


Problem and Failed Institutions
in the
Commercial Banking Industry

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 **JAI PRESS INC.**
Greenwich, Connecticut

Library of Congress Cataloging in Publication Data

Sinkey, Joseph F

Problem and failed institutions in the commercial banking industry.

(Contemporary studies in economic and financial analysis; v. 4)

Bibliography: p.

Includes index.

1. Banks and banking—United States. 2. Bank failures—United States. 3. Bank examination—United States. I. Title. II. Series.

HG2491.S55

332.1'2'0973

76-5760

ISBN 0-89232-005-2

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165 West Putnam Avenue
Greenwich, Connecticut 06830*

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*ISBN NUMBER: 0-89232-005-2
Library of Congress Catalog Card Number: 76-5760
Manufactured in the United States of America*

Acknowledgments

I thank Edward I. Altman for suggesting that I write this book for the JAI Press' monograph series, *Contemporary Studies in Economic and Financial Analysis*. Edward J. Kane and Joanne M. (Forsyth) Sinkey each read the entire manuscript. Their comments and suggestions were invaluable and they both were a tremendous source of encouragement, as they have been throughout my career.

The research for this book was generated over a number of years and numerous individuals have made valuable contributions. Robert A. Eisenbeis and Edward J. Kane deserve special mention. Others to be acknowledged (listed alphabetically) are: E. Altman, J. Arnold, J. Boorman, S. Buser, S. Cohan, R. Dince, T. Dollar, J. Edgington, G. Gilbert, G. Gonzalez, J. Hilliard, R. Hitcock, P. Horovitz, W. Hunter, W. Longbrake, A. McCall, M. Mitchell, M. Peterson, W. Roelle, S. Silverberg, J. Verbrugge, D. Voesar, D. Walker, and W. Watson.

Computer and research assistance have been provided by J. Castner, H. Dew, J. Duffy, J. Gerdnic, S. Goldstein, P. Karnes, J. Maas, H. Merrill, J. Mitchell, W. O'Brien, and B. Shipman. The typing of the manuscript was graciously and capably performed by D. Bodiford, L. McGinnis, and C. Blizzard of the Banking and Finance Department and by M. Burger, C. Lloyd, S. Jackson, K. Myers, and E. Williams of the College of Business Administration's typing pool.

A special thanks goes to John A. Castner, Jr., who provided the artistic talent that gave shape to the ideas for the illustrations in this book. John made ten of the eleven original drawings; Laurretta Bambula sketched the remaining one. Finally, thanks again to Edward J. Kane for writing the Foreword and to Melinda Bell and David Stultz for their assistance in constructing the Index.

I thank the editors of the following publications for permission to

draw upon my previously copyrighted articles. The specific credits are:

“Identifying Problem Banks: How Do the Banking Authorities Measure a Bank’s Risk Exposure,” *Journal of Money, Credit and Banking* (May 1978), pp. 184–193. This material is used in Chapter 3, pp. 48–57, 63–64.

“Identifying Large Problem/Failed Banks: The Case of Franklin National Bank of New York,” *Journal of Financial and Quantitative Analysis*, (December 1977), pp. 779–800. This material is used in Chapter 6, pp. 163–168, 177–185, 193–194.

“The Collapse of Franklin National Bank of New York,” *Journal of Bank Research*, (Summer, 1977), pp. 113–122. This material is used in Chapter 6, pp. 147–158.

“The Failure of United States National Bank of San Diego: A Portfolio and Performance Analysis,” *Journal of Bank Research* (Spring 1975), pp. 8–24. This material is used in Chapter 7, pp. 218–228.

“Bankers’ Attitudes Toward the Bank-Examination Process,” *The Bankers Magazine* (May–June 1978), pp. 43–45. This material is used in Chapter 9, pp. 256–263.

“Problem and Failed Banks, Bank Examinations and Early-Warning Systems: A Summary,” in *Financial Crises* (E. I. Altman and A. W. Sametz, eds.), New York: Wiley-Interscience, 1977, pp. 24–47. This material is used in Chapter 3, pp. 48–57, 63–64, and Chapter 6, 163–168, 177–185, 193–194.

Foreword

Bank failure is a fashionable topic in the sense that, like the hem length of women's skirts, interest in it rises and falls in a cyclical pattern. But the ebb and flow of this interest is far easier to understand than changes in ladies' fashions. The public worries about bank failures only when the flow of economic information makes the threat of widespread insolvencies seem very real.

This insight leads bankers to view their continued solvency as a matter of avoiding, *not* bad policies, but bad publicity. Even for well-run banks, adequate information on the quality of assets and operating policies is notably hard to come by. Almost without exception, banks' published financial statements are exercises in cosmetic accounting, while regulators' unburnished examination reports are tightly withheld from public scrutiny. Banks' habitually self-serving record-keeping makes unfavorable information all the more damaging when it does appear. With anxious customers having much at stake and little reliable information, adverse rumors about a bank's condition can rapidly trigger substantial outflows of deposit and nondeposit funds.

When, as in 1933, such problems become epidemic, restoring public confidence becomes a political-economic problem of great urgency. At such times, fundamental changes in regulatory arrangements are adopted, sometimes only for their dramatic effect. These regulatory reforms take their place among the causes both of the subsequent economic recovery and eventually of the next banking crisis.

For example, in the 1930s, the institution of Federal deposit insurance helped to restore public confidence in the U.S. banking system. But as time wore on, it did this too well, lulling many depositors into the mistaken presumption that, except for scattered closings of small firms, bank failures were a thing of the past.

Joseph Sinkey's book takes as its focal point the series of large-bank failures in 1973–1976 that revealed the foolishness of this presumption. He investigates how—without breaching the industry code of selective nondisclosure or reforming existing regulatory incentives—regulators could have made better use of available channels of information, regulatory controls, and legal sanctions to reduce the number and dollar value of bank failures.

Sinkey builds his case with both wit and vigor, showing that information collected in routine income and condition reports could be arrayed into an effective early-warning system for identifying potential problem banks in plenty of time for the banking authorities to concentrate examination and advisory resources where and when they promise to accomplish the most good. Although Sinkey focuses on data from the past, the thrust of his analysis is forward-looking: to persuade bank regulators to redesign their systems for monitoring individual banks. Such suggestions have traditionally been resisted by Federal bank-supervisory personnel, but Sinkey's proposed reforms seem gradualist and straightforward enough. The changes he recommends can be put into place without Congressional review or authorization. Moreover, they can be interpreted as an effort to blunt the unintended subsidization of bank risk-taking inherent in the current structure of explicit and implicit costs and benefits of FDIC insurance.

Although FDIC insurance is formally limited to \$40,000 per account (\$100,000 for government accounts), the FDIC implicitly insures all accounts in full. To maintain confidence in the banking system, the FDIC has committed itself to a policy of failure management that minimizes losses to bank depositors and other creditors. On the cost side, the explicit fees for FDIC insurance are unrelated either to a bank's asset structure or to its nondeposit liabilities. This establishes incentives for banks to improve their bargain with the FDIC by taking on additional asset risk and reclassifying large deposits as potentially riskier nondeposit liabilities. With the marginal explicit insurance cost of such balance-sheet risk equal to zero, market equilibration requires that the FDIC impose *implicit* insurance premiums via the examination and regulatory process. It is no accident that bank examiners constitute fully two-thirds of FDIC employees.

As long as the FDIC is unwilling to adopt a risk-rated system for pricing its insurance, it must continually search for improved ways of monitoring and controlling "unsafe and unsound" bank practices. Adopting a Sinkeyesque early-warning system promises to reduce chance variations in the marginal implicit cost of balance-sheet risk to

individual banks and to improve FDIC surveillance of supervisory problems generally. If a bureaucracy sought merely to optimize the performance of its mission, such a system would have been installed long ago.

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The Search for Deep Vault



Preface

It is a foggy, misty morning in Alexandria, Virginia, on the eleventh day of our Bicentennial. The weather is not the kind a prospective skier likes to see, especially at 6:30 A.M. I move quietly but quickly through the house. I have only thirty minutes to get ready and I don't want to awaken our six-month-old daughter, Alison. After dressing, I sit down to my usual breakfast of grapefruit, cereal with banana, and toast with jam. Since I am rushed, however, *The Washington Post*, a regular part of my breakfast routine, is missing—it is still on the front porch.

After breakfast, I gather my outer skiing garments and head for the basement to get my skis, boots, and poles. I open the garage door and position my equipment near the door. My friend and fellow FDIC economist, Alan McCall, and Mary Jane, his wife, are supposed to pick me up at 7:00 A.M. I am right on schedule. We are going to Massanutten in the Shenandoah Mountains for a day of skiing.

After a few minutes, I start to get restless. Patience is not one of my virtues. Knowing Alan and how long it takes him to do *anything*, I am not about to blame “MJ” for their tardiness. To pass the time, I go up to the front porch to check out *The Washington Post*.

As I pick up the paper, my pulse quickens and a lump develops in my throat. Is this another Watergate-type coup for *The Post*? Look at the headline:

Citibank, Chase Manhattan on U.S. “Problem” List

Normally, banking news doesn't turn me on this way. This is different, however, because in my research at the FDIC I am using our “problem-bank lists” in my work. Since I hadn't given the lists to anyone outside the FDIC, my main concern is whether or not someone has gotten hold of my lists, which usually are strewn all over my office. They are, after all,

confidential documents in my possession and I am responsible for their safekeeping. I quickly have a vision of fecal matter hitting the fan. “Don’t panic and read on,” I tell myself.

The by-line reads, “Ronald Kessler, Washington Post Staff Writer.” I don’t know him. A few weeks later, however, he calls me at the FDIC and, after talking to me about my research (off the record and not for quotation at my request), he indicates that if I ever want to drop any confidential material in the mail to him he will appreciate it. I politely decline to be his “deep vault” at the FDIC.

As I quickly scan the story, I feel a sense of relief. The story is based upon a problem-bank list obtained from the Comptroller’s Office. Later that week I call Bob Dince, then Acting Director of Research at the Comptroller’s Office, to find out if he knows who “deep vault” is. He doesn’t, and indicates that the atmosphere is pretty tense at the plush L’Enfant Plaza where the Comptroller’s offices are located.¹ After the failures of USNB and Franklin and the emergency merger of Security (all national banks under the supervision of the Comptroller’s Office), Jim Smith, the Comptroller of the Currency, doesn’t need any more publicity, especially this kind. Bob Dince and Jim Smith play tennis together and Bob feels that Jim is getting a “raw deal” from Congress and the press. I agree, in part, but Smith makes some *faux pas* that Congress and the press use to hound him from office.

As I reflect on the story, I recall that Citibank and Chase are *not* on our problem-bank list. I wonder if the Comptroller knows something about those banks that we don’t. He doesn’t. *The Post* story summarizes the typical examiner’s tale about a problem bank, that is, Citibank and Chase supposedly have a large volume of “substandard” loans relative to their capital and reserves. Such loans are the least risky and most subjective classifications that bank examiners make (see Chapter 3). *In practice*, it is mainly on this basis that banks are designated as “problem banks.” Knowing how subjective such classifications are, I apply the appropriate discount to *The Post’s* problem-bank story.

It is now 7:30 A.M. and the McCalls are coming up North Ashton Street. It is time to go skiing and forget about what *The Wall Street Journal* later calls “Bored by the Bank Flap.”

About a month later I am back at the breakfast table, this time with *The Washington Post*. It is Friday, February 6. *The Post* has another banking story, “Problem Banks Rising,” by Charles R. Babcock. Like Kessler, I don’t know Babcock either; unlike Kessler, however, Babcock doesn’t even call and ask me to be his “deep vault.” I am crushed. *The Post’s* story

1. The degree of tenseness is indicated in the First Illustration, “The Search for Deep Vault.”

is about one of Comptroller Smith's numerous appearances before the Senate Banking Committee. Near the end of the article, Babcock reports that Senator Proxmire charges Comptroller Smith with failing to exert pressure on large banks to increase their capital. Proxmire tells Smith, "I'm not asking you to apply it ruthlessly. Apply it in a namby-pamby way. Play the violin and sing while you're doing it. Just do it." A quick-witted Smith might have responded (à la Ogden Nash):

Ode to Bank Capital
 Oh bank capital, oh bank capital.
 Our regulators' stricken hero.
 Please don't, please don't.
 Please don't go to zero.

About thirteen months later, on March 11, 1977, I am testifying before the Committee on Banking, Housing and Urban Affairs of the United States Senate. The hearings focus upon the condition of the banking system and how effectively the banking agencies have carried out their statutory responsibility to assure a "safe and sound" banking system. My conclusions to the Committee are (1) the U.S. banking system is in a relatively healthy condition and (2) the bank regulatory agencies have done an adequate job. These are conclusions Senator Proxmire *doesn't* want to hear. He is pushing legislation to consolidate the Federal banking agencies into a monolithic system. He *wants* to hear: (1) the system is in dismal shape; (2) the agencies (especially the Comptroller's office) have done an inadequate job; and (3) the reason the system is in dismal shape is *because* of the tripartite "jurisdictional tangle." Given *these* conclusions, Senator Proxmire might be able to generate enough support for his proposed legislation. Without them, his proposal would appear to be dead—breaking up (or consolidating) a "winning combination" is un-American.

I conclude my Senate statement on a lighthearted note with my "Ode to Bank Capital." Senator Proxmire, showing a lack of appreciation for my Ogden Nashism *and*, more importantly, an apparent misunderstanding of *how markets work*, responds: "If it (bank capital) does (go to zero), that is just something that will happen because of the markets and we can't do anything about it."² There is, of course, no need to do anything about it. In an *efficient* market, *risk-adverse* investors would not permit bank capital to go to zero (technically infinite financial leverage), or even to approach zero, without demanding compensation for the increased riskiness. As a bank's capital decreases below the industry or market

2. Unedited Transcript, Committee on Banking, Housing and Urban Affairs, March 11, 1977, lines 1–3, p. 150. (Parenthetical inserts are mine.)

norm, the risk premiums demanded by investors increase, forcing the bank to reduce its leverage (i.e., increase its capital) *or* to pay for its increased risk exposure. The market's signal for greater riskiness is a higher required rate of return.

This is a book about the “dark side” of banking in the United States, problem and failed banks. Fortunately, such institutions represent only the “tip of the iceberg”; the overwhelming majority of U.S. banks are “safe-and-sound” institutions. Like a certain soap's claim to be “99 and 44/100 percent pure,” the U.S. banking industry is *almost* as clean.

My qualifications for writing this book are my educational training as a Ph.D. economist (Boston College, 1971) and my five years experience as a financial economist for the Division of Research of the Federal Deposit Insurance Corporation (FDIC).³ During my tenure at the FDIC my research centered primarily on problem and failed banks, the bank-examination process, and the development of an early-warning system for identifying problem commercial banks. The three areas are of course closely related. That is, in striving to achieve their Congressional mandate of a “safe-and-sound” banking system, the banking authorities use bank examinations to identify so-called problem banks and try to prevent them from becoming bank failures. Computerized early-warning or surveillance systems can be used as aids in this identification process. In a nutshell, this is the focus of this book.

My publications in the *Journal of Finance*, *Journal of Money, Credit and Banking*, *Journal of Financial and Quantitative Analysis*, *Journal of Bank Research*, *The Bankers Magazine*, *Financial Crises*, and *Applications of Classification Techniques in Business, Banking, and Finance* attest to the quantity and quality of some of my research. In addition, I have made numerous presentations about my research at professional meetings and invited seminars throughout the United States. At the University of Georgia, I have continued to study problem and failed banks and in general the management of financial institutions. The pedagogical value of the research has been substantial; that is, studying the *mismanagement* of financial institutions facilitates communicating to students *how to manage* them.

This book should be of interest to the business, banking, and academic communities. Moreover, since Joanne, my wife (who is not a student of banking), finds the book readable and interesting (she, of course, is biased), the book may also be of interest to the general public. Regarding the use of the book in the academic community, although it is not a

3. To some bankers, the FDIC acronym stands for *Forever Demanding Increasing Capital*.

textbook in the fundamentals of banking, it could be used as a supplemental book for courses in commercial banking, money and banking, or financial institutions.

Joseph F. Sinkey, Jr.

Athens, Georgia

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