Protecting weak banks in the name of protecting depositors

Federal Deposit Insurance: Economic Efficiency or Politics?

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THE BELIEF THAT BANKS PLAY A UNIQUE ROLE IN PROVIDING credit for economic growth has led policymakers to adopt regulations to promote stability in the banking system. Two key elements of banking regulation have been geographic limits on bank branching and federal insurance of bank deposits.

Although unit banks were understood to be inherently less stable than diversified banks, the virtual elimination of bank runs following the introduction of federal deposit insurance in the early 1930s calmed most fears about the stability of the banking system. That calm was shaken in the 1980s by the failure of many unit banks when agricultural and energy prices declined (reviving memories of the 1920s) and the bank and thrift deposit insurance crises that ensued from loan losses exceeding those of the early 1930s.

WHY DEPOSIT INSURANCE?

ALTHOUGH SOME ECONOMISTS ARGUE THAT THE ORIGINS of federal deposit insurance lie in the search for economically efficient solutions to banking crises, we suggest an alternative view: federal deposit insurance was instituted for the benefit of small banks, largely located in unit-banking states, at the expense of geographically well-diversified large banks that pushed for less restrictive branching legislation.

Specifically, deposit insurance enables small banks to hold less capital and to attract deposits. Branching regulation enables small banks to deter entry by large banks into the markets in which the small banks participate.

The conflicting interests of well-capitalized large banks, which favor branching and oppose deposit insurance, and poorly capitalized small banks, which oppose branching and favor deposit insurance, are reflected by their legislative representatives. The relative political influence of the two groups of banks determines whose interests prevail. We argue that small banks obtained branching restrictions and federal deposit insurance, in spite of the protests of large

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banks, because there are more small banks than large banks.

SOME STATISTICAL EVIDENCE

WE FOUND STATISTICAL EVIDENCE FOR OUR PROPOSITION in the history of state-level deposit insurance and in a congressional roll-call vote on an act that restricted branching.

Before the introduction of federal deposit insurance, eight states—Oklahoma, Texas, Nebraska, Mississippi, Kansas, Washington, South Dakota, and North Dakota—had experimented with the insurance of bank deposits in the early 1900s. Our analysis of pertinent economic data suggests that states with poorly capitalized, state-chartered banks were more likely to have experimented with deposit insurance. In any event, all eight of the state experiments had failed by 1930, in the wake of large insurance fund deficits.

At the federal level, analysis of the roll-call vote on the branching provisions of the McFadden Act of 1927 suggests that representatives from states with poorly capitalized, state-chartered banks voted against branching (that is, for McFadden), whereas representatives from states with well-capitalized, nationally chartered banks generally voted against McFadden.

THE STORY BEHIND THE BANKING ACT OF 1933

IN SPITE OF THE FAILURE OF THE EIGHT STATE-LEVEL EXPERIMENTS with deposit insurance, federal deposit insurance was instituted by the Banking Act of 1933. Although final passage of the act was not by roll-call vote, the contemporaneous record supports our hypothesis that deposit insurance is grounded in politics, not efficiency.

Sen. Carter Glass and the Banking Committee were initially opposed to deposit insurance. Senator Glass favored liberalized branching restrictions, higher reserve requirements, and an effective lender of last resort. The lobbying pressure for deposit insurance came from small banks. Large banks, as represented by the American Bankers Association, resisted the legislation in its final form.

The Impetus for Deposit Insurance Federal deposit insurance was not a creative new scheme prompted by the banking crisis in the early 1930s and devised by the Roosevelt administration, with the support of Congress, to protect small depositors. First, as we have noted, the idea of deposit insurance simply was not new; it had been tried unsuccessfully by eight states. Second, it was not part of the original New Deal reforms. In fact, Senator Glass, one of the primary sponsors of the Banking Act of 1933, stated at the time, "I think I violate no confidence when I say that the President who, at the beginning, was very much opposed to any insurance of bank deposits at all, very earnestly advocated that provision of the bill."

Consistent with our hypothesis, the impetus for federal deposit insurance came from certain members of Congress who were concerned about the continued viability of small unit banks. The decline in agricultural prices in the 1920s and the inability of nondiversified unit banks to compete with the larger branching banks precipitated a crisis for small banks.

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The 1920s had seen a spurt in branch banking. By 1925, 720 banks were operating 2,525 branches that accounted for 35 percent of all commercial bank loans and investments. Sensing this threat, small unit banks pushed an antibranching resolution at the annual convention of the American Bankers Association: "We regard branch banking or establishment of additional offices by banks as detrimental to the best interests of the people of the U.S. Branch banking is contrary to public policy, violates the basic principles of our government and concentrates the credits of the nation and the power of money in the hands of a few."

Nonetheless, branch banking faced a favorable climate. When less-restrictive branching laws prevailed from 1925 to 1930, the share of loans and investments held by branching banks rose from 35 percent to 46 percent. The large number of bank failures in the latter half of the 1920s and the early 1930s increased the desire of unit banks to protect themselves from competition from larger, branching banks.

Congressional Debates The importance of deposit insurance as a bulwark of the unit banking system was reflected in congressional debates over the Glass-Steagall Bill, which became the Banking Act of 1933. Comptroller of the Currency John Pole said, in his testimony in opposition to the bill, "There is only one sound remedy for the country bank situation and that is a system of branch banking.... Since by last report and recommendations to Congress on the small unit bank situation...there have been 4,000 additional small bank failures.... While, therefore, I am in agreement with the ultimate purpose of the bill, namely, greater safety to the depositor, the method proposed by the bill and the principles which I advocate stand at opposite poles. A general guaranty of bank deposits is the very antithesis of branch banking."

The original bank reform bill introduced in Congress

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did not provide for federal deposit insurance. In trying to get more branching privileges and such provisions as the separation of commercial and investment banking, Senator Glass allowed deposit insurance advocates to introduce the guarantee of deposit into his bill. The provision for deposit insurance was not introduced until April 4, 1933; the bill passed on June 16, 1933. As Glass explained, "The executive authorities at the outset were all thoroughly opposed to the insurance of bank deposits. I may say also that the majority of the subcommittee of the Committee on Banking and Currency...were utterly opposed to the insurance of bank deposits. But as sensible men, we realized that it was a problem from which we could not escape."

Members of Congress (and bankers) knew that non-risk-based deposit-insurance premiums implied transfers across banks, just as they understood that deposit insurance encourages excessive risk-taking and discourages prudent bank management. As Representative Goldsborough stated: "My doubts go to method rather than to principle. I have never understood why it is impossible or even unwise to extend the insurance principle to the insuring of deposits.... Personally, I should have preferred that it would have been done by way of a mutual insurance system fostered by the Federal Government, but if the method here proposed can succeed, I shall rejoice." Senator King put it more bluntly: "It seems to me that the strong banks, the sound banks, are to carry the weak banks." Representative McFadden stated the modern economic viewpoint that "bankers should insure their own deposits. They should apply to their deposits the same principles of insurance that they apply to their employees and to their customers and every citizen who offers to pledge his property as security." Deposit insurance was nonetheless adopted to protect small banks.

Large Banks' Futile End Game On the day of Glass-Steagall's passage by Congress, Francis H. Sisson, president of the American Bankers Association, wired his member banks to urge President Roosevelt to veto the bill: "The American Bankers Association fights to the last ditch deposit guarantee provisions of Glass-Steagall Bill as unsound, unscientific, unjust and dangerous. Overwhelmingly, opinion of experienced bankers is emphatically opposed to deposit guarantee, which compels strong and well-managed banks to pay losses of the weak....This legislation...has not had approval of the Federal Reserve Board, the Treasury, nor sympathetic cooperation of the President....The guarantee of bank deposits has been tried in a number of states and resulted invariably in confusion and disaster...and would drive the stronger banks from the Federal Reserve System. These strong banks should not be assessed to pay a premium for mismanagement."

President Roosevelt nevertheless signed the Banking Act of 1933 on the day of its passage. The act included a temporary deposit fund that gave each depositor 100 percent coverage of up to $2,500 in deposits at a national bank. As Senator Vandenberg, the author of the temporary fund, explained: "If there is one purpose more than another which is inherent in the amendment which is now at stake in this conference, it is the purpose to protect the smaller banking institutions, and to make the reopening of closed banks possible as speedily and as safely as it can be done."

A REGULATOR LOOKS BACK

BANKING REGULATORS HAVE LONG UNDERSTOOD FEDERAL deposit insurance as a prize in a political contest between small and large banks. William Seidman, former chairman of the Federal Deposit Insurance Corporation, put it this way in *The Wall Street Journal* (June 5, 1991): "Myth 4: Deposit Insurance was enacted solely for the protection of depositors.... In fact when deposit insurance legislation was enacted in 1933, the primary political reason was that it had the support of small banks that overrode the opposition of bigger banks.... Any public policy debate limiting deposit insurance coverage necessarily is about the kind of banking system we want in the U.S. and the role of small banks in the system." ■

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