The Banking and Insurance Holidays of 1933

Thomas F. Huertas
and
Joan L. Silverman
Citicorp

During 1933 there were two financial holidays, one in banking and one in life insurance. The first is well known. The Banking Holiday shut down every bank in the United States for ten days and ushered in sweeping changes in banking regulation. The second holiday is practically unknown, even to historians of insurance, who either ignore it [1; 3] or gloss over it [2, pp. 992-98; 11, p. 290; 16, p. 556; 17, p. 49]. The "insurance holiday" suspended the payment of cash surrender values and the granting of policy loans for a period of nearly six months. However, this holiday had no regulatory repercussions, although it affected millions of Americans, and it stemmed from the same cause as the banking holiday — the Depression.

This paper contrasts the two holidays. It starts with a discussion of the similarities between banking and insurance. The paper then describes the cause and consequences of the two holidays. A concluding section draws some inferences about the regulatory process.

THE SIMILARITY BETWEEN BANKING AND INSURANCE

Banks and insurance companies perform very similar economic functions. Both are financial intermediaries. Each receives money — deposits or premiums — from people or businesses who wish to save and lends it to people and businesses that wish to borrow. This is risk management pure and simple.

The difference between banking and insurance lies solely in the customer's claim on the institution. The depositor has an unconditional right to withdraw his funds at maturity. In the case of a checking account he can do so on demand. In contrast, the insurance policyholder has no such right. His claim is conditional. He has no claim unless and until the event insured against actually occurs — a fire, an accident, or death.

In the case of life insurance, the similarities with banking are closer. Except for term insurance, life insurance products contain savings and credit features. For example, a whole-life policy includes not only insurance, but also provides a tax-deferred savings account and allows the

policyholder to borrow against the cash value of the policy. Thus, "a life insurance company performs some of the functions of a savings bank and, to a smaller degree, of a commercial bank," [12, pp. 64-65].

THE GROWTH OF BANKING AND INSURANCE DURING THE 1920s

Both banking and insurance underwent rapid growth during the 1920s, reflecting the growth of the economy as a whole and the increasing specialization of the economy. The assets of all commercial banks rose from $43.7 billion in June 1921 to $62.4 billion in June 1929, an annual compound rate of growth of 4.5 percent. The assets of life insurance companies grew more than twice as rapidly, from $7.9 billion in December 1921 to $17.5 billion in December 1929, an annual compound rate of growth of 10.4 percent. Total life insurance in force jumped from $43.9 billion at the end of 1921 to $102.1 billion at the end of 1929, an annual rate of increase of 11.1 percent.[1]

Much of the growth in life insurance and commercial banking during the 1920s resulted from an expansion of their customer bases to include the working and middle classes. As America moved toward a mass consumption society, its financial institutions also moved to cater to the masses.

The life insurance companies started from a strong base. The two largest life insurers, Metropolitan and Prudential, had started as industrial insurance companies selling life insurance door-to-door for premiums of pennies a week [11, pp. 73-93]. By 1923 Metropolitan Life had 20 million policyholders, or one out of every six Americans [11, p. 272]. Overall, the number of life insurance policies in force rose from 70 million in 1921 to 123 million in 1929. Thus, by the end of the decade there were approximately as many insurance policies as there were people in the United States.

These policies were increasingly sold as, and looked on as, part of a personal investment and income program, rather than simply as burial insurance [16, p. 633]. Sales agents placed greater emphasis on the settlement options afforded by life insurance and on the build-up of a policy's cash value as a tax-free form of saving. Moreover, that cash value would, so agents assured the public, be available at any time. The policyholder could either borrow against the cash value at a rate fixed in advance or obtain the entire cash value by surrendering the policy. These investment features helped raise the average value of each life insurance policy in force from $2,040 in 1921 to $2,470 in 1929. Overall, policyholder reserves at life insurance companies — the amount companies had set aside to meet future insurance claims — rose from $6.3 billion in 1921 to $14.9 billion in 1929.

---

[1]Except where stated otherwise, all statistical information is based on United States Department of Commerce, Bureau of the Census, Historical Statistics of the United States from Colonial Times to 1970 (Washington, D.C.: GPO, 1975).

The individual customer also paced the growth of the commercial banking system in the 1920s, particularly at nationally chartered banks, the largest banks in the system. Until 1914 national banks had largely been banks for business; they lacked the power to branch, and they had little incentive to offer savings accounts. As a result, few nationally chartered banks offered accounts to the individual of modest means.

Following the passage of the Federal Reserve Act of 1913, this situation began to change. Reserve requirements on time-deposit accounts were reduced to a rate significantly below those on checking accounts. This gave national banks the incentive to start offering savings deposits. Subsequent liberalization of the branching laws, starting with the National Bank Consolidation Act of 1918 and culminating in the McFadden Act of 1927, gave national banks the means to reach the public, at least within their headquarter's city [5, pp. 47-49]. The national banks made effective use of their new powers. Total time deposits rose from $3.7 billion in 1921 to $8.2 billion in 1929. At the latter date they accounted for 38 percent of national banks' total deposits, up from 24 percent in 1921. Overall, commercial banks' time deposits in 1929 amounted to $19.8 billion, slightly over 40 percent of their total deposits, up from 33 percent in 1921. More important, the increase in time deposits funded 46 percent of the total growth in commercial banks' assets from 1921 to 1929.

Thus, by the end of the 1920s both commercial banks and life insurance companies had become increasingly similar. Each served as a repository for the savings of America's families and each promised to make those savings available on demand. The Depression would put those promises to the test, and both banks and insurance companies would fail to pass.

THE CAUSE AND CONSEQUENCES OF THE BANKING HOLIDAY

A financial intermediary fails when it is unable to pay its debts as they fall due, even after seeking to obtain refinancing or to liquidate its assets at the best immediately available price. The failing firm may also be insolvent in the sense that it has a negative net worth, or that the liquidation of assets to meet current claims will prevent it from meeting future obligations [4, p. 68]. Indeed, the realization of creditors that the financial firm is or soon will be insolvent prompts them to demand repayment of their claims as soon as possible. This can amount to a run on the institution that will exhaust its liquid assets, leading to unavoidable and massive contractual failure.

Such was the fate of many of the nation's banks in the Great Depression, even though the entire system of bank regulation had been designed to prevent bank failures from occurring. Lending limits restricted the amount of funds that a bank could advance to any one borrower, providing for some measure of risk diversification. Reserve requirements ensured that banks could meet at least part of any withdrawal in cash, providing for some measure of liquidity. Finally, the Federal Reserve's lender-of-last-resort facility was intended to provide sound banks with the opportunity to refinance themselves by discounting illiquid assets. All this

was fine in theory, but when the crisis came in 1929-1933, it did not work. First, the sharp decline in the rate of growth of money during 1928-1930 produced a severe recession and led to the Stock Market Crash. Institutions and individuals became financially weaker, as did the banks which had lent them money, despite the presence of lending limits and reserve requirements.

Secondly, and perhaps more important, the Federal Reserve restricted banks' ability to refinance themselves by failing to act as a lender of last resort. This was unexpected; after all, the Federal Reserve had been established to stop panics once and for all. As late as 1928 Secretary of the Treasury Andrew Mellon, an ex-officio member of the Federal Reserve Board, had stated that there need not be any fear of a panic since the Federal Reserve would prevent any money contraction or credit shortage [14, pp. 6-7]. Yet during the Depression the Federal Reserve repeatedly abstained from extending credit to banks that were in danger of failing. Partly the reasons were legal. Either the banks were not members of the Federal Reserve System or they had insufficient collateral eligible for discount under the terms of the Federal Reserve Act. Largely, however, the reason was that the Federal Reserve thought it neither necessary nor advisable to extend credit to failing banks. The prop under bank liquidity thought to be provided by the Federal Reserve turned out to be an illusion.

The result was a wave of bank failures, concentrated in three crisis periods of November-December 1930, June-October 1931, and January-March 1933. The first crisis centered around the failures of the Bank of United States in New York and Caldwell and Company, a Tennessee bank holding company [6, pp. 309-11; 19]. The second crisis reflected the repercussions on domestic banks of the departure of Austria, Germany, and Great Britain from the gold standard. The third and final crisis resulted from the destruction by Speaker of the House and Vice President-elect John N. Garner of the Reconstruction Finance Corporation as an alternative source of credit to failing banks. In each crisis the public accelerated their shift from deposits into currency, placing pressure on the banks. As one crisis followed another, the pressure became cumulative; by the last crisis the public was raising the currency/deposit ratio at a rate of 8 percent per month. Although some banks, such as the members of the New York Clearing House, protested that they could continue to pay out depositors by drawing on the discount facilities of the Federal Reserve, some type of restriction was plainly necessary if the total collapse of the banking system was to be avoided.

This was the Banking Holiday of 1933. As one of its first acts, the new Roosevelt Administration on 6 March 1933 closed every bank in the country. Congress then hastily passed the Emergency Banking Act on 9 March, validating the President's action, extending the holiday, and empowering the President to license banks to reopen when they were found to be in satisfactory condition. Such banks were allowed to reopen on 13 March in the reserve cities and on 15 March in other places. However, 2,100 banks never reopened at all, bringing the total number of banks that failed during the Depression to 9,100, or 38 percent of the number of banks in existence in June 1930 before the collapse began. By and large the banks that failed were smaller, rural unit banks that were not

members of the Federal Reserve. In contrast, the large money center banks and those banks with extensive branch systems generally emerged intact from the Banking Holiday.

However, these banks bore the brunt of the punitive system of banking regulation enacted in the wake of the Banking Holiday. Commercial banks, in particular large banks with security affiliates, were made scapegoats for the worst economic disaster in the nation's history. The Banking Act of 1933 punished banks for their alleged crimes. It mandated the separation of commercial and investment banking, limited the rate of interest that banks could pay on deposits, and confirmed the prohibition on interstate branching. In addition, limits were placed on brokers' loans and banks' investments in securities. Thus, banks were restricted to what Congress considered "safe," low-risk activities. This was intended to protect banks against the bankers who ran them.

This anticompetitive structure was reinforced by the introduction of federal deposit insurance. This helped prevent bank runs by guaranteeing the small, and presumably unsophisticated, depositor that his funds would be safe, regardless of what bank he put them in. Thus, deposit insurance tended to make the deposits of one bank equivalent to the deposits of any other. This especially benefitted the small, unit banks. It made branch banking unnecessary. The government's guarantee substituted for the greater diversification and lower risk that branch banking would have provided.

In sum, the consequence of the Banking Holiday was a punitive system of banking regulation that sacrificed efficiency for the sake of safety. Banks were prevented from competing too much either against each other or against other financial intermediaries. In effect, banking became a cartel, policed and enforced by the regulators [9, pp. 18-22].

THE CAUSE AND CONSEQUENCES OF THE INSURANCE HOLIDAY

The experience of the insurance industry stands in stark contrast to that of the banking industry, even though it too was forced to declare a holiday as a result of the Depression. There were no major changes in insurance regulation, even though insurance companies failed to fulfill some of their obligations to policyholders during 1933 and even though failures of insurance companies during the Depression reduced the number of active life insurance companies by 14 percent, from 438 at the end of 1929 to 375 at the end of 1933.

The failure of a life insurance company is more difficult to determine than that of a bank. Under an ordinary or whole-life insurance contract the insurance company collects premiums far in excess of the actual disbursements made in order to satisfy death claims. The insurance company invests this "excess" in order to accumulate funds sufficient to pay off the claims of all policyholders as each of them dies in the future. By employing assumptions about the expected mortality of its policyholders and the rate of interest that it will earn on its investments, the insurance company can calculate the present value of the future claims that its

policyholders will make. This sum is called the policyholders' reserve, and it represents a liability of the insurance company to its policyholders.

An insurance company fails when the value of its assets falls below the amount of reserves needed to satisfy future claims. Thus, insurance company failure generally differs from bank failure. It is failure in a traditional equity sense; it can meet currently due and payable obligations only by precluding its ability to meet future obligations. In effect, it must rob Peter to pay Paul [4, p. 68].

On the surface, insurance companies were far from failure during the Depression. Official statements of the companies showed asset values comfortably in excess of policyholder reserves during the entire period. According to these documents, life insurance companies were in robust condition, even at the nadir of the Depression. At the end of 1932 the total assets of all U.S. life insurance companies were reported to be $20.7 billion, some $1.4 billion in excess of total liabilities, and $2.9 billion in excess of policyholder reserves. Total capital of the insurance companies was reported to be $1.4 billion or 7 percent of total life insurance assets.

However, these reports did not present a completely accurate picture of the life insurance companies' condition. In the official statements assets were valued at prices far above what they could be sold for in the marketplace, if the insurance companies had to liquidate them. In particular, investment-grade bonds not in default were valued at cost, adjusted by accrued amortization of the discount or premium from par. Other bonds were priced at their value as of 30 June 1931 [7, pp. 3-6]. This resulted in a considerable overstatement of the value of insurance companies' bond portfolios. At the Metropolitan Life Insurance Company, the country's largest insurance company with nearly one-fifth of the nation's insurance in force, the market value of the bond portfolio was only 82 percent of its book value [11, p. 287]. This depreciation, if reflected on the official statement, would have practically exhausted Metropolitan's total capital [8, p. 242]. If mortgages had also been valued at what they could be sold for rather than what they had cost, Metropolitan would almost certainly have been insolvent at the end of 1932. So would practically every other life insurance company in the country.

Insurance companies therefore stood in a perilous condition at the start of 1933. During the Depression policyholders markedly accelerated the rate at which they drew on the savings and credit features of their life insurance contracts. Cash surrender payments tripled, rising from $448 million in 1929 to $1.3 billion in 1932. As a result, insurance companies' net cash flow dropped drastically, from $1.5 billion in 1929 to $655 million in 1932. This limited the insurance companies' ability to restructure their portfolios.

The dramatic increase in policy loans further restricted insurance companies' portfolio choice. Total policy loans at all companies rose from $2.4 billion at the end of 1929 to $3.8 billion at the end of 1932. At the latter date they accounted for 18.3 percent of insurance companies' reported assets [10, p. 52]. More important, the net increase in policy

loans during 1932 accounted for 67 percent of the insurance companies' net cash inflow.

At the start of 1933 policy loans and cash surrender values showed signs of increasing even more rapidly. Insurance companies were approaching the point where it would become necessary for them to liquidate their security holdings at market prices in order to meet policyholders' requests for funds due them. This would have pushed the insurance companies toward a negative-net-worth position even under the conventional value accounting system mandated by the insurance commissioners.

The advent of banking holidays, starting with the Michigan holiday of 4 February 1933 and culminating in the national banking holiday of 6 March further aggravated the situation of the insurance companies. With the banks closed or allowing withdrawals on only a restricted basis, people turned to their life insurance for cash. Like the banks, the insurance companies were faced with the possibility of a run that would force them into failure.

Rather than permit this to happen, the states took emergency measures. On 6 March 1933, the New York state legislature passed an act suspending the state's insurance law and empowering Superintendent of Insurance, George S. van Schaick "to make, rescind, alter and amend rules and regulations imposing any condition upon the conduct of any insurers which may be necessary or desirable to maintain sound methods of insurance and to safeguard the interests of policyholders, beneficiaries and the public generally," during the emergency [18, p. 11]. The law took effect the following day and applied to all companies licensed to do business in New York state, not just those headquartered in the state. Thus, the New York law covered most of the country's insurance companies. In any case, it was soon copied by twenty-eight other states. The insurance holiday was under way.

On 9 March 1933, Superintendent van Schaick issued the first regulations following a meeting with representatives of the leading insurance companies. Effective immediately, insurance companies were prohibited from paying cash surrender values or granting policy loans in cash, although each policyholder could obtain up to $100 in the case of dire and demonstrated need [18, p. 13]. Moreover, policyholders could not withdraw any sums that they had left on deposit with the company. However, insurance companies were strictly enjoined to continue payment of death claims, annuities, and matured endowments. Thus, the insurance holiday amounted to a partial suspension of companies' normal operations. After the fact, the insurance contract was changed. The savings and credit features that helped sell the policies were simply abrogated when people most wanted to make use of them.

The insurance holiday remained in effect long after banks had reopened their doors, although its terms were progressively liberalized. On 3 April 1933, the New York state regulations were amended to permit insurance companies to grant policy loans or pay cash surrender values for specified purposes such as the payment of rent or taxes where the insurance company "was satisfied that the applicant has no other

reasonable means of meeting the necessity" [18, p. 11]. Policyholders were also permitted to withdraw all deposits made after 9 March 1933 and part of the deposits made prior to that date. On 7 June 1933, the New York state regulations were further amended to permit policyholders to obtain policy loans or cash surrender values upon stating in writing how they intended to use the proceeds. Thus, the insurance company no longer had to verify the policyholder's need for the money. As Superintendent van Schaick later remarked, "This provision, in effect, will permit New York policyholders to obtain policy loans and cash surrender values without restriction except in cases where funds are sought for speculation or hoarding" [18, p. 11]. On 7 September 1933, van Schaick declared the emergency over, and on 9 September 1933 all restrictions on policy loans and the payment of cash surrender values were removed six months after they were first imposed. The insurance law was back in force.

To the insurance holiday there was no regulatory reaction. Unlike the banking holiday the insurance holiday prompted no major changes in regulation on either the state or the federal level. During the moratorium, Senator Robinson of Indiana observed, life insurance companies had increased the salaries of their executives and at the same time "violated contractual obligations by denying payments under the cash surrender clause." He called for a Senate investigation leading to a constitutional amendment federalizing insurance regulation. No one took him up on this. On the state level, the only significant change was to give insurance companies the right to delay payment of cash surrender values for a period of up to six months [13, Vol. 1, p. 167]. Thus, each insurance company could henceforth declare its own holiday.

CONCLUSION

What accounts for the stark difference in the regulatory treatment accorded banks and insurance companies following their respective holidays? Both events stemmed from the same cause — the Depression. The decline in output and prices bankrupted firms and jeopardized the financial intermediaries that had lent them money or invested in their securities. Both banks and insurance companies were driven to, and in many cases over, the brink of insolvency. Yet, banks were punished and insurance companies were not. Why?

Several hypotheses suggest themselves. First and foremost, banks were seen to be as much the cause as the victim of the Depression. Specifically, their actions as underwriters of securities were considered to have contributed to bank failure by making banks more likely to invest in frozen or illiquid investments. Yet, insurance companies, which conducted no underwriting activities, had invested a far higher proportion of their assets in securities.

Secondly, commercial banks were considered a far more central part of the financial system than insurance companies. They were seen as central to the monetary system; the role of the Federal Reserve in determining the money supply was but imperfectly understood. Moreover, banks were larger than insurance companies. Even at the end of 1932, total commercial bank assets were more than double those of insurance

companies. Thirdly, insurance companies enjoyed a closer relationship with their regulators than did banks. In insurance, the companies and the regulators seemed more allies than adversaries; in banking, the reverse was true. In part, this stemmed from the different structures of the two industries. Banking was unconcentrated. As late as 1930 there were nearly 25,000 banks in the country; the ten largest accounted for only 20 percent of the banking system's total assets. In contrast, insurance was relatively concentrated; the top ten companies had written approximately 75 percent of the insurance in force in 1930. Although each state regulated insurance separately, each insurance company could operate in many states. The leading companies did in fact operate in nearly every state, usually through local agents. They were national organizations with local roots. This gave the companies considerable clout vis-a-vis Congress and the state insurance commissioners. As a result, insurance companies remained free from federal regulation and were favored by state regulators. At no time was this more evident than during the insurance holiday.

Finally, the two holidays were different. The banking holiday was total; the insurance holiday, partial. Prior to the creation of the Federal Reserve, banks had imposed what amounted to a partial holiday during panics by suspending the convertibility of deposits into currency at par. Otherwise they continued normal operations. Generally this step was sufficient to bring the panic to a halt. Such a partial holiday for banks had been proposed for banks during the Depression, but it was rejected out of hand. The Federal Reserve had been created to remove the need for such partial banking holidays by stopping panics altogether. In the Depression this cure proved worse than the disease.

REFERENCES

1. Wendell Buck, From Quill Pens to Computers: An Account of the First One Hundred and Twenty Five Years of the Manhattan Life Insurance Company of New York, N.Y. (New York: The Manhattan Life Insurance Company, 1975).

2. Carlyle R. Buley, The Equitable Life Assurance Society of the United States, 1859-1964 2 vols. (New York: Appleton-Century-Crofts, 1967).

3. William H. A. Carr, From Three Cents a Week: The Story of the Prudential Insurance Company of America (Englewood Cliffs, NJ: Prentice-Hall, 1975).

4. Robert C. Clark, "The Soundness of Financial Intermediaries," Yale Law Journal, Vol. 86, No. 1 (1976), pp. 1-101

5. Gerald C. Fischer, American Banking Structure (New York: Columbia University Press, 1968).

6. Milton Friedman and Anna J. Schwartz, A Monetary History of the United States, 1867-1960 (Princeton, NJ: Princeton University Press, 1963).

7. Harold G. Fraine, Valuation of Securities Holdings of Life Insurance Companies, (Homewood, IL: Irwin, 1962).

8. Harry G. Guthmann and Ernst A. Dauer, "Stocks vs. Bonds as Life Insurance Investments during Depression," Harvard Business Review, Vol. 13, No. 2 (1934-1935), pp. 237-48.

9. Thomas F. Huertas, "The Regulation of Financial Institutions: A Historical Perspective on Current Issues," in Financial Services: The Changing Institutions and Government Policy, George J. Benston, ed. (Englewood Cliffs, NJ: Prentice-Hall, 1983), pp. 6-27.

10. Institute of Life Insurance, Life Insurance Fact Book 1950 (New York: Institute of Life Insurance, 1950)

11. Marquis James, The Metropolitan Life: A Study in Business Growth (New York: Viking, 1947).

12. John M. Laird, "The Moratorium on Cash Withdrawals," Actuarial Society of American Transactions, Vol. 34, No. 1 (1933), pp. 55-66.

13. Joseph B. Maclean, Introduction to Life Insurance 4 vols. (New York: Life Office Management Association, 1948).

14. Isaac Marcosson, "How is Business," Saturday Evening Post, Vol. 200, No. 42 (April 1928), pp. 6-7, 190-202.

15. Earl Chapin May and Will Oursler, The Prudential: A Story of Human Security (Garden City, NY: Doubleday & Co., 1950).

16. J. Owen Stalson, Marketing Life Insurance: Its History in America (Homewood, IL: Irwin, 1969).

17. Mildred F. Stone, Since 1845: A History of the Mutual Benefit Life Insurance Company (New Brunswick, NY: Rutgers University Press, 1957).

18. Superintendent of Insurance, New York State, Annual Report 1933 (Albany, NY: J. B. Lyon, 1934).

19. Elmus R. Wicker, "A Reconsideration of the Causes of the Banking Panic of 1930," Journal of Economic History, Vol. 40, No. 3 (1980), pp. 571-84.

RESEARCH AND DEVELOPMENT: BUSINESS, FOUNDATIONS, ACADEME