

BANKING STABILITY AND DEPOSIT INSURANCE

BANKING STABILITY AND DEPOSIT INSURANCE

Address by Dr. Edison H. Cramer, Chief of the Division of Research and Statistics, Federal Deposit Insurance Corporation, before the Cincinnati Chapter of N.A.B.A.C., Cincinnati, Ohio, October 8, 1952

When Mr. Shaffer asked me to speak to this Chapter of NABAC, he did not specify the topic he wanted discussed. As I considered different subjects in which bank auditors and comptrollers are interested, it occurred to me that a discussion of banking stability and deposit insurance is particularly appropriate in this city. For it was in Cincinnati that banking first appeared in the area known as the Old Northwest. In the years before the Civil War, Cincinnati bankers were among the leaders in devising for Ohio a banking system of great stability; one which is still regarded as a shining exception to the general rule of poor banking in those years.

Almost 150 years ago, on April 15, 1803, the Miami Exporting Company of this city received a charter from the State legislature. At that time banking was frequently conducted as part of a mercantile business and, as its name indicates, the Miami Exporting Company was no exception. Nevertheless, within a short time the company dropped its other business and concentrated solely on banking, serving for a period as one of the leading banks in this area.

In 1845 the State Bank of Ohio was established. This institution, which in reality was a federation of independent banks scattered throughout the State, operated until about 1864 when most of the banks

converted to National Banks. In the interval it provided Ohio with a model banking system, and, I might add, had an insurance program for the protection of creditors of failed banks which is recognized today as one of the forerunners of Federal deposit insurance.

Before discussing the record of bank stability and the role of deposit insurance, let me briefly examine the reason for concern with bank stability. For although we may all agree that a reasonable degree of stability is desirable for any industry, there is no question that stability in banking is of fundamental importance to the entire nation.

Function of banking. Bank stability is essential because of the rather special function of the banking industry. We perceive a clue to this function when we note that the circulating medium of the nation is composed of currency and coin in circulation plus deposits in banks and that the latter comprises a much larger proportion of the whole than does currency. Circulating medium may also be described in less precise terms, such as the sum of money and bank credit; but the concept is well established no matter how it is measured or defined.

As you know, the volume of bank deposits substantially exceeds the aggregate amount of bank reserves and cash items in banks so that partially offsetting deposit obligations are earning assets held by the banks. To the extent, in other words, that the volume of deposits exceeds reserves and cash items, to the same extent has the acquisition of earning assets by the banking system resulted in the creation of circulating medium in the form of deposits.

We are perhaps too accustomed to viewing the operations of the banking system in terms of bank lending and investing. While this is preferable for certain purposes, let us also remember that in the course of these operations banks provide circulating medium. Thus it may properly be stated that the banking industry fulfills its chief function when the nation is provided with an adequate circulating medium. If this proposition sounds strange, let me note that it is merely the reverse side of the coin which reads that banks fulfill their chief function when, so far as possible, the legitimate needs for bank credit in their respective communities are met.

In the period before the Civil War there was little question that the primary function of banks could be described as the provision of circulating medium. Indeed, banks were frequently advocated on just this ground. At that time bank borrowers generally received bank notes rather than demand deposits so that the relationship between the lending and investing activities of the banks and the volume of circulating medium was clear.

With the growth of deposit banking and the increasing use of checks *during the second half of the 19th century* ~~after the Civil War~~, this function of banking gradually became less apparent. For a time it was even staunchly denied that banks created circulating medium. Fortunately there is no such disagreement today and, in fact, the difficulty is that agreement is so general that this important banking function is given too little attention. I am emphasizing it tonight because it is at the bottom of our concern for bank stability. Instability in banking means instability in circulating

medium, with its consequent disturbing effects upon the entire price structure and upon the welfare of the nation.

Relationship of bank stability to business fluctuations. Let us examine further the relationship between bank stability and the welfare of the nation. To be sure, there are some economists who assign to money and bank credit only a permissive role in the instability that has long characterized our economy. However, there are many other economists who hold that instability in money and banking has been the paramount cause of instability in business. Moreover, this theory has been shared by many who are not professional economists. It has long been believed that the basic cause of all severe business fluctuations originates in some way from the operation of the banking system. In September, 1837, one hundred and fifteen years ago, President Van Buren, in a message to a special session of the Congress, attributed the great crisis of that year to the banks; and twenty years later, President Buchanan, in his annual message to the Congress in December, 1857, likewise blamed the banks for the crisis of that year. A historian of banking theory has said that the presidents were expressing the opinion of the majority of the contemporary students of the problem. 1/ If you were to go through the bills relating to banks introduced into the Congress during and following every business depression, you would see that this belief has been prevalent ever since the time of George Washington and Alexander Hamilton. That is to say,

1/ Richardson, Messages of the Presidents, III, 325 ff. and V 437 ff; and Harry E. Miller, Banking Theories in the United States Before 1860, p. 105.

political leaders, students of banking, and the general public have long recognized that if we are to maintain vigorous commercial and industrial activity, banking stability is a necessary condition.

Prior to the Civil War, to be sure, our economy was largely agricultural, and the industrial development that was to transform it was in its early stage. Banking played a somewhat less important role at that time, but even then the nation needed a medium of exchange with stability in its value. The recurring periods of unsettlement in the financial affairs of the nation affected the business and agriculture communities and the problem of banking instability was ever present. With the development of industrial specialization during the second half of the Nineteenth Century, the question of banking stability grew in importance and urgency.

This problem of banking instability and its effect on business stemmed from two main sources. In the first place, bank deposits expand and contract with the expansion and contraction of bank reserves and, in turn, the quantity of effective reserves available to banks now depends almost exclusively on central bank policy. But prior to 1914, we had no central bank and no adequate control over the quantity of bank assets or deposits. The Federal Reserve Act of 1913 created a central banking system, and gave it sufficient power to control the quantity of bank reserves

and thus to control the quantity of deposits and therefore to control the value of the dollar.

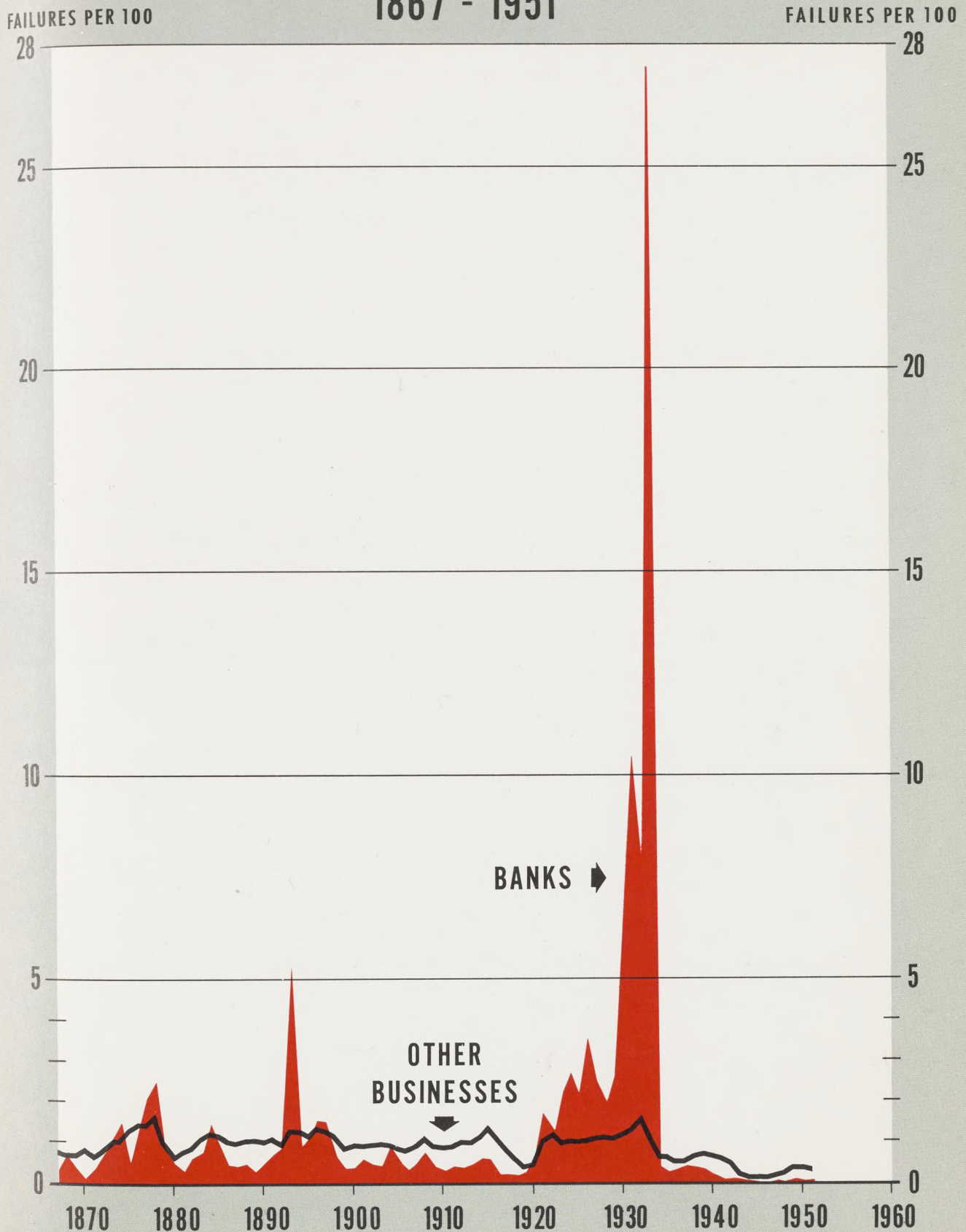
However, the Act did not correct the other source of instability in our system of free enterprise banking. This second weakness of our

banking system to which I refer was the instability of individual banks.

With thousands of independent banks--at one time more than thirty thousand *and today nearly 15,000--* there were bound to be some that failed for one reason or another. In the event of a bank failure, the public lost not only part of its circulating medium but also its confidence in neighboring banks. During periods of money stringency when banks were contracting their assets because of lack of reserves, weak banks would fail and depositor panic would spread from bank to bank and many sound institutions would be forced to close their doors. How this situation affected our banking system and the way it has been corrected is the subject I wish to discuss tonight.

Record of instability. So that we could see graphically the record of bank failures in the United States over the past three quarters of a century, we studied the available statistical data and prepared a chart showing failures in banking and business during the period 1867 to 1951. The rate of failure in banking is depicted by the red silhouette, and the black curve furnishes as a point of reference the rate of failure for other types of business. The statistical problems involved in analyzing these data were such that it is impossible to say the presentation is precisely accurate. Nevertheless, the over-all picture for this period as shown on this chart, in my opinion, is a fair representation of the historical facts. You will note that for long periods of time the record of banking was substantially better than for other types of business. However, during other periods the troublesome problem of banking instability is evident. Generally speaking, the times when bank failures were relatively more than business failures were times of deep depression and stagnation. This is

FAILURES IN BANKING AND BUSINESS 1867 - 1951



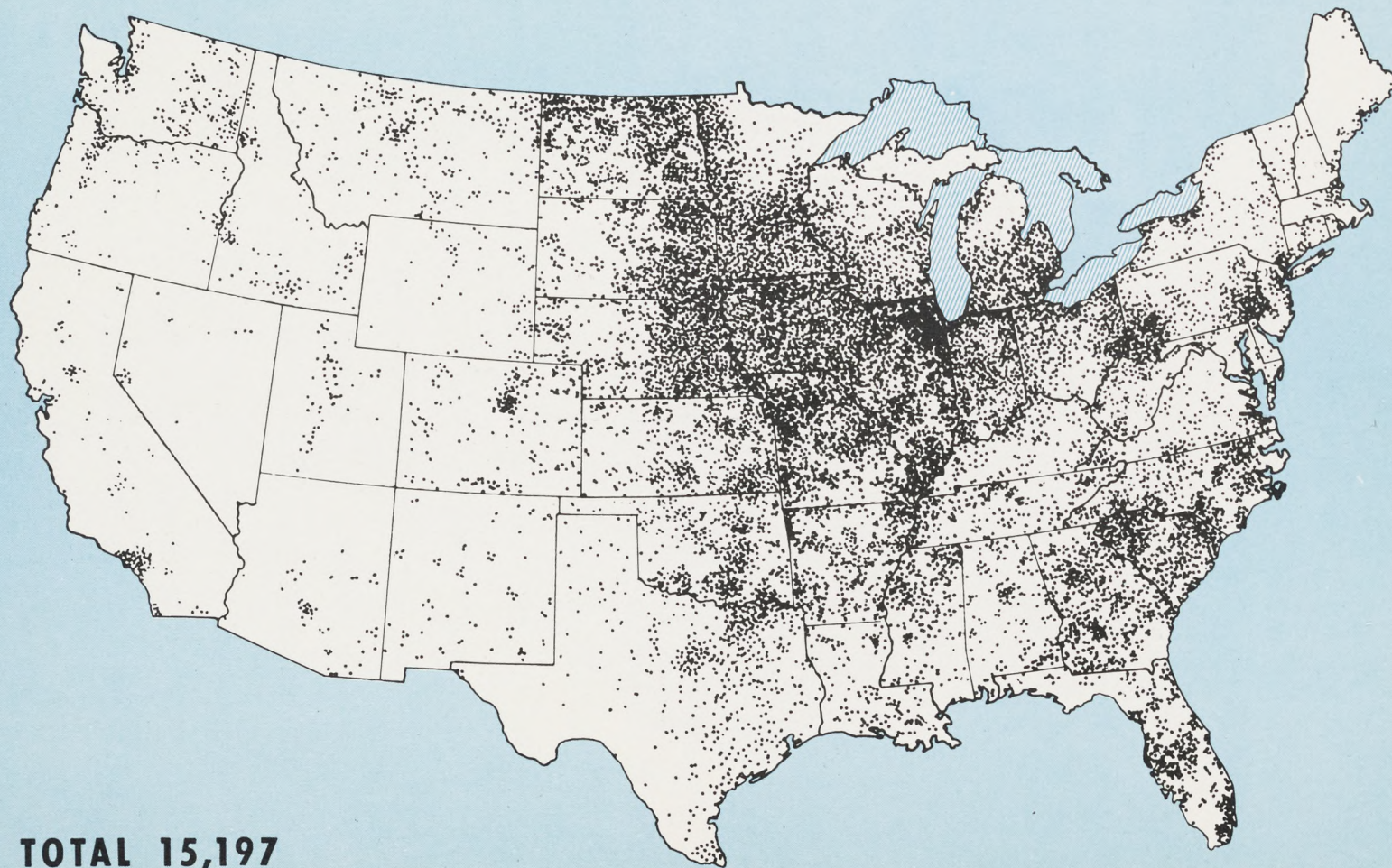
Division of Research and Statistics
FEDERAL DEPOSIT INSURANCE CORPORATION
CHART NO. 49

apparent in the great depression of the early 1930's, when the problem became particularly acute.

Now I should like to picture the facts regarding bank failures in a somewhat different form. On this map is a dot representing each bank failure for the period 1916-1933. The total suspensions during this 18-year period were over fifteen thousand. The distribution, as you can see, was widespread. Agricultural States appear to have been particularly vulnerable but no area really escaped, irrespective of the economic bases supporting the economy.

It is apparent from these charts that the problem of bank failure was not solved in 1913 by establishment of a central banking system. As a result, there were those who contended that instability in banking was an inherent characteristic of our dual banking system with its multiple chartering authorities and thousands of individual banks. The proponents of that theory pointed to the structure of banking in other commercial nations where instead of thousands of individual banks, there were a few huge institutions operating elaborate systems of branches. The critics of the dual banking system placed great emphasis on this record of banking instability that is presented by these charts. This record, it was contended, was so bad that nothing could be done to mend the banking system, and very drastic plans for its total reorganization were proposed. Many economists recommended unlimited branch banking as the most practical solution, others worked out schemes for requiring banks to keep 100 percent reserves against deposits, and still others suggested nationalization of our banking system.

FAILURES IN BANKING 1916 to 1933



TOTAL 15,197

Division of Research and Statistics
FEDERAL DEPOSIT INSURANCE CORPORATION

CHART NO. 46

Deposit insurance legislation. Fortunately, a few students of banking realized that the cause of so many bank failures could be traced to the two sources mentioned earlier--central bank operations and individual bank weaknesses. Before discussing the solution based on this analysis of the problem, I want to turn briefly to another historical factor. As I mentioned previously, prior to the Civil War bank notes were the principal medium of exchange. The National Bank Act of 1863 placed a Federal guarantee on this circulating medium. But as bank deposits gradually replaced bank notes and other forms of currency, the guaranteed portion of the money supply, or circulating medium, declined in importance.

By the middle of the 1880's, deposits had become over four-fifths of the circulating medium. The problem of protecting them was sufficiently acute to bring about the introduction in the Congress of bills providing for the guarantee of deposits. Four bills for this purpose were introduced in the House of Representatives in 1886. Fourteen more were introduced in the Congress prior to 1900. In the 60th Congress, following the panic of 1907, about thirty proposals were made for deposit guarantee legislation. The Democratic platform of 1908 contained this plank, "We pledge ourselves to legislation under which the national banks shall be required to establish a guaranty fund for the prompt payment of the depositors of any insolvent national bank, under an equitable system which should be available to all State banking institutions wishing to use it." The Senate version of the Federal Reserve Act in 1913 carried such a provision, but the banking and currency

committee of the House was instrumental in taking it out of the Act.

For the entire period from 1886 to the establishment of the Federal Deposit Insurance Corporation in 1933, 150 bills for the guarantee or insurance of deposits are known to have been introduced in the Congress.

The foregoing figure does not include bills proposing the establishment and operation of banks of deposit by the government itself. Numerous proposals of this type were introduced. Some called for a Bank of the United States with a system of branches and others for the expansion of the Postal Savings System to provide for receipt of deposits and their transfer by check at Post Offices throughout the nation. The number of such proposals has never been tabulated.

The great depression and the banking debacle in the spring of 1933 convinced the Congress that insurance of bank deposits--our principal circulating medium--could no longer be delayed. It was in this atmosphere of desperate emergency that the Federal Deposit Insurance Corporation was created. Many students of banking and most bankers believed it could not possibly succeed, but were willing to try it as a last resort.

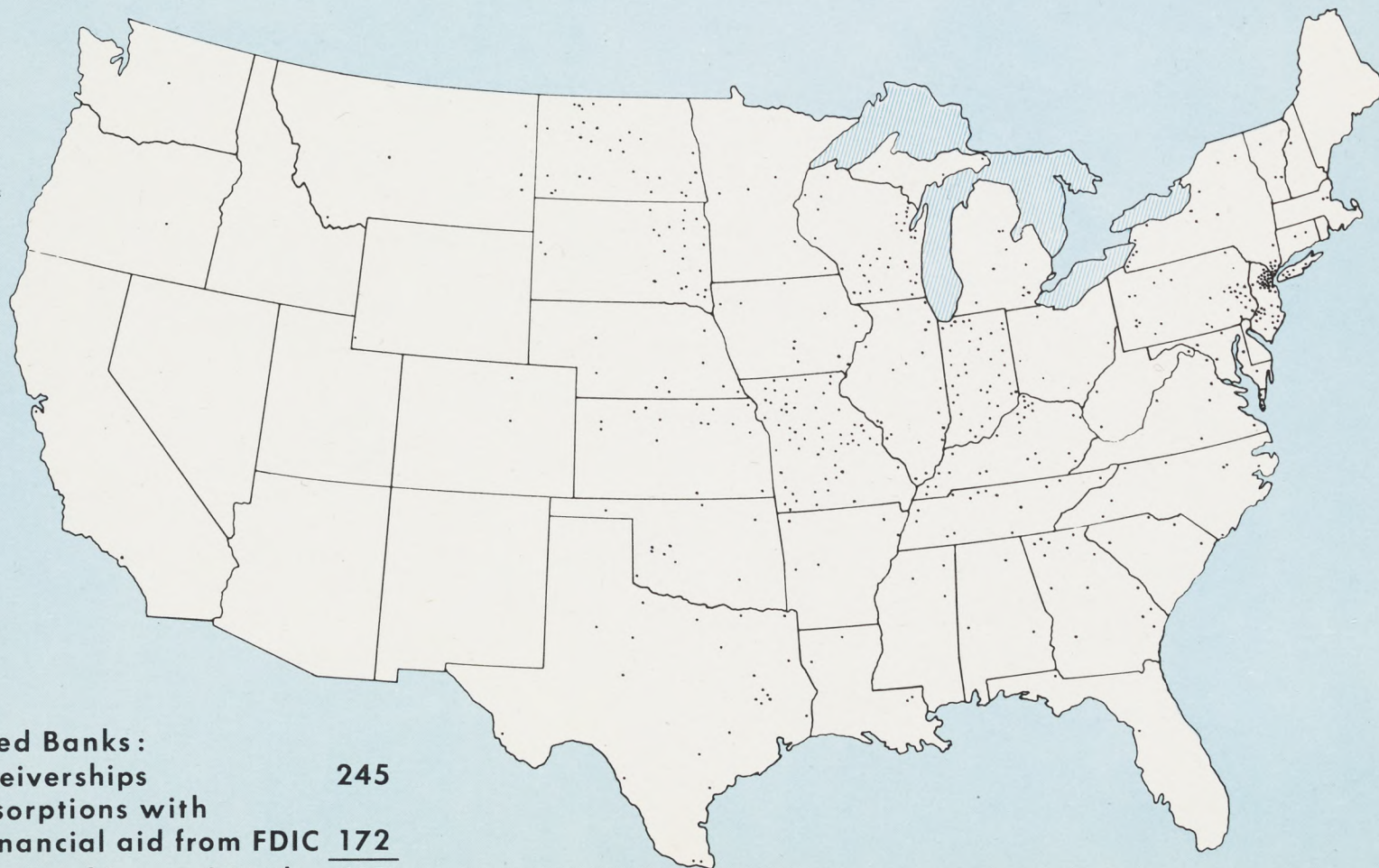
Solution to bank failure problem. Adoption by the Congress in 1933 of the principle of deposit insurance was an exercise of its sovereign power to provide and control the nation's circulating medium or supply of money, and the responsibility imposed upon the Congress by the Constitution of the United States to regulate the value of money. The monetary responsibility which the Congress has given the Federal Deposit Insurance Corporation is definite and precise. The Corporation has been given the duty of preventing the destruction of the circulating medium by reducing the number

of bank failures, and the restoration to a community in which a failure occurs of a portion of the money supply extinguished by the failure.

Now I should like to picture the facts regarding bank failures for another 18-year period, beginning with 1934 when deposit insurance became effective. You will note that there are not many black spots on the map. The total number of bank failures was only 516, of which 99 were noninsured banks. Of the 417 failing insured banks, 172 were merged with other sound banks with the financial assistance of the Federal Deposit Insurance Corporation. In these cases no depositor suffered any loss. This method of aiding depositors has been used exclusively since May, 1944.

These facts point to a conclusion which, so far as I can see, is inescapable. The long recognized and troublesome problem of bank failure was faced in the ^{1933,} ~~early 1930's~~. A way to solve the problem was developed and it was a typically American solution. The banking structure was strengthened and stabilized both by improving the central banking system and by the adoption of Federal deposit insurance legislation. Deposit insurance has fostered the confidence of depositors in banks, and it seems reasonable to expect that never again will multitudes of sound banks be swept away because depositors are panicky. Continuation of appropriate central bank policy along with stability of individual banks because of deposit insurance will greatly contribute to business stability. In fact, I am willing to go so far as to say that we need never again have a long serious depression like that of the early 1930's, for our private business enterprise economy and our American banking system are not inherently unstable, but they are extremely flexible and responsive to changing conditions and changing times.

FAILURES IN BANKING 1934 to 1951



Insured Banks :	
Receiverships	245
Absorptions with financial aid from FDIC	<u>172</u>
Total Insured Banks	417
Noninsured Bank Suspensions	<u>99</u>
Grand Total	516

Division of Research and Statistics
FEDERAL DEPOSIT INSURANCE CORPORATION
CHART NO. 47