Pamphlets and Articles Regarding Guaranty of Bank Deposits in Eight States 1908-1930

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GUARANTY OF BANK DEPOSITS IN EIGHT STATES†

By A. B. Butts*

(See article by the same author, State Regulation of Banking by Guaranty of Deposits, Mississippi Law Journal, Volume 2, p. 208, November 1929, a discussion of the history and the operation of the guaranty law in the State of Mississippi.—Ed.)

More than two decades ago the idea of the guaranty of bank deposits was written into the laws of the State of Oklahoma. Within a month after its admission as a State, and while the panic of 1907 was running its course, Oklahoma enacted its guaranty law.[1]

Seven other States have enacted guaranty laws: Kansas in 1909,[2] Texas in 1910,[3] Nebraska in 1911 (Law enacted in 1909, but suspended by injunction bill until 1911),[4] Mississippi in 1914,[5] South Dakota in 1915,[6] and North Dakota[7] and Washington in 1917.[8]

Bank-guaranty became a question of importance in other States than the eight in which legislation was enacted. The other States that gave the subject serious consideration were Arizona, Arkansas, Florida, Georgia, Tennessee, Iowa, Wisconsin, Missouri, Colorado, Nevada, Minnesota, Montana, and North Carolina.[9]

By legislative enactment seven of the eight States have repealed their bank guaranty laws. In one State, Mississippi, the guaranty law has been suspended until outstanding certificates are liquidated.[10]

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1 Compiled Statutes of Oklahoma, 1921, Chapter 34.

2 Revised Statutes of Kansas, 1923, Chapter 9.

3 Digest of Banking Laws, Texas, 1923, Chapter 7.

4 Laws of Nebraska, 1909, Chapter 10; Compiled Statutes of Nebraska, 1922, Secs. 7995-8035 (Sec. 8028 on guaranty fund); Session Laws, 1923, House Rule No. 272 and No. 237, Chapter 191, Sec. 26.

5 Hemingway's Mississippi Code, 1917, Secs. 3591-3605, as amended by Laws of 1922, Chapter 172.

6 Revised Code of South Dakota, 1919, Art. 3, Secs. 9005-9031; Session Laws, 1921, Chapter 136.

7 Laws of North Dakota, 1923, Senate Bill No. 250, Chapter 200.

8 Remington's Code, Washington, Secs. 3293-3312.

9 Federal Reserve Bulletin, September 1925, p. 627; Thomas Bruce Robb, The Guaranty of Bank Deposits (1921), Chapter 7, p. 160.

10 Laws of Mississippi, 1930, Chapter 22.

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It may be observed at the outset that recent experiences under the guaranty laws have been quite similar in several States. "Generally the laws seemed to work well for a period, winning popular favor by providing for prompt discharge of all deposit liabilities of failed banks," says the Report of the Federal Reserve Board. And this Report says further: "Generally the laws have been commended from year to year by State bank commissioners or superintendents in their annual reports as providing precisely the guaranty originally intended; and generally also . . . bank failures have piled up obligations against the funds in excess of resources immediately, or in some cases, as it would appear, ultimately available under the law, with the result that those administering the fund have resorted to borrowing . . . or to the issue of certificates of indebtedness to depositors."[11] The five years that have elapsed since this statement was made serve only to make more certain the truthfulness of the observation.

It will perhaps not be amiss to give a brief summary of the guaranty laws of each of the eight States, followed in each case by a statement of the status of the guaranty fund.

In the case of each State the summary of the law as here given will include these topics: institutions included; participation, whether compulsory or optional; character of deposits guaranteed; maximum assessments in any one year; rate of interest on outstanding warrants or certificates of indebtedness. The administrative phases of the laws concerning method of payment of depositors, powers of State Boards or Commissioners, disposition of the guaranty funds, and the requirements as to the basis and rate of regular and special assessments will not be considered here.

For convenience of comparison, a tabular presentation of the phases of the guaranty laws under consideration will be given.[12]

(1) Institutions included:

Oklahoma: Every bank, and savings departments of trust companies.

Kansas: Any bank doing business in the State with an unimpaired surplus of 10 per cent of its capital and any bank authorized to do business in the State after the passage of the act which shall have been actively engaged in business for one year and having such surplus.

Texas: Every corporation hereafter incorporated under the laws of Texas with banking and discounting privileges, and bank-

11 Federal Reserve Bulletin, September 1925, p. 626.

12 See Federal Reserve Bulletin, September 1925, pp. 626-668.

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ing and trust companies heretofore incorporated under the Texas banking law or hereafter incorporated.

Nebraska: Every corporation engaged in the business of banking.

Mississippi: Every bank organized and existing under the laws of Mississippi.

South Dakota: Every bank engaged in the business of banking under the laws of South Dakota.

North Dakota: Every corporation, except national banks, whose business in whole or in part consists of the taking of deposits or buying or selling exchange, shall be subject to the provisions of this act, and trust companies doing a general banking business separate and apart from the writing of surety bonds and other general business, and building and loan associations receiving savings deposits shall also be subject to the provisions of this act.

Washington: Any corporation organized under the laws of Washington authorizing the organization of banks or trust companies, except mutual savings banks, and engaged in the banking business in this State.

(2) Participation, whether compulsory or optional:

Oklahoma: Compulsory:

Kansas: Optional.

Texas: Compulsory. Banks were permitted to elect whether they would secure their depositors by the guaranty-fund system or the bond-security system, but such depositors must be secured by one or the other of such systems.

Nebraska: Compulsory.

Mississippi: Compulsory.

South Dakota: Compulsory.

North Dakota: Compulsory.

Washington: Optional.

(3) Character of deposits guaranteed:

Oklahoma: Deposits of failed banks, but no deposit otherwise secured, nor any deposit on which a greater rate of interest is allowed thân is permitted by the rule of the bank commissioner.

Kansas: All deposits not otherwise secured; but the guaranty shall not apply to a bank's obligations as indorser upon bills rediscounted, to bills payable, to money borrowed from its correspondents or others (any deposit on which a greater rate of interest is paid than the rate approved by the bank commissioner shall be considered money borrowed), or deposits or credits obtained by fraud or in violation of law, or evidence of debts fraudulently issued.

Texas: All deposits, provided, however, no deposit upon which interest is being paid or contracted to be paid; no deposit secured in any way; no certificate of deposit, whether interest bearing or not, that shall have been changed to a non-interest-bearing unsecured deposit within 90 days prior to the closing of the bank by the commissioner; no deposit of public funds, whether interest-

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bearing or not; and no deposit made by a creditor for the purpose of converting a loan held against the debtor bank into a non-interest-bearing unsecured deposit shall be protected or insured by the guaranty fund. Cashiers' checks, bank drafts, or exchange issued against or arising from bona fide unsecured non-interest-bearing deposits shall be protected under the guaranty fund. Non-interest-bearing certificates of deposit issued by State banks and trust companies are not protected or insured by the guaranty fund.

Nebraska: The guaranty fund is for the protection of depositors, but no money deposited in any bank upon any collateral agreement other than an agreement for length of time to maturity and rate of interest shall be guaranteed by the depositors' guaranty fund. No claim of priority in the assets of a failed bank shall be allowed which is based on evidence of indebtedness in the hands of, or issued to, a stockholder, officer, or employee of a failed bank which represents money obtained by such stockholder, officer, or employee for the purpose of effecting a loan to such failed bank.

Mississippi: All deposits not otherwise secured and all cashiers' checks, certified checks or sight exchange issued by banks operating under the guaranty fund act. The guaranty shall not apply to a bank's obligations as endorser, upon bills rediscounted, nor to bills payable nor to money borrowed from its correspondents or others, nor to deposits bearing a greater rate of interest than 4 per cent per annum.

South Dakota: All deposits not otherwise secured shall be secured by the guaranty fund, but such guaranty shall not apply to a bank's obligations as indorser upon bills rediscounted, nor to bills payable, nor to money borrowed from its correspondents or others. Banks which have fully complied with the provisions of the guaranty fund act are not required to give any further security for the purpose of being a depository of public funds, but such funds shall be secured in the same way private funds are secured.

North Dakota: All deposits for which money or its equivalent, and for which full value has been received by the bank wherein such deposit is made shall be guaranteed, but the guaranty provided for in the act shall not apply to a bank's obligations as indorser upon bills rediscounted nor to bills payable, nor to money borrowed from its correspondents or others, nor deposits otherwise secured, nor deposits upon which compensation in any manner or form or by whatever device has been promised or paid in excess of the rate of interest as limited in this act.

Washington: Deposits not otherwise secured, but the guaranty provided for in this act shall not apply to a bank's obligations as an indorser upon bills rediscounted, nor to bills payable, nor to money borrowed from its correspondents or others, nor deposits of public money in excess of its capital and surplus. The guaranty of the guaranty fund shall extend to public funds, of, or under the control of the State, or any county or municipality

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within the State deposited in guaranteed banks to an amount equal to, but not in excess of, the capital and surplus of such bank if the custodian of such fund shall elect to deposit the same under the guaranty of such fund.

(4) Maximum assessments in any one year:

Oklahoma: One-fifth per cent and in fiscal years ending in 1914, 1915, and 1916 an additional one-fifth per cent special assessment.

Kansas: Not more than five assessments of one-twentieth per cent each of the average guaranteed deposits less capital and surplus shall be made in any one year.

Texas: Two per cent of average daily deposits; but this limitation not applicable to first payment to the guaranty fund required of any bank which shall hereafter elect to secure its deposits in the depositors' guaranty fund.

Nebraska: Six-tenths of one per cent of average daily deposits exclusive of public money otherwise secured, until the guaranty fund reaches the sum of one and one-half per cent of such deposits.

Mississippi: Five assessments of one-twentieth of one per cent each, of the average daily deposits.

South Dakota: One-fourth of one per cent of the average daily deposits, less the amount of the deposits not eligible to guaranty, annually, until the fund amounts to one and one-half per cent of the average daily deposits.

North Dakota: Five assessments of one-twentieth of one per cent each of the average daily deposits.

Washington: One-tenth of the average deposits eligible for guaranty, assessed annually, until the fund shall equal 3 per cent of all deposits eligible for guaranty in all member banks.

(5) Rate of interest on outstanding warrants or certificates of indebtedness:

Oklahoma: Six per cent.

Kansas: Six per cent unless a contract rate exists on the deposit, then the certificate shall bear the contract rate.

Texas: Six per cent.

Nebraska: Rate of interest shall be fixed by the court.

Mississippi: Six per cent.

South Dakota: If issued in favor of the bank to be sold by the Superintendent of Banks and proceeds paid to depositors, not more than 7 per cent, but if issued payable to the depositors for the amount of their claims, 5 per cent.

North Dakota: Six per cent.

Washington: Five per cent, if there is not sufficient money in the guaranty fund to pay depositors.

OKLAHOMA

The bank guaranty plan operated in Oklahoma for fifteen years. During the first seven years of the law the fund

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went into arrears heavily on account of bank failures, but better conditions obtained for the five years following and in 1920 the guaranty fund showed a surplus. The post-war depression brought a severe test to the banks; credit and values collapsed in the stress of depression and numerous banks failed, resulting in plunging the guaranty fund deeply into debt. Over fifty bank failures occurred in 1921 and 1922, and in the same period almost one hundred State banks nationalized. By the end of 1922 claims of depositors in failed banks ran the fund almost seven and a half million dollars into arrears, and the interest accruing on these unpaid claims was over three times as great as the current assessments levied.

The Oklahoma guaranty law was repealed by an act of the legislature in March 1923.[13] At the time of the repeal there were to date outstanding banking board warrants of approximately a million and a quarter dollars. There was a number of unpaid deposits in failed banks for which no warrants were ever issued on account of the insolvency of the fund. It is estimated by the State Banking Department that there are at present about a million dollars of unpaid deposits. There is something like $220,000 cash on hand to apply to the outstanding banking board warrants. In addition to that, the State Banking Department holds over a million dollars of practically worthless assets belonging to the guaranty funds, by reason of bank failures. No provision was made for paying off the debts of the fund.[14] Only the small proceeds recoverable from the liquidation of failed banks, plus the small amount of cash on hand, it would seem, are available for this purpose. Small comfort is given the depositors of failed banks by the provision of the repealing statute which reads: "Provided, That the provisions of this section shall not relieve or release any bank, firm, or corporation, or any officer, stockholder, or director, or any other person from any obligation, assessment, or liability to the depositors' guaranty fund or to the depositors or creditors of any failed State bank, which obligation, assessment, or liability existed at the time of the passage and approval of this act."[15]

KANSAS

The bank guaranty law of Kansas was in effect for twenty years; the law became effective June 30, 1909, and

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13 Laws of Oklahoma, 1923, Chapter 137.

14 Letter to writer from C. G. Shull, Bank Commissioner of the State of Oklahoma, November 19, 1929.

15 Laws of Oklahoma, 1923, Chapter 137, Sec. 10.

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was repealed March 14, 1929. The Kansas law was not obligatory upon all banks. The high point in the operation of the Kansas guaranty system was reached in February 1922, when out of 1,108 banks in the State there were 714 banks which were operating under the guaranty fund system. This number was gradually decreased by voluntary withdrawals and forfeitures, so that in January 1929, out of 854 State banks there were 34 banks which remained members of the guaranty system.

Shortly before January 1926, sixteen guaranteed banks in Kansas withdrew from the fund and brought suit to determine the amount of their liability to the fund, there having been up to that time 78 failures among guaranteed banks. At that time there were outstanding guaranty fund certificates of approximately five and one-half millions of dollars. The Supreme Court of Kansas handed down a decision[16] to the effect that a guaranteed bank, upon withdrawal from the fund, was liable only to the extent of its bonds on deposit with the State Treasurer to guarantee the payment of assessments. Immediately following this decision the member banks began to withdraw from the fund, either voluntarily or by default in the payment of their assessments.

The fact that the Kansas system was the principal one[17] of the voluntary plans of bank guaranty makes it not inappropriate to call attention to the amounts collected over a period of years for the credit of the guaranty fund. The guaranty law of Kansas provided that the bank commissioner could levy not to exceed five assessments a year of one-twentieth of one per cent of the average guaranteed deposits, less capital and surplus of each bank. Amounts received from assessments were as follows:

Year	Amount	Year	Amount
1920	$ 85,379.79	1925	$342,890.51
1921	91,007.81	1926	129,405.50
1922	155,962.34	1927	24,896.28
1923	74,692.12	1928	8,994.88
1924	343,728.42	1929	1,321.00

On March 14, 1929, the date on which the Kansas guaranty law was repealed, the thirty-four banks which were still members of the fund and had paid their assessments regularly, demanded a return of the bonds which they had deposited with the bank commissioner to guarantee the payment of their assessments. At that time a suit was instituted praying mandamus to compel the bank commissioner to

16 121 Kansas Reports 151 (1926).

17 The Washington law was optional, and in Texas the banks could choose between the guaranty plan and a bond security system.

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return the bonds pledged by the member banks. In an opinion delivered by Justice Richard J. Hopkins, the court held that the bonds were needed to pay claims against failed member banks, whose affairs had not been closed within six months of the time when the banks attempting to recover their bonds endeavored to withdraw from membership.

The status of the Kansas guaranty fund certificates outstanding as of October 31, 1929, was $13,706,682.69, less dividends paid of $6,859,408.37, leaving a balance due of $6,847,274.32. The court held that these various certificate holders had a vested right in the bonds pledged by the member banks and the bank commissioner was not ordered to return the bonds.[18] No arrangements other than the continued liquidation and collection of the assets of the failed banks were made to pay off the claims of the guaranty fund.

TEXAS

The Texas bank deposit guaranty plan was a dual system, since banks could choose between the guaranty plan and a bond-security system. Experience with deposit guaranty in Texas covered a period of seventeen years. During the first ten years comparatively few banks failed. Of the 983 State banks in 1920, all but 42 operate under the guaranty fund plan. From the early part of 1920 until the close of 1925 about one hundred and fifty banks failed with a net loss to the guaranty fund of about thirteen million dollars. The immediate results brought about by this situation may be summarized: a large cash drain fell upon the solvent banks (The Texas law made no provision for the issuance of warrants against the fund during periods of frequent failures); during the first half of 1925 nearly seventy State banks nationalized; many guaranty plan banks sought the right to switch over to the bond-security plan of guaranty; early in 1925 a law was passed permitting the shift. The subsequent history of the Texas guaranty plan followed the usual course; during the next two years about forty more banks failed, with further losses to the guaranty fund; by 1927 all but twenty-five banks had withdrawn from the guaranty fund system; there were 721 banks under the bond-security plan by 1927, which meant that the guaranty fund plan was virtually dead.

With the guaranty fund plan no longer extensively used in Texas, the bond security plan gave some protection to

18 Letter to writer from H. W. Koeneke, Bank Commissioner of the State of Kansas, November 19, 1929.

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depositors until a decision rendered by the Supreme Court of Texas[19] made the latter plan ineffectual. The court held that "the bonds by deposit of which a State bank is permitted . . . to secure its depositors by the bond security, instead of the State guaranty system may be those owned by the bank itself and constituting a part of its assets." This meant that the Bank Commissioner was required to accept in lieu of a surety bond government and municipal bonds which were part of the bank's assets. Prior to this decision the bank commissioner had refused such bonds on the ground that they would not provide the additional security above the regular assets which the law intended. A bank could, under this interpretation of the law, after having withdrawn from the guaranty fund system, deposit some of its regular assets in the form of approved bonds with the banking commissioner and thus be free of any special liability to depositors.

The Texas guaranty law was repealed on February 11, 1927. The amount outstanding against the guaranty fund at that time was $2,323,883.99. No arrangements were made by the repealing statute for paying off the liabilities against the guaranty fund. Claims against the fund have not been paid off, and, it is stated that several suits involving the fund will keep the matter in litigation for several years.[20]

SOUTH DAKOTA

The guaranty fund system of South Dakota promised to be successful during the first five or six years of its operation, for from 1916 to the beginning of 1922 the loss to the fund was not great; but the failure of about one hundred and forty banks during the next period of three years put the guaranty fund badly in arrears. The first real dissatisfaction with the mutual guaranty fund system did not result in the repeal of the guaranty plan outright; instead, a statute was enacted requiring each state bank to build up a fund against its own failure only.[21]

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19 Texas Bank & Trust Company vs. Chas. O. Austin, Bank Commissioner, 115 Texas Reports 201 (1926).

20 Letter to writer from J. E. Roberts, Deputy Bank Commissioner of the State of Texas, November 19, 1929.

21 The law provides that each bank shall pay annually, in cash or approved securities, about the same assessments as under the old law. The assessments are placed not in a mutual fund but with the state treasurer, who sets up a separate account for each bank, allowing its balance to be dormant or investing it in approved securities. When the account, with accruals, reaches an amount equal to the capital stock of the bank, no further assessments are levied against that bank and the entire amount is retained in trust only to indemnify the creditors of that bank against loss on its failure. This amount, together with the double liability ordinarily imposed on shareholders in South

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In 1925 the legislature of South Dakota passed an act for the repeal of the guaranty system, to be effective January 1, 1926. A petition was filed requiring submission of the act to referendum at the general election in 1926, and at this election the people by a small majority refused to ratify the act repealing the guaranty law. At this same meeting of the legislature a bill which proposed a tax levy to take up the outstanding certificates of indebtedness, then over twenty-five million dollars, was defeated. In 1925 and the first half of 1926 sixty-seven more banks failed; the total liabilities against the guaranty fund amounted to over forty million dollars on June 30, 1926. A decision of the Supreme Court of South Dakota rendered in December 1926, holding that any state bank might convert into a national bank and withdraw from the guaranty system without liability by paying its current assessment, greatly weakened the bank deposit guaranty plan.[22] The fact that there was the forty million dollar deficit; that probably more banks would fail; and that already, at five per cent interest per annum on the guaranty fund deficit, the annual interest charge was two million dollars, made this decision very pleasing to banks that wished to nationalize.

On July 1, 1927, the South Dakota mutual bank deposits guaranty law was repealed. The amount outstanding against the guaranty fund at that time was $42,879,516.21. No arrangements were made under the repeal statute for paying off the claims against the guaranty fund. The amount still due depositors under the guaranty law is $40,058,559.47. This amount, however, will be reduced by liquidation of the assets of the suspended banks to approximately $25,000,000.00, it is estimated.[23]

NORTH DAKOTA

The North Dakota guaranty system which went into effect in 1917 ran into difficulties very early, due to the postwar depression. The total number of bank failures reached about one hundred and ninety by the end of 1925. By that

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Dakota banks, assures ultimately a fund against losses equal to three times a bank's capital. Laws of South Dakota, 1929, Chapter 73, Sec. 9016, amending Chapter 102, Sec. 12, Art. 3, Laws of 1915, and Chapter 123, Session Laws of 1919, Chapter 54, Laws of 1927.

22 Citizens' State Bank of Garden City vs. Smith, Superintendent of Banks, 50 S. D. Reports 579, 210 N. W. 990 (1926).

23 Letter to writer from F. R. Smith, Superintendent of Banks, State of South Dakota, November 26, 1929.

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time the total claims against the guaranty fund amounted to almost twenty million dollars; the maximum yearly assessment of about $180,000 at the time amounted to less than one-fifth of the interest accruing. More failures came after 1925. In 1928 plans were considered for proposing a bond issue of twenty million dollars to pay off depositors of failed banks holding claims against the guaranty fund. The proposal was not adopted.

The 1928 session of the North Dakota legislature passed a bill repealing the guaranty fund act of the State, the repealing act to become effective July 1, 1928; but before this date the people of the State circulated petitions, under the referendum law, and the bill was referred to the voters at the next general election, held in June 1930. The result of this election was 94,124 for repeal and 55,853 against repeal. The amount due from the guaranty fund to depositors of closed banks was $24,111,541.97 on October 1, 1929. No provision was made at the time of the repeal of the law to pay off this amount.[24]

WASHINGTON

The experience of the State of Washington with bank guaranty was brief and unusual. The Washington system became effective in March 1917; it went out of existence in fact by the end of 1921, though the law was not repealed until 1929.[25] During the first four years of the operation of the Washington guaranty system no bank failures occurred among the guaranteed banks. On June 30, 1921, one hundred and twenty banks with guaranteed deposits aggregating seventy-one million dollars were members of the system. With two exceptions these banks were banks with total deposits of less than two million dollars each. The exceptions were banks with total deposits of over fifteen millions and eleven millions. On July 1, 1921, the larger of these two banks, the Scandinavian American Bank of Seattle, with guaranteed deposits totaling almost eight and a half million dollars, failed. This completely broke down the guaranty system in Washington. By the end of 1921 every bank had withdrawn from the system. The liquidation of this bank was not completed until 1927. Depositors of that bank were paid eighty-five per cent of their claims,

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24 Letters to writer from Gilbert Semingson, State Bank Examiner of North Dakota, November 19 and December 3, 1929.

25 Laws of Washington, 1929, Chapter 11.

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of which the guaranty fund paid ten per cent.[26] The only reference in the repealing act to the balance due the depositors of the failed bank is the section which reads: "This repeal shall not be considered as affecting any rights accrued or obligations incurred under said acts or either of them or the completion of any actions or proceedings begun under the provisions thereof, or the collection and distribution of any funds under the provisions of said acts."[27]

MISSISSIPPI

The Mississippi guaranty system went into effect May 15, 1915. The law provided for five one-twentieth of one per cent assessments annually on total deposits, less capital and surplus. In the beginning the maximum assessments were not levied. Only one assessment was made each year for the first two years; then two assessments were made a year; then three; then with a threatened depletion of the guaranty fund the full five assessments were made each year. The five assessments a year have been levied since 1920. During the first ten years of the operation of the guaranty law twenty-eight banks failed, the majority during 1921 and 1922; and until about the close of the first ten-year period it seemed as if the guaranty law would produce the results that it was intended to achieve by such a system.

In May 1929 the Superintendent of Banks of Mississippi reported that fifty-two banks had been taken over by the Banking Department since the guaranty law went into effect; that the depositors in twenty-seven of the failed banks had been paid in full, in some of which it was not necessary to use the guaranty fund at all; and that the deficit in the guaranty fund at that time was $3,074,288.71.[28] The total

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26 Letter to writer from S. Zeno Varnes, Deputy Supervisor of Banking, State of Washington, November 19, 1929.

27 Laws of Washington, 1929, Chapter 11.

28 The Mississippi Banker, Journal of the State Bankers Association of Mississippi, Vol. 13, No. 12, May 1929, pp. 55-56.

Examination of the decisions of the Supreme Court of Mississippi under the guaranty law reveals a definite tendency on the part of the court to extend the benefits of the guaranty plan in as broad manner as possible. In Anderson, Bank Examiner, vs. Owen, (1916) 112 Miss. 476, 73 So. 286, the court stated that "the remedial and salutary effect of the statute should not be restricted or limited by any narrow interpretation." In Anderson, Bank Examiner, vs. Baskin and Wilbourn (1917), 114 Miss. 81, 74 So. 682, the court, En Banc, held that the general creditors are entitled to participate in the distribution of the assets of an insolvent bank along with depositors; the dissenting opinion of Justice Ethridge, in which Justice Cook concurred, in this case is of interest; see 35 Okla. 535, 35 Okla. 404, 33 Okla. 535, where the Supreme Court of

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assessments received for the guaranty fund from the over three hundred State banks runs about $300,000 a year. The interest on guaranty certificates outstanding is about $125,-000 to $135,000 a year, leaving only about $175,000 a year to be used in liquidating guaranty certificates outstanding. The State Superintendent of Banks has made this statement:[29]

"The time is rapidly coming when assessments will take care only of interest payments, and then would arise an intolerable condition. The only thing that can be done is to repeal the guaranty act, applicable to the future. The banks now operating under the act should be required to retire the outstanding indebtedness against the fund, but no more should be issued. If the guaranty feature is repealed, it is my prediction that the banks would get together and quickly retire the outstanding certificates and get it behind them."

At its meeting in May 1929 the Mississippi Bankers' Association adopted resolutions looking to the repeal of the guaranty law and appointed a committee to co-operate with the State Superintendent of Banks "to work out such terms and conditions for the repeal of the act as will meet with the approval of the State legislature."[30]

The 1930 session of the legislature of the State enacted a statute (Chapter 22, Laws of 1930) suspending the operation of the guaranty of deposits law until outstanding certificates are liquidated, at which time the guaranty law is to again become operative. The act provides for issuance of State bonds in the amount of about $5,000,000.00 for retirement of outstanding bank guaranty certificates issued prior to March 11, 1930 to depositors in failed banks. Banks will continue to pay assessments as in the past, such assessments to be used for the retirement of the bonds. Meantime depositors will be partially protected under a year-by-year payment plan under which banks are required to pay a three per cent annual assessment upon their tax-exempt surplus. By this method a depositors' Protection Fund of

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Oklahoma held that depositors take prior claim to general creditors. Public funds are guaranteed under the Mississippi deposit-guaranty act: 114 Miss. 850, county funds; 131 Miss. 93, city funds; 100 So. 277, state funds. Fraud on the part of the bank's officer did not constitute cause for not allowing the innocent depositor to claim protection under the guaranty act, 135 Miss. 110; see also, 134 Miss. 639. In 134 Miss. 729 it was held that "all deposits not otherwise secured" includes a special deposit as well as general deposits. See also, 102 So. 279; 100 So. 179.

[29] J. S. Love, Superintendent of Banks, State of Mississippi, in the Memphis Commercial Appeal, news item, November 10, 1929.

[30] The Mississippi Banker, Journal of the State Bankers' Association of Mississippi, Vol. 13, No. 12, May 1929, p. 54.

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not to exceed $300,000.00 a year is to be collected from the banks.

In *Mangum vs. Love, Superintendent of Banks,* heard in the Simpson County Chancery Court, Chancellor T. Price Dale held the act unconstitutional; but in *Deposit Guaranty Bank and Trust Company vs. City of Jackson,* Judge W. H. Potter in the Hinds County Circuit Court held that the statute is "clearly constitutional." Both of these cases were appealed to the Supreme Court of Mississippi, where they are now (January 1931) pending.

NEBRASKA

The Nebraska bank deposits guaranty law was passed March 25, 1909. From the start the banks of Nebraska, both state and national, were opposed to a guaranty law, an attitude which led the northern group of the Nebraska Bankers' Association to pass a resolution on April 23, 1909, a month after the passage of the law, voicing their disapproval of the law and sanctioning actions seeking to test the legality of the measure. Very soon, therefore, a suit was filed in the name of fifty-two banks to test the validity of the law.[31] The Nebraska law had been largely patterned after the Oklahoma law. It is not surprising that the contention of the Nebraska bankers was much the same as that of the Oklahoma bankers in the litigation that had been commenced to test the legality of the Oklahoma guaranty law.[32] Among other things, the bankers contended that the guaranty feature of the law was an arbitrary and capricious exercise of power, in that it takes the assets of solvent banks without compensation and appropriates the same to the payment of private debts of insolvent banks; that it was a taking of property for a private use without due process of law and without compensation; that it was not a proper exercise of the police power, since the police power cannot justify the invasion of any property or contract right of the citizen granted him under the constitution; and that the principle which underlies the bank guaranty deposit laws, when carried to its ultimate legitimate result, means unrestrained socialism in State government.[33]

On June 30, 1909, a few days before the law was to go into effect, Circuit Judge Willis Van Devanter and District Judge Thomas C. Munger granted a temporary injunction restraining the State Banking Board from putting the law into operation. The same judges later decreed that the law

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31 176 Federal Reports 999.
32 Noble State Bank vs. Haskell, 219 U. S. 104.
33 176 Federal Reports 999.

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was unconstitutional and made the injunction perpetual. The judges held that the law appropriated the assets of one bank to meet the obligations of another, and that this was taking the property of one person without compensation to pay the debts of another, in violation of provisions of the Fourteenth Amendment to the Federal Constitution. The case was appealed to the Supreme Court of the United States. The court advanced the Nebraska case and considered it with the Oklahoma[34] and Kansas[35] cases which were pending, and handed down a unanimous decision upholding the constitutionality of all three laws.[36] Justice Holmes in his opinion overruled the decree of Justices Van Devanter and Munger and dissolved the permanent injunction by which they had restrained the State Banking Board from putting the Nebraska law into operation.[37]

The Nebraska law had been in the courts nearly two years. The Attorney-General of Nebraska ruled that the banks would not be required to pay the assessments while the law was in litigation and the State legislature soon after amended the law omitting such assessments and provided that the assessments should begin on July 1, 1911.[38]

During the first ten years of the operation of the Nebraska guaranty law only seven banks failed, with negligible loss to the fund. Then, as was the case in some of the other States, the post-war depression suddenly changed the situation. Nearly one hundred and forty banks failed from January 1921 until March 1928. The fund was placed badly in arrears. In addition to the banks already failed, over seventy banks in weakened condition were in March 1928 being operated by the Guaranty Fund Commission. At that time, when the law had been in operation about seventeen years, over thirty-eight million dollars had been paid to depositors of failed banks, of which amount fifteen millions were paid out of assessments to the guaranty fund.[39]

In 1909, at the time of the enactment of the guaranty fund law in Nebraska, there were 659 State banks, with a capital of $12,000,000.00 and deposits of $71,000,000.00; in 1928

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34 Noble State Bank vs. Haskell, 219 U. S. 104, decided January 3, 1911.

35 Assaria State Bank vs. Dolley, 219 U. S. 121, decided January 3, 1911.

36 Shallenberger vs. First State Bank of Holstein, 219 U. S. 121, decided January 3, 1911.

37 It is interesting to note that the day after his opinion was overruled, Justice Van Devanter was sworn in as an Associate Justice of the Supreme Court of the United States. See, Thomas Bruce Robb, The Guaranty of Bank Deposits, Chapter 5, p. 136.

38 Laws of Nebraska, 1911, Chapter 8.

39 Guaranty of Bank Deposits, in Commerce Monthly of the National Bank of Commerce of New York, Vol. 10, January 1929, pp. 12-15, 27-30.

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there were 739 State banks, with a capital of $19,000,000.00 and deposits of $268,000,000.00. This would seem to indicate great prosperity in the business of State banks in Nebraska. But the assessments exacted of State banks in Nebraska since the year 1920 aggregate in excess of $16,-000,000.00. Since 1920 the number of bank failures has been of alarming proportions: in 1920 the number of State banks was 1009; at the close of the year 1928 there were 739 State banks, 270 State banks having ceased business because of insolvency in the eight-year period. From January 1, 1929 to December 1, 1929, a period of only eleven months, 127 State banks failed.[40]

In December 1928 an injunction suit was begun in the District Court for Lancaster County by the Abie State Bank, in which it was joined by 558 other Nebraska State Banks. The suit was brought to enjoin the collection of a special assessment of one-fourth of one per cent of the average daily deposits from the State banks for 1928. It was alleged by the banks that the special assessment together with the regular assessment to the guaranty fund was of such confiscatory nature as would, in a few years, deplete or wipe out the entire capital stock of the State banks, since such assessments were already exceeding the net annual earnings of the banks.[41] The majority of the State banks, therefore, joined in this suit, and meantime declined to pay further assessments to the guaranty fund.

The special assessment complained of in the Abie State Bank case was made December 15, 1928, by the Department of Trade and Commerce, for the benefit of the depositors' guaranty fund, pursuant to authority conferred by Section 8028, Compiled Statutes of 1922, as amended by Section 26, Chapter 191, Laws of 1923. The Act, as amended, follows:

"If the depositors' guarantee fund shall, from any cause, be depleted or reduced to any amount less than one per cent of the average daily deposits as shown by the last semi-annual assessment statement thereof filed, the department of trade and commerce shall levy a special assessment against the capital stock of the corporations governed by the provisions of this article, to cover such deficiency, which special assessment shall be based on the said average daily deposits, and, when required for the purpose of immediate payment of depositors, said special assessment may be for any amount not exceeding one per cent of said average daily deposits for the year 1923, and thereafter not exceeding one-half of one per cent of said average daily deposits in any one year."

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[40] See briefs for plaintiff and defendant, Abie State Bank et al. vs. Arthur J. Weaver, Governor, et al., Nebraska Supreme Court, No. 27070.

[41] Ibid. See, also, U. S. Daily, IV, 2719, p. 15, December 12, 1929.

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A decision favorable to the banks was handed down by Judge Lincoln Frost of the District Court of Lancaster County, and the case was appealed to the Supreme Court of Nebraska.

In a five to two decision the Supreme Court of Nebraska, on December 7, 1929, reversed the action of the District Court, and held that the special assessments on State banks were not confiscatory, but was a reasonable regulation and not a taking of private property without due process of law. The decision rests on three broad grounds: first, that unless it is clearly shown that a legislative act is against public policy or contravenes clearly a provision of the constitution, the courts have no right to set it aside; second, that similar enactments have been upheld by the Supreme Court of the United States; and third, that the banks, having accepted the benefits of the legislation, and having made much in their advertising campaigns of the protection afforded by the act, cannot now be heard to protest its validity.[42]

A motion for rehearing and ultimate appeal to the Supreme Court of the United States was announced by attorneys for the plaintiff banks.

The exact amount of the guaranty fund deficit at this time cannot be determined for the reason that no one can ascertain exactly the amount of salvage which may ultimately be collected from assets of the failed banks. A legislative committee made an investigation in February 1929, estimating the deficit at over sixteen million dollars. Disregarding the salvage, the fund owes now, according to terms of the law, over twenty-five million dollars, and this is drawing interest at seven per cent per annum, which means that if the law had remained in effect and the assessments had been restored to their maximum, the income from these assessments would have been less than the annual interest accumulation.[43] The Nebraska guaranty fund system was repealed in March 1930.[44]

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42 Abie State Bank et al. vs. Arthur J. Weaver, Governor, et al., Nebraska Supreme Court, No. 27070, December 7, 1929. For record of the case, see United States Daily, IV, 2719, p. 15.

43 Letter to writer from G. W. Woods, Bank Commissioner of the State of Nebraska, November 12, 1929, and letter from L. K. Roberts, Chief National Bank Examiner, Kansas City, Missouri, December 5, 1929.

44 At a special session of the Nebraska legislature held in March 1930, a statute was enacted repealing the guaranty of deposits law; under the terms of the act the Depositors' Guarantee Fund is discontinued, but there is provided an annual assessment of two tenths of one per cent, during a period of ten years, upon the average daily deposits of each state bank for the Depositors' Final Settlement Fund.

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Clark Warburton

The Guaranty of Bank Deposits

Bulletin No. 3

Commission on Banking Law and Practice

Association of Reserve City Bankers

1933

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The Guaranty *of* Bank Deposits

A Report of

The Commission on

Banking Law and Practice

Association of Reserve City Bankers

CHICAGO, NOVEMBER, 1933

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The Association of Reserve City Bankers was organized in 1912 to provide a medium for the exchange of ideas among its members on matters relating to banking law and practice. Its members are located in every part of the United States, and associated with banks whose deposits are in the aggregate over 50 per cent of the total deposits in the commercial banks and trust companies of the country. It is made up not of banks but of bankers as individuals.

The Association has hitherto confined itself largely to what may be termed laboratory work in the field of banking, and has rarely made public the results of its investigations. However, at a meeting held last May, it was decided that the present emergency called for a somewhat different policy. A Commission on Banking Law and Practice was appointed to make a study of recent legislation, and its probable effects upon bank operations, and to undertake an analysis of the banking system as a whole, with recommendations for strengthening the banking structure. The Commission was directed to make its findings public, not with any idea that they would be the final word, but in the hope that they would help to clarify and crystallize opinion on the vital problem of good banking.

The Association desires to cooperate fully with all groups, both State and national, in or out of the banking business, who are working for the same end. It has pledged itself to devote its best efforts to the cause of developing a strong and effective banking system in the United States, no matter how long it may take.

Communications may be addressed to the Secretary of the Association, Joseph J. Schroeder, 162 West Monroe Street, Chicago, Illinois.

The Secretary will be glad to supply additional copies of this Bulletin.

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The Guaranty* of Bank Deposits

PURPOSE OF THE REPORT

Bank failures over a period of several years have brought distressing losses to hundreds of thousands of depositors and have seriously interfered with the business life of the country. The loss of confidence in our banking and credit structure reached such a stage as to endanger seriously our whole economic system and make business recovery impossible.

The situation reached a crisis in March, 1933. Referring to this, the President said in his radio speech of March 12, 1933:

> "What, then, happened during the last few days of February and the first few days of March? Because of undermined confidence on the part of the public, there was a general rush by a large portion of our population to turn bank deposits into currency or gold—a rush so great that the soundest banks could not get enough currency to meet the demand.
>
> "The reason for this was that on the spur of the moment it was, of course, impossible to sell perfectly sound assets of a bank and convert them into cash except at panic prices far below their real value."

(*) "Guaranty" and "Insurance":
In this bulletin a distinction is made between "guaranty" and "insurance" of deposits. The present law refers to the plan as "insurance." But it is not insurance in the generally accepted sense of the word. Insurance implies the protection of a beneficiary through the building up of a fund to which the beneficiary contributes. And the payments or "premiums" are graded in relation to the quality of the risk. These elements are not present in the plan established by the Banking Act of 1933. Consequently, for the sake of clarity, the term "guaranty" has been generally used in this discussion.

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As a result of these conditions depositors demanded safety of their deposits and the business community demanded greater stability in banking. All parties recognized that their difficulties arose out of a defective banking system, and various remedies were proposed.

In an effort to give the depositor safety, restore public confidence in the banking system, and bring about a return of sound business conditions, Congress incorporated in the Banking Act of 1933 provisions for the guaranty of bank deposits. The Act provides for two plans, one temporary and the other permanent. *The temporary plan* guarantees deposits up to $2500 and will operate from January 1 to July 1, 1934. *The permanent plan*, which will become effective on the latter date, guarantees in full all deposits up to $10,000, 75 per cent of deposits from $10,000 to $50,000, and 50 per cent of deposits over $50,000. The losses to depositors of banks which fail will be covered by assessments on the open banks. In the case of the temporary plan the assessments are limited in amount, but in the case of the permanent plan the assessments are *unlimited*, and the open banks may be called upon for any amount necessary to meet losses to depositors of closed banks.

The important question at this time is whether the guaranty plan will in fact cure the defects in our banking system and give depositors the safety which they seek and to which they are entitled, or whether it will prove to have the same defects as the State deposit guaranty systems, all of which collapsed when adverse conditions arose, and failed the depositors at the time they most needed protection. In the opinion of this Commission, while the depositors of the country demanded safety, the great majority did not demand guaranty of bank

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deposits. They were not so much interested in methods as in results. This Commission believes that there are comparatively few persons who, after fairly studying both sides of the case, would favor guaranty as a principle. Practically all its proponents favor it as a means to an end. They believe it will increase public confidence, stop bank failures, and lead to a stronger banking system.

This Commission, after a thorough study of the whole subject, has attempted to present a constructive viewpoint. We recognize fully that the motives of the advocates of guaranty have been in the public interest. They saw a great public wrong, and tried to right it. Furthermore, this Commission believes that bankers should accept a full share of criticism for not standing forth earlier and in full force to reform and strengthen the banking structure. It should be said that there are many obstacles, not only economic but also geographic, social and political, which stand in the way of true banking reform, and it is doubtful if any banking leadership could have brought about remedial action until the defects of our banking system had been demonstrated by recent events.

There are always thoughtful and constructive men who are alive to the existing defects in their respective business systems. But in times of prosperity the average man wants to be let alone. It is only after a period of misfortune that public opinion is aroused to support reform either in law or in practice. It will be recalled that the panic of 1907 led to the appointment of the Aldrich Commission whose efforts laid the groundwork for the banking reforms of 1913. In our judgment, the time is opportune for the appointment of a similar body, under Federal auspices, to make a thorough and im-

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partial study of the banking system, in the light of present conditions, with recommendations which will lead in a gradual way to a sound and permanent structure.

In the meantime, we have found that great numbers of bankers in all parts of the country are thoroughly awake to the necessity not only of maintaining their own banks in sound condition but also of studying the banking system as a whole in the light of their own experience and with a view to permanent reforms. As one contribution toward this result, the present study of deposit guaranty has been made.

CO-OPERATION WITH THE GOVERNMENT

In presenting this report, the Commission is conscious of the responsibility involved in criticising any measure passed by Congress and adopted by the Administration as part of a constructive effort to remedy nation-wide distress. It feels that economic recovery must be the deep concern of every citizen irrespective of party or occupation. Criticism based upon selfish motives is unthinkable in times like these.

However, spokesmen of the Administration have frequently said that it must depend upon expert counsel in producing workable plans in the numerous technical fields dealt with by the recovery program. The basic principle of N.R.A. Codes, including the banking code, is "self-government of business with the government as a helpful partner." The government and the depositors in the banks have a right to expect from bankers an expression of opinion on any law involving the banking business.

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RECOMMENDATIONS

The Commission has considered a number of recommendations along constructive lines, looking toward amendments to existing laws. Other groups are giving careful study to the same subject, and before final recommendations are made it is hoped that the viewpoints of all concerned may be coordinated.

However, we have found a wide-spread interest in the subject of deposit guaranty, and an urgent demand for a discussion of its essential features which might be of assistance in arriving at necessary immediate decisions. Consequently, in view of the short time remaining before January 1, 1934, when the temporary insurance plan takes effect, the following suggestions are offered:

1. The Immediate Government Program. Entirely aside from the question of deposit guaranty, the Commission believes that the program of the government for strengthening the banking structure merits immediate and active support. This can be given by banks in two ways:

(a) through support of the President's appeal for cooperation with the Reconstruction Finance Corporation which is purchasing preferred stock or capital notes, to the amount of approximately $1,000,000,000; and

(b) through assistance to the Federal Deposit Insurance Corporation in its attempt to bring banks into the temporary fund in as sound condition as possible. We are advised that the Corporation has made every possible effort to procure competent examiners. Over a thousand examiners are actively

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> at work. But if several thousand of the 8,500 non-member banks hold back till the last moment no possible effort can achieve satisfactory examinations by January 1, 1934.

In this connection the President said in his speech of October 22, 1933:

> "The Government Bank Deposit Insurance, on all accounts up to $2,500, goes into effect on January 1. We are now engaged in seeing to it that on or before that date the banking capital structure will be built up by the government to the point that the banks will be in sound condition when the insurance goes into effect."

2. The Temporary Insurance Plan. While this Commission does not believe in the principle of deposit guaranty nevertheless it recognizes that (a) an effort is being made to use the temporary guaranty plan as a means toward building up the banking structure to a sounder position; (b) the temporary guaranty plan is limited as to the assessments which can be made upon the banks, its operation is limited to six months, and no bank joining the temporary plan is obligated to join the permanent plan; (c) the wisest way to make progress toward the elimination of the evils of deposit guaranty is to cooperate with the earnest emergency effort being made to strengthen thousands of banks. Certainly no permanent banking reform can be hoped for while the banking situation is in a position of uncertainty. If this uncertainty is substantially eliminated, a breathing space may be created in which the whole problem can be viewed more constructively. On the basis of these considerations the Commission recommends that the banks which are subject to examination prior to January 1, 1934 make

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immediate application for membership in the *temporary* fund.

It should be noted that this temporary plan covering all deposits up to $2,500 insures *in full* approximately 96½ per cent in number of all depositors in banks admitted to the fund. This provision completely protects those depositors who most need protection. It appears to this Commission that if guaranty is retained after July 1, 1934, this temporary plan, in some modified form, would meet every emergency need, and eliminate many of the dangers in the permanent plan.

Even in recommending support of the temporary plan, the Commission would point out that in the very success of any guaranty plan there lurks a fundamental danger. If we find ourselves left with the guaranty plan but not a sound banking system, it will be a disaster. Banks may be temporarily stimulated to the point where they can qualify for the guaranty, but if they are not basically sound and competently managed, if they cannot earn satisfactory profits, they will fail in the end, and impose heavy burdens on the other banks and on the entire business structure. *What we are recommending, therefore, is co-operation in an emergency measure of the sort that has been deemed necessary in almost all branches of our economic life, but we are not, directly or indirectly, endorsing the principle of deposit guaranty.*

3. The Permanent Insurance Plan: "Signing a Blank Check." We urge upon bankers an intensive study of the permanent insurance plan which, under the law, goes into effect on July 1, 1934. We have attempted to set forth in this report its danger to sound banking.

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In effect, it compels the banks which have survived the depression, despite an unsound banking system, to sign a blank check for all losses that may occur in the future. It imposes upon American banking the principle that one bank is as good as another, a proposition which is false. It threatens the high sense of responsibility essential to sound banking. Under our present system, where it has been easy for banks to obtain charters, irrespective of adequate capital or management, and with little prospect of successful operation, it must be obvious that a deposit guaranty system will further encourage the establishment of weak institutions and tend to tear down everything that the government is now trying to build up. It gives the banks no way to protect themselves against mismanagement or fraud on the part of those whose liabilities they are obliged to assume.

The most unfortunate aspect of the permanent guaranty legislation is that it completely ignores the causes of bank failures at a time when the emergency offers a golden opportunity to eliminate those causes once for all. If the guaranty is continued as a permanent measure it will postpone true banking reform indefinitely. It would be one of the greatest tragedies in our financial history if the lessons we have learned in the present depression should lead only to tinkering and to patchwork, and not to a sound and permanent rebuilding of the banking structure. We stand alone among the great nations of the world in not having established a banking system that will safeguard the savings of our people. The banking systems of other nations have achieved safety without deposit guaranty.

In our opinion, the public, and particularly the stockholders and depositors of banks, do not understand this

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permanent guaranty proposal, and when they do understand it they will disapprove it.

4. **Permanent Reconstruction.** We assume that no one who has studied the matter believes that the effort now being made by the government to bring temporary strength to the banking structure is the final step in this direction. It carries out, for the period of the emergency, the pledge given to the nation on March 12, 1933. But clearly what the public demands is banking safety. Both logic and history demonstrate that the guaranty of deposits does not guarantee banking safety. It deals with effects and not with causes.

On July 1, 1934, under the law, it is proposed to place the burden of future banking losses upon the banks themselves without giving the banks the power to control those losses. Instead of correcting the fundamental defects of our banking system, the Act penalizes for their success those banks which have been able to keep themselves in a strong position in spite of an unsound system. It is believed that officials of the government realize that this is not the correct answer. The bankers know it is not. It is the duty of the bankers to demonstrate to the depositors of the banks that there is a better method. *In our opinion, the right way to solve the problem is not to look for someone to assume the losses, but to eliminate them.* It must be shown that the weakness in the present system can be eradicated, and that deposit guaranty merely covers up and even encourages this weakness. Courageous statesmanship will seek the root of the trouble and remove it.

The Commission urges joint effort on the part of the banks and the public for the adoption of a program of

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permanent bank reform. If such a step is not taken while public opinion is aroused, the country may have to wait until the next inevitable economic crisis subjects the depositors of banks to further cruel and wholly needless losses.

If such a step is not taken the government recovery program will be retarded. As was recently said by the Chairman of the Reconstruction Finance Corporation, "I do not believe we can have business recovery, or sustained endurable conditions, without a sound banking system—not just in a few spots, but everywhere in the United States."

There is no vagueness nor uncertainty as to the fundamental elements necessary in a sound banking system. The chief problem is to interpret these factors to the public so that the simple essentials may be generally understood and supported by public opinion. This involves time. It cannot be done hastily.

Obviously, limitations of space make it impossible to discuss permanent reform in this report. But this Commission is formulating a number of constructive proposals and will offer specific recommendations in the near future. Other groups are working toward the same end. Advice is being sought from business men, from the banking officials of the Federal Government and of the various States, and from others interested. In our opinion, such a constructive program will meet an urgent popular demand, and will win the support of the depositors of banks throughout the nation.

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THE PERMANENT INSURANCE PLAN

What the Plan Is.—The Banking Act of 1933 provides for a permanent insurance fund to become operative July 1, 1934, and creates a Corporation with three directors to administer it. Member banks of the Federal Reserve System are required to participate, while non-member commercial banks and mutual savings banks may participate by meeting specified requirements. The Corporation will have a subscribed capital of between $450,000,000 and $500,000,000 of which about one-third will be paid in and the remainder subject to call by the Corporation. The Treasury of the United States will subscribe for $150,000,000 and the Federal Reserve Banks for about $139,000,000. Banks participating in the fund will subscribe an initial amount equal to one-half of one per cent of their total deposit liabilities. One-half of each bank's subscription is payable when its application for stock is granted and the other half is subject to the call of the Corporation.

Before a national bank is admitted, the Comptroller of the Currency must certify on the basis of a thorough examination that its assets are adequate to meet all liabilities to its depositors and other creditors, and before a State member bank is admitted the Federal Reserve Board must make a similar certification. Under this certification, a bank may have its capital impaired or wiped out and still be admitted into the fund, although, as we understand the Federal Reserve Act, no bank with

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impaired capital can be admitted to the Federal Reserve System.

Non-member banks, other than mutual savings banks, which are operating on an unrestricted basis number about 8,500 and have deposits of something over $5,000,000,000. If these banks are admitted to the temporary fund they can secure the benefits of the permanent fund until July 1, 1936, by subscribing to stock in the Corporation on the same basis as member banks. Before they are admitted to the temporary fund, their respective supervisory authorities must certify that they are solvent and they must be examined by the Corporation. After July 1, 1936 they must qualify for membership in the Federal Reserve System or retire from the insurance fund.

The deposits of all mutual savings banks aggregate nearly $10,000,000,000. If the mutual savings banks as a whole remain out of the fund, the total deposits of all banks participating in the guaranty plan will probably be between thirty and thirty-four billion dollars, say thirty-two billions as a working basis.

Amount of Deposits Insured.—The Act provides 100 per cent guaranty on the amount due each depositor not exceeding $10,000; 75 per cent guaranty on the amount in excess of $10,000, but not in excess of $50,000; and 50 per cent guaranty on the amount in excess of $50,000. In the case of member banks of the Federal Reserve System, guaranteed deposits will aggregate about 79 per cent of total deposits, but for large banks the proportion will be less than for small banks. It is estimated, for example, that only about 60 per cent of the deposits of some of the largest banks will be guar-

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anteed, while in some of the smaller banks nearly 100 per cent will be guaranteed. All banks, however, are assessed on their total deposits.

It will be possible, of course, for depositors to split their accounts among a number of banks in order to secure a larger coverage. In practice, therefore, the ratio of guaranteed deposits to total deposits may be higher than the above figures indicate. No data are available showing the classification of non-member bank deposits by size of account. The great majority of these are small banks with few large accounts and it is probable that 90 to 95 per cent of their deposits will be guaranteed if they are admitted to the fund. For mutual savings banks the figure would probably be nearly 100 per cent.

Possible Cost to Participating Banks.—In addition to the capital requirements already mentioned the Act imposes an unlimited contingent liability on all participating banks. There is no limit to the number of assessments which may be levied against the open banks to meet the losses of the closed banks. It is of interest in this connection to note what would have been the probable cost to banks during the twelve years 1921-1932 if this guaranty plan had been in effect during those years and if all State and national banks had participated. This is shown in the table on the following page.

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Estimated Losses to Depositors of State and National Banks Which Suspended During 1921–1932
Exclusive of Mutual Savings and Private Banks—Amounts in Millions of Dollars

Year	Deposits of Active Banks June 30	Capital Funds of Active Banks June 30	Deposits of Banks Suspending	Estimated Loss to Depositors of Failed Banks (1)	Estimated Loss Which Would Have Been Borne by the Guaranty Fund (2)	Ratio of Losses to Deposits of Active Banks (%)	Ratio of Losses to Capital Funds of Active Banks (%)
1921	$32,948	$5,884	$163	$56	$50	0.15	0.85
1922	35,193	5,987	89	31	27	0.08	0.46
1923	37,818	6,177	146	50	45	0.12	0.73
1924	40,884	6,373	202	69	62	0.15	0.98
1925	44,704	6,580	160	55	49	0.11	0.75
1926	46,346	6,954	250	86	77	0.17	1.11
1927	48,534	7,331	195	67	60	0.12	0.82
1928	49,645	7,879	139	48	43	0.09	0.54
1929	48,796	8,513	223	76	69	0.14	0.81
1930	50,550	8,943	822	281	253	0.50	2.83
1931	46,770	8,326	1,669	571	514	1.10	6.17
1932	35,311	7,039	698	239	215	0.61	3.05
Total	$517,499	$85,986	$4,756	$1,629	$1,464	.....	.....
Annual Average for 12 Years	$43,125	$7,165	$397	$136	$122	0.28%	1.70%

(1) Estimated on the basis of experience at 11 per cent of the deposits of reopened banks and 40 per cent of the deposits of banks placed in liquidation.

(2) Estimated at 90 per cent of the total loss to depositors because of the predominance of small institutions among failed banks.

Note.—The losses in the failed banks during recent years do not tell the whole story because many insolvent banks were kept open temporarily until the crisis of 1933. See following pages for discussion of this subject.

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Under a loose banking system the losses even under average conditions would be a heavy burden for the banks as a whole. But the true test of a guaranty fund will come in periods of crisis. It must weather the storms of panic and depression if it is to prove its worth. During the lifetime of men now living there have been four or five major crises which have severely tested our banking system, and there is nothing to indicate that these periodical tests will not continue in the future. Only in periods of depression, and under the influence of the uncertainties created by an unsound banking system is there any demand for deposit guaranty. It is when most needed that deposit guaranty breaks down.

The table on the following page shows the estimated losses which would have been borne by the guaranty fund if it had been in effect during the three years 1930-1932.

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Estimated Losses to Depositors of State and National Banks Which Suspended During 1930–1932

(Exclusive of Mutual Savings and Private Banks)
(Amounts in Millions of Dollars)

Year	Deposits of Active Banks June 30	Capital Funds of Active Banks June 30	Deposits of Banks Suspending	Estimated Loss to Depositors of Failed Banks (1)	Estimated Loss Which Would Have Been Borne by the Guaranty Fund (2)	Ratio of Losses to Deposits of Active Banks (%)	Ratio of Losses to Capital Funds of Active Banks (%)
1930	$50,550	$8,943	$ 822	$281	$253	0.50	2.83
1931	46,770	8,326	1,669	571	514	1.10	6.17
1932	35,311	7,039	698	239	215	0.61	3.05
Annual Average for 3 Years (3)	$44,210	$8,102	$1,063	$364	$327	0.74%	4.04%

(1) Estimated on the basis of experience in prior years at 11 per cent of the deposits of reopened banks and 40 per cent of the deposits of banks placed in liquidation.

(2) Estimated at 90 per cent of the total loss to depositors because of the predominance of small institutions among failed banks.

(3) The losses in the failed banks during the above years do not tell the complete story because many insolvent banks were kept open temporarily until the banking crisis of 1933. If the banks which have been placed in liquidation in 1933 or reorganized because of financial difficulties, and the banks still operating on a restricted basis, had all closed under a guaranty plan such as the one provided for in the Banking Act of 1933, their losses, plus those shown above for the years 1930–1932, would probably have amounted altogether to about 8 per cent of the deposits of all banks now operating on an unrestricted basis, or about 48 per cent of their capital funds.

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According to the table on the opposite page the estimated losses borne by the guaranty fund during the three years would have averaged *annually* three-quarters of one per cent of the deposits and 4.04 per cent of the capital funds of active banks.

These losses for several reasons are undoubtedly understated. In the first place, banks failing during the depression years, as a rule, have paid smaller dividends to depositors than those failing during prior years, on the basis of which the above estimates were made.

In the second place, many of the banks which have closed and reopened in recent years have scaled down their deposits substantially in reorganizing, and the losses to depositors would average much higher than the statistical experience of reopenings in former years would indicate. A tabulation of the reopened State banks in one State since March 4th of this year, for example, shows a scaling down of deposits ranging from 20 to 65 per cent.

Moreover, the losses in banks which closed during the three years referred to in the above table, do not complete the story. Many insolvent banks were kept open temporarily by various methods until the banking crisis developed in March of this year. The deposits of banks which are still operating on a restricted basis aggregate nearly $2,000,000,000. Many have been reopened by putting in new capital and scaling down deposits. Others will be reopened in the same manner. Substantial amounts of new capital must have been put into shaky banks by directors and stockholders in order to keep them from closing. The question naturally arises whether such sacrifices would have been made if deposits had been protected by a guaranty plan.

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If the deposits of those banks which have been placed in liquidation since the first of this year or reorganized and placed on an operating basis by the infusion of new capital, and, in many cases, the scaling down of deposits, and the deposits of those banks still operating on a restricted basis, are added to the deposits of those banks which failed during 1930-1932, the total would amount to nearly $7,000,000,000. If all those banks had closed under a guaranty plan such as the one provided for in the Banking Act of 1933, the losses falling on the fund would probably have aggregated over $2,500,000,000. This amount is equal to about 8 per cent of the deposits of all banks now operating on an unrestricted basis, and about 48 per cent of their reported capital funds. In many individual cases where the ratio of capital funds to deposits is small, the burden would have been equal to 75 or 100 per cent of capital funds.

Take, for example, a bank with $50,000 capital; $50,000 surplus and $1,000,000 deposits. Assessments aggregating 8 per cent of deposits would wipe out the entire surplus and all but $20,000 of the capital. In the case of this bank an assessment of one per cent a year on the deposits would equal 20 per cent of capital or 10 per cent of capital and surplus. Many banks upon which these assessments would have been levied already had their capital impaired and the additional burden might have placed more institutions in the insolvent class, thus greatly narrowing the basis for assessments. These results would have been cumulative as failures continued, with the burden falling upon fewer and fewer banks.

The past record is no indication, of course, as to what future losses may be. There is no basis for estimating future losses, and the above figures are given merely to

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indicate what can happen to the fund in periods of depression under the present banking system. But in the judgment of many persons the losses here estimated would be increased, in our present loose banking system, under a guaranty plan, because of the tendency toward careless and irresponsible banking which deposit guaranty induces.

The Administration is making strenuous efforts to rebuild the capital structure of banks before the guaranty plan begins to operate. But there is no assurance that the banks which enter the guaranty fund will all be in strong condition. Despite the most heroic efforts, the problem of examining thoroughly and permanently strengthening the capital structure of 8,500 non-member banks before January 1, 1934, or even before July 1, 1934, is a very real one. Under the terms of the law, banks may enter the permanent guaranty fund with impaired capital or even without capital, if the supervisory authorities certify that their assets are sufficient to meet liabilities to depositors and other creditors. Under the law, if a bank fails after entering the guaranty system, its insured deposits must be paid in full. The Insurance Corporation immediately organizes a new bank. If the bank fails a second time the guaranty fund bears the losses again.

Although nearly one-half of the banks of the country have been eliminated since 1920, there are still many uneconomic units in our banking structure. A bank which does not earn a fair average rate of return over a period of years not only is unable to build up reserves against bad times, but, in order to improve profits, is under constant temptation to take risks which in the end are likely to lead to failure.

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The tendency of a guaranty plan will be to nurture these unprofitable units and keep them going temporarily in the knowledge that upon failure the losses can be shifted to other banks. Because the depositors are protected, a bank which cannot justify its existence economically might continue to operate and accumulate losses. Such banks are a constant menace to the system as a whole.

These factors must all be taken into full consideration in estimating the possible cost of the guaranty plan during another period of depression.

If all commercial banks now open were to take stock in the Insurance Corporation, the deposits represented would be in the neighborhood of $32,000,000,000. The capital funds (capital, surplus and undivided profits) of these banks, as shown on their books, will probably aggregate $5,500,000,000. On the basis of these figures the following table has been prepared to indicate roughly the estimated cost to the guaranteed banks under certain assumptions.

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Estimated Cost to Insured Banks Under Certain Assumptions as to Failures[1]

Assuming Deposits of Failed Banks Aggregate	Estimated Losses (40 Per Cent of Deposits)[2]	Assessments on $32,000,000,000 of Deposits (Per Cent)	Ratio of Assessments to Reported Capital Funds (Per Cent)
$1,000,000,000	$ 400,000,000	1.25	7.27
2,000,000,000	800,000,000	2.50	14.55
3,000,000,000	1,200,000,000	3.75	21.82
4,000,000,000	1,600,000,000	5.00	29.09
5,000,000,000	2,000,000,000	6.25	36.36
6,000,000,000	2,400,000,000	7.50	43.64
7,000,000,000	2,800,000,000	8.75	50.91

[1]Assuming that banks belonging to the fund will have deposits of $32,000,000,000 and capital funds of $5,500,000,000.

[2]This 40 per cent loss is a very rough estimate based on past experience of liquidated banks. The reopened banks have shown smaller losses. Furthermore, it is estimated that only about 90 per cent of the losses under the present plan will fall on the guaranty fund. In view of different conditions, however, and especially the fact that the method of handling closed banks under the guaranty fund will be quite different from past methods, any estimate as to percentage losses must of necessity be little more than a guess. The above table is given merely as an indication of possible results.

In the case of those banks with a low ratio of capital funds to deposits, the assessments would represent a higher proportion of capital funds than indicated above. The State banks of a typical middle-western agricultural State had a ratio of capital funds to deposits of about 1 to 7 at the time of the latest available condition report. In the case of these banks the assessments on deposits as shown in the preceding table would affect the capital funds as follows:

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Ratio of Assessments in Previous Table to Capital Funds of State Banks in a Typical Middle-Western Agricultural State

Assessments on Deposits (Per Cent)	Ratio of Assessments to Reported Capital Funds (Per Cent)
1.25	8.75
2.50	17.50
3.75	26.25
5.00	35.00
6.25	43.75
7.50	52.50
8.75	61.25

Any bank may readily calculate the ratio of assessments to its own capital funds on the following blank table:

Deposits of Bank	Rate of Assessments on Deposits	Amount of Assessments	Capital Funds of Bank	Ratio of Assessment to Capital Funds (Per Cent)
	¼%			
	½%			
	¾%			
	1%			

Earnings and Assessments.—The assessments against the banks which are suggested by the advocates of deposit guaranty sound disarmingly small when stated in terms of a fraction of one per cent of deposits. But to get a fair perspective of these assessments they must be measured against the earnings of the banks. The banks of the country as a whole have not shown high earnings. For the decade ending in 1930 the average annual net profits for all national banks was 7.3 per cent of capital funds, which is equivalent to about 1.25 per cent of the

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average amount of deposits. For the fiscal year ending June 30, 1931, the rate of net profits on capital funds was only 1.4 per cent, and for the fiscal year ending June 30, 1932, national banks as a whole showed a net loss of $140,000,000. For the fiscal year 1933 the net loss was probably even greater. There is no evidence that the earnings record of State banks has been any better than that of national banks.

Burden Falls on Small Banks as well as Large Banks. — In total amount the large banks will pay the bulk of the assessments. But it should be noted that pro rata the small banks pay just as heavily as the large banks. And the small banks are often in a position where they cannot afford to pay.

The greatest problem of most small banks has been, for many years, to earn their operating expenses, and there is no doubt that this will be a real problem for several years to come. Even under more prosperous conditions many of the small banks were unprofitable. During the years 1926-1930 all national banks in the country with loans and investments of less than $500,000, earned collectively about two-thirds of one per cent annually on their aggregate deposits. *An assessment of one-half of one per cent would have taken nearly 80 per cent of the earnings of this group of banks in those years.* At that time nearly 60 per cent of the banks of the country (State and national) were in that size group and probably over 50 per cent are still in that size group. For the past two years these banks have been operating deep in the red. Furthermore, the saving to these institutions through the non-payment of interest on demand deposits will be negligible. In fact, they will

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lose interest on their balances carried with correspondent banks.

It is obvious that annual assessments might prove exceedingly burdensome to the great majority of small banks even in normal years. In depression years, when earnings decrease or disappear, the assessments would be paid mostly out of capital funds.

Interest on Deposits.—Under the provisions of the Banking Act of 1933 member banks were prohibited from paying interest on demand deposits. It was the motive of the framers of the bill to discourage competition in interest payment, which has worked against conservative banking, and to provide a saving to the banks which would enable them to write off losses and build up capital structure. They also had in mind that the measure would provide funds out of which to meet the assessments under the guaranty plan. For many years there has been considerable sentiment among bankers against indiscriminate payment of interest, and there are many reasons why restrictions should have been imposed earlier. Competition between banks in interest payment has undoubtedly been a source of weakness in the banking structure. It has led many banks to purchase high yield securities and to make loans at high rates of interest. It has also doubtless been one of the factors which has prevented many banks from writing off losses as they occur or from building up the necessary surplus to meet emergency conditions.

Figures have been presented by the Comptroller of the Currency which indicate that interest paid on demand deposits by member banks has averaged $246,000,000 per annum during the past five years. For the

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past year, however, payments probably amounted to less than one-third of that amount. There is little basis as yet for estimating the amount of saving from this source which might be available for assessments, because there are many offsetting factors to be considered. It is very obvious, for example, that many banks are becoming more cautious in their loan and investment policies, with the result that they will probably show lower earnings in proportion to assets. Moreover it will take many years for even some of the good banks to write off accumulated losses and build up the necessary surplus for safety. A more rigid policy of writing off future losses as they occur will probably further reduce earnings. It should also be noted that many banks have never paid interest upon demand deposits, and as a result will have no saving under the new law.

There has been a substantial shifting from demand to time deposits since the law went into effect, but there is no basis for estimating the extent to which this shift may continue. With the return of more normal conditions the large depositors doubtless will demand compensation in some form, such as lower interest rates on loans or additional services of some kind. There may also be a shift of funds from deposits to active uses. Many large depositors may invest their funds directly rather than keep them on deposit at no interest. Others may deposit their funds abroad where interest is paid.

In view of all the above factors, it is not possible to estimate with any degree of accuracy what the saving on demand deposit interest may be. *Above all, the fact stands out that a sound banking system cannot be developed without adequate profits with which to build reserves and to pay dividends.* In recent years the earn-

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ings of banks as a whole have been inadequate for the safety of the system. It seems clear that the saving effected through non-payment of interest on demand deposits should first of all be applied to building up the depleted capital structure of the banks. At the highest estimate, such saving will not provide reserves adequate to meet heavy assessments under deposit guaranty.

Geographic Distribution of Losses and Assessments.—In some sections of the country failures have not been so numerous as in other regions. But the banks in the regions with the most successful records will be assessed to pay for the losses in other regions. The middle Atlantic States, for example, will pay about 44 per cent of the assessments, but in the past they have sustained less than 20 per cent of the losses. New England will pay nearly 8 per cent of the assessments, but has sustained less than 4 per cent of the losses. The estimates of assessments and losses sustained by geographic districts is shown in the following table:

ESTIMATED ASSESSMENTS AND LOSSES BY GEOGRAPHIC DIVISION

Geographic Division	Per Cent of Assessments in Each Division to Total Assessment	Per Cent of Losses in Each Division During 1921-1931 to Total Losses
New England	7.6	3.7
Middle Atlantic	44.0	20.0
North Central	18.6	21.9
Southern Mountain	3.5	5.8
Southeastern	2.8	13.7
Southwestern	4.3	7.0
Western Grain	8.0	20.7
Rocky Mountain	1.8	4.5
Pacific Coast	9.4	2.7
United States	100.	100.

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Mutual Savings Banks.—If the mutual savings banks should all join the fund it would, of course, add about $10,000,000,000 to the amount of deposits to be insured, and increase the base for assessments by the same amount. The extent to which this might affect the assessments in all banks would depend upon the future failure record of mutual savings banks as compared with commercial banks. In the past there have been few failures among mutual savings banks.

It is, of course, a fact that all assessments levied on mutual savings banks would have to be paid out of depositors' funds, since they have neither stockholders nor capital stock. In strict accuracy payments would be made out of surplus or reserves, but these reserves are a cushion behind the deposits and belong to the depositors. Their position in this respect is different from that of the commercial banks, where the assessments will be paid out of capital funds. This raises the fundamental question as to whether in any guaranty plan the assessments should not fall upon the beneficiary in all cases and be determined according to the quality of the risks insured.

Guaranty is not Insurance.—In the law as written the guaranty plan is referred to not as a guaranty of bank deposits, but as an insurance plan. There is nothing in this plan that entitles it to be classed as insurance. Insurance involves an old and tried principle. The essence of insurance is the payment *by the insured* of premiums in *actuarial relation to the risk involved.* Under the terms of the permanent plan, however, the costs or premiums are not charged according to the risk. There is no penalty for bad management. If the premium could be assessed according to hazard, the insurance plan might be used as an instrument of reform. The cost to

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the badly managed bank or the uneconomic bank would be so high as to force the changes, reorganizations or reforms necessary to secure lower premiums.

Furthermore, the stockholders of the Federal Deposit Insurance Corporation who will pay the cost of the insurance have no voice in the management of the Corporation and no vote in determining the risks to be covered.

Another feature of the guaranty plan which departs from insurance principles is that the heaviest burden falls upon banks during periods of adversity. In periods of prosperity there will be few failures and few assessments, but no provision is made for building up a reserve fund as would be the case under a true insurance plan. When adversity comes and each bank is having its own troubles, the additional burden falls.

The Commission has received scores of suggestions, mostly from businessmen rather than bankers, with regard to various forms of deposit insurance under which the protection would be paid for, either voluntarily, or involuntarily, by those receiving the protection. Some have suggested that the borrowers should pay the premium. Others believe that the depositors should pay it. In the Steagall bill as introduced into the House of Representatives on May 10, 1933, it was proposed to charge the borrower ¼ of 1 per cent on the face amount of his loans.

While some form of insurance might appeal to common sense as fairer than the outright guaranty, and thus tend to relieve the banks of an unfair burden, any such plan might still encourage the lack of responsibility and the unsound practices characteristic of all deposit guaranty or insurance. We believe all such plans are basically so unsound in principle that they cannot be made by

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any device whatever to take the place of good banking. They all appear to accept the existing evils as incurable and merely look about for someone to pay the bill. However, this proposal of genuine deposit insurance will be given further study by this Commission and others interested.

Public Confidence.—The present guaranty plan was designed to protect depositors, especially small depositors, from losses, and to restore confidence in the banks, thereby reducing failures to a minimum. But the banking difficulties experienced during the past twelve years have not been due to a mere lack of confidence on the part of the depositing public. Unfortunately the trouble is much more fundamental. If the same banking structure and the same quality of banking are allowed to continue, the guaranty of deposits may postpone the date of closing in some cases but it can hardly be expected to obviate ultimate losses, because no bank can operate indefinitely with bad assets and no profits. It will be recalled that none of the State guaranty systems inspired sufficient confidence to prevent failures so numerous and heavy as in every instance to bankrupt the systems.

Guaranty of Deposits does not Guarantee Good Banking.—When banks which have little chance of ultimate success are taken into a guaranty fund, it will be the hope of the managers of the fund to build up these units to a position of safety. But against this desire there is a dangerous trend in the opposite direction. For it appears to be a fundamental fact of human nature that if a man is operating under a scheme whereby someone else is obliged to make good his losses, he will not be as careful as he would be if his losses fell upon himself,

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and upon the funds for which he is a trustee. A banker is subject to the most subtle influences tending toward weakening his best judgment. He must face every kind of social, personal and political appeal. The local pride of the community favors business development. This means pressure on the banker to make loans which are in excess of what he believes to be sound. In the last analysis, the firm foundation upon which safe banking must always rest is the absolute independence of judgment which a banker applies to the lending of the funds entrusted to his care. Any influence which tends to weaken this independence of judgment strikes at the root of the banking structure.

It is this line of thought that has impressed so many men who have given deep study to deposit guaranty plans. Under our banking system, which has permitted the promiscuous granting of bank charters, the tendency to unsound banking has been definitely and directly increased by the guaranty. It is impossible not to sympathize with the public spirited men who have felt a deep sense of responsibility for the millions who have been injured by bank failures. Bank failures must be stopped. On this point all men must agree. But those who advocate deposit guaranty stop short of the true and courageous remedy. To prescribe the true remedy requires a knowledge of a complex business which comparatively few public men have the time or inclination to master. Through the guaranty of deposits they are quite unintentionally proposing a remedy which may destroy what they are so earnestly working to save.

State Guaranty Plans.—The history of guaranty plans is a black chapter in our banking records. In a detailed

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study of the eight State guaranty systems adopted and abandoned in the last twenty-five years, which was recently issued by the Economic Policy Commission of The American Bankers' Association, the following comment is made:

> "These lessons of experience appear to demonstrate conclusively that in practice the guaranty of deposits plan generally tended to induce an unsound expansion in the number of banks and the volume of bank deposits under its supposed protection. This was clearly connected with the indiscriminate popular confidence created toward the banks under the guaranty. Unneeded, undersized and unsound banks, as well as unqualified bank operators, were enabled to command public patronage because of the belief that the banks in the State system were guaranteed by the State and therefore the depositor could not lose."

Without exception these plans failed. They failed because instead of strengthening the banking system of each State they weakened it. They cost the banks and the public vast sums of money. They came to an end because the sound banks found it impossible to pay further assessments without weakening their position beyond the point of safety. The bankers and the public in each of these States regret that the experiment was tried, except as demonstrating its futility to accomplish its purpose.

It has been argued that the admitted complete failure of all the State guaranty systems, without exception, is no proof that such a plan would not succeed when put into operation on a national scale. It is suggested that many of the State systems lacked a diversification of risk, and that a single crop failure could shake the stability of all the banks in a State. On a national scale

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the plan would operate upon a broader base. This is true. A Federal guaranty plan would embrace strong units. But it would also take in many weak units. It would have all the liabilities instead of only part of them. And from the deeper viewpoint, the evil tendencies inherent in the conception of guaranty, whereby the unsuccessful pass along their failures to others, are still present. Human beings are the same under a national plan as under a State plan. A State plan may fail, and its losses will be restricted to a small area. But under the present Federal law, with its inevitable leveling down of all the good banks, we face the more alarming threat of the breakdown not of a single restricted group of banks, but of all our banks.

The following table presents the salient facts on the experience of the various State deposit guaranty systems. These figures are taken from the publication of The American Bankers' Association referred to above.

The plans prospered in good times and failed with large unpaid deficits in bad times. They were all discontinued by repeal or otherwise.

RESULTS OF STATE GUARANTY PLANS

State	Duration	Type	Total Assessments	Final Deficit
Kansas......	1909–1929	Voluntary	$2,685,000	$7,175,000
Mississippi...	1915–1930	Compulsory	1.2% of capital	5,000,000
Nebraska....	1911–1930	Compulsory	$17,700,000	22,000,000
North Dakota	1917–1929	Compulsory	2,000,000	14,000,000
Oklahoma....	1908–1923	Compulsory	3,700,000	7,500,000
South Dakota.	1916–1931	Compulsory	....	36,769,000[3]
Texas........	1910–1927	Choice (1)	15,000,000[2]	....
Washington..	1917–1921	Optional	(4)	....

(1) Choice between joining fund or posting bond equal to capital.
(2) For period 1920–1925.
(3) As of June 30, 1930.
(4) Because of the failure of one large bank in 1921 the plan broke down and the banks withdrew, but the law was not repealed until 1929.

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Stockholders of Banks.—In a true perspective of the banking problem the stockholder has an important place. It is his money which makes the venture possible at the outset, and it is his money which is in the forefront of the risk. The stocks of even the best banks are now selling at low prices. There has been general weakness during the past few years, increasing during the past few months. We have tried to find the causes of this weakness by inquiry of bank stockholders. The reasons given may be classified under three principal heads:

(1) Investors in bank stocks have been moved by the general uncertainty of the times, the failure of many banks, and the indiscriminate and partly unwarranted criticism of all bankers, in the press, in Congress, by public officials and by the public.

(2) Fear has been aroused by the public pressure put upon banks to lend money against their best judgment. The stockholder fears any influence which may be exerted in the direction of unsound use of the funds of the bank.

(3) Stockholders fear the effects of the guaranty law. Many are quite free in saying that they will not leave their money at the risk of any business which is subject to an unlimited contingent liability. Many who have given close study to the assessments which may, under the present law, be charged against the banks whose stock they hold, have made up their minds to sell unless the unlimited assessment feature is changed. This position, while it may appear radical, is certainly understandable. They see the possibility that their banks will be liable for losses up to the full amount of their capital funds. They can hardly be expected to sit idly by and submit to the confiscation of their life savings.

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Another factor to which stockholders must give consideration is the expressed opinion of lawyers that if the assessments upon a bank were to exhaust its capital funds the stockholders would be subject, under the national banking law and many State laws, to double liability to make the assessments good.

It is the feeling of this Commission that the unlimited assessment clause in the banking law is the greatest obstacle to the declared desire of the Administration "to strengthen the capital structure of the banks." The desired result obviously is to build up a banking system which will run on its own power without artificial stimulation. The money now being put into the banks by the government will not by itself accomplish this result. In the long run, unless the banking business can be made sound enough to attract capital on its merits our problem cannot be solved.

Restriction of Credit.—Heavy guaranty assessments on the banks would compel them to press for payment of loans, curtail credit and sell securities, thus forcing business contraction, driving down prices, and weakening many banks which might otherwise have remained in sound condition.

CORRECTING FUNDAMENTAL DEFECTS

It seems to this Commission that the time has come for all bankers, large and small, to unite in an effort to accomplish the ends which we all know to be sound. There may be differences of viewpoint as to methods. The problem involved is a social problem as well as a banking problem. But on one point we must all be in agreement, namely that there must be sound banks, at whatever necessary sacrifice of personal preferences. If

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a sincere effort is made to work together with this one primary purpose in view, the effort cannot fail. It should be clearly recognized that no program supported by bankers alone will prevail. But if the facts and principles of a sound banking system are understood and approved by the stockholders and depositors, the necessary reforms may be effected.

The essential elements of such a system are well-known to all students of the subject. The only question is whether or not the public wants sound banking and will submit to the changes necessary to its establishment. The fundamentals of a sound banking structure will be discussed in the next bulletin of this Commission.

In conclusion, it would seem necessary for all responsible citizens to lay aside political or other prejudices and to admit the vital importance of the problem here presented and the enormous potential dangers which it involves. The problem is sufficiently critical to command the most careful thought of every member of this Association and of the public. The authorities in Washington are working tirelessly to carry out the heavy burdens imposed upon them by the law. They have indicated, as have many members of Congress, that they will welcome constructive suggestions on this subject. We urge that the matter be given immediate attention.

Suggestions are requested and may be addressed in care of the Secretary, Joseph J. Schroeder, 162 West Monroe Street, Chicago, Illinois.

COMMISSION ON BANKING LAW AND PRACTICE
ASSOCIATION OF RESERVE CITY BANKERS.

November, 1933.

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REPORT OF SAVINGS BANKS COMMITTEE

The Banking Act of 1933 made mutual savings banks eligible to apply for membership in the Deposit Insurance Corporation. The mutual savings banks of the country are one of the most powerful groups in the country, represented by banks in seventeen States, with approximately thirteen million depositors. They have been entrusted with the savings of these depositors in the amount of ten billion dollars, or nearly one quarter of the total bank deposits in the United States. During the past fifty years the losses to depositors in mutual savings banks have been so small as to be negligible. For these reasons, the viewpoint of the committee of savings bankers who studied the guaranty plan is of unusual interest.

The following is taken from a report of the Committee on Deposit Insurance, of the Savings Banks Association of the State of New York, October 17, 1933.

> The welfare of our depositors is inextricably bound up with the welfare of the nation. Our Institutions are not only holders of first mortgages on real estate throughout the State of New York which have in general survived the depression remarkably well, they are, quite properly, large holders of government, state and municipal securities and particularly of railroad bonds. The railroads in which we have investments reach into every important agricultural, industrial and commercial section of the country. Our depositors are accordingly directly interested in the financial and general business recovery of the nation. Nor do we lose sight of the facts that New York State has the largest population of any State in the Union, that the wages and salaries of our fellow citizens in this State are in large measure dependent upon business conditions throughout the rest of the country and that our six million accounts

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represent the savings of a thorough cross section of those who live in our State.

Your Committee would, accordingly, be unworthy of its responsibilities if it failed to look upon the problem of Deposit Insurance from a nationwide point of view.

Viewed from this aspect, we reach an obvious conclusion. We are in complete sympathy with the determination of the government in Washington to develop and maintain an indisputably sound banking structure. We believe this to have been the clear purpose of Congress when it included Deposit Insurance in the Banking Act of 1933. We endorse the principle that banks of all kinds should be so managed and so controlled that no depositor should be subject to the fear or of the fact of losing any portion of his deposit. We believe that the recovery of business and the building of the foundations for a better standard of living throughout the country are in a large measure dependent upon a thoroughly safe banking structure the purpose of which will be to stimulate industry, agriculture and commerce without imperilling the integrity of the depositors' money.

We recognize the need for unusual steps in order to speed the accomplishment of those objectives. We are convinced, moreover, that increasing efforts will be made to draw the attention of depositors to deposit insurance.

But your Committee does not believe that deposit insurance is the proper solution of the banking problems in the country. It is, however, the only solution offered by the existing law of the land.

Because of the foregoing and because of the safeguards with which we find that the authorities in Washington propose to endeavor to protect funds paid into the Deposit Insurance Corporation, your Committee believes, with certain definite reservations hereinafter set forth, that every savings bank in the State of New York should consider joining in this nationwide

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step as a measure designed to promote recovery. It is a significant fact that, according to the information we have obtained both here and in Washington, every savings bank in the State can qualify for membership in the Deposit Insurance Corporation.

We suggest, therefore, that the special meeting of the Association should consider joining the temporary insurance plan which becomes operative in January 1934, with the proviso, however, that a special committee of this Association will be formed at once to prepare a comprehensive report before Congress reconvenes which will point out the many ways in which the holders of six million savings accounts in this State, not to mention the holders of seven million other savings accounts in mutual savings banks in other States, will be subjected to grave injustice unless material changes are made in the Banking Act of 1933.

Certain facts appear clear to us:

A—The ultimate solution of our banking problems can and will be found through some means other than Deposit Insurance, and that in the meantime,

B—The unlimited liability feature in the permanent insurance plan is manifestly unsound.

C—Based on actuarial records, mutual savings banks are clearly a preferred risk and should be treated as such.

D—Savings Banks whose legal maximum deposit is $7,500 should not participate in insuring the amounts by which deposits in other institutions exceed this figure.

E—In the event that we should ever want to or be obliged to join the Federal Reserve System, provisions should be set up for the sake of all concerned, recognizing the fundamental differences of purpose and of structure between mutual savings banks and other Banks and Trust Companies.

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In recommending the formation of a Committee to deal with these questions, we specifically recommend that such committee should

A—go beyond criticism of existing laws and develop constructive suggestions for proper legislative action designed to accomplish the purpose of the existing law as we understand it, at the same time eliminating its unsound features, and

B—cooperate with the proper representatives of mutual savings banks in other States as well as other bankers, representatives of the Administration and legislature who may be charged with the responsibility of developing a well integrated and sound banking system in this country.

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COMMENT ON DEPOSIT GUARANTY

"What hope can there be that a guaranty of the deposits of the member banks of the Federal Reserve System will be any more workable and satisfactory to either the banks or their customers, than the guaranty systems attempted by the different States for State banks? In my judgment, the guaranty of bank deposits, if carried out in this country to its logical conclusion, will completely destroy the entire banking system of the nation.

"Talk about guaranteeing bank deposits is but political salve to a wound that needs a business caustic. The principle of guaranty is not the answer, because relaxing of vigilance on the part of bank officers is the inevitable psychological effect. The guaranty of bank deposits is the start of a vicious circle that is ruinous to depositor and stockholder alike."

—Governor Landon of Kansas, *in an address made on September 2, 1933, to the Kansas bankers. (The guaranty of deposits was tried in Kansas. This statement is, therefore, of special interest).*

"If the experience of guaranteeing bank deposits previously obtained ranging over a period of 23 years in eight of our American States, in all of which the deposit guaranty system failed, is any criterion, the burden upon the guaranty fund is likely to increase as time goes on, rather than diminish. If the deposits of most depositors are as safe in one bank as in another, by reason of the government guaranty, a continually increasing proportion of bank customers are going to keep their deposits and do their banking business at those banks that are most 'liberal' in their loan policies. For it is to be remembered that the weak banks get the same insurance as the strong ones, and, unlike the situation in other kinds of insurance, the bad risk pays no more for its insurance than the good one. This means competition among banks in slackness in the granting of loans. The bank with the loose credit policy gets the business and the bank with the careful, cautious credit policy loses it. The slack

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banker dances and the conservative banker pays the fiddler. If the conservative banker protests, the slack one invites him to go to a warmer climate. Soon all are dancing and the fiddler, if paid at all, must collect from the depositors or from the taxpayers."

—PROF. E. W. KEMMERER, *Research Professor in International Finance at Princeton University, in an address delivered before the Savings Bank Association of Massachusetts on September 14, 1933.*

At the last Democratic National Convention Senator Glass, in discussing the guaranty of bank deposits, declared that such a provision would "drive out of the Federal Reserve System the strongest supporting banks that the system now has within its membership. So that the effective results of the adoption of this disturbing proposition will be to endanger depositors in the banks of the country rather than to secure them against loss. The strong banks have always contended that they should not be assessed to pay a premium to mismanaged banks."

—SENATOR CARTER GLASS, *from the Official Proceedings of the Democratic National Convention, Chicago, 1932.*

"The law should then be rewritten as a single comprehensive code, with the primary purpose in view of providing for a unified banking system which will be in effect a national monetary system, absolutely safe as far as depositors are concerned and at all times responsive to the needs of the country for a circulating medium. With such a system in operation, all such measures as the guarantee or the insurance of bank deposits, or other efforts to patch up an inherently defective mechanism, would become unnecessary and irrelevant."

—GUY GREER, *formerly an expert with a special investigating committee of the Federal Reserve System. From an article, "Wanted: Real Banking Reform," in Harpers Magazine, October, 1933.*

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". . . It is to be feared that the adoption of deposit guaranty laws may have somewhat retarded the inevitably slow and unsensational process of strengthening the banking system by strict regulation, vigilant public opinion and strict requirements with regard to the ability of organizers, and the minima of capitalization, which are always necessary in any state or any community, old or new.

To the extent that residents came to look upon one bank as being as good as another because of the guaranty, the system was foredoomed to failure.

Integrity, financial ability and responsibility form the very essentials of the banking business. No insurance scheme can take the place of these requisites, even if it be handled on the most scientific and technically impeccable basis.

Whatever depositories receive the public's money, whether for banking or investment, should be rigorously and minutely regulated and supervised. Any ability which government may possess to detect, root out and punish fraud can find its normal exercise in this field. But if freedom of choice on the public's part is to be deadened, if government attempts to supply the integrity, experience, ability and responsibility without which any financial institution is a hollow sham, only failure and disaster are to be expected."

—SATURDAY EVENING POST, *leading editorial, August 9, 1924.*

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Clark Warburton

The Guaranty of Bank Deposits

Economic Policy Commission
American Bankers Association
New York
1933

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The Guaranty of Bank Deposits

A Historical Account, with Statistical Analyses of the Banking and Actuarial Results, of Guaranty of Bank Deposits Experiments in Eight Western States.

Published by Economic Policy Commission
American Bankers Association
New York

1933

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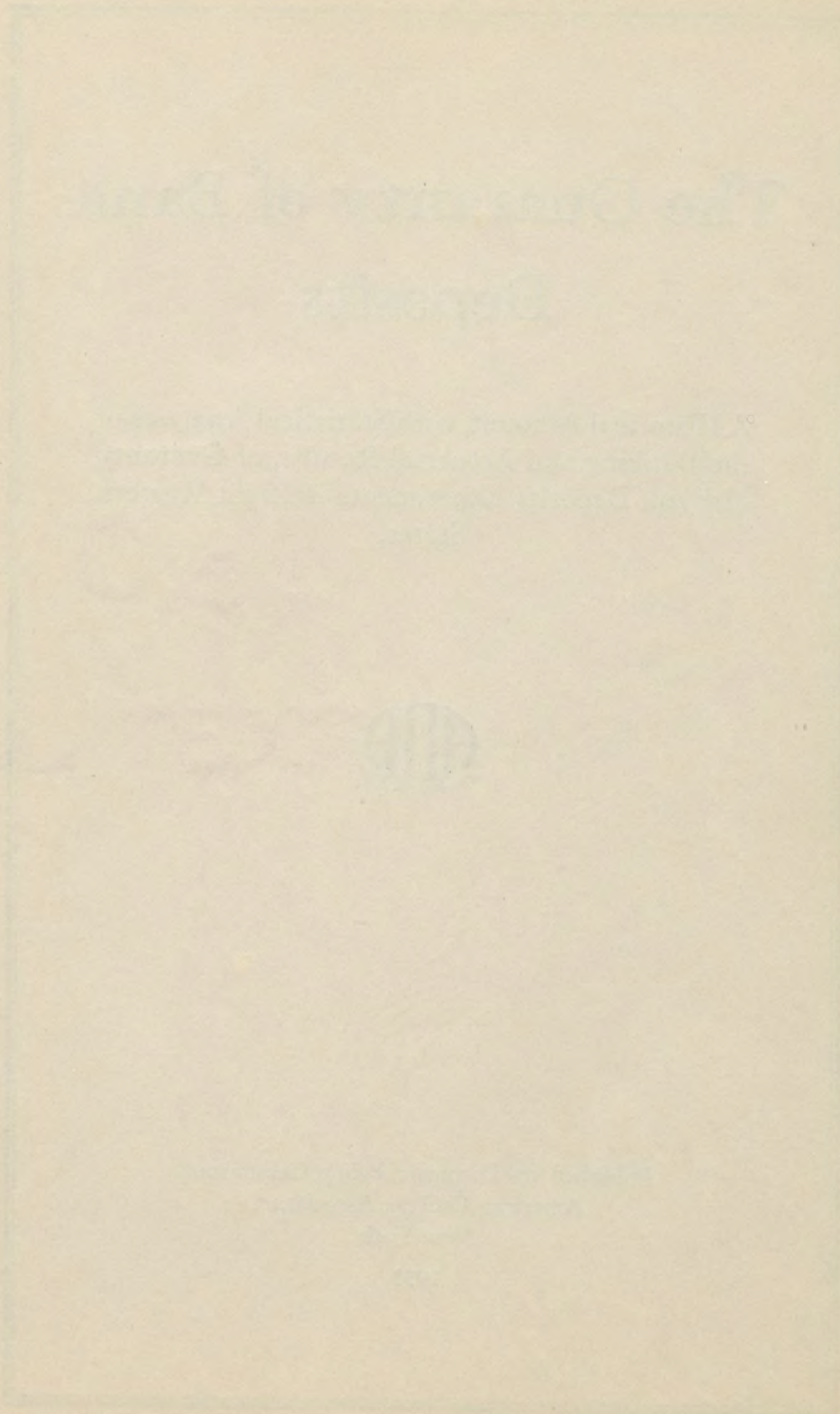

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FOREWORD

In view of renewed widespread discussion as to the desirability of some form of general guaranty of bank deposits or plan of deposit insurance, the Economic Policy Commission of the American Bankers Association has thought it well to make a somewhat more detailed study than had previously been made concerning the facts and definite effects upon banking conditions connected with the eight experiments with guaranty plans carried out by a group of western states in the period from 1908 to 1930. This study was undertaken by Gurden Edwards, Secretary of the Commission, and the results, drawn from official records and other first hand sources, are presented in the following pages as a contribution to the literature and history of American banking.

LEONARD P. AYRES, *Chairman*
Economic Policy Commission
American Bankers Association

Cleveland, Ohio, May 15, 1933.

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THE GUARANTY OF BANK DEPOSITS

I. THE EIGHT ATTEMPTS BY STATES

Eight large scale tests, by practical working experience, of the guaranty of bank deposits plan as a means for strengthening banking conditions and safeguarding the public interest are a matter of record. Each one of these attempts failed of its purpose.

Taken separately, special circumstances such as technical defects in the plan or faulty administration might be held accountable for the breakdown in any given instance, leaving it an open question as to whether the idea might not be successful under different circumstances. Taken as a composite whole, however, the failures of the various plans not only confirm one another in their defects, but each one also supplies added special features that were tested and found wanting. Taken thus all together they give a complete picture. It would appear, therefore, that there is no essential aspect of the guaranty plan that is not covered in the coördinated history of the failure of these eight applications of it.

As to the history of the guaranty plan, a wave of guaranty of state bank deposits laws swept over the seven contiguous western states of Oklahoma, Kansas, Texas, Nebraska, Mississippi, South Dakota and North Dakota and the Pacific Coast state of Washington in the period 1908-17. The movement was at its height when the depression of 1920-21 occurred. It subsided and disappeared in the period 1923-29. The laws establishing it were repealed or allowed to become inoperative as one after another of the plans became financially insolvent and was recognized as serving to make banking matters worse.

The general argument employed to promote the guaranty plan began with the premises that property can be insured and bank deposits are property. It travelled to the broad assumptions that the principle of the distribution of risk through insurance could be applied to bank deposits, that this should be done for the benefit of depositors at the expense of the banks and that it should be carried out through assessed contributions to a common fund by the banks pro rata with their deposits. This fund was to be administered by the state and from it deficiencies in the assets of failed institutions to meet depositors' claims should be covered.

It was assumed that sufficient means would accrue to the fund from assessments on the banks in prosperous periods of large deposits and few failures to meet the emergency of increased bank failures to be expected in periods of business depression. In no case was it provided in the plans that the state itself guaranteed deposits, directly or indirectly, by contributing public moneys to the fund or assuming any obligations which the fund should prove unable to meet.

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It was argued that salutary influences would react to the benefit of all banks comprised in the plan, since the public confidence which it would inspire would reduce panics and bank runs and prevent money stringency through hoarding. Likewise, the plane of banking conduct was expected to be raised on the theory that the collective liability borne by all the banks for the acts of each would make conservative bankers vigilant to curb irresponsible bankers whose activities might add to their common risks. The bankers, however, were given no punitive powers to enforce such discipline.

These arguments were nowhere sustained by the eight subsequent tests of practical experience. The significant facts of these eight cases follow.

II. OKLAHOMA

Oklahoma was the first to try the guaranty of bank deposits plan and the first to abandon it. It was put into effect here in 1908 and was compulsory for all banks under state charter. Each existing state bank was required to deposit with the guaranty fund securities equivalent to 1 per cent of its average daily deposits as surety for payments of assessments, and new banks the equivalent of 3 per cent of their capital. Regular annual assessments were fixed at the rate of 1/5 of 1 per cent of average daily deposits of the banks until the fund should reach 2 per cent of their total average daily deposits. At first special assessments were callable in such amounts as might be needed for the immediate payment in full of depositors in failed banks; later these were limited to 1/5 of 1 per cent and to the years 1914-16, with none thereafter.

An important aspect of any guaranty or insurance plan is the conditions under which risks are admitted to its protection. Under the Oklahoma banking law the State Banking Commissioner had no discretion as to granting new charters, it being mandatory upon him to issue certificates to all persons fulfilling the technical legal requirement for organizing a new bank. The guaranty law provided that all existing state banks were to be especially examined as to their fitness before being admitted to the guaranty. In actual practice the time allowed for this was too short and the system went into operation without any effective application of this provision, becoming virtually a blanket insurance for all state banks indiscriminately. Therefore there was no real limitation, selection or official control as to the character of the banks creating risks against the guaranty fund. This was especially significant in view of the fact that the state was on the verge of a reckless speculative boom in land, building and oil schemes when the plan was adopted.

A Boom for State Charters

Before this law went into effect there were in Oklahoma and Indian Territories, which were combined in 1907 as the State of Oklahoma, 370

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state chartered banks. In June of 1908, the year of the application of the guaranty law, the number had jumped to 494, and by June, 1910, rose to 685, an increase in three years of 315, or 85 per cent. These increments came from new state charters granted and from conversions to state jurisdiction by national bankers who feared the loss of deposits to state banks as a result of the prejudicing of public confidence in favor of the guaranty institutions. During the same period state banks in the nation as a whole increased in the ratio of only 22 per cent; that is, under the zone of the influence of this guaranty law in Oklahoma, state banks increased almost four times as fast as elsewhere.

Altered Bank Structure

The net result of these shifts was to alter the banking structure between 1907 and 1910 in Oklahoma to a marked degree. In 1907 there were besides the 370 state banks with deposits of $16,300,000, national banks to the number of 294 with deposits of $48,300,000, or a total of 664 units with deposits of $64,600,000. By 1910 the 685 state banks had deposits of $48,000,000 and there were now only 215 national banks with deposits of but $38,900,000. This was a total of 900 units with deposits of $86,900,000. These changes meant an aggregate gain of 236 banking institutions of both kinds, or 35 per cent, and of $22,300,000, or 34 per cent, in deposits. As between the two classes of banks they meant a rise of $31,700,000 or over 194 per cent for deposits in banks under state charter, and a drop of $9,400,000, approximately 19 per cent, in deposits in national banks, which also decreased by 79 institutions, or 27 per cent. The ratio of the number of national banks to all banks in the state fell from 44 per cent to less than 24 per cent, while the ratio of their deposits to the total fell from approximately 75 per cent to 44 per cent.

It is also to be noted that, despite the substantial increase in total deposits, the average deposits per bank of all kinds declined from $97,200 to $96,500, indicating a trend toward a larger number of smaller institutions competing for business. Furthermore, the number of persons in the state per bank was decreased from 2,100 in 1907 to only 1,800 in 1910.

Summarized, these changes meant at this stage that there were many more state banks, more banks all told, a great shift of deposits to the banks under guaranty, smaller average deposits and fewer people per bank than before the guaranty plan was adopted.

Following this initial boom of state banking under the guaranty law, there was some recession in the number of banks under state charter and an increase in those under federal charter, but the general picture was not changed. During the period from 1910 through the depression of 1920-21, the mid-year numbers of state banks in Oklahoma ranged from 638 down to 553, with an annual average number of 590, while the number of na-

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tional banks ranged from 266 up to 342, with an average of 318. The number of all banks ranged from 876 to 964, with a mid-year average of 908. Thus the preponderance of state banks over national banks and the increase in total number of units in the state remained.

Bank Failures Under the Guaranty Plan

During the first eleven years of the operation of this guaranty plan in Oklahoma, that is from 1908 leading up to the depression years 1920-21, 54 state banks with deposits of $7,790,000 were suspended and only 2 national banks. This period opened with a three year boom followed by a collapse in 1912 and 1913, succeeded in turn by the period of war prosperity that ended in 1920. In the unsettled four years 1920 through 1923, state banks to the number of 68 with deposits of $13,000,000 were closed and only 7 national banks. Although in 1923 the guaranty plan was abandoned, disaster continued to beset the state's banks and in 1924, 58 more state institutions with deposits of about $8,500,000 went under; in this year 18 national banks were suspended.

Thus during the period of the guaranty plan and its immediate after effects 180 state banks failed, or 35.6 per cent of the average number in operation, while only 27 of the non-guaranty national banks failed, or a ratio of 7.6 per cent of their average number.

Financial History of the Plan

The financial troubles of the guaranty plan in Oklahoma began early in its career. In the first year of its adoption two banks closed, but their resources proved sufficient to cover depositors' claims. These were met at once from the guaranty fund which was later fully reimbursed from the liquidated assets of the banks.

However, the second year brought a crisis. Three bank failures occurred with liabilities of $3,000,000, of which $2,800,000 was due depositors of a single institution whose deposits had made a mushroom growth of more than 700 per cent in only eleven months under the hotbed stimulation of guaranty banking. The guaranty fund, however, had not yet had time to accumulate sufficient strength to meet such heavy claims. At the time of this failure there was only $300,000 in hand. A special assessment of ¾ of 1 per cent was levied on the solvent banks and a state loan of $450,000 was arranged. This tided over the crisis until the suspended institution's assets were liquidated. This failure alone cost the other state banks over $580,000.

From the viewpoint of the public the guaranty plan in Oklahoma during the first twelve years of its operation had the outward appearance of success. The depositors of the 62 member banks that failed during this period were paid in full, the deficiencies between their liquidated assets

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and deposit liabilities eligible to guaranty being made up from the sums collected from the solvent banks through regular and special assessments. In 1914 concern was caused by a deficit of $800,000 that appeared in the fund as against outstanding obligations, but by 1920 this was wiped out by income from assessments and there was $75,000 in the treasury with a $275,000 assessment due. The State Bank Commissioner's reports during this period spoke in glowing terms of the soundness and fairness of the plan.

The Burden on Sound Banks

From the viewpoint of the banks, however, these twelve years had meant a heavy burden on the sound institutions to make good the shortcomings of the unsound banks. During 1908-1919 Oklahoma state banks paid assessments into the fund in the amount of over $3,000,000 to cover the deficiencies between the assets of the banks that failed and the sums they owed their depositors. These assessments amounted to an annual levy of about 3 per cent on the average capital stock of the state banks; during 1908-12 the levy was at the rate of 5 per cent.

The specific burden falling on an individual bank varied in respect to its capital in accordance with the ratio of its capital to its deposits on which the assessments were based. It is recorded that in a four year period one bank with capital of $10,000 paid assessments of $1,300, another of $15,000 capital paid $3,000 while another of $30,000 capital paid assessments of no less than $20,000.

Thus, for the state banks as a group the burden was heavy, and as among the members its distribution was inequitable and without any relation to their abilities or moral obligations to pay, since the faults that led to these penalties were committed not by them, but by other banks in respect to whose chartering they had no voice and over whose activities and methods they had no control. It was notorious that many unfit persons were permitted under the state law to enter banking, and that improper practices were followed by many of the institutions that failed and whose shortages were paid for by the confiscation, through the guaranty fund, of a large part of the earnings of sound banks and honest bankers.

The prosperous conditions generally prevailing during the greater part of the first twelve years of the guaranty plan enabled the banks to support the burdens it imposed, but in the thirteenth year, that is, 1920 when the first post-war depression began, conditions changed sharply. They produced the emergency of a severe depression which the plan was theoretically devised to meet, but it failed completely under the test. It proved to have been a fairweather device that quickly went to pieces in the first storm.

In 1920, when falling agricultural prices undermined the position of the banks' customers and credit structure, eight state banks failed. In

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1921 ten more went under. In 1922 another 37 closed, bringing the total for these three years to 55 banks with deposits of about $9,000,000. In this same period among the non-guaranty national banks in Oklahoma, averaging 366 in number as compared with an average of 573 state banks, only 2 failed.

The Financial Breakdown of the Plan

This sudden rise in failures produced chaos in the financial condition of the guaranty fund. In March 1920, the assets of the fund in cash and assessments due totalled $350,000. A series of thirteen failures beginning at this period consumed this sum and necessitated the issuance of depositors' guaranty warrants to the amount of $2,196,000, representing the amount of claims which the fund could not meet. With the fund in this position, there came the failure in 1921 of another bank with deposits alone of $1,732,000, followed by the collapse of several other smaller institutions. Under these conditions the plan became inoperative by force of necessity.

By 1922 the liabilities of the fund amounted to about $3,350,000 in the form of depositors' guaranty certificates bearing interest of 6 per cent, or over $200,000 annually. Total deposits then in state banks subject to assessment were about $156,000,000, from which the yield under the maximum impost of 1/5 of 1 per cent per annum fixed by the law would be but $312,000, leaving only $112,000 to apply against the principal of the debt after payment of the interest charges. This meant that it would be more than twenty years before existing obligations could be liquidated, provided assessable deposits remained at this level and there were no more failures to cast added obligations on the fund.

Enforced Abandonment

Neither of these essential requirements was to be fulfilled. In 1922 there were 37 more state bank failures with deposit liabilities of about $7,500,000, and in 1923 another 13 failures with some $3,500,000 in deposits. Also there was a rapid decrease in the number of state banks through liquidation and conversion to national charter, which was permissible upon discharge of pro rata liabilities under existing indebtedness of the fund. As a result of these changes the number of state banks dropped from 622 in 1921 to 486 in 1922 and 445 in 1923, while their total deposits fell by 1923 to approximately $74,000,000.

Under these circumstances the guaranty plan in Oklahoma was abandoned and the law was repealed in 1923. During its fifteen years on the statute books the plan cost the state banks in assessments $3,700,000. The unpaid depositors' claims at the time of its repeal were about $7,500,000, which amount was subsequently somewhat reduced by liquidation of the

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assets of failed banks. How pressing was the need of relieving the banks from the burden of the plan and its obligations was expressed by the Oklahoma Bank Commissioner, who said: "If the law had not been repealed it is doubtful if there would be very many solvent state banks in Oklahoma."

Psychological Effects

In addition to the foregoing statistical and financial facts relating to state banking in Oklahoma under the guaranty of deposits plan, the experience of bankers within the shadow of its operations also presents an essential aspect of its inherent weakness. This has to do with what might be called the psychological defects of its conception and operation. Arguments in favor of the plan placed considerable emphasis on its psychological virtues. It was held that public confidence would be created in the banks under the guaranty system. In actual result the effect on the public mind was to create not sound confidence in banking but rather a sense of false security and lack of discrimination as between good and bad banking.

It was generally assumed by the public, for instance, that deposits in any state bank were guaranteed by the state, although the law specifically indicated that this was not true and made it a misdemeanor, punishable by fine or imprisonment, for any bank to advertise that its deposits were state-guaranteed. All the law did was to prescribe the collection and administration of assessments against state banks on a basis which it was assumed would produce a sufficient special reserve or insurance fund to protect depositors against loss through bank insolvencies. In case at any given time sums in hand or collectible were not sufficient to meet the current obligations of the fund, interest bearing warrants were to be issued, but these were in no sense liens on any of the resources of the state. They could be liquidated in order of issue solely out of future income as it accrued to the fund from the assessment rates against the state banks or the liquidation of the assets of failed state banks.

Despite these facts a special sense of security, as of reliance on the state itself, was manifest on the part of the public toward the guaranty banks. By aid of this popular misconception, according to the practical competitive experience of bankers in the state, many incompetent or reckless, or even demonstrably fraudulent operators were able to command public confidence and patronage. Unrestrained by safe and conscientious banking methods, principles and scruples, operators of this type were frequently enabled to gain substantial competitive advantages over more careful bankers, both state and national, by reason of large earnings and liberal policies toward customers made possible by the speculative and temporarily successful uses under conditions of prosperity to which they put the funds entrusted to them. In the long run this added to the number of bank failures.

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Such results of the guaranty system as these operated to weaken the banking structure and were undoubtedly an important factor in causing the situation that finally destroyed the guaranty plan itself.

Summary

Summarizing, without attempting to draw any rigid causal relationships from the foregoing facts, the following statements are fully justified:

1. During the regime of the guaranty plan in Oklahoma, the increase in the number of state chartered banks increased the condition there of over-banking, which is unquestionably a major cause of banking weakness and trouble.

2. The actual and relative number of bank failures was very much greater among the guaranty state banks than among the non-guaranty national banks practicing in the same environment.

3. The scheme failed to show any of the basic qualities of a practical insurance plan. Even though very heavy financial levies were exacted from the contributing institutions, and although several years of relatively prosperous conditions attended the first period of its operations and gave it a head start, the first major test found it without adequate reserve. The burden of assessments that would have been actuarially sufficient to maintain the fund on a sound and solvent basis would have made banking under it impractical.

4. An essential deficiency of the plan from an insurance point of view was that no adequate control could be exercised by either its participants or administrators over the type or practices of banking institutions admitted to it as risks. It was thus analogous to a fire insurance scheme that would admit without discrimination or restrictions manufacturers of explosives or storers of gasoline or other inflammable materials on the same rate and basis as class A fireproof office buildings.

5. Finally, during the period of false security engendered in the public mind by the supposed protection given their deposits by the state through the plan, there was actually an increase in unsound banking practices so that banking weakness rather than strength was fostered during its existence and the security of deposits became less rather than greater.

III. NEBRASKA

Impressed by the outward appearance of success presented by the Oklahoma guaranty scheme during the first years of its operations, three other states passed some form of guaranty law in 1909. The plan adopted in Nebraska was the only one of these three that was fully compulsory upon all banks under state charter as in the case of Oklahoma. Its opera-

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tion was delayed for two years by a federal suit to test its constitutionality, which was upheld, and it did not become effective until July, 1911.

Under this law the Depositors' Guarantee Fund of the State of Nebraska, as it was called, was created by semi-annual assessments on all state banks equivalent to 1/20 of 1 per cent of their average daily deposits until the fund should reach 1½ per cent of deposits. New banks were assessed 4 per cent of their capital stock, which was credited to their subsequent pro rata obligations to the fund as established institutions. Special assessments, not exceeding 1 per cent, reduced in 1923 to ½ of 1 per cent, of daily deposits in any one year, were collectible whenever the fund should fall below 1 per cent of deposits. The maximum total assessments collectible in any year, after the reduction of the special assessment limit, were 3/5 of 1 per cent.

In operation each member bank was allowed to set up on its own books the amount of its assessments as a cumulative liability designated "Depositors' Guarantee Fund." If a member failed, a judgment for approved claims, which covered only unsecured individual deposits, was obtained against the fund, and each member was drawn on ratably for enough to pay in full the guaranteed deposits in the insolvent institution, whose assets were taken over by the state, liquidated and the proceeds paid back to the fund.

Nebraska was another state in which the banking department had no discretionary power with respect to issuing new bank charters, and from 1911 until 1923, when discretion was granted to it, state banks increased rapidly.

The Boom in State Charters

When this law became operative in Nebraska in 1911 there were 647 state banks with deposits of $53,200,000, and 231 national banks with deposits of $56,800,000. The first nine years, that is, up to the depression that began in 1920, were normal in banking and the plan in Nebraska as in Oklahoma acquired the outward appearance of success. Under it state banking expanded and national banking in the state suffered by comparison. The number of state banks increased every year, reaching 1,008 by June 1920, an increase in nine years of 361 units of this class, or over 55 per cent. Their deposits grew to $291,100,000, an increase of $237,900,000 or 447 per cent. A large part was money attracted to Nebraska state banks from other states by the fancied security of the guaranty plan. In the nation, state banks increased but 33 per cent in number and deposits expanded only 126 per cent in this period.

During this same period the number of national banks in Nebraska fell to 175, a loss of 56 or 24 per cent, and their deposits rose to $98,800,000, or by $42,000,000, which was less than 74 per cent, as compared with 447 per cent for the state banks.

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The effect of these changes on the total banking structure of the state was to increase the aggregate number of both classes of institutions from 878 in 1911 to 1,183 in 1920, a gain of 305 or almost 35 per cent, while combined deposits rose from $110,000,000 to $389,900,000, a gain of $279,900,000 or more than 254 per cent. In this altered picture, the ratio of the number of national banks in the state fell from 26 per cent to less than 15 per cent, while their proportion of the aggregate deposits dropped precipitately from over 51 per cent to only 25 per cent. Abnormally rapid expansion in state bank deposits caused a marked increase in average deposits per bank of both classes from $125,000 to $329,000. In this period, the number of persons per bank in the state decreased from 1,360 to 1,090.

Summarized, these changes meant a great increase in state banks and in the number of banking institutions in the state all told, a disproportionate increase in the deposits in the banks under guaranty as compared with the increase that occurred in the non-guaranty banks and fewer persons per bank in the state as a whole.

During this economically peaceful nine year opening period of the Nebraska guaranty plan there were relatively few bank failures in this state. The decade was largely dominated by the booms, inflation and easy financial prosperity of the World War era, which brought large demands for livestock and agricultural products to the West, with inevitable over-expansion and speculative stimulation, along with soundly based economic activity. From June 1911 to June 1920 only five very small state banks with aggregate liabilities of $235,000, were suspended and but two national banks.

Bank Failures Under the Guaranty Plan

The collapse of the war inflation, however, brought a disastrous test. In the depression year ending June 1921, 16 state banks suspended and in 1922 there were 23 more suspensions. The direct cause of these failures was the disastrous fall in agricultural prices that occurred in these as in the ensuing years. In 1923, 18 state banks closed, 19 in 1924, 11 in 1925, 23 in 1926, 19 in 1927, 44 in 1928 and in 1929 there were 106 state bank failures with total liabilities in excess of $30,000,000. In 1930 there were 50 more with liabilities of $13,000,000 and in this year, following several years of desperate efforts to reorganize the guaranty fund, it was abandoned through repeal.

The foregoing record shows in the period 1921 through 1930 a total of 329 state bank failures in Nebraska, with total liabilities of $88,700,000. That is, against a yearly average number of 855 state banks in these years, an average of 33, or 3.8 per cent, failed. In the same ten year period 31 national banks failed in the state, or an annual ratio against the average total of 158 of banks of this class in operation of 1.9 per cent.

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Obviously, this comparison between the guaranty state banks and the non-guaranty national banks is not to be taken as a measure solely of the ill effects of the guaranty of deposits plan. There were numerous other factors causing the inferior showing of the state banks in Nebraska as compared with the national banks.

Other Causes of Weakness

One of these factors was the matter of under capitalization. When the guaranty plan went into effect in 1911 the banking code placed the minimum capital with which a bank could open at $10,000 in hamlets of less than 100 inhabitants, at $15,000 for towns of between 100 and 500 inhabitants, and on a rising scale for larger places. There were also in operation a number of state banks chartered previously to this law with but $5,000 capital. About 65 per cent of all the state banks had capital of $20,000 or less and the great majority were in small towns. The minimum for national banks since 1900 has been $25,000 and a greater ratio of them was situated in larger places. Of 337 state banks suspended during 1920-1931, 89 had capital of $15,000 or less, and 141, or nearly 42 per cent, had capital of $20,000 or less.

Although these factors would doubtless have given the state banks a worse record than the national banks in Nebraska even without the guaranty law, the testimony of bankers who lived through the period of the operation of the scheme is that it greatly contributed to the amount of small, weak and irresponsible state banking. A general atmosphere of false security, confidence in all state banks and lack of discrimination between good and bad banking was engendered by the mistaken idea that no one would lose his deposits since they were guaranteed by a supposedly trouble-proof banking structure. As a result, greater numbers than ever of under-capitalized, ill-situated banks, as well as of persons wholly unfitted as to training, character or methods to be allowed to conduct banks, were able to command public trust and patronage and to attract large deposits to their institutions through high interest rates and trading on faith in the guaranty plan. This is reflected in the tremendous expansion in state bank deposits between 1911 and 1921 as brought out above.

Therefore, although the guaranty plan cannot be held wholly responsible for the bank failures that occurred during its regime, nevertheless it doubtless was mainly to blame since it fostered the excessive development of those other weaknesses which produced the unusual severity of the state banking disaster. This in turn destroyed the ability of the fund itself to meet its obligations.

In drawing the foregoing comparisons reference is had specifically and solely to state and national banking in Nebraska during 1911 to 1931. It is not in any sense implied that they have any parallel application else-

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where or constitute an argument in favor of national as against state banking under normal conditions, for these aspects are not considered here. There is no inherent reason why, under sound banking codes and well conceived standards of supervision, state banking should not be as successful as national banking.

Financial History of the Plan

The financial history of the plan was a reflection of the foregoing statistical history. During the first nine years there was the semblance of success, with assessments creating a fund of $2,367,000, against which draughts of only $239,330 were required to pay depositors in failed banks.

However, the sudden rise of failures that began in 1920 brought it to the point of insolvency by 1922. The state bankers undertook steps to save the plan through forming a State Agricultural Loan Association which sold stock and notes to member banks in the amount of $2,000,000. Its funds were applied to paying depositors in failed banks whose assets were taken over by the association. The guaranty plan assessments on state banks in 1921 were $2,320,000, in 1922, $1,970,000 and in 1923, $2,050,000. Yet by 1923 the losses through added failures were so large that these combined efforts were unable to meet the situation. Then the state legislature created the Guaranty Fund Commission with power to decide whether crippled banks should be operated in an endeavor either to rehabilitate them or postpone their liquidation so as to cut down current claims on the fund, or whether they should be placed in receivership for liquidation at once.

By 1926 the banking crisis in the state showed signs of abating and it was hoped the guaranty plan might pull through. At this point, the state banks had paid assessments of about $12,500,000 to the fund in 15 years and every depositor in every closed bank had been paid in full. On the other hand the Guaranty Fund Commission was operating 38 banks, which were being carried along as going institutions instead of being closed, and the possible postponed losses were estimated at another $6,000,000. The maximum annual assessments collectible from the state banks on the basis of the then existing average daily volume of deposits, about $265,000,000, would be about $1,600,000, and it was felt by the supporters of the plan that this prospective income, together with sums it was hoped could be realized from assets in the hands of the commission, would restore the financial equilibrium of the plan within three years.

This close-drawn hope was based on the assumption that the assessible volume of deposits would not diminish and that there would be no additional bank failure to throw added losses on the fund. Neither of these basic expectations was realized. During the year ending in June 1926, 23

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more banks failed and 19 more in 1927, while deposits steadily shrank. Also, solvent banks were expected to purchase the receivers' certificates, which were issued under the authority of the commission against the assets of failed banks, in order to create immediate funds with which to cover current deficiencies in the sums available for payment of depositors' claims, but they lost confidence in the value of those certificates and declined to purchase them further.

The Financial Breakdown of the Plan

Disintegration of the plan was rapid. In 1928, 44 more banks were suspended and in the year ending June 1929 another 106. This startling figure of 106 included the banks that were being carried along by the Guaranty Fund Commission but which were now ordered to be closed. In January 1929, 135 banks were on the hands of the Guaranty Fund Commission, with unpaid deposits of about $25,000,000. Sixty-one of these banks were in receivership and 74 were being operated by the commission.

In 1928 bankers started court action to have the guaranty law declared confiscatory and unconstitutional. This suit was decided by the District Court in favor of the banks but later the decision was reversed by the State Supreme Court. Following this decision state banks began to nationalize in large numbers. The uneasiness of depositors in the situation resulted in heavy withdrawals from state banks and increased failures. This development prompted the calling of a special session of the Legislature to repeal the law in March 1930.

The Governor of the state indicated that the then apparent deficit of the guaranty fund was from sixteen to twenty million dollars, that the interest on the depositors' claims represented in this deficit would likely absorb virtually all the prospective income from assessments and that nothing would be available to pay against the principal of the deficit. He ended his statement with the assertion that under such a situation the guaranty fund could not afford protection to then existing deposits against any future losses.

This signalized the virtual suspension of the guaranty law as an operating plan. A few months later the Guaranty Fund Commission, created in 1923 with power to operate or liquidate crippled banks in its discretion, was abolished. The 69 banks it was then operating were ordered closed and a new department of bank examination and supervision was set up. It was given powers to bring about sounder banking methods and to work out with the depositors the settlement of the affairs of such banks as subsequently failed or became weakened on a plan of composition or rehabilitation applicable to each case individually entirely outside the guaranty plan.

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Litigation and Confusion

As to that plan itself, the rest of its history deals with the steps taken to remove it from the statute books and the methods and litigation involved in the attempt made to date to wind up its confused and bankrupt affairs. When the law was repealed in March 1930 the deficit was estimated at $20,000,000.

The terms of the repeal relieved all state banks of further special and regular assessments to guarantee existing or future deposits and substituted a levy of 2/10 of 1 per cent on their average daily deposits, to continue for a period of ten years, the proceeds to be applied wholly against the old deficit through what was designated as the Depositors' Final Settlement Fund. This assessment was expected to produce $3,000,000 during its life. Also, all monies due under old assessments levied before the repeal, expected to yield another $3,000,000, were to be similarly applied, as were the proceeds of the liquidation of the assets under the control of the formerly abolished Guaranty Fund Commission, consisting chiefly of the wreckage of the banks that had been closed or operated under its auspices.

Finally it was decided to submit a constitutional amendment to the people to permit a state bond issue of $8,000,000 whose proceeds should be appropriated to the settlement fund. This proposal was based on the theory that certain state policies, such as the operation of banks known to be insolvent by the Guaranty Fund Commission, the permitting of certain depositors to withdraw funds from these insolvent institutions, and also former chartering conditions which had permitted many undesirable banks to start operations, had all contributed to the burden of insolvency and that, in equity, it should therefore not fall solely upon the well conducted banks.

Remedial Plans Also Collapse

This plan collapsed. The bond issue project to meet part of the deficit with general state funds was defeated. Also, the banks resisted through joint litigation the collection of the old and new assessments as provided for in the law. The Supreme Court of Nebraska upheld their contentions.

It found that the intended public purposes of the guaranty plan, namely, to stabilize business and create confidence in the banks, were under radically changed conditions, wholly lacking in the final settlement fund plan which, it declared, would in practical effect have results opposite to those anticipated. The new assessments, it held in substance, would take money from one class of persons not protected by the guaranty plan to pay to another special class of persons who had been protected, and this it held to be unconstitutional.

Also, the court held, the collection of the old assessments from solvent banks was confiscatory under the changed conditions that had come into

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existence, since they had operated at a loss during the period these assessments covered and payment could be made only through an impairment of their capital. Such actions as these, it declared, could serve no public purpose, would weaken solvent state banks, destroy public confidence in them and tend to disrupt commerce. In such terms did the highest court of the state indict and condemn, if not the original guaranty plan itself, the only steps short of actual repudiation of its obligations that seemed feasible for meeting the difficulties it had caused.

The Net Results

Seventeen years' operation of the Nebraska Guaranty Plan cost the state banks there $17,700,000 in assessments. During the first nine years these imposts averaged 1.3 per cent of their aggregate capital, surplus and undivided profits. During the last eight years they were equivalent to an average of 4.16 per cent. The burden was highly uneven as among the contributing banks, some with a high ratio of deposits to capital funds paying as much as 15 per cent.

Even these ruinous expropriations of the legitimate earnings of blameless institutions to make good the shortcomings of others were far from sufficient to serve the supposed public purposes for which they were taken. Weaker instead of stronger banking resulted and depositors were only partly protected. It would appear that, under the conditions that were allowed to go on under the public banking policies that were followed, the creation of sufficient funds to constitute an actual guaranty against any loss by depositors would have consumed the earnings of good, well managed banks to so great an extent as to drive investment capital away from them entirely and render the maintenance of a state banking structure impossible.

In addition to this expropriation of $17,700,000 through guaranty assessments from the fair earnings of persons who had invested in bank capital, the depositing public was left with a loss through unpaid deposits and interest of $22,000,000, as measured by the latest estimates of the deficit left by the guaranty fund. There seems little doubt, in view of the history of banking under the distortions of the guaranty plan, that this combined sum of $39,700,000 mulcted from the public by bank failures was greatly augmented by the type of banking fostered by the very plan set up to prevent such losses.

IV. MISSISSIPPI

The next state to adopt a compulsory guaranty plan was Mississippi, where it was put into effect in 1915. Each state bank was required to deposit cash or securities in the amount of $500 for every $100,000 of deposits, less capital and surplus, as assurance that regular and special assessments

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would be paid when called for. The regular assessment was 1/20 of 1 per cent annually of average daily deposits, less capital and surplus, until the fund should reach $5,000,000. In case of emergency, a maximum of four extra assessments of 1/20 of 1 per cent could be levied in a year.

The history of the operation of this law in Mississippi illustrates the weakness of the guaranty plan under different attendant circumstances from those which surrounded the cases of Oklahoma and Nebraska. These different circumstances, from some points of view, gave the plan a more favorable and clear-cut opportunity to function on its own merits, free from the confusing influences of such by-factors as the excessive increases in state bank charters that resulted from, and in turn reacted against the success of, the guaranty plan under conditions that prevailed concurrently with its operation in those other two states. The banking authorities in Mississippi had full discretion in the matter of granting new charters and used it liberally in refusing permission for unneeded banks or to unqualified promoters to open new institutions.

A Moderate Increase in State Charters

An examination of the banking statistics, therefore, during the period of the guaranty plan in Mississippi discloses some significant contrasts with those for Oklahoma and Nebraska. When it went into effect in Mississippi in 1915 there were 280 state chartered banks with $41,600,000 in deposits and 35 national banks with deposits of $16,900,000, or a total of 315 banking units in the state with deposits of $58,500,000. This meant that about 89 per cent of the banks and 71 per cent of the deposits were in the state system.

During the operation of the plan no great changes in respect to the number of banks occurred, although the trend for a time was a moderate increase of state banks and a decrease of national banks. At the end of the first five years, leading to the depression year beginning in 1920, there were 324 state banks and 30 national banks, a total of 354. This meant that the number of banks then in the state system had increased to 91 per cent of all banks in the state.

In respect to deposits the changes were more significant. State bank deposits rose to $145,000,000 by June 1920, an increase of $103,400,000, or almost 249 per cent, while national bank deposits rose to $39,900,000, an increase of $23,000,000, or only 136 per cent. At this stage the state banks held over 78 per cent of the deposits.

It would appear from these data that guaranty state banking had received a relatively greater stimulation of public patronage than non-guaranty national banking, and perhaps at the expense of the latter type of banks, although as compared with general financial developments of this period of expansion for the nation as a whole it does not appear that the

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guaranty plan in Mississippi was accompanied by the same extreme developments of over-banking and one-sided increases in deposits as were manifest in Oklahoma and Nebraska.

Restraint Exercised by Banking Department

This lack of a marked increase in over-banking in Mississippi under the stimulus of the guaranty law is attributable to the restraining policies of the State Banking Department. This department was created in 1914 under the same general banking law that embodied the guaranty plan. While the general law, which in most respects was an excellent and much needed banking code, became effective at once and the banking department began to function immediately in promoting a sounder state banking structure, the guaranty feature itself did not become compulsory until over a year later.

During this period existing banks were subjected to a rigid scrutiny before being admitted to the plan. Also, in respect to the chartering of new banks, the law gave the state authorities adequate discretion. These powers presented effective barriers to the rush of unqualified persons into banking, or the organization of an excess number of institutions, such as the banking authorities in Nebraska frequently complained they were powerless under the law to prevent since the courts held that it was mandatory upon them to issue charters whenever the technical legal requirements of an application were complied with.

The number of Mississippi state banks increased in the period of the guaranty to a maximum of 325 units, a rise of only 45 over the number in operation at the outset of the plan. When the guaranty law went into effect there were about 6,000 persons per bank in the state. By 1920, largely due to a loss of state population, which made the increase in banks relatively larger in effect, the number of persons per bank dropped to about 5,000.

However, while these data reflected at both periods too large a number of small banks, they did not indicate that the condition of over-banking in Mississippi was so great as in Oklahoma and Nebraska, or that it had followed the inauguration of the guaranty plan or was made materially worse by it. To the contrary they would imply that, in this instance, a better opportunity for the demonstration of the possible merits of the guaranty plan was afforded by the restraining influences of the banking laws and state authorities in preventing a large growth in over-banking as a confusing factor.

Bank Failures Relatively Moderate

Another relatively favorable set of attendant circumstances is found in the bank failure records. Between June 1915, the year when the guar-

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anty law became compulsory, and June 1920, there were only three state bank failures with total liabilities of $290,000. In this period no national banks in Mississippi failed. Beginning with the depression that started in 1920 the rate of state bank failures rose, there being 4 in the year ending June 1921, 5 in 1922, 4 in 1923 and 1924 each, and 3 in 1925, while in 1926 the number dropped to 1. In 1927 the failures of state banks rose to 7, in 1928 there were 3, 1929, 8 and in 1930, when the plan was suspended, there were 14. During this same period, June 1920, to June 1930, 3 national banks, or 10 per cent of the number in operation at the outset, were closed. The total state bank failures in this decade were 53 and their aggregate liabilities were $13,900,000. The number of closed state banks was equivalent to over 16 per cent of those in operation at the outset of the period. Similar figures for Oklahoma show a failure ratio of over 32 per cent, and for Nebraska a ratio also in excess of 32 per cent. Thus, as to numbers of failures, the guaranty plan in Mississippi did not have to contend with so great a burden as in those other two states.

Financial History of the Plan

Yet, despite these various relatively favorable circumstances, the financial history of the Mississippi fund is not dissimilar to that of the deficits and bankruptcy that broke down those others.

The first five years of the operation of the plan was without untoward circumstance and led to its being acclaimed as a success. In no year up through 1920 was the maximum amount of assessments called for, and all depositors in failed banks were promptly paid. In 1921 and 1922 the rise in bank suspensions and liabilities required the collection of the maximum levies. By 1925 a large deficit had accumulated. The situation as it then stood was that during the first ten years of the plan $1,396,000 in assessments had been collected and $371,000 realized from the assets of closed banks, making a total of $1,767,000 paid to depositors in failed banks, while there remained guaranty certificates outstanding, with no funds to meet them, amounting to $1,941,000. This deficit, it was hoped, could be wiped out in seven years by assessing the banks the maximum levies, provided their volume of deposits did not fall and there were no more failures.

Financial Breakdown

At the date of these foregoing figures, the deposits in the state banks in Mississippi aggregated $134,900,000. They rose to $153,500,000 in 1927 and 1928, falling back to $147,500,000 in 1929 and $132,200,000 by 1930. Thus, while the additional favorable factor of an increased volume of deposits as the basis for assessments prevailed in all except the last year, the burden of suspended banks and of their deposit liabilities increased at a faster rate. By March 1930 the deficit had risen to $5,000,000, represented

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by certificates of indebtedness held by about 125,000 depositors of some 30 state banks. Under these conditions the operation of the guaranty plan was suspended by a legislative enactment.

This measure halted the further issuance of certificates of indebtedness against deposits in failed banks. However, it continued the annual assessments of the guaranty plan, amounting to a maximum of $\frac{1}{4}$ of 1 per cent of deposits, less capital and surplus, the proceeds to be applied to interest and retirement of a state bond issue authorized to liquidate the claims of holders of certificates of indebtedness. In case this assessment should not yield sufficient to meet the services on this bonded debt, the deficit was to be met from state taxation. This law also levied a special assessment of 3 per cent of their capital and surplus against state banks, the collections from which, limited to an aggregate of $300,000 annually, were to protect depositors of banks failing after the suspension of the guaranty plan. This substitute guaranty plan operated only on an annual basis and was not accumulative, the proceeds of a year being applicable only to the failures of the same year, with no carry-over of such deficits or surpluses as might occur. In view of this special impost certain tax exemptions were granted the state banks.

Summary

Summarizing the Mississippi case,—despite the adoption of a sound new banking code, the establishment of an efficient department of supervision, adequate control over the chartering of new banks, the concurrence of a relatively moderate burden of bank failures and a rise in the volume of deposits of state banks as a basis of assessment income for the guaranty fund, it failed to give full protection to depositors, caused a contingent obligation for general state taxation and did not aid in bringing about a stronger banking structure.

As elsewhere, the guaranty plan in Mississippi dulled public discrimination as between sound and unsound bankers by creating the impression that all deposits in state banks were guaranteed by the state, and thereby enabled bankers with easier standards to gain competitive advantages over those who adhered to sounder but less attractive methods. Through such channels so large an element of weak banking crept into the state banking structure and was productive of so great a volume of depositors' claims against the fund that it broke down and became a public liability.

The contention may be made that the crucial cause of the breakdown of the plan in Mississippi was of an actuarial character,—that the assessments were placed too low to create a sufficient insurance reserve against the risks involved. Accepting this contention, consideration of the facts indicates the impracticability of creating adequate reserves by a flat rate against an unselected range of risks such as is involved in the guaranty of

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deposits idea. They show that a premium, or assessment, rate low enough to be supportable by a conservative banker with his moderate scale of profits, would be insufficient to set up adequate reserves against the disproportionate risks created by the speculative banker.

During the period 1915-25, the average assessments collectible from all the Mississippi state banks amounted to the equivalent of approximately 1.20 per cent of their capital. Yet the deficit at the end of this period was $1,940,000. In order to have created sufficient reserves to meet the obligations of the guaranty plan up to this point it would have been necessary to levy an annual rate of assessments equivalent to about 2.65 per cent of the capital of the state banks. By 1930 the deficit had grown to $5,000,000. To have created reserves to meet this volume of claims would have required annual assessments during the fifteen year life of the fund at an annual rate in excess of 3½ per cent of capital.

The disturbing effects and unsound influences of such a heavy special tax against the earnings of a particular class of institutions would inevitably set up reactions tending to weaken the banking structure. Primarily it would tend to drive capital away from the banks so taxed to seek more lucrative employment elsewhere. For institutions that continued in the field it would retard and add difficulties to the building up of proper surplus out of earnings. Among some, the pressure it would exert would doubtless induce less conservative methods and practices in an effort to enlarge earnings so as to meet the exactions of the guaranty plan and still return a satisfactory yield on invested capital.

Thus it is evident that the guaranty of deposits scheme contains within itself forces inherently tending to cause weaker rather than stronger banking.

V. SOUTH DAKOTA

South Dakota was the fourth state to adopt a compulsory guaranty plan. It was put in operation here in 1916. It provided for an annual assessment of ¼ of 1 per cent of average daily deposits until the fund should reach 1½ per cent of the aggregate of state bank deposits, when collections were stopped, to be resumed if the fund should fall below 1 per cent. New banks were required to pay into the fund an amount equivalent to 4 per cent of capital stock when opening for business, constituting a credit against subsequent adjustment on the basis of daily deposits. No special assessments were provided for and the total collections in any one year could not exceed ¼ of 1 per cent of average daily deposits.

The banking code setting up this guaranty plan gave the Bank Examiner full discretion in respect to the issuance of new charters, specifically authorizing him to consult with the Guaranty Fund Commission and to withhold certificates to proposed institutions to commence business if he had reason to believe they were organized for any other purpose than the

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conduct of a legitimate banking business, or if he considered that no additional banking facilities were warranted in the location chosen.

When the plan went into effect there were in South Dakota 486 state banks, as of June 1916, with deposits of $70,500,000, and 124 national banks with deposits of $52,700,000. The state banks thus numbered 79.6 per cent of the total of 610 units, and held 57 per cent of the aggregate deposits. By June 1920, the number of state banks increased to 558 with deposits of $173,500,000, and national banks to 136 with deposits of $90,-300,000. Thus state banks increased in point of numbers by about 15 per cent and in deposits by 146 per cent, while national banks increased by less than 10 per cent in numbers, and by 71 per cent in deposits.

The state banks now constituted 80.4 of the total and held almost 66 per cent of the aggregate deposits. The number of persons per bank in 1916 was only 1110, and by 1920 it fell to 920 as a result of a recession in population and the increase in banks. Thus a very high degree of over-banking existed in this state when the guaranty plan went into effect, and grew worse under it.

Bank Failures Under the Guaranty Plan

During the first five and a half years of the plan, that is through June 1921, there were only 3 state bank failures with aggregate total liabilities of $330,000. In 1922 there were 5 suspensions, and in 1923, 14 more. The fund had been sufficient to meet its obligations up to this point, although its reserve had dropped to $94,000.

In the year ending June 30, 1924, 117 state banks failed. Their total liabilities were $44,000,000. Thirty-one more closed in 1925, 49 in 1926 and 35 in 1927. This was a total of 232, or almost 42 per cent of the state banks in operation at the outset of this four year period; in the same period 44 national banks, or 33½ per cent, failed in this state. This avalanche of failures was attributed principally to the violent collapse of agricultural prices that occurred, although certain banking practices came in for criticism.

As a result of the situation thus created the superintendent of banks proposed in 1924 that the bank guaranty law be amended to provide that no interest be paid on guaranty fund certificates. Without such action, he said, the law would become a dead letter since the interest alone would consume the proceeds of the annual assessment.

Financial Breakdown of the Plan

The financial history of the plan from this point deals with the after-math of its complete bankruptcy. The depositors of only sixteen of the banks that failed during its operation received payment in full on their claims. These payments depleted the fund. This was in March 1923. The

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1925 legislature passed a repeal of the guaranty law effective in January 1926, but a popular referendum rejected the repeal act. The situation then was, as of June 1926, that there were 194 insolvent state banks whose depositors held claims against the fund amounting to $43,400,000. Against this sum the fund had the assets of the failed banks, listed at $49,000,000, but with a liquidating value estimated at less than half this sum; it also had the income from the annual assessments on solvent banks.

The basis of these assessments was rapidly shrinking. At the peak, in 1920, there were 558 state banks with deposits of $173,500,000. The assessment yield was about $400,000. By June 1926 the number of state banks had fallen to 358, a loss of 200 units, and deposits had shrunken to $92,700,000, or by $80,800,000. At this point the assessment was yielding about $230,000 a year, which was less than enough to pay the interest on the certificates of indebtedness in the hands of depositors. The number of going state banks and the volume of their deposits continued to decrease, falling to 311 institutions with $71,300,000 deposits by June 1927.

In that year when the legislature met it was stated that all told 297 state banks had failed under the operation of the guaranty law, that 244 of these had remained closed, that $54,000,000 of certificates had been issued to depositors and that the ultimate realizations from liquidation of the assets of the failed banks could not reduce this obligation by more than 50 per cent so that the apparent deficit at that point was upwards of $27,000,000. Furthermore the annual increase of the deficit from interest accruing, above the receipts available from guaranty assessments, was at the rate of $2,500,000. In addition more banks were failing, 35 going under in 1927 with total liabilities of almost $7,000,000.

A Political Issue

Despite the manifest hopelessness of the plan under these conditions, it had been made a popular political issue. The new governor was elected in 1926 on a platform declaring for the retention of the law. Political expediency and obligations over-rode practical considerations, and forthright abandonment of even so clearly demonstrated a failure of the attempt to add strength to the state's banking structure was impossible. However, some change was imperative, and in 1927 the law was amended so as to provide that the depositors of banks that failed after July 1 that year should be entitled only to protection from a guaranty fund to be established by each state bank individually, but not to any benefits from the original general fund.

This new legislation in effect increased the double liability of bank stockholders to treble liability. It retained the guaranty assessment, each state bank being required to pay in annually ¼ of 1 per cent of its average daily deposits before any distribution to stockholders could be

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made. It provided that these payments, held to the credit of each bank respectively in the custody of the state treasurer, should be invested under the direction of each paying bank for its account. When additions and interest made these sums equal to the par value of the paying bank's capital stock, no more payments by it were required and the further earnings on its own accumulated fund were to be paid to it. The capital sum remained the property of the bank; in case of failure it was to be applied toward the obligations of the bank.

Abandonment of the Insurance Principle

This plan, obviously, was not based on the insurance principle in any sense, since it was not a device to distribute the risks of the individual over the group. It therefore constituted in fact the abandonment of the guaranty of deposits plan in South Dakota. Some real virtues in the revised law lay in the closer supervision over banking which it provided and the increased power to exclude undesirable institutions and persons from banking activities which it gave to the banking authorities.

As to the original guaranty fund, the report of the Superintendent of Banks for 1930 showed the deficit on June 30 that year at $36,769,000.

In 1931 the Supreme Court of South Dakota, in a case involving the determination of the status of the fund, reached the following conclusion:

> "The inescapable facts in this case render necessary the conclusion that the guaranty fund scheme proved in actual operation, under the conditions which it was required to meet, and for whatever reasons, entirely unable to accomplish what was hoped for it. Whatever assets remain in the insolvent banks wherein their deposits were made properly applicable to that purpose will, of course, be received by the petitioners, but we can see no reasonable expectation of their receiving anything from the guaranty fund beyond what is now therein. The facts are harsh, but undoubtedly the quicker they are faced and realized by all concerned, and false and specious hopes abandoned, the better the situation will be. The guaranty fund experiment in this, as in other states where it was attempted, has failed completely."

VI. NORTH DAKOTA

The fifth and last state to adopt a compulsory guaranty of bank deposits plan was North Dakota. The law went into effect here in 1917. It provided for a regular annual assessment of 1/20 of 1 per cent of average daily deposits until the fund should reach 2 per cent of deposits when assessments ceased until it fell below 1½ per cent. In case of emergency four extra assessments of 1/20 of 1 per cent in any one year could be called for, making the maximum total levy ¼ of 1 per cent.

The banking law in this state gave the banking authorities full discretionary authority to investigate and pass upon the desirability of granting charters for new banks both from the point of view of the qualifications of the organizers and of the public need for additional banking facilities.

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They had powers to submit to careful scrutiny all established banks before admitting them to the guaranty plan and to close those that could not comply with the prescribed requirements of condition and management; under this power several banks were closed. Minimum capitalization for a new bank was $15,000, in places up to 1000 population, with a rising scale for larger places. When the guaranty law went into effect there were 430 banks with capital less than $15,000, of which 414 had capital of $10,-000 or less. For several years immediately prior to the passage of the act there were no state bank failures reported in North Dakota. The apparent success of the plan in other states during the first years of its operations under favorable conditions was a factor in its adoption in North Dakota rather than any immediate situation there as an argument for its adoption.

When the plan started there were all told 695 state banks in North Dakota, with deposits of $90,300,000, and 158 national banks with $59,-000,000. Thus there was a total of 853 banks with $149,300,000 in deposits, of which 80 per cent were in the state system, holding 60 per cent of the deposits. At this time there were only 910 persons per bank in this state.

Moderate Expansion of State Banking

In the first three prosperous years of the plan the number of state banks increased moderately. On June 30, 1920, there were 717 state banks, an increase of only 22 units, with deposits of $124,100,000, or an expansion of $33,800,000. In the same period the number of national banks rose to 181, a gain of 23 units, with deposits of $76,800,000, a gain of $17,800,000. At this stage there were 898 banks of both classes, a gain of 45, or 5 per cent, and $200,900,000 in deposits, an expansion of $51,600,000, or 34 per cent. State banks now constittued 80 per cent of the total as to numbers and held about 62 per cent of the deposits. At this point there were only 720 persons per bank, so that the condition of over-banking had become even more acute.

The contribution of state banking to the inward weakening of the banking situation during this initial period of the guaranty plan was greater than appears on the surface of the foregoing figures, which indicate but a moderate expansion. Between June 30, 1917 and June 30, 1920, 89 new state banks were chartered, a number that was partially offset by consolidations and liquidations among state banks and by conversions to national charters. Among the newly chartered state banks 62 had capital of $20,000 or less and 50 had the minimum of $15,000. The net result of these shifts tended to increase the number of banks in the state with small capital and located in small places. The number of banks in the $15,000 to $20,000 classes increased from 169 in 1917 to 221 in 1920.

During its first three years the North Dakota guaranty plan experienced no difficulties. In this period, in the third year, two banks were sus-

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pended and their depositors were promptly paid in full with the aid of the guaranty fund. In the fourth year the collapse began.

The Basic Fallacy of the Guaranty

In the year ended June 30, 1921, 51 state banks failed. Crop failures among bank borrowing customers and national money stringency were attributed as the main causes in the report of the state bank commissioner. This, then, accentuates in clear-cut terms the basic fallacy of the guaranty idea. It attempts by means of premiums on the limited basis of the banks, which are only a part of the financial structure, to insure against the results of risks which originate outside the banks and are as wide in their source as the entire economic situation. It is as though a single insurance rate, based on fire experience alone, were made to serve for indemnity against all kinds of disaster.

In 1922, 12 state banks closed, in 1923, 20, and in 1924, 127. The aggregate liabilities of the 210 banks that closed in the four year period, 1921-24, were $39,600,000. The number of suspended banks was 29 per cent of those in operation at the beginning of the trouble in 1920. During this period 28 national banks, or 15 per cent of those at the outset, were suspended.

Bank Failures Under the Plan

During the next five years, 1925-29, 175 more state banks closed in a steady average of 35 a year. In 1929 the law was repealed. In the ten years of the operation of the plan from 1919 to 1929, a total of 387 state banks suspended, out of 710, or more than 50 per cent, with aggregate liabilities of $67,000,000. In this period 61 national banks in North Dakota also failed, which was 35 per cent of those in operation at the outset. This unusually high ratio for national banks doubtless was indicative of the unusually difficult conditions that were prevalent and which created economic risks that were wider than banking and entirely uninsurable through the limited medium of assessments against banks, based on their deposits for computation, but falling wholly on the much narrower basis of capital earnings for source of payment.

Financial Breakdown of the Plan

The financial disaster of the North Dakota guaranty plan was complete. The assessments during the life of the fund amounted to about $2,000,000. This was sufficient only to pay 10 per cent on the claims of depositors of about 200 of the closed banks. At the close of 1928 the outstanding certificates and claims eligible to guaranty totalled $25,000,000, against which there were estimated assets in the hands of the fund totalling

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approximately $13,000,000, leaving a then apparent deficit of $12,000,000, which was increased to some $14,000,000 by subsequent claims.

There was, in this case, no provision for interest, so that all the income from assessments was applicable against the principle, but this income in 1928 was only about $140,000, and the deposits in state banks were rapidly shrinking. The prospects of ever actually wiping out the deficit by this means were therefore hopeless. A proposal to issue state bonds to pay off the depositors of the closed banks was overwhelmingly defeated. The guaranty law was repealed in 1929.

VII. KANSAS

Three other states enacted non-compulsory plans. A voluntary system was set up in Kansas in 1909, providing that any bank that had been in business a year and had unimpaired surplus of 10 per cent could qualify for membership in the fund. On entry, banks were required to deposit bonds or cash of $500 for each $100,000 of average unsecured deposits, to which the guaranty was restricted. In addition, assessments were fixed at 1/20 of one per cent a year on average guaranteed deposits, less capital and surplus, until the fund should total $1,000,000. Further assessments in the same ratio, not exceeding five in one year, could be called for, to meet payable claims should the fund fall below $500,000.

The minimum capital required for organizing a bank in this state was $10,000 in places with population less than 500, with a rising scale for larger places. In 1918, the State Bank Commissioner in his biennial report, in commenting on bank chartering policies and on the increase in the number of state banks from 987 in 1916 to 1044 in 1918 said that "this increase has been brought about by the Charter Board taking a broad view of the needs of our state, and granting charters wherever there has been a showing made that there was need for increasing banking facilities."

When the guaranty plan went into effect in 1909 there were 757 state banks with deposits of $84,800,000 in Kansas. National banks numbered 202 with deposits of $61,700,000. There were about 1760 persons per bank in the state at this time. By 1912 the number of state banks had increased to 890, a gain of 133 units, while their deposits rose to $96,900,000, a gain of $12,100,000. The figures for the national banks in Kansas were virtually unchanged during this period.

Membership in the Voluntary Plan

Of these 890 state banks in 1912, 456 had become members of the voluntary guaranty plan. The larger banks entered the system more generally than the small banks so that whereas about 50 per cent of the state banks as to numbers were under the guaranty plan, it covered about 60 per cent of the deposits in state banks as a whole.

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Between 1912 and 1920 the number of state banks grew to 1096. This was an increase of 206 units or 23 per cent. They held deposits of $291,-400,000, an increase of $194,500,000, or 200 per cent. In this period the number of guaranteed banks grew from 456 to 676, an increase of 220 units or 48 per cent. Guaranteed state banks in 1920 had come to represent through these increases over 61 per cent of all the state banks in the state, the volume of their increases comprising all of the growth in the number of state bank units. The guaranty banks held about 68 per cent of the deposits in state banks, or approximately $199,600,000.

In this same period the number of national banks in Kansas grew from 204 to 240, an increase of 36 units or a fraction over 17 per cent. Their deposits rose from $60,700,000 to $143,100,000, a gain of $82,400,000 or almost 136 per cent.

These data show that in 1920 there was an aggregate of 1336 banking units in the state. This made one bank for each 1320 persons as compared with one for each 1760 persons ten years earlier. Ninety per cent of the net increase in the number of banking units in the state during this decade consisted of state guaranty plan banks.

A Three-Fold Banking Structure

At this point, on the eve of the 1920-21 depression, the banking structure in the state was made up as follows:

There were 240 national banks with deposits of $143,100,000; this represented about 18 per cent of the banks and 33 per cent of the deposits.

There were 420 state banks that were non-members of the guaranty system holding deposits of $91,800,000; this was 31 per cent of the banks and 21 per cent of the bank deposits in the state; it was 38 per cent of the state banks and 31 per cent of their deposits.

There were 676 state guaranty fund banks holding $199,600,000 in deposits; this was over 50 per cent of all banks in the state, and 46 per cent of total deposits; it was 62 per cent of the state banks and 69 per cent of their deposits.

This was the three-fold structure that was to face the test of the depression that began in 1920.

During the preceding ten years, embracing the first decade of the guaranty plan in Kansas, there had been but eight state bank suspensions there, of which six were non-guaranty banks and two were guaranty banks. Depositors of the failed banks had promptly been paid in full and the plan was hailed as an unqualified success as a means both for strengthening banking and facilitating and insuring prompt payment of depositors.

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Guaranty Banking Makes the Poorest Showing

In the ordeal of hard times that was now to come however, the guaranty system was to prove the weakest of the three parts of the banking structure. Both the unguaranteed state banks and the national banks made a better showing in the bank failure record.

During the two year period September 1920 to September 1922 there were 23 suspensions of state chartered banks. Of these, 17 were members of the guaranty plan and 6 were not. This was in the ratio of 2.5 per cent of the number of guaranty banks in operation and of 1.4 per cent for the non-guaranty state banks. During this period no national banks failed.

During 1922-24 there were 54 suspensions of state banks in Kansas. Forty-two were guaranteed banks and 12 were unguaranteed. This was a ratio of 5.9 per cent for the guaranteed banks, and of 3 per cent for the unguaranteed state banks. In the same interval 4 national banks closed, a ratio of 1.5 per cent of those in operation.

In 1924-26 there were 35 guaranteed banks suspended, a ratio of 5.3 per cent; 10 non-guaranteed state banks, a ratio of 2.6 per cent; and 2 national banks, a ratio of 8/10 of 1 per cent.

The State Bank Commissioner officially attributed these failures to incompetency, dishonesty, over-banking and the general fall in values of the period. Thus, the guaranty plan, since the bulk of the failures occurred in this part of the banking structure, plainly fostered by means of the blind public confidence and lack of discrimination which it created, the entry of these first three major causes of weakness into the banking situation, instead of serving as a source of stronger banking conditions.

The Collapse of the Plan

Following this debacle of the guaranty plan, and under a court rule fixing the liability of guaranteed banks at the amount of bonds on deposit in the fund, an exodus of the members began, there remaining only 255 in good standing in September 1926. The State Bank Commissioner expressed the belief that under these conditions the fund could never meet its obligations and formally recommended repeal and liquidation of the scheme. By 1928 the membership had fallen to 42.

The financial position of the fund at the end of 1926 showed total net liabilities, mainly in the form of outstanding 6 per cent guaranty certificates issued to depositors of failed banks, of $6,500,000, with assets of $1,115,000, leaving a deficit of over $5,000,000.

The Kansas plan was repealed in 1929. During the 20 years of its existence there had been 212 failures of state banks in Kansas, of which number, 152, or almost 72 per cent, were guaranteed banks. At no time did the proportion of guaranteed banks to the total number of state banks amount to a ratio comparable to 72 per cent. During this 20-year period

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the number of banks in the guaranty system ranged from 51 to 64 per cent of the total number of state banks, with an average of less than 58 per cent, so that the guaranteed part of the state banking structure contributed a disproportionate share of the number of bank failures in the state.

The records of the fund show that guaranty certificates in the amount of $13,595,000 had been issued to depositors of failed member banks. Dividends to depositors to the amount of $6,420,000 were paid, of which $2,685,000 came from contributions to the fund on the part of banks through assessments and deposits in it. Five of the failed guaranty banks were able to pay their depositors in full out of their own assets; in all, the depositors of 29 guaranty banks were paid in full in the order of liquidation, and those of two others were paid in part. The depositors of the remaining 121 banks received nothing. The deficit amounted to $7,175,000 at the abandonment of the plan.

VIII. TEXAS

In Texas state banks were given the compulsory choice of securing their depositors by the guaranty fund system or a bond security system. This law went into effect in January 1910.

Under the bond security system banks electing this method were required to furnish a bond, policy of insurance or other acceptable guaranty of indemnity, in an amount equal to their capital as additional security for depositors. Provisions for maintaining adequate and satisfactory security, and for increasing the amount of the bonds as deposits increased beyond a specified ratio to capital, were set up. Only about 40 banks with capital of approximately $4,000,000 chose this method and the number remained about this level until 1925.

The remainder of the state banks, numbering about 475, adopted the guaranty fund system. The Texas plan was distinguished from others by the high rates of its assessments and the size of the fund it sought to create. Established banks on becoming members were required to deposit in the fund 1 per cent of average daily deposits for the preceding year, and new banks 3 per cent of capital and surplus. Regular assessments were ¼ of 1 per cent of average daily deposits until the fund should reach $5,000,000. In case of depletion of the fund or of an emergency the State Banking Board was empowered to levy 2 per cent of average daily deposits, this being the maximum for any one year. All public, secured and interest bearing deposits were excluded from the guaranty so that its protection covered, it was estimated, less than half the total bank deposits.

In this state the minimum bank capital on organization was $10,000 in places of less than 800 inhabitants, with a rising scale for larger places. The State Banking Board was given full discretion in granting new charters

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on the basis of the public expediency of proposed new institutions and the character of their organizers.

The Boom in State Charters

Despite these restraining powers a rapid rise in state banking ensued after the adoption of the plan up until the inevitable turning point of the 1920-21 economic reaction.

In 1910 there were 584 state banks with deposits of $42,100,000. National banks numbered 485 with deposits of $104,900,000. Thus state banks constituted about 55 per cent of the number of banks in the state and held about 29 per cent of the deposits. There were at this date 3640 persons per bank in the state. By 1920 the number of state banks had increased to 992 with deposits of $297,100,000. This was a growth of 408, or 70 per cent in numbers, and $255,000,000 or 605 per cent in deposits. National banks had increased to 520, with $339,800,000 in deposits, a rise of only 35, or 7 per cent in numbers, and of $234,900,000, or 224 per cent in deposits. State banks now constituted over 65 per cent of the institutions and held more than 46 per cent of the deposits as compared with 29 per cent ten years earlier. The number of persons in the state per bank at this stage was 3080.

During the first 10 years of the guaranty plan 17 state banks failed with total liabilities of $2,370,000. In this period 4 national banks suspended. The amounts withdrawn from the guaranty fund to pay depositors of failed member banks amounted to $880,000. In view of these external aspects, the plan was hailed as a great success.

Inwardly, however, fostered by public confidence that deposits in any state bank were safe owing to the guaranty, serious weaknesses were developing. One was the chartering of an excessive number of small banks. As an instance, during the year ending August 1912, 82 institutions were granted state charters, and of these 40 had the minimum capital of $10,000; 52 had capital of $20,000 or less. Again in 1914, when there were 867 banks, 249, or almost 29 per cent, had the minimum capital of $10,000; 455, or 52 per cent, had capital of $20,000 or less.

Writing on the effect of the plan W. A. Philpott, Jr., Secretary of the Texas Bankers Association, said that after the guaranty plan was adopted there "began the period of wildest promotion, the greatest bank expansion Texas had ever seen," and that it was the signal for numerous persons of no banking experience "to open a bank and offer the depositing public the same degree of safety afforded by the old, well-established, conservative banker with ample capital and seasoned experience. . . . Banks were organized in every town and hamlet until the peak of more than 1000 banks was reached. Every one hung out the sign 'Guaranty Fund Bank'

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and was allowed to advertise the statement that no depositor had ever lost a dollar in a guaranty fund bank in Texas."

The booming prosperity of this first decade of the fund made its assessments an easy burden for the banks to bear, distributed as it was over almost a thousand institutions, and even banking opinion is reported as having generally been won over to the belief that the plan was sound and helpful.

Bank Failures Under the Guaranty

However, in the six year period, 1920-25, about 150 guaranty fund banks failed. Of these, 52 were reorganized without loss to the fund. Under the Texas plan no certificates were issued to depositors, but when a bank was taken over by the banking department and liquidation begun, depositors were paid until its available cash was exhausted, then the guaranty fund was drawn upon, and as it became depleted assessments were collected from the banks up to 2 per cent in a year of their average daily deposits. By this process about $19,000,000 was pumped out of member banks in 1920-25; final liquidation of the closed banks returned about $4,000,000 to them, leaving their net losses at $15,000,000.

While this system took care of the depositors, it threatened to wreck the banking structure as a whole. Enforced guaranty fund assessments reduced and in some cases eliminated dividends, cut into surpluses and even impaired the capital of solvent banks, until both stockholders and depositors in all state banks became alarmed for fear their institutions would be dragged down also.

Desertion of the Plan

The situation became so acute that in 1925 the guaranty law was modified so as to permit banks to shift over to a new bond plan whereby they could obtain relief from guaranty fund liability by furnishing a bond in the amount of their capital stock. All the state banks, with the exception of 24 whose condition was too weak to furnish the required sureties, left the guaranty system at once, 654 changing to the bond plan and 88 converting to national charter.

The bond security plan was later made ineffectual by a Texas Supreme Court decision to the effect that under the law as amended the Bank Commissioner must accept government and municipal bonds which were part of a bank's assets in lieu of a surety bond, and in 1927 the law was repealed.

IX. WASHINGTON

The experiment with the guaranty plan in the state of Washington was short-lived, disastrous and too restricted in its scope and experiences to add anything to the picture already presented. This state adopted a wholly

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optional plan in 1917 and about 39 per cent of the state banks joined the system, or 46 in number, mostly small, having aggregate capital of $3,445,000 and deposits eligible to guaranty of $37,379,000. By June 1921, 120 banks were members, with guaranteed deposits of about $71,000,000. Assessments had built up the fund to about $525,000.

In June 1921 occurred the first failure of a guaranteed bank. It involved the largest bank in the system with deposits subject to guaranty in the amount of $9,000,000. In addition to the $525,000 then in the fund, contingent and special assessments brought in $300,000 more. The assets of the failed bank liquidated at about $6,750,000, so that depositors received from this source and from the guaranty fund a total of $7,575,000 or about 84 per cent of their guaranteed deposits.

This single failure broke down the plan. Under the law the member banks were permitted to withdraw by giving six months' notice and making payment of all existing pro rata obligations. All members quickly withdrew after meeting their losses and within the year the law became inoperative. It was formally repealed in 1929. The unpaid warrants of depositors were about $1,400,000.

X. SOME NATIONAL COMPARISONS

Comparisons of banking during the years from 1910 to 1930 in the guaranty states as a group, omitting the brief and inclusive Washington experiment, with that in the non-guaranty states show that guaranty banking made very much the poorer record.

A degree of inflation occurred in the deposits of state banks in the guaranty group, largely, and in some cases mainly, through the influence of false public confidence created by the guaranty laws, that stands out in marked contrast with the deposit data of non-guaranty banking, both state and national. This is shown by the figures for 1910 as compared with 1920. Between these years all the guaranty laws were passed and the boom of banking under them reached its heights, creating the situation that existed on the eve of the reaction that began in 1920. In 1910 the state banks in the seven guaranty states had aggregate deposits of $400,100,000. By 1920 this figure had grown to $1,468,600,000, an expansion of $1,068,500,000 or 267 per cent. In the same period the deposits of the national banks in the same states grew from $336,400,000 to $966,800,000, an expansion of $630,400,000 or 187 per cent. As to state banks in the non-guaranty states, containing all the more populous commonwealths and the rapidly developing industrial areas, their deposits increased in the ratio of but 134 per cent.

In the following decade, 1920-30, the failure record of guaranty banks makes a conspicuously bad showing. It was at the opening of this period that the guaranty plan received the first real test of its value in the 1920-

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21 general business reaction following seven years of easy times, and also during the greater part of the decade the guaranty laws remained on the statute books and their effects were operative in the banking structures of the guaranty states. This period, therefore, constitutes a revealing basis for judging between guaranty and non-guaranty banking.

On June 30, 1920 there were 5306 state banks operating in the seven guaranty states of Oklahoma, Kansas, Nebraska, Texas, Mississippi, South Dakota and North Dakota. During the next ten years 1624 state banks suspended in these states. This number was in the ratio of 30.6 per cent of the state banks operating in this group at the outset of the period. On the same date there were 16,004 state banks in operation in the 41 non-guaranty states, and during the decade 2914 state institutions failed in these states, a ratio of 18.2 per cent. These figures further show that the guaranty group of states, constituting less than 15 per cent of the states in the Union, containing but 12 per cent of the population of the nation and having but 25 per cent of the state banks, contributed during these ten years almost 36 per cent of the state bank failures in the nation as a whole.

It is plain from these comparisons that guaranty plans contributed substantially to creating in the area of their influence a conspicuously weak spot in the nation's banking structure.

XI. GENERAL SUMMARY AND CONCLUSIONS

Of none of the eight cases studied in the foregoing pages could it be said that the aims of the guaranty plans to protect the public were realized or that banking was benefited.

In the case of Oklahoma, state banking was greatly stimulated at the expense of competing national banks, both as to numbers and volume of deposits. During the operation of the plan a yearly average of 2.4 per cent of the number of guaranteed state banks failed while the ratio was ½ per cent for the non-guaranty national banks. In the fifteen years of the plan state banks paid into the guaranty fund assessments aggregating $3,700,000, the payments averaging over a considerable part of the period 5 per cent annually on the total state banking capital. When the plan was abandoned there were left unpaid depositors' claims of $7,500,000. The moral effect of the guaranty was to create a sense of false security in the public mind and a lack of discrimination between reliable and unreliable banks and bankers, since it was felt that all deposits alike were equally protected by the state. Under these conditions unworthy bankers and unsound banks were enabled to command public confidence and patronage. From an insurance point of view, the unselected risks creating claims against the fund through the failure of unsound banks made it

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impossible for any practical rate of assessments to create sufficient reserves to keep the fund solvent and able to meet its obligations.

In Nebraska, a similar over-stimulation of state banking followed adoption of the guaranty plan, as well as an excessive rate of failures; in a ten year period 329 state banks suspended, on a yearly average of 3.8 per cent of those in operation as compared with 1.8 per cent for national banks in the state. Seventeen years' operation of the plan cost Nebraska state banks $17,700,000 in assessments, yearly payments during the last eight years of its existence running at the rate of 4.16 per cent on the aggregate capital, surplus and undivided profits of all state banks there. When the plan terminated, the deficit in the form of principle and accrued interest on unpaid depositors' claims amounted to $22,000,000. As in Oklahoma the moral effects of the plan had been to foster unsound banking, create false public confidence, place unfair burdens upon well conducted banks to pay for the misdeeds of others and to leave unfulfilled the faith of the public in the special security of their deposits in the guaranty banks.

In Mississippi no excessive increase in the number of state banks occurred under the guaranty plan, although their deposits increased much more greatly than in the competing national banks. The rate of failures also in this state was relatively moderate as compared with what occurred in Oklahoma and Nebraska. Yet, due to large deposit liabilities of the banks that failed, at the end of fifteen years a deficit of $5,000,000 had accumulated despite substantial assessments collected from the banks. It was estimated that it would have been necessary to triple the rate of assessment to have kept this plan solvent, but that would have placed an insupportable burden upon sound state banking.

South Dakota, already seriously over-banked when the guaranty plan went into effect, became somewhat more over-supplied with state banks under its influence. In the four years 1924-1927, 232 state banks, or 42 per cent of those in operation at the outset of the period, failed due to a collapse of agricultural prices and questionable banking. All told 297 state banks failed under the operation of the plan. The depositors of only sixteen of these received payment of their claims in full, the fund being thereby exhausted. The legislature repealed the guaranty law but a popular referendum reinstated it. The deficit, in the form of unpayable guaranty certificates issued to depositors, was upwards of $27,000,000, with income from assessments on sound banks insufficient to meet even the interest on these claims. More failures were adding to the volume of claims. Yet the plan had been made a political issue and repeal was impossible. Finally, a compromise was worked out that was an abandonment of the insurance feature of the plan in fact, though not apparently so in form. Three years after this change, the original fund was reported as showing a deficit of nearly $37,000,000. Subsequently the State Supreme Court ruled that these claims were uncollectable beyond the proceeds from

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liquidation of the remnants of the assets of insolvent banks remaining in the custody of the fund.

In North Dakota the increase in the number of state banks under the influence of the guaranty plan was moderate, although there was a marked increase in the number with small capital located in small places. The collapse of the plan began in the fourth year when 51 state banks suspended, largely due to crop failures among borrowers and to national money stringency. The results indicated clearly the fallacy of attempting to operate an insurance scheme based on a single part of the financial structure, but subject to losses arising from unselected risks and from hazards coming from the entire economic field. During the ten years' operation of the plan a total of 387 state banks suspended out of 710, more than 50 per cent, with aggregate liabilities of $67,000,000. Assessments during the life of the scheme amounted to $2,000,000, sufficient to pay only 10 per cent of the claims of depositors in 200 of the suspended banks. At the time of repeal of the law the deficit was some $14,000,000.

Kansas adopted a non-compulsory plan, resulting in three classes of banks in the state,—the national banks, the non-guaranteed state banks and the guaranteed state banks. About half the 900 state banks were members of the guaranty plan by the third year of its operation. In the next eight years the number of guaranty banks increased by nearly half, while the non-guaranty state banks stood still. The number of national banks increased moderately. On the eve of the 1920-21 depression the guaranty banks comprised over 50 per cent of all banks in the state and held 46 per cent of the total deposits. In the ensuing hard times the guaranteed banks made the worst showing of the three classes. During 1920-22, 17 guaranteed banks, or 2.5 per cent, failed, 6 non-guaranteed state banks, or 1.4 per cent, and no national banks. During 1922-24, 42 guaranteed banks or 5.9 per cent of those in operation, 12 unguaranteed state banks or 3 per cent, and 4 national banks, or 1.5 per cent, made up the suspensions. In 1924-26 there were 35 guaranteed banks closed, a ratio of 5.3 per cent, 10 non-guaranteed state banks, or 2.6 per cent, and 2 national banks, or 8/10 of 1 per cent. The cause of these failures was attributed largely to incompetency, dishonesty and over-banking which therefore prevailed to a predominant degree among guaranteed banks. During the 20 years of the plan in Kansas, 212 state banks failed, of which 152, or about 72 per cent, were guaranteed banks, which averaged only 58 per cent of the number of state banks, so that they contributed a highly disproportionate share of the failures. During the 20 year life of the fund failed banks created depositors' claims of about $13,600,000. Proceeds of liquidated assets amounted to $3,700,000, while assessments on banks amounted to $2,700,000. The deficit at the abandonment of the plan was $7,200,000. In all, the depositors of only 29 banks with claims against the fund were paid in full and two in part; those of 121 banks received nothing.

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Texas, with a plan optional as between a bond security system and a guaranty plan, drew virtually all state banks into the latter, 475 in number. In ten years the state banks increased 70 per cent in numbers and 605 per cent as to deposits. The national banks there increased by only 7 per cent in numbers and 224 per cent in deposits. An excessive number of small banks and persons unfit to engage in banking characterized the excessive growth in state banking. In the six year period 1920-25 about 100 guaranteed banks failed, costing the solvent banks some $15,000,000 in assessments. These caused inroads on the earnings and even capital of the solvent banks, threatened to wreck the entire state banking structure and caused such public alarm that the banks were allowed to withdraw from the plan and subsequently both it and the bond security scheme were annulled.

A single bank failure wrecked the voluntary Washington guaranty plan. It cost the member banks $825,000 and left depositors with unpaid warrants of about $1,400,000 when the plan was abandoned.

The Lessons of Experience

These lessons of experience appear to demonstrate conclusively that in practice the guaranty of deposits plan generally tended to induce an unsound expansion in the number of banks and the volume of bank deposits under its supposed protection. This was clearly connected with the indiscriminate popular confidence created toward the banks under the guaranty. Unneeded, undersized and unsound banks, as well as unqualified bank operators, were enabled to command public patronage because of the belief that the banks in the state system were guaranteed by the state and therefore the depositor could not lose.

The rate of bank failures was greater among guaranteed banks than among non-guaranteed banks doing business side by side with them. This produced a higher rate of loss than the guaranty funds, set up by assessments against member banks, were calculated to meet and resulted in the insolvency of the funds, their financial breakdowns and large deficits in unpayable claims in the hands of disappointed depositors.

This inadequacy of the funds occurred even though the assessments on the member banks were oppressively high. Higher assessments, sufficient to sustain the funds, would have driven many banks out of business. In one case, where the method of assessment was such as to permit exactions from sound banks sufficient to meet the claims against the fund in full, the impairment of sound banks was so great as to cause serious public alarm and to force abandonment of the plan.

Actuarial Difficulties

The apparently unsurmountable actuarial difficulty in the guaranty plan appears to be the impossibility of placing it on the basis of selected

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risks. For one thing, the causes leading to many bank failures arose from general and wholly unpredictable economic conditions far broader than the field of banking experience itself. Again, either unrestrictive laws as to chartering new banks or lax administration of the laws admitted to the plan a large volume of banking of a character that created abnormally high volumes of claims upon it. Even where no great increase was allowed in the number of banks, and therefore a certain degree of numerical selection of risks prevailed, internal deterioration of banking under the influence of the plan tended to negative this selectivity. From such causes, therefore, weaker banking and higher mortality among the guaranteed banks destroyed the expected balance between the risks and the reserves created by the assessment.

As a matter of unbiased history, therefore, the guaranty of deposits plan proved fallacious and unworkable, whether from the point of view of banking practice, actuarial science as applied to the insurability of bank deposits, the effects on the human element within banking, the effects on the public attitude toward banks, the attitude of public bank supervisory officers in respect to their duties and administrative functions, or the fortifying of the banking structure to withstand adverse economic conditions.

These historical experiences show that the guaranty plan is inherently fallacious and based on erroneous premises and assumptions. It has proved to be one of those plausible, but deceptive, human plans that, in actual application only serve to render worse the very evils they seek to cure.

Good Banking the Only Guaranty

It is fundamental that the only real guaranty for bank deposits is good banking. Deposit guaranty is not good banking. It is an attempted substitute for good banking. Good banking, like good health, cannot be created by post mortem measures to make good for the ravages of previous bad habits or conditions that have been allowed to thrive behind the screen of concealment, which is exactly the way in which guaranty plans have consistently operated.

The time and the way to guard against banking troubles is by applying sound habits, principles, safeguards and forehanded methods concurrently with and as an inherent part of banking operations themselves. The aim should be to prevent at the roots the growth of an abnormal bank failure situation requiring treatment as a special public problem. The aim should be to keep, by good banking, the inevitable troubles that occur in banking within normal economic limits, such as are the unavoidable expectancy in any line of business.

In other words, the matter of depositing money in banks should not be looked upon as an extra-hazardous business relationship requiring spe-

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cial guaranties by law. Ample security should inhere in the care and soundness of the banking processes themselves. It is a fundamentally wrong approach to the banking problem to set banking apart as a financial activity that is normally liable to cause losses and business confusion that must be indemnified against.

This, in effect, would be to recognize that there must be tolerated and carried in the banking structure types of banking and classes of bankers whose methods and shortcomings are bound to cause disasters analogous to fire and high water, whose damage must be paid for out of assessments against the legitimate earnings of good banking. Insurance is justifiable against unpreventable natural risks, but it is essentially anti-social when used as a make-good for preventable wastes and controllable losses.

Prevention Better Than Indemnity

The causes of insecurity of bank deposits are found for the most part in economic conditions and banking practices that can be identified. The logical procedure is to aim at prevention of these causes so far as possible and at fortifying the banks by good banking against adverse circumstances so as to avoid failures. The guaranty plan acts to defeat this aim, since it tends to cover up and aggravate certain aspects of the very conditions and practices that cause bank troubles.

Foremost among the deleterious effects of the guaranty of deposits, glaringly apparent in every case in which it was tried, was that it served as a smoke-screen for bad banking. It dimmed the perceptions of the public and its discrimination between sound and unsound banks. Within the banks it tended to dull the sense of responsibility resting upon the individual banker to defend the sanctity of his depositors' money by every faculty at his command, since a large part of that responsibility had been supposedly taken over by the state.

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THE GUARANTY OF BANK DEPOSITS

ARTHUR ALVIN SMITH

A THESIS
IN ECONOMICS
PRESENTED TO THE FACULTY OF THE GRADUATE SCHOOL IN
PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR
THE DEGREE OF DOCTOR OF PHILOSOPHY

NASHVILLE

1933

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THE GUARANTY OF BANK DEPOSITS

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ARTHUR ALVIN SMITH

Winfield, Kansas.
June, 1934.

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The Guaranty *of* Bank Deposits

By Arthur Alvin Smith

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PERHAPS THE most significant, and certainly one of the most drastic, phases of the Glass-Steagall Banking Act of 1933 is the provision which creates a federal system of deposit insurance. Although generally considered a revolutionary measure and a decided break with traditional banking principles, the insurance or guaranty of bank deposits is not without precedent in the annals of American banking. As early as 1829, the legislature of New York, in an effort to protect bank creditors, more especially noteholders, created the famous Safety Fund System, under which all member bank obligations, deposit liabilities as well as notes, were insured by a fund composed of annual assessments from each member bank to the extent of one-half of one per cent of its paid-in capital stock.

The system met its first real test in the panic of 1837, and, despite heavy losses, the fund withstood the strain and had a substantial sum in 1840. However, the failure of eleven banks in 1841 and 1842 resulted in a loss of $2,630,000, depleted the fund, and mortgaged it far into the future. Realizing the hopeless insolvency of the fund, the legislature of 1842 amended the Safety Fund Law in such a manner that only obligations in the form of circulating notes were protected, thus no longer guaranteeing deposits. As a guarantor of notes the Safety Fund System operated until 1865 when it became extinct following the levy of a Federal tax of 10% on state bank issues.

When the national banking system was created in 1863 a plan for securing notes was adopted with little essential change from the free banking system of New York, but no provision was made for the guaranty of deposits. The nearest approach to the latter was the legal requisite that each national bank maintain a liquid reserve.

Our modern guaranty-of-deposits movement had its inception in the Middle West during the last decade of the nineteenth century. The Populists strongly advocated the idea as an item of reform legislation following the panic of 1893, and William Jennings Bryan, a true son of the Middle Border, introduced the proposition in Congress, where it received little consideration. However, the measure was the center of acrimonious legislative wrangling in Kansas and Nebraska. In the former state a special session of the legislature was convened in 1898 and a bill to compel all banks in the state to guarantee their deposits passed the Senate by a good majority only to fail in the House by two votes.

The return of prosperity at the close of the century tempered the guaranty movement somewhat, and it was not until the distressing financial crisis of 1907 that popular sentiment was once more aroused in favor of the plan. Again the agitation was focused in the

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states of the Middle West—the radical Middle West where so many expressions of frontier liberalism have been conceived and have broadened into national issues. On December 17, 1907, the legislature of the month-old state of Oklahoma enacted the first modern deposit guaranty measure, after the constitutional convention a short time earlier had failed by only a few votes to inject the principle into the Oklahoma Constitution.

Deposit guaranty caught the popular fancy throughout the nation; it was widely heralded as a preventive of panics and a sure cure for many of our financial ills. Its advocates argued that salutary influences would react to the benefit of everyone, the public, the depositor, and the banks which participated in the plan. Not only was it claimed that public confidence would preclude the dangers of bank runs and of money stringency resulting from hoarding, but the plane of banking conduct was expected to be raised as a consequence. The national Democratic convention of 1908, meeting at Denver, adopted the Oklahoma plan as a plank in its campaign platform. The Republicans, realizing that any proposal for the security of the depositor was a vote-getter, advocated the postal savings system.

Although a drawn political issue in the national campaign of 1908, both parties in several Middle-western states pledged themselves to deposit guaranty in local campaigns. The fact that Oklahoma had passed a guaranty law soon aroused apprehension among bankers in southern Kansas over the possibility that guaranteed banks in the neighboring state would attract Kansas deposits. Pressure was brought to bear upon the state administration, and Governor Hoch, a Republican, called a special session of the legislature in 1908 for the specific purpose of enacting a guaranty law, but opponents of the idea succeeded in substituting an abortive measure which the governor vetoed. During the regular session of 1909, however, the legislature of Kansas enacted a guaranty law. Nebraska (1909), Texas (1909), Mississippi (1914), South Dakota (1915), North Dakota (1917), and Washington (1917) all established guaranty systems, and during the same period of years the legislatures of more than a score of other states seriously contemplated similar action.

In the case of *Noble State Bank v. Haskell,* 219 U.S. 110, a test case instituted and financed coöperatively by a number of state and national banks of Oklahoma, the Supreme Court of the United States held the state guaranty laws constitutional under the police power.

A Description of the State Systems

Participation. Laws of five of the states, Oklahoma, Nebraska, Mississippi, North Dakota, and South Dakota, compelled all state banks to become members of the guaranty systems, whereas Kansas and Washington permitted optional participation. In Texas a dual system was created embracing a guaranty fund plan under which member banks mutually guaranteed each other's deposits and a bond security plan under which each bank furnished a bond securing its own deposits. State banks were obliged to choose one of the two methods.

Provision was made in most of the laws enabling national banks to participate voluntarily in the guaranty systems, but shortly after the enactment of the Oklahoma law, the Attorney-General of the United States, upon request of the Comptroller of the Currency, rendered an opinion to the effect that national banks as instruments of the government of the United States could not operate under the state guaranty plans.

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Administration. Responsibility for the administration of the guaranty systems varied among the states. In Oklahoma the original act created a State Banking Board comprised of ex-officio members, the Governor, the Lieutenant-Governor, the State Treasurer, the President of the Board of Agriculture, and the State Auditor. Later the personnel of the Board was changed to the Bank Commissioner and three members appointed by the Governor from a list of names submitted by the State Bankers' Association. In Kansas the State Department of Banking through its regular staff administered the guaranty system, and the guaranty fund was in the custody of the State Treasurer subject to order of the State Bank Commissioner. The Nebraska guaranty system was under the administration of a State Banking Board at the outset, but in 1923 was placed under the control of a Guaranty Fund Commission. Guaranty Fund Commissions likewise were in charge of the systems in North Dakota, South Dakota, and Washington. In Mississippi the administrative body until 1922 was a Board of Bank Examiners consisting of three members elected directly by the people; in that year, however, the Board was abolished and the office of Superintendent of Banks was created. In Texas ultimate responsibility rested with the State Banking Board.

Guaranty Funds and Assessments. Member banks in each state were required to pay assessments for the creation of a fund known as the guaranty fund, from which losses to depositors were paid. In five of the states the maximum size of the guaranty funds was expressed by a percentage relationship, varying from 1.5% of average daily deposits in Nebraska and South Dakota to 4% in Washington. In Kansas, Mississippi, and Texas maximum amounts were expressed in definite sums of $1,000,000, $500,000, and $5,000,000 respectively. The laws provided that when the maximum of the funds should be realized assessments against the banks were to cease until the funds had been reduced below a stated minimum.

Regular annual assessments varied from as low as one-twentieth of one per cent of average daily guaranteed deposits in Kansas, Mississippi, and North Dakota to one-fourth of one per cent in Texas and South Dakota.

In order to make what was thought to be a satisfactory allowance for emergencies, the laws of seven of the states provided for special or extra assessments when regular assessments were insufficient to meet the losses. Special assessments could not exceed a legally stated maximum in any year, ranging from one-fifth of one per cent of average deposits in North Dakota to two per cent in Texas. The guaranty law of South Dakota made no provision for special assessments, and in Oklahoma by amendment they ceased after 1916.

In order to have their deposits guaranteed from the opening day of business, new banks organized subsequent to the enactment of the laws were required in most of the states to pay into the guaranty fund an amount equal to a stipulated percentage of their capital, later to be adjusted on the basis of assessments.

In Nebraska, South Dakota, North Dakota, and Washington the guaranty fund was held in member banks subject to the order of the Guaranty Fund Commission. Immediately upon receiving notice that assessments, either regular or special, had been levied, banks in these states were to set apart on their books such amounts to the credit of the fund. In Oklahoma assessments were paid with non-interest bearing cashiers' checks which were held by the State Banking Board un-

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til necessary to collect payment. In Kansas and Mississippi member banks paid the amount of their assessments to the State Treasurer who disbursed it upon order of the Bank Commissioner. In Texas 25% of the guaranty assessments had to be paid in cash to the State Treasurer. The remaining 75% could be paid in the form of demand deposits in the respective banks to the credit of the State Banking Board.

Nature of the Guaranty. With a single exception, all of the laws provided that the guaranty or insurance should apply only to deposits not otherwise secured and not bearing a greater rate of interest than a statutory rate, or a rate fixed from time to time by authority, either by the Bank Commissioner or by the Guaranty Fund Commission. In Texas only non-interest bearing, unsecured deposits were protected by the guaranty fund.

Under no conditions did the guaranty apply to a bank's obligations as endorser upon bills discounted, to bills payable, or to money borrowed from correspondents or others. Clearly it was the intention of the laws to safeguard the depositor and not all bank creditors. However, in Nebraska and Mississippi holders of exchange in good faith came within the protection of the guaranty fund.

Although the guaranty systems were creatures of the states and in the years of stringency many people contended that the states were liable, most of the statutes definitely excluded the state from any financial liability whatsoever. The banks were mutual guarantors and the state was responsible only for the administration of the system.

Loss Settlement Procedure. The method of paying losses to depositors in failed guaranty banks was substantially the same in all of the states. When a guaranty bank failed, the liquidating officer certified the names of depositors entitled to protection and the amounts of their deposits either to the Bank Commissioner or to the Guaranty Fund Commission, and upon approval of such authority the certified depositors were paid from the guaranty fund. By right of subrogation the fund then held prior claim against the assets of the insolvent institution.

If the money in the guaranty fund were insufficient to pay the certified claims, the Bank Commissioner or the proper authority was required to issue guaranty certificates or warrants against the future assets of the guaranty fund. These certificates were negotiable and were in most states interest-bearing. In Texas the law made no provision for the issuance of certificates.

Liability of Withdrawing Banks. In most of the states member banks were held liable for their proportionate share of the existing indebtedness of the guaranty fund in the event that they should voluntarily liquidate, nationalize, or, as in the cases of Kansas and Washington, where participation was optional, withdraw from the guaranty system. This provision was designed to thwart any attempt on the part of the banks to avoid payment of their share when the guaranty fund should become heavily indebted.

By a State Supreme Court ruling in Kansas in 1926 withdrawing banks were held liable only for the amount of bonds which that state required to be pledged as good faith for the payment of assessments. At the time, the indebtedness of the fund was far greater than the amount of bonds pledged, and banks willingly forfeited, making a wholesale exodus from the system.

Operation of the Systems

Prior to the depression of 1920-1921 all of the state guaranty systems, with

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the single exception of that of Oklahoma, which encountered certain frontier difficulties, operated successfully and at a very low cost. During the prosperous years there were few bank failures and losses were almost negligible; guaranty funds grew near the maximum and the guaranty principle was hailed as a boon both to depositors and to the banks. In Kansas only two guaranteed banks failed during the first ten years and the actual losses resulting therefrom amounted to only $83,000, or a cost of only 15 cents per year for each $1000 of deposits insured during the period. Economic conditions in Nebraska from 1911-1920 were highly conducive to a successful experience in that state. There were only two small failures resulting in losses to the fund. During the period deposits in guaranty banks increased more than 275% as compared with only 117% in national banks of the state. The guaranty fund on November 15, 1919, showed a balance of $2,174,000. With the advent of the post-war deflation the fortunes of the various systems began to experience a pronounced change. Banks failed in large numbers and losses to the funds mounted. Despite the fact that regular and special assessments were levied to the maximum extent in every state, the funds became insolvent, and the amount of guaranty certificates issued ran into the millions of dollars. Confidence in the systems waned, further aggravating an already precarious situation.

Oklahoma, after experiencing heavy losses early in the life of her guaranty experiment, had scarcely liquidated her old indebtedness when the new avalanche of failures set in, completely wrecking the system. Fifty-nine state banks failed in Oklahoma during the period 1920-1922, some of which were in such bad condition that the guaranty fund was called upon to bear more than fifty per cent of the deposit liabilities. When the legislature met in 1923, the Oklahoma fund showed a deficit of more than $2,500,000, the interest upon which would almost equal the annual assessments levied against the member banks. The law was repealed on March 31, 1923.

In Washington the failure of the Scandinavian American Bank of Seattle in 1921, the largest bank in the state, resulted in such a tremendous loss to the fund that all member banks withdrew from the system, rendering it inoperative. The law remained on the statutes, however, until 1929.

The Kansas system experienced the failures of 130 guaranty banks from 1920 to 1929, resulting in a net deficit of approximately $7,000,000 as of February 18, 1929, and wrecking the fund beyond all chance of rehabilitation. The law was repealed in 1929.

A similar fate befell most of the other guaranty systems. Nebraska with a deficit of $20,000,000 charged to her guaranty fund, as a consequence of more than 400 failures from 1920 to 1930, abolished the experiment early in 1930. South Dakota by an act of 1927 radically modified her guaranty system, repealing the mutual plan and substituting an individual plan under which each bank accumulates its own guaranty fund. At the time, guaranty certificates outstanding amounted to $34,365,000, and there was available for the payment of these a sum of approximately $1,000,000. North Dakota, whose fund was burdened with a net deficit of $15,000,000, repealed her law July 1, 1929. In Mississippi the mutual guaranty plan was suspended in 1930, and bonds secured by the credit of the state and by the assets of the insolvent banks were issued to pay a deficit of $5,000,000.

Texas owns the exceptional record of being the only state whose guaranty system through its regular operation was able to pay every depositor in full.

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Two factors were largely responsible. First, both regular and emergency assessments in Texas were the highest of all the systems. Second, a relatively large reserve was accumulated in the Texas fund before the inauspicious period of the twenties set in.

By virtue of an amendment in 1925 state banks in Texas were allowed to change at will from the guaranty plan to the bond security plan or vice versa, and inasmuch as the guaranty plan was proving the more expensive, all but 75 of the 800 guaranty banks elected within two years to operate under the other plan. This action wrecked the guaranty system, and a Supreme Court decision with respect to the bond security plan rendered it ineffective in 1926. With both plans practically killed, the legislature of 1927 repealed the law.

Causes of Failure

Although the collapse of most of the guaranty systems may be immediately attributed to the post-war deflation and the protracted agricultural depression which followed, there were certain concomitantly related factors which were fundamentally responsible. In its final analysis deposit guaranty as provided in the several states must be regarded as a form of insurance subject to certain underlying principles, the violation of which inexorably leads to failure. In the light of these principles there were patent weaknesses in all of the state guaranty systems, and the heavy financial losses during the decade of the twenties only served to reveal the magnitude of these defects.

Concentration of Risks. No program of insurance is sound whose risks are concentrated. There must be sufficient diffusion or spread to provide reasonable certainty that the reserve will not be wiped out in an instant. The guaranty programs flagrantly violated this principle. The Washington fund assumed the risks of 120 banks, two of which were large institutions and held 35.8% of all the guaranteed deposits in the state. The value of the risk concentrated in these two institutions alone was equivalent to more than twenty-five times the maximum reserve of the guaranty fund as fixed by law. Consequently, when the larger of the two failed, the system collapsed. The amount of deposits in the defunct Scandinavian-American Bank was twice as great as the total deposits in the forty-four smallest member institutions. In other words, out of the 120 member banks forty-four could have failed without subjecting the guaranty fund to more than half the risk concentrated in the large Seattle bank.

Concentration of risks was equally as evident in another form. Each guaranty system was confined in its operations to the banks within the limited area of its state, and these states in practically every case were economically dependent upon the experience of a single industry—agriculture—which has suffered greatly since 1920 from a deflation in land values and from the persistence of unprofitable prices for its products, two conditions which were particularly severe when contrasted with the abounding prosperity and appreciation in value of farm property in the years immediately preceding. The banking systems carrying a heavy farm mortgage indebtedness obviously had to bear the brunt of the financial debacle. When values vanished, a hollow credit structure remained, and banks failed in prodigious numbers. The various guaranty funds were completely obliterated. The crash was not unlike a great tempest or conflagration striking an area wherein the property risks have been assumed by an insurance carrier whose total un-

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derwriting activities have been confined to that area. The lack of a diversification of risks, then, was one of the causes for the failure of the guaranty systems.

Lack of a Sound Acturial Basis. A second weakness of deposit insurance as it operated in the states may be traced to unsound and unscientific rate-making practice. Apparently there was no adequate analysis of bank losses over a period of time in any of the states, and, therefore, the rates or the assessments were devoid of any reliable actuarial basis. In 1907 the Comptroller of the Currency calculated that the losses to depositors in failed national banks since the establishment of the national banking system had been approximately one-twentieth of one per cent of total deposits, and some of the first states to adopt deposit guaranty based their assessments upon this figure. However, the Comptroller's estimate was drawn from the experience of national banks throughout the country, and plainly it should not have been used as a basis for assessments in any one state. Furthermore, the differences between the federal and the state banking regulation and supervision were sufficiently great to render the experience of the two systems dissimilar.

As previously indicated, regular assessments varied greatly in the different systems, the highest ratio being five times that of the smallest. Emergency assessments ranged from none in two states to as high as two per cent in Texas.

Despite the emergency measures which purported to furnish sufficient flexibility to withstand any conceivable contingency, the income from assessments proved inadequate in seven of the eight states. Although space forbids an extensive discussion of the point, the question might be raised as to whether deposit losses lend themselves to actuarial prediction especially in view of the apparently increasing severity of our economic depressions.

Guaranty Funds Inadequate. Another evident weakness in the guaranty laws, and a corollary of the rate-making problem, may be found in the inadequacy of the guaranty funds which were created. Seemingly these reserves were established without much regard for total risks assumed, for degree of risk concentrated in a few large institutions, or for the nature of the banking business. Most of the funds were to be built up gradually by annual assessments over a period of time, yet from the outset deposits were guaranteed. Fortunately, the laws were passed just prior to or during a period of rising prices and prosperity, when there were few bank failures, thus allowing most of the funds to accumulate much of the maximum reserve contemplated by law.

Unlike those forms of insurance covering losses which respond to a certain regularity in occurrence, deposit guaranty must be so administered that a sufficient fund will be accumulated to meet periods of losses, because bank failures almost always harmonize with the business cycle, few occurring during the periods of recovery and prosperity, but many during a crisis and depression. To meet losses during the latter period a reserve much greater than those set up in the states must be provided, and if risks are to be assumed 100% from the inception of the system, then a sizable fund must be available at the start.

Poor Selection of Risks. An essential requisite of sound underwriting is the right on the part of the insurer to accept or reject an applicant for insurance and no carrier can survive that accepts without question every risk offered it. This principle was

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recognized by the authors of most of the guaranty laws when they specifically provided for a preliminary examination of all banks as a requirement for admission, but only a cursory, inadequate inspection was made in far too many instances. A blanket coverage was thrown over the entire state without respect to weak or strong banks and a level assessment rate was levied against them all on the basis of average daily deposits.

Not only was this condition true, but deposit guaranty stimulated a growth in the number of banks, and entirely too many institutions were established. During the era of war-time expansion Nebraska chartered 315 banks and guaranteed their deposits. By 1920 the state had a commercial bank for every 1092 people, whereas the average number of people per bank in the United States as a whole was 3507. When state bank officials began to realize the danger of such an unwarranted growth and attempted to curtail it, the courts in Nebraska ruled that the state department could not refuse charters on the grounds of a lack of economic necessity. In the Dakotas the over-banked condition was even worse. In 1920 North Dakota was served by 898 banks or on the average of one bank for every 720 people, and in South Dakota there were 693 banks or one for every 920 people. Kansas with 1370 banks was likewise over-banked. She had an average of one bank for every 1291 inhabitants.

Not only were too many banks chartered in the guaranty states, but it was a notorious fact that many unqualified and financially irresponsible persons were allowed to enter the business of banking. Under the mutual guaranty schemes the practices of these incompetents resulted in losses which the honest and efficient bankers were obliged to pay.

The extent to which the guaranty states became over-banked subsequently manifested itself in heavy losses to the guaranty funds, because banks increased in numbers until competition brought disaster since there was not sufficient safe and profitable business for all who were seeking it. Each additional bank, other things being equal, meant a poorer risk.

Lax Supervision. Since depositors were not inclined to discriminate between banks under a guaranty system, the strength of the whole banking fabric depended upon state inspection and supervision, and unhappily this proved to be none too rigid in several of the guaranty states. In South Dakota a legislative committee appointed to investigate banking conditions in that state found that one of the chief causes for the tremendous losses charged against the guaranty fund was improper and inadequate supervision. The committee found that because of a small staff of examiners, the Department of Banking had been unable to examine banks at least twice a year as provided by law. Examinations were made not more than once every nine months, and some banks operated for a year or more without inspection. It was further disclosed that the department had permitted banks to operate knowing full well that they were in an insolvent condition. The investigating committee condemned examiners for not calling bank directors together immediately upon discovery of an undesirable condition and in the meeting compelling the directors to take official action to correct the defect. It was shown that several serious losses to the guaranty fund could have been avoided thereby. Much of the department's dereliction was attributed to political influences.

In Nebraska lax administration by state officials and futile efforts on the part of the Guarantee Fund Commis-

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sion to operate insolvent banks were important influences working toward the collapse of the guaranty system in that state. A bank commissioner reported a short time after he took his office that there were 150 insolvent banks operating in Nebraska all of which should have been closed long ago.

In Kansas evidence showed that banks had been allowed to operate without respect for law and without much attention to repeated criticisms and warnings. Some banks were persistent offenders in making excessive loans, permitting customers to overdraw heavily, and lending to stockholders. Questionable administrative practices, the acceptance of bribery being not the least, with respect to banks in Oklahoma led to the indictment and impeachment of certain state officials. In Texas the charge was made that poor supervision and the lack of a vigorous and forceful policy of enforcing the law were responsible for the enormous losses suffered by the guaranty fund.

Moral Hazard. In the absence of proper examination and regulation, the various guaranty laws stimulated reckless banking, because unscrupulous bankers utilized the insurance feature to get control of funds which they never could have obtained otherwise. Bankers hard pressed for cash and near insolvency, as a result of depressing economic conditions and the bitter competition engendered by the existence of too many banks, often grasped every opportunity to hold on, secretly paying greater interest on deposits than the guaranty laws allowed, secretly entering collateral agreements, or in some manner using time certificates of deposit to borrow. Many banks thus built up their volume of business largely through exploitation of the protective feature of the laws, or by a lenient lending policy.

The effects of the increased moral hazard revealed themselves not so much in the number of bank failures as in the tremendous losses per failure. In salvaging the assets of defunct institutions a relatively small percentage of realization was obtained in most instances. Of course, here too, we must place part of the blame on incompetency in the handling of receiverships. In Kansas the officials in charge of receiverships were accused of "inefficient wasteful, and in some cases illegal" administration. It was shown that the liquidation of failed member banks had been much more expensive than necessary; that the assets of such banks had been carelessly dissipated, sold for less than their value, and that guaranty certificates had been issued to depositors whose deposits were not entitled to protection.

In Nebraska liquidations under the old court receivers realized only 43.54% from assets. Under the control of the Guarantee Fund Commission created in 1923 much waste was eliminated and an average of 66.12% was obtained.

According to a statement as of December 1, 1931, the first 35 liquidations under the Mississippi guaranty system realized only 50% of assets. While many failed banks in that state have as yet not been fully liquidated, in all probability their results will average about the same.

Salvage of assets in South Dakota failures, as shown in a consolidated statement of all failed banks to whose depositors guaranty certificates were issued, amounted to less than 40%, with little hope of a greater realization from the remaining resources.

A Federal System of Deposit Insurance
The Act of 1933

Membership. After numerous rejections of proposals for the creation of a federal system of deposit guaranty or insurance during the last forty

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years, Congress, under pressure to restore public confidence in our banking system, which had virtually collapsed, enacted the Glass-Steagall Banking Bill, June 16, 1933, one of whose salient features is deposit guaranty. The insurance provisions of the act were made applicable by compulsion to all member banks of the Federal Reserve System, and non-member banks obtaining a certificate of solvency from state banking authorities and otherwise qualifying for membership were allowed to participate voluntarily. After July 1, 1936, however, all participating banks must be members of the Federal Reserve System. The Federal Reserve Act was amended so as to permit Morris plan banks and other incorporated banking institutions engaged in similar business to become members of the system.

The Federal Deposit Insurance Corporation. For the purpose of insuring deposits, the law created a Federal Deposit Insurance Corporation whose management was vested in a board of three directors, one of whom must be the Comptroller of the Currency. The other two members of the board were to be appointed by the President for a term of six years. One of the appointees must act as chairman.

The capital stock of the Corporation was divided into Class A and Class B certificates, each having a par value of $100. The holders of Class A stock are entitled to cumulative dividends of six per cent annually; Class B stock bears no dividends.

The act authorized the Secretary of the Treasury to subscribe, on behalf of the United States, to Class A stock to the extent of $150,000,000, the money to be paid out of the treasury. Payments upon this subscription are subject to call, in part or in whole, by the board of directors of the corporation.

Every bank which is, or which becomes, a member of the Federal Reserve System and every non-member bank which applies and qualifies for participation under the insurance features must subscribe to Class A stock in an amount equal to one-half of one per cent of its total deposit liabilities. If state banking institutions are not permitted by their state laws to purchase stock in the Federal Deposit Insurance Corporation, they are allowed admission to the benefits of the act by depositing with the corporation an amount equal to one-half of one per cent of their deposits.

In order that new banking institutions may have their deposits insured from the outset, they must subscribe to Class A stock equal to five per cent of their paid-up capital and surplus. At the end of twelve months the amount is to be adjusted on the basis of total deposits.

A third source of capital subscription was the Federal Reserve Banks, each of which was obliged to subscribe to Class B stock in an amount equal to one-half of its surplus on January 1, 1933. One-half of the subscription had to be paid immediately.

Estimates indicated that the Federal Deposit Insurance Corporation would be capitalized at approximately $500,000. This amount is only an approximation and will vary from time to time as deposit liabilities in participating banks increase or decrease, because the Act of 1933 specifically provides for annual adjustments of the outstanding Class A stock so that each bank will own an amount equal to one-half of one per cent of its deposits. If a bank experiences an increase in deposits, it must subscribe for additional stock. In case of a decline in deposits, it must surrender a proportionate amount of its holdings of stock in the corporation. Under no circumstances can shares of stock be hypothecated or transferred.

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In order to provide still greater resources the corporation is authorized to issue and have outstanding at any one time its notes, debentures, bonds, or other obligations in an amount not to exceed three times its capital.

The Temporary Insurance Fund. Although the permanent insurance provisions of the Act of 1933 did not become effective until July 1, 1934, certain temporary features were operative January 1, 1934. The temporary provisions created a Temporary Federal Deposit Insurance Fund which was administered by the Corporation for the purpose of insuring all deposits up to $2,500. Each participating bank filed with the corporation on or before the date of its admission a sworn statement certifying the number of depositors and the total amount of its deposits eligible to guaranty as of the fifteenth day of the preceding month. Each bank was obliged to pay the fund an amount equal to one half of one per cent of its eligible deposits as shown in the statement. One half of the assessment had to be paid immediately and the remainder was subject to call. In the event that losses exceeded the amount of the fund, the banks were subject to an additional assessment of one-half of one per cent.

At the close of the six-months period of temporary insurance, the balance remaining to the credit of the fund was returned to the participating banks on an equitable basis.

The Permanent Insurance Plan. After July 1, 1934, the Federal Deposit Insurance Corporation opened a deposit insurance account on its books and will debit to this account all losses sustained in insuring deposits of participating banks. In support of the account the corporation has its total capitalization plus the authority to issue its notes and debentures, but if the losses should be so great that the net debit balance of the deposit insurance account equals one-fourth of one per cent of the total deposit liabilities of all insured banks, the corporation has the power to levy upon the banks an assessment of one-fourth of one per cent of deposits and credit the amount to the insurance account.

Depositors in failed member banks are insured 100% on deposits up to and including $10,000; 75% on the next $40,000, and 50% of any amount in excess of $50,000. For example, a depositor whose deposit account amounts to $70,000 at the time of a bank's failure will receive a claim against the Insurance Corporation for the sum of $50,000 ($10,000 + $30,000 + $10,000). Partial insurance for the large depositor is justified on the grounds that there will still remain sufficient incentive for him to discriminate between banking institutions. The small depositor, it is believed, is not so likely to have the facilities for analyzing the financial condition of his bank, and, therefore, should be protected in full.

Loss Settlement Procedure. Immediately upon the closing of an insured bank, the Federal Deposit Insurance Corporation is to be appointed receiver and a new national banking unit is to be established. The corporation is then to determine as expeditiously as possible the net amounts due to each depositor of the closed bank and to make available to the new unit an amount sufficient to cover all of the insured liabilities of the closed bank and credit upon its books the amounts due to the depositors, subject to check. The new unit is to be authorized to accept deposits and to honor checks, so that depositors may continue to transact their daily business without interruption and inconvenience, but no other function of banking may be conducted.

The Corporation is subrogated to all rights of the depositors against the closed bank, and is entitled to as much

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of the proceeds from the liquidation of assets as the amount advanced to the new banking unit. Any additional proceeds from liquidated assets must be paid as dividends to depositors whose deposits are not insured 100% and to other creditors of the defunct institution. If the total amount realized by the corporation on account of its subrogation to the claims of depositors should be less than the amount advanced, the deficiency is to be charged to the deposit insurance account of the corporation.

If the board of directors of the corporation should deem it advisable to establish a permanent banking unit in the community where the closed institution conducted its business, the corporation may offer for sale capital stock of the new banking unit, giving the stockholders of the defunct bank first opportunity to purchase such stock. As soon as an adequate amount of stock has been subscribed and paid for in cash, the Comptroller of the Currency must issue a certificate of authority to commence business, and thereafter the bank may assume all of the functions of an ordinary commercial bank. If subscriptions should be insufficient, the corporation at its discretion has the right to turn over the going business of the new banking unit to any approved banking institution already in existence in the same locality.

In either case there would be created a natural customer to buy from the receiver the sound assets of the closed bank. It would be to the decided advantage of the new organization or an existing organization to acquire as much of the desirable business of the old bank as possible.

Sources of Income. Inasmuch as the Class A stock of the corporation bears six per cent cumulative dividends, and the debentures and notes which it may have outstanding are interest bearing, there must be some source of profit for the corporation. The law contemplates the investment of the corporation's capital in government securities and in slow assets of closed banks. Another source of earnings will be in the form of fees for receivership or liquidating services. As has already been indicated insurance losses will not be losses to the corporation itself, but will be carried only until the total debit account amounts to one-fourth of one per cent of deposit liabilities in all insured banks, then the corporation will levy an assessment against the banks for such an amount.

Actually the dividend provision is a superfluous one since stockholding banks are liable for assessments. It would be just as well to allow the income to be credited to the insurance account and thus reduce by that amount the assessments against member banks.

Other Provisions. Other important provisions of the act pertaining only indirectly to deposit guaranty may be briefly summarized. (1) All member banks are forced to divorce themselves from any affiliations with organizations dealing in securities. (2) Interest on demand deposits is forbidden and the Federal Reserve Board is authorized to fix the rate of interest on time deposits. (3) The powers of the Federal Reserve Board are materially increased. (4) Branch banking is favored by provisions which permit its extension.

Federal versus State Guaranty—An Appraisal

In weighing the merits and the disadvantages of the federal plan for insuring deposits it is necessary to ascertain whether the plan has features fundamentally different from those of the eight state guaranty systems whose experience has been described in the foregoing sections. The fact that

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deposit guaranty has failed in every state where it has been tried is not, as some critics would have us believe, necessarily a justification for the induction that it will fail on a national scale, although its disastrous operation in those states stands as a serious indictment against it. If there are basic differences between the new plan and the defunct state plans, the vital question to be answered is: Are the differences sufficient to indicate a more successful operation?

Differences. (1) Foremost among the distinctions is that the federal insurance system covers a larger area and thereby provides a more adequate distribution of risks than its predecessors which were confined to the boundaries of individual, agricultural states. This difference must be regarded as a significant one inasmuch as it tends to remove one of the principal causes for the failure of the state systems. A nation-wide insurance plan is far more compatible with recognized insurance principles than is a state plan.

(2) The Act of 1933 provided for the creation of an insurance reserve of almost a half a billion dollars at the very outset and authorizes the Federal Deposit Insurance Corporation to issue debentures and notes to the extent of three times this amount, if necessary, thus making a total financial strength of approximately two billion dollars. The state systems, on the other hand, endeavored to build up a fund by small assessments over a period of years, and yet risks were assumed 100% from the beginning. As a consequence early failures in some of the states sent the funds into debt and both depositors and bankers lost faith in deposit guaranty.

Bank failures, however, tend to concentrate in periods of depression, and it might be argued that the system would have broken down under the strain of the years 1929-1933, when almost five thousand institutions closed their doors with deposit liabilities of approximately three billion dollars, one-third of which will be lost. On the contrary, the system would have absorbed the tremendous shock and would have had one-half of its financial strength left to meet another.

(3) Assuming that the Corporation is honestly and efficiently administered, the new plan promises more economical liquidation of failed banks and greater salvage from assets than was realized under most of the state guaranty systems. This will reduce losses to the insurance account and make assessments smaller.

(4) The new plan is under federal supervision and control, a fact which might or might not mean a more successful operation of the system. In the author's opinion, however, the federal regulation will be superior to that of the states which had guaranty systems.

(5) The Glass-Steagall Banking Act does not insure all deposits one hundred per cent. The large depositor is only partially protected, making it necessary for him to discriminate between the sound, well managed institution and the bank which is weak and poorly managed. Most of the state guaranty systems, on the other hand, sought to protect all depositors in full, and thus tended to reduce every bank to the same level of efficiency and safety in the minds of the depositors.

(6) As has been shown the new legislation by no means corrects all of the defects of our banking system, but it strikes at the very heart of some of them, especially speculation, thereby reinforcing the insurance features with improved banking regulations which were absent in the guaranty states. More stringent control should greatly reduce the number of bank fatalities in the future and thereby

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diminish the burden upon the insurance account.

(7) The federal insurance plan goes into operation under more favorable circumstances than most of its state predecessors. The American banking system has undergone a decade of severe strain and liquidation during which time one-half of the banks have been eliminated and definite adjustments have been made to changing economic conditions. The process of elimination has not only weeded out the infirm element, but it has taught many lessons which should be of inestimable value in the future.

Conclusions

In the light of the aforementioned differences the new Glass-Steagall deposit insurance plan precludes many of the defects of the old state guaranty schemes and from the standpoint of insurance principles should enjoy a more auspicious operation than its predecessors. The warning should be repeated, however, that deposit insurance is not a panacea for all our banking ills. It, like all other insurance, is only a social device for the elimination of risk and the redistribution of loss. Viewed in any other light it has greater potentialities for evil than for good. The real danger in the new banking act is that it will tend to assuage the passion of the nation for genuine banking reform and obstruct the enactment of legislation which will remove the fundamental weaknesses evident in our banking structure. The law was hastily passed in a frantic effort to restore confidence at a time when the country was panic-stricken, and a lack of confidence as the cause of our deplorable experience seemed to shroud most of the actual causes. The law left untouched most of the basic defects in the banking system.

The real crux of our banking problem lies in the creation of a system which will sustain, in fair weather and bad, its essential position as the foundation of the nation's business and financial structure. If the banking system of tomorrow is to safeguard the depositor by means of mutual insurance, the premiums of which all banks will be obliged to pay, steps must be taken to reduce the number of failures so that losses will not be so great that the cost of insurance will weaken the financial status of solvent, well managed institutions. If any lesson is to be derived from the bitter experience of the state guaranty systems, it most assuredly is the fact that deposit insurance as the superstructure must have sound, honest management, rigid supervision, and a strong, well conceived general banking law as its foundation. In the absence of such a foundation there are potential dangers for all who seek shelter under the superstructure—dangers both to the bankers and to the depositors.

To support the permanent insurance provisions of the Act of 1933 we should be assured that the decayed materials of the old foundation are removed and strong and enduring reforms substituted in their stead. It is believed that this can be accomplished by the following means:

1. Uniform and standardized commercial banking should be established through the unification of all banks under the supervision of the federal government, thus displacing forty-nine different systems of widely varying supervision and regulation with one system the responsibility for which will be concentrated in the hands of federal authorities. This is not the view of a few short-sighted nationalists or centralists, but is the firm conviction of many of the nation's leading bankers and of many unbiased students of the banking problem.

Unification could be accomplished under three general constitutional

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powers reserved to Congress, namely, the power to create and maintain a banking system, the power to provide a national currency, and the power to regulate interstate commerce. The Act of 1933 indirectly seeks to accomplish eventual unification by compelling all insured banks to belong to the Federal Reserve System after 1936, but this method will not lead to a genuinely national banking system, which is desirable.

2. There should be a strict licensing of those who engage in the business of banking in order to make it more difficult for unscrupulous, inexperienced, and financially irresponsible individuals to enter the field.

3. Regardless of the integrity of those who seek to own and operate a bank there should be careful restriction upon the number of institutions established. In the past we promiscuously granted charters and as a consequence the entire banking fabric was greatly weakened, not only by the presence of unqualified operators but by the very fact of number itself. There is every reason to believe that even now after the reduction of banks from approximately 30,000 in 1920 to about 15,000 we have too many in operation for public safety. If all of these are permitted to come within the insurance provisions of the Act of 1933, the system will be endangered by their very presence, not to mention the added hazard of the strong urge to realize a profitable operation.

4. Every effort should be extended to encourage the organization of larger banking units. The number of fatalities among the small and financially weak institutions has been both absolutely and relatively greater than among the larger institutions, and has brought out in stark and bold relief the fact that many of our banking difficulties since the war have been due to the existence of thousands of banks so small that they could not earn through ordinary commercial banking functions enough profit to justify their existence. In too many instances these banks were forced to yield to the temptation of making commitments in more speculative waters where the siren of greater returns beckoned.

5. A complete separation of commercial and investment banking into two accurately defined catagories is an exigent reform which we have long recognized, but toward which we have accomplished very little. Experience during the past few years has demonstrated the folly of allowing commercial banking institutions to invest in long-term securities and perform other services which logically fall within the jurisdiction of investment banking.

6. Supervision must be so improved as to render reckless, imprudent, dishonest, and inefficient banking wellnigh impossible. While there has always existed such a need, under a deposit insurance program the demand for better supervision becomes more urgent than ever. Without improved supervision one might well expect a reënactment, on a more widespread scale, of some of the malpractices which developed under the old state guaranty experiments. The insurance of bank deposits without vigorous regulation will unquestionably create a sense of false security.

Although the Banking Act of 1933 makes a few gestures in the proper direction, it is grossly deficient in provisions which will assure the attainment of the above objectives. Further legislation is imperative.

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History of Guaranty of Bank Deposits in the States of Oklahoma, Texas, Kansas, Nebraska, and South Dakota, 1908-1914, prepared for the Senate Committee on Banking and Currency by George H. Shibly, 1914. Copy is in FDIC library.

The Annual Report of the Comptroller of the Currency, 1921, pages 187-193, contains a section entitled, "Guaranty of Bank Deposits".

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