

What Have We Learned about Deposit Insurance from the Historical Record?

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THE INCREASE IN depository institution failures in the last dozen years and the resulting losses to the bank and thrift insurance funds have understandably generated interest in the costs and benefits of deposit insurance. Calomiris (1989a, p. 12) defines a successful deposit insurance system as "one that fully protects the payments system, without encouraging any excessive risk-taking," that is, risk taking beyond what would be optimal without insurance. The federal government's apparent willingness to guarantee deposit insurance fund liabilities reduces the probability of widespread banking panics that would threaten the payments system.² Providing fully credible insurance, however, may increase the likelihood of a significant deposit insurance bailout by giving depository institutions an incentive to take excessive risks. Until the 1980s, risk taking was discouraged by regulations that enhanced the charter values of depository institutions and limited competition for deposits.³ Deregulation, however, has lowered the value of charters and provided the means for banks to increase risk.

Federal deposit insurance was enacted in 1933 as a response to the bank failures of the Great Depression. Deposit insurance was not, however, a new policy at that time. During the 19th and early 20th centuries, many states experimented with deposit insurance systems. The state systems were funded entirely by insured banks,

and the states did not guarantee the liabilities of the insurance funds. Recently, researchers have been studying these systems to gain insights to the effects of deposit insurance in different regulatory environments. This article reviews the historical record and attempts to draw useful lessons for the current debate.

STATE INSURANCE SYSTEMS

Six states operated insurance systems before the Civil War. The Vermont, Michigan and Indiana systems, and the New York system before 1842, insured both bank notes and deposits. In Ohio and Iowa, and in New York after 1842, only bank notes were insured. The performance of the different systems varied considerably. The Michigan system opened on the eve of the Panic of 1837 and subsequently closed without reimbursing any depositors or note holders of failed banks. The New York and Vermont systems were more successful because their insurance funds had time to accumulate assets before significant failures occurred. As a result, note holders and depositors of insured banks that failed in these states received at least some reimbursement for lost funds. In Indiana, Ohio and Iowa, no depositor of an insured bank lost any money. The success of deposit insurance in these states has been traced to the mutual-guarantee form of their insurance systems.

¹Senior economist, Federal Reserve Bank of St. Louis. Kevin Dowd, Mark Flood and Steve Russell made helpful comments on a previous draft.

²When the FDIC was established, there was no explicit

statement that the federal government would bail out the insurance fund if it became insolvent. See Flood (1992).

³See Keeley (1990).

In mutual-guarantee systems, insured banks that were still solvent could be assessed any amount to cover the obligations of an insured bank that had failed.

With the exception of the Michigan system, the antebellum deposit insurance systems remained open until the Civil War, though not all of them still had active members. The tax imposed on state bank notes under the National Banking Act of 1863 caused many state banks to reincorporate as national banks. National banks were permitted to issue notes valued at up to 90 percent (later 100 percent) of the face value of the U.S. government bonds they deposited with the Comptroller of the Currency. The notes in turn were guaranteed by the federal government.⁴

During the last two decades of the 19th century, the expanded use of deposits (which were not taxed) and the liberal chartering requirements that many states adopted caused a resurgence of state-chartered banking. By the mid-1880s, Congress and several state legislatures began to consider proposals for deposit insurance. None of these was accepted until 1907, when a surge of bank failures led Oklahoma to establish a deposit insurance system for its state banks. Kansas, Nebraska, South Dakota and Texas followed within two years. Mississippi enacted insurance in 1914, as did North Dakota and Washington in 1917.⁵

LESSONS FROM THE STATE SYSTEMS

The absence of significant bank and savings and loan failures between 1934, when federal deposit insurance began, and 1980 suggests that regulations limiting competition for deposits and maintaining charter values effectively discouraged excessive risk taking. The performance of the 19th and early 20th century state insurance systems also shows that the effects of deposit insurance depend largely on the regulatory environment. For example, each of the states with

deposit insurance in the 19th century permitted banks to avoid the insurance system by incorporating as "free banks." In some states, such as New York, weaknesses in the insurance system caused conservative banks to exit and adopt free bank charters. Indiana, on the other hand, had a notorious free banking law that tended to attract risky banks; conservative banks chose to belong to the insurance system.⁶ This may be one reason why insured banks in New York had a higher failure rate than those in Indiana.

Each of the states that had a deposit insurance system in the early 20th century prohibited branch banking but set low minimum capital requirements and permitted relatively free entry. Although the states imposed various regulations to limit risk taking by insured banks, such as minimum capital/deposit ratios and deposit interest rate ceilings, supervision tended to be cursory. In each of these states, deposit insurance is generally believed to have encouraged excessive risk taking by banks. Whether this was due to inadequate regulation and supervision or to inherent flaws in the insurance systems is not clear. It seems likely that both the insurance systems and the regulatory environment were to blame.

Alternative Funding Methods

The 19th century insurance systems of New York, Vermont and Michigan, and all eight of the early 20th century state insurance systems, required insured banks to pay into a fund for reimbursing depositors of failed banks. The insurance premiums the banks paid were unrelated to risk of failure, and upper limits were set on the assessments that could be imposed in any year. In each state but one, the liabilities of the insurance system eventually exceeded its assets and depositors of failed banks had to absorb some of the losses.⁷

The mutual-guarantee feature of the 19th century deposit insurance systems in Indiana, Ohio and Iowa ensured that there were ample funds to reimburse depositors and note holders and

⁴National banks also had to contribute 5 percent of the value of their notes to a cash redemption fund maintained by the U.S. Treasury. [See Friedman and Schwartz (1963, pp. 20-21)]. The backing provisions for national bank notes were similar to those of most antebellum state free banking laws. See Dowd (1992) for analysis of free banking in this era.

⁵White (1981) investigates the characteristics of states adopting deposit insurance and concludes that rural farm-

ing states were the most likely to adopt insurance and eschew branch banking.

⁶See Calomiris (1989a).

⁷The one exception was Texas, where insured deposits at failed banks were paid off in full. In Mississippi, the insurance fund was unable to pay off all depositors, but the state issued bonds to settle all claims eventually.

discouraged the excessive risk taking that appears to have characterized banks in the other state insurance systems. In mutual-guarantee systems, insured banks could be assessed any amount necessary to reimburse insured depositors or note holders. Insured banks consequently had a strong interest in the behavior of other members of the system—an interest that the state harnessed by giving members considerable supervisory authority over one another. The relatively small number of insured banks operating in each of these states further enhanced regulatory control.⁸

Voluntary vs. Mandatory Insurance

If insurance premiums are inadequately related to risk, then risk-prone banks tend to gain more from deposit insurance than banks that are managed conservatively. In the absence of insurance, depositors will demand risk premiums on deposit interest rates and will withdraw their funds from banks that take unacceptable risks. Deposit insurance removes the incentive for depositors to monitor bank risk and may “create a sense of false security in the public mind and a lack of discrimination between reliable and unreliable banks and bankers.”⁹ Because risky banks gain the most in terms of increased public acceptance and reduced deposit costs, they will be more likely than conservative banks to join voluntary insurance systems. Historically, this adverse selection problem has hampered the funding of deposit insurance systems.

Because banks in the early 19th century could incorporate as free banks, bank insurance systems of this time were in essence voluntary. As noted above, the performance of each state’s insurance system depended on its funding method and on the incentives provided to both insured and free banks. Insurance worked better in states like Indiana, where conservative banks were attracted to the insurance system.

Because a ruling by the Comptroller of the Currency prevented federally chartered banks from participating in state deposit insurance systems, all of the state systems of the early 20th century were also essentially voluntary. Even where insurance was mandatory for state-

chartered banks, a bank could opt out by switching to a federal charter. Doing this was costly, however, because national banks were subject to different regulations, including generally more restrictive limits on their lending than were imposed on state banks.

Deposit insurance was optional for state-chartered banks in Kansas, Texas and Washington. Though all eight of the early 20th century deposit insurance systems ultimately collapsed, their survival does not seem to have depended on whether insurance was mandatory. Freedom to exit did cause the Washington system to have the shortest life. When the state’s largest insured bank failed in 1921, all other insured banks withdrew from the insurance system, thus ending bank deposit insurance in Washington.

Kansas also permitted insured banks to withdraw from its insurance system, though a withdrawing bank was held liable for funds needed to reimburse depositors of institutions that failed within six months of the bank announcing its intention to drop out. Despite a large number of failures and increasing insurance premiums, banks did not leave the Kansas system *en masse* until 1926, when the state supreme court ruled that a bank could withdraw simply by forfeiting the bonds it had deposited with the state as a guarantee of insurance premium payments. Most insured banks then decided to withdraw, and state deposit insurance in Kansas effectively ended.

Texas banks were given the option of joining the state deposit insurance system or purchasing a private bond to guarantee their deposits. Before 1920 most banks chose to join the insurance system. Like other commodity-producing states, Texas suffered many bank failures for several years after commodity prices collapsed in mid-1920. In 1925 the state permitted banks to drop out of the insurance system. Membership then fell off dramatically, from 896 banks holding \$302 million of deposits in 1924 to 34 banks with just \$3 million of deposits by the end of 1926.¹⁰

The histories of the mandatory deposit insurance systems are not qualitatively different from the history of the Texas system. In each case,

⁸Calomiris (1989a) compares the two types of insurance systems in greater detail and notes that in many large cities bank clearinghouse members often jointly guaranteed the liabilities of each member during financial panics.

⁹See American Bankers Association (1933, p. 39).

¹⁰See Federal Deposit Insurance Corporation (1957, pp. 66–7).

insurance fund liabilities eventually exceeded assets and the state legislature simply repealed the insurance law instead of raising insurance premiums to cover the shortfall. Only Mississippi required taxpayers to bail out insured depositors.

CHARACTERISTICS OF INSURED INSTITUTIONS

Empirical investigation of the effects of insurance on the behavior of banks today is hampered by the fact that virtually all U.S. bank deposits are insured by the Federal Deposit Insurance Corporation. Comparing the behavior of insured and uninsured banks in the states that had optional insurance systems during the early 20th century is possible, however. In a study of Kansas banks, Wheelock (1992) found that members of the state's deposit insurance system had a greater likelihood of failure than their uninsured competitors and that insurance had its greatest effect on banks that were near failure. Like many banks and thrifts in the 1980s, Kansas banks often took extreme risks as they neared insolvency. Wheelock (1992) found that for banks within one year of failure, insurance system membership was an especially good predictor of failure. Wheelock and Kumbhakar (1991) also show that risky banks were more likely to join the Kansas insurance system and that insurance led banks to reduce their capital/assets ratios over time.

The early history of federal insurance of deposits at thrift institutions provides a similar opportunity to examine the effects of deposit insurance. Although insurance was mandatory for federally chartered thrifts, it was optional for state-chartered institutions and many chose not to become insured. In a study of Chicago and Milwaukee thrifts during the 1930s, Grossman (1992) found that when institutions first acquired insurance, they were less prone to risk than uninsured thrifts. Insured thrifts increased their exposure to risk over time, however, and after being insured for five years were more risky than uninsured thrifts. Grossman attributes the delay in the emergence of excess risk to the examinations the institutions underwent before their deposits were insured.

CONCLUSION

By the mid-1920s, many observers viewed deposit insurance as "an experiment that failed."¹¹ Despite regulations intended to contain risk taking, the state systems appear to have suffered from adverse selection and moral-hazard problems and in most instances did not fully reimburse depositors of failed banks. Bank failure rates were high in states with deposit insurance systems, and insured state banks had higher failure rates than uninsured state and national banks in the same states.¹²

Deposit insurance also appears to have created greater losses for failed institutions than there might have been otherwise. Without insurance, depositors have an incentive to withdraw their funds once a bank becomes insolvent. Deposit insurance removes this incentive, making it possible for insolvent banks to continue to operate unless closed by regulators. As in the 1980s, regulators during the 1920s sometimes permitted insolvent banks to remain open, hoping that they would regain solvency. Forbearance seems to have been unsuccessful, however, because the average liquidation value of insured state banks that closed was less than that of uninsured state banks that failed.¹³

Although the historical record of deposit insurance is not favorable, it seems unlikely that deposit insurance will be eliminated, or even significantly scaled back, in the near future. Two non-mutually-exclusive options for reform seem available. A mutual-guarantee system like those of 19th century Indiana, Ohio and Iowa could be adopted. Mutual guarantee seems to have discouraged excessive risk taking and ensured ample funds to protect depositors from losses. To operate effectively, however, such a system might require a considerable consolidation of the U.S. banking industry. Any privately funded insurance system, moreover, could be vulnerable if depositors lose confidence in the entire banking system. For insurance to be fully credible, the Federal Reserve must thus be willing to act as lender of last resort—a role it failed to perform during the Great Depression.

An alternative option that would combine some limits on insurance coverage with regulatory

¹¹See Harger (1926).

¹²Alston, Grove and Wheelock (1992), after controlling for the extent of agricultural distress and other possible causes of bank failures, found that states with deposit in-

surance had systematically higher bank failure rates during the 1920s.

¹³See Calomiris (1989b).

constraints on risk taking seems more politically feasible. Recent moves to increase capital standards for insured banks and thrift institutions, and to bring about the early closure of troubled institutions, are steps in the right direction. Historical evidence, including the events of the 1980s, however, illustrates the difficulty of limiting excessive risk taking when there are thousands of institutions to supervise. If monitoring and supervision are left primarily to public officials, moreover, there is likely to be continued political pressure for forbearance.

The United States has paid a high price for for-

getting the historical lessons of deposit insurance. When the federal deposit insurance system was set up in the early 1930s, its leading Congressional proponents understood many of these lessons, and implemented regulations that checked excessive risk taking.¹⁴ The United States should not try to restore the post-Depression bank regulatory system. Repeal of New Deal restrictions on branch banking and the securities-related activities of banks would reduce risk through diversification and economies of scope. But if federal deposit insurance is to remain, policies that prevent excessive risk taking will be required.

¹⁴See Flood (1992). Kareken (1983) was prescient when he argued that deregulation without deposit insurance reform was like "putting the cart before the horse."
