# THE IMPACT OF THE FEDERAL DEPOSIT INSURANCE CORPORATION ON BANKING STABILITY

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As we approach the 35th anniversary of the climax of the greatest banking crisis in American history, a review of some of the truly revolutionary changes that have occurred in banking seems appropriate. Most contemporary Americans are totally unfamilar with the era when large unintended fluctuations in the money supply resulting from bank failures or from changing confidence in banks aggravated movements in the business cycle.

No institution is given more credit for the improved stability in the banking industry than the Federal Deposit Insurance Corporation. Scholars as highly different in their intellectual outlook as Milton Friedman and Arthur Schlesinger, Jr., have hailed the establishment of Federal deposit insurance as one of the most significant reforms of the twentieth century.

## Banking Stability Before 1930

Time does not permit an extensive review of banking before 1933. It should be mentioned briefly, however, that concern over the economic consequences of the failure of some banks to cover their liabilities led New York State to establish a Safety Fund in 1829--more than a century before the adoption of Federal deposit insurance.

The large number of bank failures in 1907 and 1908, particularly in the wheat growing states in the Great Plains, led to an adoption of deposit insurance plans in eight states. None of these plans was operational at the time the Federal Deposit Insurance Corporation began in 1934. They failed for a variety of reasons: inadequate assessments, insufficient bank regulation, the failure to make insurance mandatory for all banks (which led to strong banks staying out of the system), and the fact that these agricultural states underwent a severe depression after 1920.

The depression in agriculture after 1920 partially explains the curious phenomenon of a record high rate of bank failures occurring in a period of unprecedented prosperity. This is documented in Table I. Banks with a high proportion of their assets in agricultural loans found their capital impaired when farmers were unable to repay their loans and when the value of collateral underwent serious decline. Another major factor in the failures in the 1920s was bad bank management, often including acts of embezzlement. The banks that failed were typically quite small institutions in rural areas.

Despite the large number of bank failures in the 1920s, depositor confidence generally was quite high. The historic trend

toward maintaining a higher proportion of money in the form of bank deposits continued. The ratio of deposits to currency rose from about 7 to 1 in 1920 to more than 11 to 1 in 1929.

## The Banking Crises of the 1930s

So great was confidence in banks in the 1920s that it remained high for a long time after the economy began its downturn in the summer of 1929. Indeed, the unique thing about the financial panic is that banks did not experience "runs" as in previous panics, such as the one in 1907. The deposit-currency ratio actually rose in the months following the stock market crash. It was not until the fall of 1930 that banks began to fail at a rate significantly greater than the 50 failures per month that was the average in the 1920s.

Table 1

Commercial Bank Suspensions, 1900 - 1966

| Period | Average Suspensions Per Year | Average Annual Deposits in Closed Banks | Deposits as % Of All Bank Deposits |
|---|---|---|---|
| 1900-1904 | 70 | 24,910,000 | 0.32% |
| 1905-1909 | 103 | 104,177,000 | 0.84% |
| 1910-1914 | 105 | 41,174,000 | 0.25% |
| 1915-1919 | 79 | 27,152,000 | 0.11% |
| 1920-1924 | 489 | 143,436,000 | 0.39% |
| 1925-1929 | 684 | 200,058,000 | 0.42% |
| 1930-1933 | 2,274 | 1,707,556,000 | 4.04% |
| 1934-1940 | 64 | 67,573,000 | 0.14% |
| 1941-1966 | 6 | 16,318,000 | 0.01% |

Source: Milton Friedman and Anna Schwartz, A Monetary History of the United States, U.S. Bureau of the Census, Historical Statistics, and Federal Deposit Insurance Corporation, 1934 Annual Report and 1966 Annual Report.

## The Bank Crises, 1930-1933

It appears that the trigger for the first banking crisis was a rash of failures of small banks resulting from crop failures in agricultural areas. In any case, the sudden increase in failures led to an uneasiness on the part of depositors. Silent (and sometimes not-so-silent) runs on banks began all over the country. The failures of a huge New York bank, with the highly unfortunate name of "Bank of the United States," added to the crisis in December 1930.

Two more waves of bank failures followed this first crisis. All told, 9,000 banks closed between January 1930 and April 1933. Unlike in the 1920s, a general decline in depositor confidence appears to have been responsible for the closing of a large proportion of these banks. The ratio of deposits to currency, more than 11 to 1 in early 1930, declined to less than 4.5 to 1 immediately after the national bank holiday in March 1933. The fear of depositors became self-justifying. In order to get cash, banks were forced to sell securities at unfavorable prices. The contraction in loans aggravated the economic decline and thereby increased the number of "slow" or uncollectable loans.

Many banks, in the absence of a decline in depositor confidence, would have survived. The average depositor of banks suspended in the 1930 to 1933 period received over 80 percent of his deposit upon liquidation of the bank, in spite of the incredibly adverse conditions in which banks were liquidated. This evidence tends to detract from the notion that a substantial decline in the quality of bank investments *ex ante* in the 1920s was the major factor in the failures of the 1930's. A tremendous demand for currency, not bank assets of low quality, explains the failures of the 1930s.

Phillip Cagan, Milton Friedman and Anna Schwartz and other students of monetary history have concluded that the decline in the ratio of deposits to currency, reflecting diminishing confidence in banks, explains virtually all of the 33 percent decline in the money stock from 1929 to 1933. To the extent that a change in the stock of money is an important determinant of the level in economic activity, the decline in confidence is a factor in explaining the severeness of the Great Depression.

## The Passage of Federal Deposit Insurance Legislation

In reaction to the dramatic deterioration in the banking system, Congress approved a number of significant changes in banking legislation in the Emergency Banking Act and the Banking Act of 1933. This latter act created the Federal Deposit Insurance Corporation.

Two related misconceptions prevail about the beginnings of Federal deposit insurance. First, deposit insurance was *not* an economic reform promoted by the Roosevelt administration. In fact, President Roosevelt publicly and privately opposed the measure, and probably would not have accepted it had it not been included as part of an omnibus banking bill including other

measures that Roosevelt regarded as highly desirable. Deposit insurance was strictly a creation of Congress. Indeed, it was the only reform approved during the first 100 days of the New Deal that was not sought by the Roosevelt administration.

Second, the protection of small depositors against financial loss was <u>not</u> the major purpose of the legislation, at least as far as its major sponsors were concerned. Representive Henry Steagall, who steered the legislation through the House of Representatives, seemed to regard deposit insurance as an anti-cyclical stabilizer, since insurance would presumably reduce the decline in the money supply resulting from bank failures. Less than two percent of the estimated $75 billion decline in wealth in the 1929-33 period is represented by deposits lost by bank suspensions. Clearly the economic decline resulting in part from monetary instability was a far more grievous problem than the loss of wealth by depositors. Steagall's bill, which became law but was later revised, called for substantial protection of large depositors as well as small depositors. All deposits were to be completely insured to $25,000, and substantial protection was to be given for accounts in excess of that figure. The leading influence of banking legislation in the Senate, Carter Glass, favored deposit insurance as a device to force state banks to join the Federal Reserve System. The provision to require insured banks to join the Federal Reserve by 1936 was included in the Banking Act of 1933, but was later repealed.

The limitation of deposit insurance coverage to small depositors was supposed to be temporary. However, Congress, at President Roosevelt's insistence, modified the permanent legislation in the spring of 1934. In a telegram to the Speaker of the House, Henry Rainey, Roosevelt stated:

> Brother Steagall's suggestion of increasing insurance on deposits up to ten thousand dollars would aid only the three percent of our depositors who have more than twenty five hundred in any bank. The bill as passed by the Senate takes care of the other ninety-seven percent who are people like you and me.

Steagall and others reluctantly accepted a $5000 limit on protection, accepting the Administration's argument that since "runs" on banks reflected the declining confidence of small depositors, even limited protection would be adequate in securing the money supply. Subsequent studies, incidently, show that large depositors, not small ones, were primarily responsible for the bank runs of the 1920s and early 1930s.

## Economic Effects of Deposit Insurance

For many reasons, including the fact that deposit insurance was merely one of the many banking reforms introduced in 1933, it is difficult to measure with precise accuracy the impact of deposit insurance on the behavior of depositors, bankers, and on the economy as a whole. Some educated speculation, however, is in order.

To begin with, deposit insurance cannot take much credit

for the dramatic improvements in banking that immediately followed the third banking crisis in early 1933. The rate of bank failures in the last half of 1933 was substantially below the rate of failures prevailing in the 1920s. Inasmuch as deposit insurance was not operative until January 1, 1934, it is unreasonable to conclude that insurance was a major factor in the improvement in banking in the first months following the bank holiday, although the knowledge after June 1933 that insurance was going to be implemented may have bolstered confidence somewhat. A better explanation for the increase in confidence was that people thought that the weak banks had been eliminated, or strengthened with the help of the Reconstruction Finance Corporation, and that bad banking practices were being checked by the Banking Act of 1933.

While there was a dramatic reduction in bank failures after March 1933, banking recovery was limited. While the ratio of deposits to currency increased steadily, it was still lower in December 1933 than it had been in January--before the third banking crisis. The money supply increased less than four percent in the last eight months of the year, remaining substantially below the level prevailing in January. In short, the banking system, at the end of 1933, was relatively stable and safe from collapse, but it had not contributed enormously to any economic expansion occurring after March 1933.

Federal deposit insurance began on January 1, 1934. While insured banks had over 90 percent of the nation's commercial bank deposits, less than 40 percent of deposits were protected, owing to the limited protection of $2500 per depositor. Deposit insurance had an immediate impact on the banking system. The ratio of deposits to currency showed the largest one month jump in January 1934 for any period for which monthly data are available. Within three months, deposits rose 6.6 percent--an annual rate of increase of 28 percent. Deposits increased more in the first two months after the beginning of insurance than in the seven months prior to its introduction. At the same time, currency held by the public declined abruptly. Postal savings, guaranteed by the Federal government, began to decline for the first time since the 1920s, reflecting growing confidence in commercial banks. Clearly, this surge in confidence was largely a result of the inauguration of Federal deposit insurance.

Only 61 banks failed in 1934--nine of which were insured. Deposits in closed banks amounted to $37 million--or 0.13 percent of total deposits, a figure lower than in any of the years of the Twenties. This decline, however, does not merely reflect the adoption of insurance; the major decline in bank failures had already occurred in 1933. The major immediate benefit of deposit insurance was an upsurge in confidence that led persons to convert cash into deposits. The 25 percent increase in the deposit-currency ratio can explain most of the 14 percent increase in the stock of money occurring in 1934.

Long-Run Effects of Deposit Insurance

The major effect of deposit insurance in the 34 years since its inception has been a marked increase in monetary stability. The Federal Deposit Insurance Corporation (FDIC) has succeeded where the Federal Reserve System, in its first 20 years, had failed. Human behavior has been altered in such a way as to prevent financial panics. This is strikingly illustrated be the deposit-currency ratio. Before 1934, frequent changes in confidence in banks led to large short-term changes in the deposit-currency ratio. As persons began to became apprehensive about banks, they converted deposits into currency, lowering the deposit-currency ratio, and often forcing banks to sell bonds or reduce loans in order to maintain reserves. Since 1934, the deposit -currency ratio has not been subject to as severe fluctuations as before that date. This is illustrated in Table 2. Whereas month-to-month changes in the deposit-currency ratio of less than one percent were the exception rather than the rule in the quarter of century before 1934, that is no longer true. Fluctuations of more than one percent over a 30 day period have been rare since 1945. The virtual disappearance of violent fluctuations in preferences for deposits and currency has reduced unintended changes in the supply of money. If the money supply changes today, it is primarily because of monetary policies of the central bank and/or policies of individual bankers. No longer do unintended fluctations in money occur as a result of the wavering confidence of millions of individual depositors. The management of monetary policies has become infinitely easier.

A stabilization of confidence in banks is only one factor, although it is an important one, in explaining the dramatic decline in bank failures since 1934. Hundreds, indeed probably thousands, of banks failed in the 1920s for reasons unrelated to confidence. Yet today banks rarely fail for any reason--indeed, the incidence of bank failures is substantially below that for other commercial enterprises. Aside from reducing failures by improving depositor confidence, insurance has helped reduce failures in other ways as well Regulation of state nonmember banks by the FDIC has unquestionably led to more rigorous examination standards in many instances. The FDIC assists banks in difficulty to merge into stronger banks, preventing outright failure. This approach has been used by the FDIC in a majority of instances. The FDIC assumes the bad assets of the bank in difficulty, providing incentive for a stronger bank to take it over. No depositors, including large ones, lose a penny, and there is not even a temporary decline in the monetary assets held by the public. A number of factors other than insurance help explain the decline in failures: general economic prosperity, the fact most small weak banks closed during the Depression, the conservatism of bankers in the 20 years after the Depression, etc. The Federal Deposit Insurance Corporation, however, seems to have been a particularly important factor.

Table 2

Monthly Changes in the Deposit-Currency Ratio, 1908-1960

| Period | Stable | Fairly Unstable | Unstable |
|---|---|---|---|
| 1908-1919 | 40% | 30% | 30% |
| 1920-1929 | 42% | 36% | 22% |
| 1930-1933 | 27% | 33% | 40% |
| 1934-1939 | 60% | 30% | 10% |
| 1940-1944 | 50% | 27% | 23% |
| 1945-1949 | 83% | 15% | 2% |
| 1950-1960 | 98% | 2% | 0% |
| 1908-1933 | 39% | 33% | 28% |
| 1934-1960 | 78% | 15% | 7% |

A stable period is defined as one where the change in the deposit-currency ratio over a one month period is less than one percent. "Fairly Unstable" refers to a 1.0 to 1.9 percent change over a month period in the deposit-currency ratio; "Unstable" refers to a change of more than two percent.

Source: Milton Friedman and Anna Schwartz, A Monetary History of the United States, pp. 800-808.

The FDIC and Banker Behavior

While deposit insurance clearly has had an impact on depositor behavior, its effect on the management of banks is far less clear. One might expect that the stabilizing of the deposit-currency ratio would lead bankers to maintain a smaller proportion of their assets in cash and secondary reserves, and to engage in more long-term lending. No longer are banks subject to "runs" requiring substantial cash reserves.

While the proportion of assets kept in the form of loans has risen in the past 20 years, banks today maintain a higher proportion of assets in the form of cash and government bonds and a smaller proportion in the form of loans than was true in some of the period before federal deposit insurance was adopted.

For example, loans fell from 73 percent of commercial bank assets in mid-1927 to 54 percent in mid-1967. Factors other than deposit insurance clearly have been responsible for these changes. Reserve requirements are significantly higher now than 40 years ago. World War II, with the program of pegged bond prices, had an enormous impact on portfolios. To summarize, the effect of deposit insurance on portfolios is difficult to determine, but in any case is probably modest compared with Federal Reserve monetary policy and other factors.

Has the FDIC tried to encourage bankers to follow untra-conservative policies in order to protect the deposit insurance fund? There is little indication of this. In fact, during the 1930s the FDIC Chairman, Leo T. Crowley, often urged bankers to lend more, rather than to hoard cash. The recent remarks of the current chairman, K. A. Randall, indicated that he favors vigorous banking activity with a minimum of government regulation--an attitude similar to that held by former Comptroller of the Currency James J. Saxon. The FDIC has until recently been relatively powerless in influencing banking policies. The only weapon it could use against a bank which it regarded as following unsound policies was termination of insurance--an extremely strong weapon, to be sure. Very recently the FDIC has received the power to issue "cease and desist" orders against undesirable practices. To date, however, the FDIC has not vigorously attempted to alter the major policy decisions of large numbers of commercial bankers by use of its legal power.

In conclusion, the Federal Deposit Insurance Corporation has been a major force in eliminating monetary instability and bank failures resulting from a loss of confidence on the part of depositors. The existence of insurance has reduced business fluctuations resulting from the changing attitudes of persons towards banks. Whether insurance has actually been a major factor in influencing the decisions of bank officers is doubtful. Considering its low costs and its many benefits, the nearly universal support of Federal deposit insurance seems justified.