability is threatened due to severe financial conditions. The Corporation may make loans secured in whole or in part by assets of an open or closed bank, or it may purchase any assets or guarantee any other insured bank against loss by reason of the Federal Deposit Insurance Corporation assuming the liabilities and purchasing the assets of an open bank.

Ordinary members of the public are usually unaware of the risks which banks take until something happens to make them question their confidence. One particular event in 1974 shattered that confidence. In May of 1974, the Franklin National Bank in New York which at the time was the twentieth largest in the United States, shook the financial world by passing its second quarter dividend and also announcing losses of $40 billion, which was equal to nearly a quarter of its capital. Depositors immediately
began withdrawing their money and within a few months the Franklin National Bank was sold to a group of European banks on terms favorable to the Europeans. From the time of the first announcement of trouble, to the time when the bank was sold, depositors withdrew more than $1.5 billion; an amount which approached half of that bank's total deposits.

The overall weakening of public confidence in banks is in many ways traceable to the well-publicized misadventures of the Franklin National Bank. Franklin National Bank had been a weak-earning bank for years, and many people believed that it would be promptly liquidated by the regulatory authorities and the deposits would be assumed by another bank. Contrary to what the people thought would happen, Franklin National Bank stayed afloat during the next few months thanks to a massive loan by the Federal Reserve which helped them meet their deposit withdrawals.

Many people found the spectacle of a major bank being propped up for months rather frightening. Another concern directed towards Franklin National Bank was the reason behind their foreign-exchange losses. The public was questioning whether Franklin's foreign-exchange losses were typical of other United States banks. Although many banks speculate in foreign-exchange, none did so as recklessly or as heavily as did Franklin National Bank. Franklin National Bank was forced to speculate in foreign-exchange because they were unable to make money in less risky ways. Their normal operations were not bringing in the same amount as other United States banks. While the details of the foreign-exchange difficulties are gruesome enough, Franklin National Bank's real problems lay in the area of their normal operations. Excluding foreign-exchange transactions, Franklin National Bank made approximately $5 billion in 1973, which amounted to about one-tenth of one percent of the bank's assets. During 1973, the average United
States bank made more than eight times as much on assets.

Although Franklin National Bank's total operating shortfall was not quite as high as their foreign-exchange loss, it is this operating shortfall which is of great significance. Recurring operating losses are a definite clue of an up-and-coming crisis. Franklin National Bank's problem was that they simply could not manage the spread between the yield on loans and bonds and the cost of investable funds, personnel, and occupancy. To sum this all up, if Franklin National Bank had not received the large monetary assistance from the Federal Reserve, they would have been forced to shut the doors sometime in 1974 even if it had not incurred any loss in the foreign-exchange market.

Many of the problems at Franklin National Bank can be attributed to the management. The bank had been run by amateurs for decades. In the 1950's and 1960's the bank had two great advantages not usually enjoyed by many other banking institutions. It was located in Long Island which was one of the fastest-growing market areas of the country; and it was insulated from competition by the branching restrictions on New York City banks. Franklin National Bank became very comfortable in this setting and did not see the need to professionalize their management. Arthur Roth who headed the bank at the time, ran Franklin as a one-man show and was known to surround himself with incompetents.

After many problem years, in 1967 Franklin National Bank merged with the Federation Bank and Trust, and Harold Gleason was named chief executive in 1968. Gleason turned out to be too generous of a man who lacked the disposition to control personnel expenses which soared beyond all belief. Under Mr. Gleason's rule, the number of employees increased dramatically, salaries as well as bonuses rose, and expense accounts became increasingly
larger. In 1972, Franklin National Bank had a net return of less than three quarters of a cent per dollar of investable funds, while its peers made more than twice that amount. So, not only was Franklin National Bank paying more for its money than its peers, but also earning less.

While a myriad of other events within the organization compounded their problems, the bank was becoming dependent on borrowed funds in a period of rising rates. Overcoming great difficulties, Franklin National Bank was still able to buy in excess of $500 million a day in federal funds during the first week of May. The signs were very obvious that within a very short period of time, the bank would be totally unable to finance itself. With the federal funds rate continuing to remain at the same high level, the bank was sure to continue losing money throughout the second quarter which led to the massive run by its depositors. The episode of the Franklin National Bank played a strong part in the public's weakening confidence in the banking system.

To get a complete picture of the Continental Illinois crisis, we must first go back to the years of 1979 and 1980, and the Penn Square Bank of Oklahoma City, Oklahoma. It was during these years that there were soaring gasoline prices along with words of doom of the impending energy shortage. Although Penn Square bank had assets of only $500 million, they lent upwards of $2 billion to wildcatters and other companies which were servicing the oil-drilling industry in Oklahoma. At that point in time, they were very confident that the only way oil prices could go was up.

A purchaser of more than $1 billion of Penn Square's loans was Continental Illinois. Apparently, Continental Illinois along with several other banks which acquired smaller amounts of Penn Square's loans overlooked two not-so-apparent possibilities. First, they evidently did not consider the poss-
ibility that the price of a barrel of oil might plunge, or the possibility that a bank which was the size of Penn Square may have trouble analyzing and supervising the vast number of energy loans it was making. Other big banks which bought loan participations and should have known better were Chase Manhattan -- $220 to $300 million, Seafirst Corporation -- $400 million, Michigan National Corporation -- $200 million, and Northern Trust Corporation -- $125 million.

Real trouble started when the economic stability of the nation was shaken with two back-to-back recessions in 1980 and 1981-1982. At the same time, people were starting to conserve energy which lessened the oil demand, and the Federal Reserve pushed the prime lending rate increasingly higher. All of these factors combined, and before anyone knew what was happening, many wildcatters went broke, a result of an interest rate of 21 and one-half percent on their bank loans.

In addition to the state of the economy as a whole at the time, which can absorb some of the blame for the failure, there is clear evidence of mis-management on the part of Penn Square administrators. A former executive of Penn Square was charged with misapplication of bank funds and wire fraud. Evidence points to at least one loan of $565,000 to an executive at Continental Illinois by Penn Square.

When Penn Square was unable to collect on its oil and energy loans the bank failed on July 5, 1982. Due to the size of Penn Square, the vast amount of loan participations sold to other banks and the volume of uninsured deposits at risk, the failure was more painful than others previously. William M. Isaac, Chairman of the Federal Deposit Insurance Corporation had this to say about the problems at Penn Square,

No, the people of the Federal Deposit Insurance Corporation are not the source of your problems. Let me be blunt about
who is. The Penn Square debacle was caused by a gross dereliction of duty on the part of the bank's Board of Directors and management. They were able to perpetrate their abusive practices by obtaining funds -- normally through money brokers -- from banks, credit unions, and savings and loans around the nation. These financial institutions, which held 80 percent of the uninsured funds at Penn Square, were motivated solely by the desire to make a fast buck.\textsuperscript{76}

William M. Isaac gave the big depositors at Penn Square a real shock when the bank failed. The Federal Deposit Insurance Corporation heard many pleas for help, mainly from the above mentioned financial institutions which had purchased loan participations and had uninsured funds tied up. The Corporation was under a great deal of pressure to try and arrange a merger, but they are prohibited by law from arranging a merger unless it is determined that the cost of the merger would be less than a direct payoff to the insured depositors. When a merger does take place the Federal Deposit Insurance Corporation is required to provide the purchaser with protection against any off-balance sheet or contingent claims. In addition to the $2 billion sold in loan participations previously mentioned, Penn Square had $1 billion in letters of credit outstanding. In total there were $3 billion of off-balance sheet claims which created an overwhelming exposure to loss on the part of any potential purchaser. So, as you can see, the Federal Deposit Insurance Corporation had no choice in the matter, but to handle the Penn Square failure by a payoff of insured depositors rather than a merger. Penn Square folded and many large depositors lost their shirts. The United States' government did absolutely nothing to help the large depositors, many of whom were wealthy individuals and small businesses in Oklahoma. While many people during this time looked at the Federal Deposit Insurance Corporation as a source of their problems, actually they are part of the solution. Because the Federal Deposit Insurance Corporation
had paid off the insured depositors, it became the major creditor in
the Penn Square receivership. It is interesting to note that many of
the remaining receivership claims are not the naively innocent victims
that so many people believe. The majority of the victims are the
financial institutions that helped make the Penn Square fiasco possible
by promoting their reckless lending activities by supplying funding.
In the United States today, there is just no such thing as a painless
bank failure. People and businesses as well as the entire community
are subject to the stress and uncertainty they create. While the Federal
Deposit Insurance Corporation and William M. Isaac came under a lot of
criticism on occasion, when all aspects are examined, the conclusion is
that they had no choice but to handle the case by paying off only the
insured depositors.

The story of the Continental Illinois National Bank and Trust Company
was the big news in the banking system in 1984. Continental Illinois
embarked on a strategic plan to become one of the world's largest corporate
lenders during the mid-to-late 1970's. Their plan to go to the top
entailed a rapid growth rate in loans, which due to the branch banking
restrictions in the state of Illinois could not be maintained by retail
funding sources. To make the situation riskier, Continental Illinois relied
very heavily on short-term, volatile funding. The bank found that it
was able to purchase funds at a lower cost than longer term funding by
way of shortening its liability schedule.

Continental Illinois' problems were first brought into the open after
the Penn Square failure. They had bought over $1 billion of energy loans
for the bank in Oklahoma City, Oklahoma. At the time Continental Illinois
was the sixth-largest bank in the United States, and the attention brought
to it after Penn Square led to increased attention on other troubled loans which Continental Illinois held in its portfolio.

The next two years saw the situation at Continental Illinois deteriorating. Top management at Continental simply ignored its own internal reports that something was wrong at Penn Square. After Continental got in trouble, several of its executives were discharged for not maintaining adequate supervision over Penn Square lending. The majority of the loans purchased from Penn Square turned out to be even worse than originally anticipated. Other problem loans were surfacing, particularly in the bank's special industries division. Sellers of funds were opposing longer term commitments, which made Continental Illinois' funding even more volatile. This resulted in the bank purchasing around $8 billion each day, an amount equal to twenty percent of its total funding.

In response to Penn Square the bank tightened up controls and made some management changes. Interesting to note here is that for nearly two years changes were not made in the top management, and when the changes did occur, the bank did not go outside for replacements. David G. Taylor was named chief executive of the bank in April and Edward S. Bottum was named president at the same time. Both men were longtime Continental Illinois executives. Mr. Taylor was the treasurer who steered the bank through its funding crisis after Penn Square. Mr. Bottum has a background in lending, although at the time problems began surfacing he was in charge of trust and investment services.

The superaggressive policies of Continental Illinois made it the largest commercial lender in the United States. The problem lay in the fact that Continental Illinois had a big chunk of the loans to about
every major company that failed during the recession. At the end of
1982, Continental Illinois' nonperforming loans (those on which the
borrower has not paid interest for ninety days or more) had soared
near $2 billion, an amount more than its net worth.

Continental Illinois then became more conservative in writing new
loans; they tried to salvage any amount they could from bankrupt
customers, and they hoped that the economic recovery would bring new
life to the rest of its nonperformers. Fortunately for others recovery
came, but Continental Illinois was not among the lucky ones.

Early in 1984, companies began to see that there was some risk in
keeping their money in Continental Illinois and gradually began pulling
funds out. Also in January, several foreign banks began to cancel their
lines of credit to Continental Illinois. As time wore on, the news got
worse for Continental Illinois, and in April their nonperforming loans
had jumped. In 1983, net income had risen sharply, rebounding from
the effects of the Penn Square write-off, but the first quarter of 1984
saw net income of only $29 million, and this amount included a $157 million
pre-tax gain on the sale of their credit card operation to Chemical Bank.

The credit card operation at Continental Illinois was one of the bank's
most profitable which produced approximately $20 million a year. In order
to meet their dividends of $80 million a year, Continental Illinois was
literally forced to sell this most profitable operation. On May 1, 1984,
Continental Illinois paid $20 million in quarterly dividends, but announced
that there would be no more money for the time being. The concept of
Continental Illinois selling assets to pay dividends really upset some
creditors. Continental Illinois felt that by maintaining the dividend,
the public would see this as a sign that the nation's now seventh-largest
bank was on the road to recovery with its earning power stable. To cut or forego the dividend at this particular point in time could raise fears that the new team in charge was having problems catching up with the bank's problems. The new management team feared that a loss of confidence in their abilities could prompt big depositors to pull their money out. Mr. Taylor firmly believed in maintaining the dividend even in hard times, as can be seen when he said, "Banks are publicly funded institutions, and dividend maintenance is a sign of strength".

For a while Continental Illinois tried to pass the whole episode off as a nine-day panic touched off by "baseless rumors". The truth is that it was a heroic feat by the Federal Reserve, the Federal Deposit Insurance Corporation, and the Comptroller of the Currency which was able to save the bank. By the time the Federal Reserve and the Federal Deposit Insurance Corporation finally acted, it was necessary to issue a blanket guarantee for the total $40 billion of Continental Illinois' liabilities to cease the panic. The actions which the Federal Deposit Insurance Corporation took with Continental Illinois National Bank and Trust Company were a direct result of section 13(c) of the Federal Deposit Insurance Act of 1950 which was mentioned previously. The blanket guarantee reduced the chances of "runs" on other banks, but some people also argued that it reduced the pressure on other problem banks to straighten up and fly right.

After seeing Mr. Isaac's performance at Penn Square, some money managers were skeptical of his pledge to protect the large depositors at Continental Illinois. The money managers were nervous and well aware of the fact that the last depositors out the door usually go empty-handed, thus everyone wanted to be first out the door. By the time they were done removing their funds, more than $9 billion had been withdrawn.
The Government had hoped to protect the money managers by merging Continental Illinois with another bank. Unfortunately, yet understandably, no buyers could be found, and the United States Government was faced with the predicament of keeping Continental Illinois alive. Before the rescue was over, the Federal Deposit Insurance Corporation would put up $4.5 billion from its insurance fund, borrow $3.6 billion from the Federal Reserve, and also arrange a $5.5 billion line of credit from 28 private banks. At the end of all the assistance, the United States Government would effectively own 80 percent of the total shareholder equity in what is by substance a new Continental Illinois.

While the Federal Deposit Insurance Corporation actually had four options to choose from in the Continental Illinois case, they chose to provide interim direct assistance. Their other options were to close the bank and pay off the depositors within the insurance limit, arrange a quick merger, or grant permanent direct assistance. In the sense of liabilities exceeding assets, Continental Illinois was not and is not insolvent. This is one important test in judging the viability of a bank and the test which the Comptroller of the Currency often uses when closing a national bank. Admittedly, the bank had severe liquidity and confidence problems, but closing the bank and paying off the insured depositors could possibly have had disastrous consequences for not only other banks, but the entire economy. The insured accounts at Continental Illinois totalled slightly more than $3 billion. This meant that over $30 billion in claims by depositors and other private creditors would be tied up for an uncertain length of time in bankruptcy proceedings. There were literally hundreds of small banks which would have been particularly hard hit.
To arrange a merger in a few days time would have been nearly impossible, and even if it was the prospective purchasers would not have had enough time to properly evaluate the bank. Thus the Federal Deposit Insurance Corporation would have had to step in and provide assistance to the purchaser to protect against any uncertainties. This could have made this option extremely expensive for the Federal Deposit Insurance Corporation.

There were several reasons for rejecting the granting of permanent assistance right away. At first, there was not enough known about the bank and its needs. The needed time was not available to sort through all of the legal and accounting red tape and to arrange for new management. Also, the Federal Deposit Insurance Corporation believed that they should use every resource for a private sector solution before they would go ahead with a permanent direct assistance.

With all of the previously mentioned sources of action ruled out, only one remained -- interim direct assistance. This would help to stabilize the situation while the bank was examined and meetings could be held with prospective investors in order to set up a permanent assistance package. There were three key elements to the interim assistance package: first, a massive infusion of temporary capital -- $1.5 billion from the Federal Deposit Insurance Corporation and $500 million from leading banks; second, the Federal Deposit Insurance Corporation's assurance that the permanent solution would protect all depositors and other general creditors of the bank against loss; and finally, liquidity support from the Federal Reserve and leading banks.

On July 26, 1984, the permanent assistance program was announced. The major parts of the assistance plan include installation of a proven,
internationally recognized management team, the removal of $4.5 billion in problem loans from the bank, the infusion of $1 billion in new capital, and also ongoing lines of credit from the Federal Reserve and a group of 99 major United States' banks. The institution which stands after this assistance will be smaller, but considerably stronger and better positioned to serve the banking needs of its customers.

The boards of directors of the bank and its parent, named two new executive officers as part of the program to rehabilitate Continental Illinois. John E. Swearingen was named Chairman of the Board and Chief Executive Officer of Continental Illinois Corporation, and William S. Ogden was named Chairman of the Board and Chief Executive Officer of Continental Illinois National Bank. These men took the place of Mr. Taylor and Mr. Bottum whose resignation became effective on August 13, 1984.

As a result of the permanent assistance program, Continental Illinois is now strongly capitalized and relatively free of problem loans. It is now smaller and less dependent on volatile funding sources. The Federal Deposit Insurance Corporation has agreed not to interfere with the bank's day-to-day operations, nor will it control the hiring or compensation of officers, lending or investment policies or other normal business decisions. Only time will tell if the right decisions were made, but under the circumstances action had to be taken swiftly to ensure confidence and trust in the banking system. With a little luck, and a great amount of skill, maybe one day Continental Illinois will regain the respect and dignity it once had as one of the nation's leading banks.
Now that a few major bank failures have been looked at, you can see that there is no single factor which causes their failures, but usually it is a combination of things. Because of the fierce competition between financial institutions to give the consumer higher rates of return on their investments, in the early 1970's many banks were scrambling to arrange their own portfolios to reap a higher profit. Towards the latter part of the 1970's the deregulations which were taking place in the financial services market placed additional strains on the banks. Bankers were practically forced to take on riskier and riskier loans with the benefit of a higher interest rate. Many people attribute the recent record number of bank failures to the declining quality of loans that banks were making.

In the case of the Seminole State National Bank which was mentioned earlier, acting Comptroller of the Currency, H. Joe Selby said,

Over the past year, the bank experienced substantial deterioration in the quality of its loan portfolio. Seminole State National Bank was unable to remedy its problems and losses finally exhausted the bank's capital funds, resulting in its insolvency.103

The very problem which Seminole State National Bank faced -- "deterioration in the quality of its loan portfolio" -- is not unique. Just what is the solution to this problem? The answer lies in part with capital adequacy.

In the International Lending Supervision Act of 1983, the federal banking agencies were granted the power to set and enforce minimum capital requirements. The bankers and bank supervisors play an important role here. Bankers must keep enough capital to operate at a profit first and foremost, and to attract a wide array of depositors. In order to promote and preserve a sound financial system, and also to protect the deposit insurance fund, bank supervisors are also striving to
maintain capital adequacy. Although some people feel that minimum capital requirements are not the best means of limiting the risks that are posed by inadequate bank capital, due to the competition and current deregulations taking place in the financial services industry they are definitely needed now more than ever. If there were not some kind of enforceable minimum requirement, quite a few banks would be at serious risks due to their inadequate capital levels. Even with the current levels which banks are supposed to maintain, the alarming number of bank failures is evidence that when banks are forced to find ways to make a better profit by taking on riskier loans, even these minimums are not enough to save the banks.

According to the banking definition of capital, it performs two functions: it finances the purchase of fixed assets and it protects creditors. Also included in the definition of bank capital are loan loss reserves and long-term debt. Loan loss reserves are made up of retained earnings held to absorb losses in the case that any should occur. When losses do occur, instead of reducing current earnings, the reserve account is just reduced. It is in the function of absorbing losses that the loan loss reserves protect the creditors. The long-term debt represents long-term loans to banks and are frequently used to finance fixed assets. Long-term debt protects creditors due to the fact that if a bank fails, the long-term creditors are paid after the depositors are paid.

Bank capital adequacy has been a major concern of supervisory agents for many years. To a large degree, the safety and soundness of the banking industry goes hand in hand with capital adequacy. This sounds easy enough, but just how much is enough? It is very difficult to give a cut and dry percentage of capital that will ensure that banks do operate in a safe and
sound manner. Everybody in the United States would love to see smooth-sailing banks; which would put small and large business managers at ease as well as the consumers. The supervisory agencies have tried to set capital guidelines for the banking industry which were based on the agency's view of the level of risk facing the industry. Unfortunately, there are problems with this. Only through bank examinations can the supervisory agents determine if a bank has enough capital to meet its needs. There is more than one bank-specific factor which needs to be examined. The banks investment qualities as well as the quality of management is of paramount importance and needs to be looked at individually and in depth when reaching decisions concerning capital adequacy. It is only common sense which tells you that a bank with a portfolio chock-full of very risky loans had better have a little nest egg of capital built up in case something should happen and a few loans turn out to be uncollectable. On the other hand, a bank which holds a portfolio of loans which were well researched by their credit department and loan officers does not have as much to worry about, although the threat of default is always present. The supervisory agencies look at a number of items, such as the bank's loan portfolio, their financial statements, and their operating policies, before they can make a judgement. The two decisions they may come to are: 1) the bank's capital is adequate to finance the purchase of assets as well as protect their creditors, or 2) the bank's capital is not adequate and additional capital must be raised.

Banker's reactions to a request for additional capital are often followed by a careful weighing of the costs of providing the additional capital, or not providing the additional capital. The bankers were well aware that by providing additional capital, earnings would be diluted which often hurt the
shareholders. With the passage of the International Lending Supervision Act, the banks really do not have a choice of complying with their request, or not complying. Federal banking agencies can now legally set minimum capital requirements along with carrying the power to enforce them by issuing directives to banks they judge to be capital-deficient. The supervisory agency's directives and minimum capital requirement are enforceable in a court of law, and the banks are often asked to submit and stick to often stringent plans.

There was previously an imbalance in the standards for capital adequacy. Small banks were required to maintain higher capital ratios than larger banks. It was a common belief that the smaller banks were riskier due to poorly diversified portfolios and restrictions on access to financial markets. In July of 1984, the Federal Deposit Insurance Corporation, the Comptroller of the Currency, and the Federal Reserve all gathered together and presented new standards for bank capital adequacy. (See chart #7) One important feature of the new standards is that there appears to be uniformity across bank size. As a result of the new standards, large banks were forced to increase their capital levels, and small banks were permitted to decrease their capital levels; thus, the injustice which had been placed on the smaller banks was at last lifted.

There has been some concern over the trend toward lower capital ratios. The concern lies in the question, "Do low capital ratios make for a riskier banking system?" It can be argued that the lower capital ratios do expose the banking industry to greater risk, although this does not necessarily add up to a riskier banking system in the sum. Bankers and bank supervisors look at optimal levels of capital ratios in a different light. On the whole, bankers prefer lower capital ratios than bank supervisors. This is only