

## Chapter 2

# Antecedents of the FDIC

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### *Insurance of Bank Obligations, 1829-1866*

During the years immediately following the organization of the federal government in 1789, banks were chartered by special acts of state legislatures or the Congress, usually for a limited number of years. Initially, bank failures were nonexistent. It was not until 1809, with the failure of the Farmers Bank of Gloucester, Rhode Island, that people realized that such an event was even possible.<sup>1</sup> Any notion that this failure represented an isolated incident was dispelled after the first wave of bank failures occurred five years later. The ensuing economic disruptions caused by these and subsequent bank failures fueled demands for banking reform.

In 1829, New York became the first state to adopt a bank-obligation insurance program.<sup>2</sup> New York's program was devised by Joshua Forman, a Syracuse businessman. The insurance concept embodied in his plan was suggested by the regulations of the Hong merchants in Canton.<sup>3</sup> The regulations required merchants who held special charters to trade with foreigners to be liable for one another's debts. Writing in 1829, when bank-supplied circulating medium was largely in the form of bank notes rather than deposits, Forman noted:

The case of our banks is very similar; they enjoy in common the exclusive right of making a paper currency for the people of the state, and by the same rule should in common be answerable for that paper.<sup>4</sup>

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<sup>1</sup>Carter H. Golembe, "Origins of Deposit Insurance in the Middle West, 1834-1866," *The Indiana Magazine of History*, Vol. LI, June, 1955, No. 2, p. 113.

<sup>2</sup>The term "bank obligation" refers to both circulating notes and deposits.

<sup>3</sup>*Assembly Journal*, New York State, 1829, p. 179.

<sup>4</sup>*Ibid.*, p. 179.

The plan conceived by Forman had three principal components:

- The establishment of an insurance fund, to which all banks had to pay an assessment;
- A board of commissioners, which was granted bank examination powers; and
- A specified list of investments for bank capital.

The first two provisions were adopted virtually intact; the proposal pertaining to the investment of bank capital initially was rejected. Upon reconsideration during the 1830s, the bank capital proposal was modified and subsequently enacted.

Between 1831-1858, five additional states adopted insurance programs: Vermont, Indiana, Michigan, Ohio, and Iowa. The purposes of the various plans were similar: (1) to protect communities from severe fluctuations of the circulating medium caused by bank failures; and (2) to protect individual depositors and noteholders against losses. Available evidence indicates that the first of these, concern with the restoration of the circulating medium *per se*, predominated.<sup>5</sup>

*Nature of plans.* In striving to meet these insurance goals, the states employed one of three approaches. Following New York's lead, Vermont and Michigan established insurance funds. Indiana did not; instead, all participating banks were required mutually to guarantee the liabilities of a failed bank. The insurance programs adopted by Ohio and Iowa incorporated both approaches. While participating banks were bound together by a mutual guaranty provision, an insurance fund was available to reimburse the banks in the event special assessments were necessary immediately to pay creditors of failed banks. The insurance fund was replenished from liquidation proceeds.

Table 2-1 summarizes the principal provisions of the six programs which operated between 1829-1866.

*Coverage.* In the first four programs adopted, insurance coverage primarily extended to circulating notes and deposits. New York later restricted coverage to circulating notes. In the case of Ohio and Iowa, insurance coverage from the outset only extended to circulating notes. None of the six programs placed a dollar limit on the amount of insurance provided an individual bank creditor.

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<sup>5</sup>Carter H. Golembe, "The Deposit Insurance Legislation of 1933: An Examination of Its Antecedents and Its Purposes," *Political Science Quarterly*, Vol. LXXV, No. 2, June, 1960, p. 189.

The extension of insurance coverage to bank notes in all of the six programs reflected their importance as a circulating medium. Because it was common practice for banks to extend credit by using bank notes, nearly one-half of the circulating medium prior to 1860 was in this form. In those states that limited insurance coverage to bank notes, the belief was that banks affected the circulating medium only through their issuance. Additionally, it was believed that depositors could select their banks, whereas noteholders had considerably less discretion and thus were in greater need of protection.<sup>6</sup>

*Methods used to protect creditors of banks in financial difficulty.* *Ad hoc* measures frequently were taken in some of the six states to protect creditors of banks in financial difficulty. Faced with the possible insolvency of several banks in 1837, New York State's Comptroller began redeeming their notes from the insurance fund. This action prevented the banks from failing and they eventually were able to reimburse the insurance fund. In 1842, New York faced a more serious crisis after the failure of eleven participating banks within a three-year period threatened the solvency of the insurance fund. The legislature authorized the State Comptroller to sell bonds sufficient to meet all claims against the insurance fund. The bonds later were redeemed from subsequent payments into the fund by participating banks.

Other states similarly grappled with the question of whether to assist or close a distressed bank. On several occasions authorities in Ohio kept a number of distressed banks from closing by levying special assessments upon healthy participating banks. Indiana and Iowa also granted financial assistance to distressed banks.

*Method of paying creditors of failed banks.* Only the programs of Ohio and Iowa provided for immediate payment of insured obligations. Necessary funds were made available in those two states through special assessments levied on the sound participating banks. Creditors in New York, Vermont and Michigan were not paid until the liquidation of a failed bank had been completed. Indiana's program provided that creditors were to be paid within one year after a bank failed if liquidation proceeds and stockholder contributions were insufficient to cover realized losses.

*Role of bank supervision.* Bank supervision was an essential element of the insurance programs that operated prior to 1866.

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<sup>6</sup>Federal Deposit Insurance Corporation, *Annual Report*, 1952 (1953), p. 61.

The function of supervision was essentially twofold: (1) to reduce the potential risk exposure of the various insurance programs; and (2) to provide some measure of assurance to well managed banks that the unsound banking practices of badly managed banks would not go completely unchecked.<sup>7</sup> Table 2-2 summarizes the principal provisions relating to bank supervision in the six insurance states.

Better supervision of banks was achieved by the programs with mutual guaranty than by the simple insurance fund programs.<sup>8</sup> Under the mutual guaranty programs in Indiana, Ohio and Iowa, supervisory officials were largely selected by, and accountable to, the participating banks. The officials were given wide latitude to check unsound banking practices because the participating banks were keenly aware that the cost of lax supervision ultimately would be borne by them.

During the Indiana program's 30 years of operation, not one state-chartered bank failed. Indiana's success principally was attributable to the quality of bank supervision.<sup>9</sup> A strong supervisory board was the cornerstone of the program. The board, which included four members appointed by the Indiana General Assembly and one representative from each of the participating banks, could close any member bank. The causes for closing a bank were: (1) insolvency; (2) mismanagement; and (3) refusal to comply with any legal directive of the board. The board's power was absolute since there was no provision for appeal to the courts or to any other state agency.

Supervisory authorities in Ohio and Iowa could issue cease-and-desist orders, as well as require banks to be closed. Ohio had four banks fail: one in 1852 because of defalcation and three in 1854 because of asset deterioration. While none failed in Iowa, it should be noted that Iowa's program operated during a period of more favorable economic conditions.

*Assessments and the insurance funds.* Insurance fund assessments were levied on capital stock or insured obligations. To provide a basis for comparison with later assessment rates under federal deposit insurance, previous researchers have computed the equivalent average annual rate on total obligations

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<sup>7</sup>Carter H. Golembe and Clark Warburton, *Insurance of Bank Obligations in Six States* (Washington, D.C.: Federal Deposit Insurance Corporation, 1958), pp. I-9 - I-10.

<sup>8</sup>Federal Deposit Insurance Corporation, *Annual Report*, 1953 (1954), p. 59.

<sup>9</sup>Golembe and Warburton, p. I-18.

(i.e., deposits plus circulating notes) levied by the five states that had insurance funds (Table 2-3). On this basis, Michigan's annual rate of one-tenth of one percent most closely approximated the present statutory rate of one-twelfth of one percent under federal deposit insurance (before credits). Other rates were substantially higher, ranging from one-fifth of one percent in Vermont to almost two percent in Iowa.

Three insurance programs had positive fund balances at the time of their closing (Table 2-3). The Vermont and Michigan insurance funds were deficient by \$22,000 and \$1.2 million, respectively. In both states the first failures occurred before the insurance funds were adequately capitalized. Michigan's program collapsed under the strain. Although Vermont's fund subsequently recovered, it had a negative balance at the time the program closed due to the payment of unauthorized refunds to banks previously withdrawing from the program.

*Demise of the insurance programs.* Two primary factors contributed to the eventual collapse of the state insurance systems. The first factor was the emergence of the "free banking" movement in the 1830s. This movement developed in response to the void created by the closing of the Second Bank of the United States in 1836. To fill this void, many states enacted laws designed to ease bank entry restrictions. The movement produced an alternative for insurance of bank notes, which permitted a bank to post bonds and mortgages with state officials in an amount equal to its outstanding bank notes. Banks taking advantage of this alternative were excluded from insurance.<sup>10</sup> As the number of "free banks" increased, participation in state insurance programs declined. Consequently, the original intent to include all banks in the individual state insurance programs was thwarted.

The second factor was the establishment of the national bank system in 1863. In 1865, Congress levied a prohibitive tax on state bank notes causing many state-chartered banks to convert to national charters in order to escape the tax. As conversions increased, membership in the state insurance systems declined, eventually to the point where these programs ceased to exist.

### *Guaranty of Circulating Bank Notes by the Federal Government*

National bank notes were collateralized by United States bonds. More importantly, the primary guaranty for the notes was the

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<sup>10</sup>This exclusion did not apply in Michigan.

credit of the federal government rather than the value of the posted collateral. Holders of notes of a failed national bank were to be paid immediately and in full by the United States Treasury regardless of the value of the bonds backing the notes. As the Comptroller of the Currency stated in his first report to Congress:

If the banks fail, and the bonds of the government are depressed in the market, the notes of the national banks must still be redeemed in full at the treasury of the United States. The holder has not only the public securities, but the faith of the nation pledged for their redemption.<sup>11</sup>

So long as national bank notes retained their relative importance in the circulating medium, bank-obligation insurance was considered unnecessary. However, bank deposits soon overtook and then eclipsed national bank notes in importance. By 1870, deposits were about twice, and by the end of the century seven times, circulating notes. It was against this backdrop that efforts were renewed to provide for deposit insurance. Various proposals to that effect were introduced at the federal and state levels. Although the first attempts were made in Congress as early as 1886, the states took the lead.

### *State Insurance of Bank Deposits, 1908-1930*

Between 1907-1917, eight states adopted deposit insurance programs. Seven of the eight states were located west of the Mississippi in predominantly agricultural areas. Table 2-4 summarizes the principal provisions of the eight programs.

*Coverage.* Insurance coverage in the eight states only extended to deposits. Although the insurance programs were commonly known as "deposit guaranty" programs, the guaranty was that of a fund derived from assessments on the participating banks. In no instance did the state explicitly guarantee the deposits.

None of the states, except Kansas for a brief period, placed an insurance limit on the size of account or amount of deposits owned by a depositor. However, some restrictions were applied to various classes of deposits.

*Methods of paying depositors of failed banks.* In Kansas and Mississippi the depositors of a failed bank received interest-bearing certificates. Dividends on these certificates were paid from liquidation proceeds. Upon final liquidation of all assets, the balance due on the certificates was paid from the insurance fund.

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<sup>11</sup>U.S., Comptroller of the Currency, *Annual Report*, November 28, 1863 (1864), p. 58.

Mississippi law stipulated that if the insurance fund was insufficient to pay the depositors, they were to be paid *pro rata*, and the remainder paid from subsequent assessments.

In the remaining six states the deposit insurance law provided for immediate cash reimbursement by the fund, either in full or to whatever extent was practical. In most instances provision was also made for the issuance of certificates of indebtedness in the event there was insufficient money in the fund.

*Role of bank supervision.* A majority of the eight states granted authority to regulate banks.<sup>12</sup> Semiannual bank examinations were the norm. Banking officials could enforce capital requirements and issue cease-and-desist orders to bring about correction of various infractions. In four of the states, supervisory authorities could order the removal of bank officials for just cause.

Despite the powers granted to banking authorities, supervision often proved to be lax. Because of understaffing and insufficient funding, examiner workloads frequently were untenable. In other instances banking authorities were thwarted when they tried to enforce existing laws. In a few cases the authorities were the root of the problem. Oklahoma provided the worst example in that the bank commissioner's office itself became corrupt after 1919.

*Assessments on participating banks.* All of the insurance programs derived the bulk of their income from assessments. Both regular and special assessments were based on total deposits. The assessments levied ranged from an amount equivalent to an average annual rate of about one-eighth of one percent in Kansas to about two-thirds of one percent in Texas. Some states permitted participating banks to retain their insurance assessments in the form of deposits, subject to withdrawal by order of the insurer. Other states provided for the physical collection of assessments by the insurer or the state treasurer.

*Adequacy and termination of insurance funds.* The state insurance funds were unable to cope with the economic events of the 1920s. The depression of 1921, and the severe agricultural problems that persisted throughout much of the decade, resulted in numerous bank failures. The resultant claims on the various insurance funds generally exceeded their size. While the Texas fund was able to meet all claims, the insured deposits in the other states that were never paid from any source ranged as high as 70 percent.

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<sup>12</sup>An in-depth discussion of the role of bank supervision appears in Clark Warburton's study, *Deposit Insurance in Eight States During the Period 1908-1930* (Washington, D.C.: Federal Deposit Insurance Corporation, 1959).

The first fund to cease operations was Washington's in 1921. By early 1930, all of the funds, including the Texas fund, which became insolvent after most of the participating banks withdrew, had ceased operations.

### *Congressional Proposals for Deposit Guaranty or Insurance, 1886-1933*

A total of 150 proposals for deposit insurance or guaranty were made in Congress between 1886 and the establishment of the Federal Deposit Insurance Corporation in 1933. Financial crises prompted the introduction of many of these proposals. In the 60th Congress, following the panic of 1907, more than thirty proposals for deposit guaranty legislation were introduced. Similarly, in response to the developing banking crisis, more than twenty bills were introduced in the 72nd Congress, which opened in 1931.

Another group of bills, similar in principle to deposit insurance, proposed to authorize national banks to issue circulating notes on the basis of various types of assets or as general obligations of the banks, backed by a guaranty or insurance fund to which all national banks would contribute. These proposals were numerous during the thirty years preceding establishment of the Federal Reserve System in 1913.

Three general methods of providing depositor protection were proposed in the bills. Of the 150 bills, 118 provided for the establishment of an insurance fund out of which depositors' losses would be paid, 22 provided for United States government guaranty of deposits, and 10 required banks to purchase surety bonds guaranteeing deposits in full.

Most of the deposit insurance bills introduced prior to establishment of the Federal Reserve System authorized participation of national banks only. After 1913, about one-half of the deposit insurance bills provided for participation of all members of the Federal Reserve System (national and state member banks). Only a few provided for coverage of deposits in nonmember banks, and then participation was usually optional.

Nearly two-thirds of the bills introduced prior to establishment of the Federal Reserve System provided for administration of the insurance system by the Comptroller of the Currency. After 1913, some of the proposals provided for administration by the Federal Reserve Board or by the Federal Reserve Banks under supervision of the Board. Other proposals called for the establishment of a special administrative board to oversee the insurance system.

Eighty percent of the bills provided for insurance or guaranty of all, or nearly all, deposits. The bills that provided for only partial coverage of deposits contained a variety of limitations. Generally, all liabilities not otherwise secured were to be protected by the insurance or guaranty system.

In nearly one-half of the bills the entire cost of deposit insurance, and in about one-fourth of the bills the major part of the cost, was to be met by assessments based upon total deposits or average total deposits. The rates of assessment ranged from one-fiftieth of one percent to one-half of one percent per year, while in a number of cases assessments were to be adjusted to meet the total cost. The most common rate was one-tenth of one percent. Many of the bills provided for special initial assessments, or for assessments as needed, in addition to those collected periodically.

In a number of bills, assessments upon the banks were to be supplemented by appropriations from the United States government, or, particularly in the bills introduced in the later years, by levies on the earnings or surplus of the Federal Reserve Banks. In several cases the cost was to be met solely by the United States government. In cases where the insurance was in the form of surety bonds, the cost of the bonds was to be borne by the banks.

Many of the bills called for a limit on the accumulation of funds by the insurance or guaranty system. In a few bills, assessment rates were to be adjusted by the administrative authority and were required to be sufficient to meet all losses to depositors or to maintain the fund at a given size. In some proposals, the fund was authorized to borrow if necessary, and in others to issue certificates to unpaid depositors if the fund were depleted.

### *Summary*

The disruption caused by bank failures was a recurrent problem during the 19th century and the first third of the 20th century. Numerous plans were proposed or adopted to address this problem. Many embodied the insurance principle.

Insurance of bank obligations by the states occurred during two distinct periods. The first began in 1829 with the adoption of an insurance plan by New York. During the next three decades five other states followed New York's lead. Except for Michigan's insurance plan, which failed after a short period of operation, these plans accomplished their purposes. Nevertheless, the last of these insurance programs went out of existence in 1866 when the great majority of state-chartered banks became national banks.

Insurance of bank obligations was not attempted again by the states until the early 1900s. Eight states established deposit guaranty funds between 1907 and 1917. In contrast to the earlier state insurance systems, those adopted between 1907 and 1917 were generally unsuccessful. Most of the eight insurance plans were particularly hard hit by the agricultural depression that followed World War I. The numerous bank failures spawned by that depression placed severe financial stress on the insurance funds. By the mid-1920s, all of the state insurance programs were in difficulty and by early 1930 none remained in operation.

The federal government, in turn, sought to secure the safety of the circulating medium through direct guarantee by the Treasury of national bank notes, beginning in the 1860s. However, the subsequent rapid growth of bank deposits relative to bank notes once again aroused concern regarding the safety of the circulating medium in the event of a bank failure. Consequently, 150 proposals for deposit insurance or guaranty were introduced into Congress between 1886 and 1933.

The basic principles of the federal deposit insurance system were developed in these bills and in the experience of the various states that adopted insurance programs. These principles included financing the federal deposit insurance fund through assessments, the use of rigorous bank examination and supervision to limit the exposure of the fund, and other elements, such as standards for failed bank payoffs and liquidations, intended to minimize the economic disruptions caused by bank failures.