Bank Liability Insurance Schemes Before 1865

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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"

Introduction

- 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"

Introduction

- 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


13
The Commercial Bank
OF THE CITY
OF NEW-YORK
Will pay Thirteen dollars
to the bearer on demand
NEW-YORK
No
A
NEW-YORK
Safety Fund
Cash.
Pres.

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**

Implications

- 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

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

Assets	Liabilities
	Due to banks

Implications

Assets	Liabilities
Overdrafts	Due to banks
Notes of other banks	

- If member bank failed, Suffolk stuck with losses on holdings of that bank's notes

Implications

- 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

State	Number	Failures	Failure Rate
		New England States	
Massachusetts	214	11	5.14
New Hampshire	28	2	7.14
Vermont	52	4	7.69
Maine	60	7	11.67
		Other Eastern States	
New Jersey	86	8	9.30
New York (chartered)	100	14	14.00
Pennsylvania	95	15	15.79
Maryland	44	10	22.73

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