Bank Liability Insurance Schemes Before 1865

Warren Weber

Conference in Honor of Gary Stern
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Introduction

- Gary known for Too Big To Fail (TBTF) and moral hazard concerns

  The change in behavior induced by the TBTF guarantee is just one example of so-called moral hazard. Every insurance policy creates a moral hazard, in that the insured have less incentive to monitor risks than they would in the absence of coverage. (Stern-Feldman, p. 17)

- My focus: moral hazard and risk monitoring

- ...but in the context of “deposit insurance”
Insurance of bank obligations did not begin with FDIC in 1933

Some state insurance of deposits in the 1920s

Federal insurance of all banknotes under the National Banking System starting in 1864

Some state insurance of banknotes (many cases all bank liabilities) prior to the Civil War
Two basic state insurance schemes

1. Insurance funds (Safety Funds)
   - New York Safety Fund System (1829-1863)
   - Vermont Insurance Fund (1831-1858)

2. Mutual guarantee systems
   - State Bank of Indiana (1834-1863)
   - State Bank of Ohio (1845-1863)
Introduction

According to Henry B. Steagall (1933) the purpose of deposit insurance:

1. Provide public with “money as safe as though it were invested in a government bond”

2. “Prevent bank failures, with depositors walking in the streets”
Allan Meltzer in recent Congressional testimony:

*We cannot have deposit insurance without restricting what banks can do. The right answer is to use regulation to change incentives – making bankers and their shareholders bear the losses.*

The pre-Civil War experience shows the importance of incentives and who bears losses for controlling moral hazard.

It also suggests considering schemes with mutualization of losses may be worthwhile.
Outline

1. Brief background on monetary environment
2. Describe basic structure of the two schemes
3. Facts: bank runs, completeness of insurance, bank failures
4. Implications
Background on the antebellum period

- Bimetallic commodity money system
- No central bank
- Bank regulation state-by-state
- Banknotes most prevalent medium of exchange
Safety Funds: Basic structure

- Covered all bank liabilities
- Banks paid a percentage of capital stock into Fund managed by state
- Creditors of insolvent banks paid by Fund only after liquidation completed
- Supervision
Safety Funds: Basic structure

- Partial mutualization of losses
  - Additional assessments if Fund reduced by insurance payments
  - Partial because
    - Cap on annual contributions
    - Banks could leave before Fund restored (but only when charter expired)
    - “proportional share” of Fund returned to leaving bank
Mutual Guarantee: Basic Structure

- Despite name (State Bank of ...), a system of independent banks called Branches

- Each Branch:
  - had its own stockholders and directors
  - issued own notes redeemable only at that Branch
  - distributed profits only to stockholders of that Branch

- State Bank did no actual banking
Mutual Guarantee: Basic Structure

- State Board overseeing the Branches composed of
  - Some members appointed by legislature
  - 1 member from each Branch

- Board had power to
  - Close a Branch
  - Limit dividends
  - Limit ratio of loans and discounts to capital
Mutual Guarantee: Basic Structure

- Full mutualization of losses:
  - Indiana: Branches mutually guaranteed “all debts, notes, and engagements of each other”
  - Ohio: “Each solvent branch shall contribute … to the sum necessary for redeeming the notes of the failing branch”

- Assessments on survivors and payments to creditors immediate
Facts: Bank Runs

- Bank runs under both schemes
- Although may have made been less lengthy and less likely
Facts: Completeness of Insurance

- **New York**: No losses to creditors, but...
  - Failures not fully paid until 5 or 6 years after they occurred
  - In the interim, notes of failed banks discounted between 30% and 50%

- **Vermont**: Losses to creditors

- **Indiana and Ohio**: No losses to creditors
Facts: Failure Rates

- Safety Fund banks’ failure rates generally same or slightly higher than similar uninsured banks

- State Bank of Ohio: Failure rate about the same as similar banks in state

- State Bank of Indiana: **No failures**
Meltzer’s “right answer” to controlling the moral hazard problem with deposit insurance is to have agents that both

1. have the potential to bear losses
2. can regulate bank behavior

The pre-Civil War insurance schemes show these agents do not have to be shareholders or creditors of the bank

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Implications

- Both Safety Fund and mutual guarantee systems had shareholders of other banks potentially bearing losses.

- However, only the State Bank systems gave other banks the power to regulate.

- Hypothesis: This is why State Bank of Indiana seemed to work better than the Safety Fund systems.
Implications

- **Puzzle:** Why didn’t State Bank of Ohio achieve same outcome?

- **Answer:** strength of incentives to regulate (“skin in the game”)

\[
\text{exposure} = \frac{\text{average liabilities of branches}}{\text{number of survivors} \times \text{average capital of branches}}
\]

- State Bank of Indiana branches: exposure \( \approx 20\% \)
- State Bank of Ohio branches exposure \( \approx 5\% \)
Implications

- Another example to illustrate Meltzer’s “right answer”: Suffolk Banking System

- Par note clearing system in New England, 1825 - 1858

- Operated by single bank – the Suffolk Bank in Boston

- Cleared large value of notes each month
## Implications

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>Due to banks</td>
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</tbody>
</table>

If a member bank failed, Suffolk was left with losses on its holdings of that bank's notes.

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## Implications

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overdrafts</td>
<td>Due to banks</td>
</tr>
<tr>
<td>Notes of other banks</td>
<td></td>
</tr>
</tbody>
</table>

- If member bank failed, Suffolk stuck with losses on holdings of that bank’s notes
Suffolk Bank did “regulate” member banks

*It appears evident . . . that too large a portion of your loan is in accommodation paper, which cannot be relied upon at maturity to meet your liabilities. . . . [W]e hope you will take measures to change the character of your loan, and render it more available in case of need.*
## Implications

- New England banks had low failure rates

<table>
<thead>
<tr>
<th>State</th>
<th>Number</th>
<th>Failures</th>
<th>Failure Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>New England States</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Massachusetts</td>
<td>214</td>
<td>11</td>
<td>5.14</td>
</tr>
<tr>
<td>New Hampshire</td>
<td>28</td>
<td>2</td>
<td>7.14</td>
</tr>
<tr>
<td>Vermont</td>
<td>52</td>
<td>4</td>
<td>7.69</td>
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<tr>
<td>Maine</td>
<td>60</td>
<td>7</td>
<td>11.67</td>
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<tr>
<td><strong>Other Eastern States</strong></td>
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<tr>
<td>New Jersey</td>
<td>86</td>
<td>8</td>
<td>9.30</td>
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<tr>
<td>New York (chartered)</td>
<td>100</td>
<td>14</td>
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</tr>
<tr>
<td>Pennsylvania</td>
<td>95</td>
<td>15</td>
<td>15.79</td>
</tr>
<tr>
<td>Maryland</td>
<td>44</td>
<td>10</td>
<td>22.73</td>
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Conclusion

Need more thinking about implementing deposit insurance or systemic risk schemes that

1. include a higher degree of mutualization of losses than under present schemes
2. provide survivors with the means to change the incentives of other members of the scheme