Lessons from American Bank Supervision from the Nineteenth Century to the Great Depression

Eugene N. White
Rutgers University and NBER

Federal Reserve Bank of Chicago-IMF
13th Annual International Banking Conference
September 23-24, 2010

A Look Back to 1864-1933

- Is Micro-Prudential Regulation Sufficient?: Can the financial system's safety be ensured by ensuring individual financial Institutions are safe
- If there are externalities/spillovers, what kind of Macro-Prudential Regulation is needed to manage the overall system's risk?
- Look back at history
- (1) A time when Micro-Prudential Regulation was sufficient—what was different?
- (2) How this regime was overturned to vastly greater regulation & supervision

Five Policy Regimes of Bank Supervision in the U.S.

1. <u>National Banking Era 1864-1913</u>
2. <u>Early Federal Reserve Period, 1914-1932</u>
3. <u>New Deal, 1933-1970</u>
4. Demise of the New Deal, 1971-1990
5. The Contemporary Era, 1991-2008

What Are Today’s Key Issues

1. Do Price Stability and Financial Stability Conflict?

   Countercyclical Policy for Price Stability→Financial Instability? LOLR in Financial Crises→Price Instability?

2. Supervision: Independent of the Central Bank?

   Does LOLR require Supervision Powers?

3. Industry-Specific Agencies or a Central Agency?

   How to Prevent Regulatory Capture/Rogue Agencies

4. Agency Transparency and Political Oversight
5. Philosophy of Bank Supervision?

   Reinforce market discipline? or Independent of the market? If so, then Rules or Discretion-Based

National Banking Era, 1864-1913

1. No Central Bank—No Conflict
   - Money supply determined by gold standard
2. Independent Supervision
3. Industry-Specific Agencies or Central Agency?
   - One federal bank agency---the OCC
   - State bank agencies regulate state-chartered banks
4. Independence/Transparency/Oversight:
   - Comptroller has long-terms of office
   - Regularly Reports
   - Occasional Congressional Hearings
5. Philosophy:
   - Supervision Reinforces Market Discipline

Regulation and Bank Structure National Banking Era,1864-1913

- Capital
  - Minimum Capital Requirements for entry
  - No Capital Ratios
  - BUT Double Liability
  - No Deposit Insurance
- Easy Entry + Prohibition on Branching = Thousands of Single Office Banks
- In 1900   8,136 national and state banks
  - Range from tiny to large city banks
- No Central Bank & High Reserve Requirements:
  - Reserves held at city correspondent banks = “Pyramiding of Deposits” in NYC, Chicago
  - Increases Potential for incipient Panic to become nationwide

Examination & Supervision: OCC

- Disclosure: 3 Yearly Surprise Call Reports
- Examination: 2 Yearly Surprise Exams
- Enforcement:
  - Only Tool: Revocation of Charter
  - Mark-to-Market & Prompt Closure
- Number of Examiners & National Banks
  - 1889: 30 examiners/ 3,239 banks
  - 1907: 100 examiners/6,422 banks

"*It is scarcely to be expected, if a robber or a forger is placed in control of all its assets, that a national bank can be saved from disaster by the occasional visits of an examiner.*"

Comptroller Knox, Annual Report (1881).

Developments: 1864-1913

- Growth of Banking Outside of Federal "Safety Net"
  - Growth of State-Chartered Banks
    - Become dominant in rural areas
    - Weaker regulations---increasingly small & undiversified
  - Growth of Trust Companies
    - Challenge national banks in cities
    - Weaker regulations, more leveraged
    - Panic of 1907 starts in NYC Trust Companies

	National Banks	State Banks	Trust Companies
1890	3,484	2,534	255
1905	5,664	7,920	1,115

Frequent Financial Crises 1864-1913

- Major Banking Panics: 1873, 1884, 1890, 1893, 1907 and many minor panics.
  - Public panics→currency/deposit ratios soar
  - Bankers panic→country banks withdraw from city banks, quickly makes a panic nationwide
- No Central Bank to act as LOLR.
- Some Panics end in Suspension of Payments
- Recessions with Panics are more severe and longer in duration
- <u>BUT these panics are primarily Liquidity Events NOT Solvency Events-</u>--even if a bank failure started a panic, no large system-wide losses from bank insolvencies.

Costs of Bank Failures

- 1864-1913: <u>501 National Bank insolvencies</u>
  - Average Payout 76%
    - 89% collected from assets
    - 11% in assessments on shareholders (paying 48 cents on every dollar assessed)
  - Total Loss $20 million
    - 1870 Total National Bank Deposits: $705 million
    - 1913 Total National Bank Deposits: $8.1 billion
- Why so small?
- <u>1864-1913: 2,373 National Bank voluntary liquidations-</u>--directors close banks---no losses to customers
- State Banks same magnitude of losses

Assessment of 1864-1914

- “Microprudential” Rules Work Well to Limit Insolvencies---Capital/Asset Ratio>20%
  - Double Liability/No Deposit Insurance/Supervision Reinforces Market Discipline
- But there are Panics and they occur because:
- Key Problem 1: Fragmented Banking System—small, undiversified banks with reserves at correspondents
- Key Problem 2: Absence of a Central Bank to act as LOLR

Federal Reserve Act of 1913

- Problem 2 “solved”: Fed to prevent panics by providing liquidity through the discount window and reduce seasonality of interest rates.
- Problem 1 remains—no change in branching prohibition, system with thousands of small, undiversified unit banks.
- Fed Reserve Era begins to change bank supervision

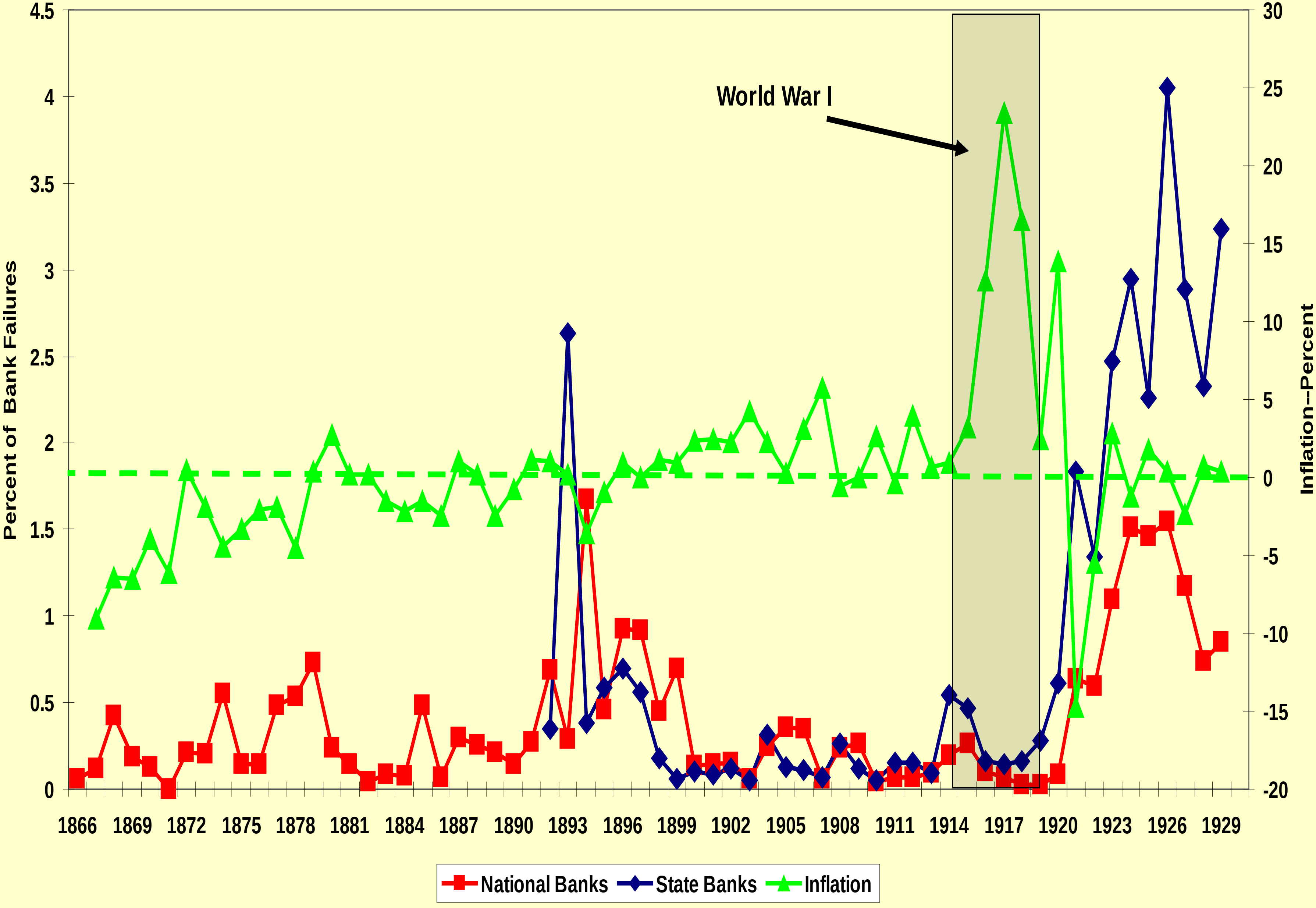
Early Years of the Fed: 1914-1932
Key Issues

1. **Monetary/Financial Policy Conflict?**
   - Postwar Deflation→Surge in Bank Failures.
2. **Supervision independent of central bank?**
   - Supervision is contested
   - Fed takes "call" reports from OCC
   - OCC blocks Fed access to examination reports for discounting/LOLR
3. **More than one agency?**
   - Struggle erupts between Fed and OCC, as Fed attempts to attract state member banks
4. **Political Independence /Transparency /Oversight**:
   - OCC unchanged.
   - FR Banks not government agencies—different oversight
5. **Philosophy of Supervision?**
   - Weakening of Supervision to Reinforce Market Discipline

Conflict emerges between Monetary Stability and Financial Stability

- High Inflation World War I
- Fed raises rates in 1920→Deflation & Recession
- Number of bank failures rise
  - Most severe for small state banks with longer term agricultural loans
  - Failures 1921-1929: 766 out of 8,000 NB banks fail.
  - Payout is lower than in 1865-1913: 40¢ per $.
  - Total loss for all banks $565 million ($6.9 billion in 2009$) or 0.6% of 1925 GDP
  - Modest for size of shock.

Percentage of Banks Failing and Inflation 1866-1929



Monetary Policy→More Risk-Taking and Less Incentive to Voluntarily Liquidate—Relative Decline

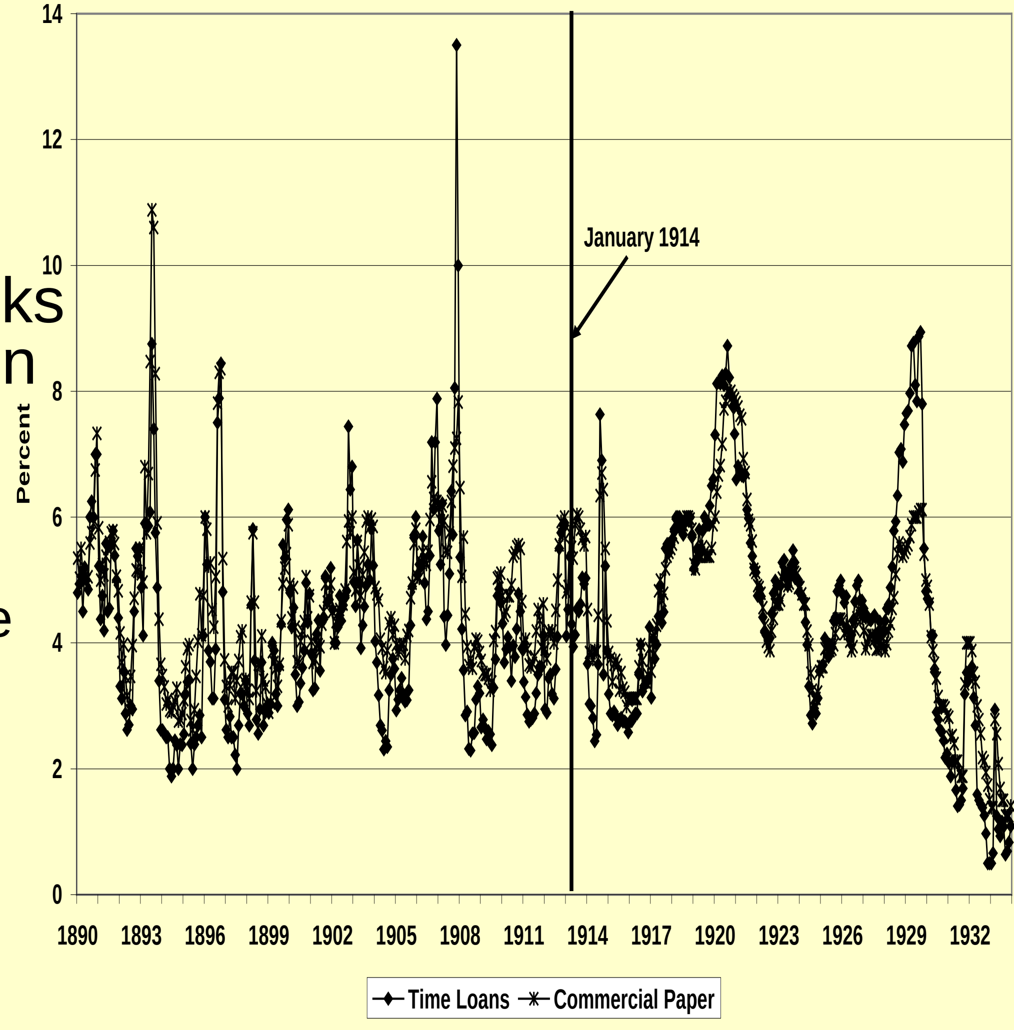
1. "Greenspan Put": Fed promises to end panics by smoothing interest rate fluctuations→risk-taking
2. Discount window: Some banks rapidly become dependent on discount window—voluntary liquidations decline

    In 1925,

    593 banks borrowing for more than one year

    239 borrowing continuously since 1920

    Fed est. 259 of failed banks since 1920 were "habitual borrowers."



Changes in Bank Supervision arising from Regulatory Competion

- Disclosure: 1918→1926 Fed Reduces "Call" Reports Reduces 5→2 (April 12 & June 30).
- Examination: OCC charges for examination—FR Banks absorb the cost.
- Number of OCC Examiners rise—cope with failures
- Capital to Asset Ratio Declines.

	No. of Examiners	No. of Banks	Banks per examiner
1915: OCC	103	7,597	74
1925: OCC	221	8,054	36
1925: Fed	21	1,472	70

The "Great Regime Shift" to the New Deal

- **Great Depression 1929-1933**
  - Unexpected Deflationary Shock, Prices drop 23%
  - Real GDP falls 39%
- **Banking Shrinks**
  - July 1929: 24,504 commercial banks, $49 billion deposits
  - Bank Holiday March 1933 ("Stress Test") 11,878 banks with $23 billion.
- **Losses from failed banks**
  - Totaled $2.5 billion ($39 billion in 2009)
  - Half to depositors and to half shareholders
  - 2.4% of GDP.

The "Great Regime Shift" to the New Deal: A Misdiagnosis

- **Regulation**: Competitive Market→ Government-Regulated Cartel.
- (Erroneously Assume Competition Failed---not Deflationary Shock)
- **Supervision**: Reinforcing Market Discipline→ Discretion-Based Supervision & Forbearance
- (Erroneously Assume Markets Can't Value Assets because of Volatile Price Expectations)
- **Deposit Insurance ends Double Liability**

The New Deal: 1933-1970 and beyond

1. **Monetary/Financial Policy Conflict?**
   Supervision Subordinated to Monetary Policy
2. **Supervision independent of central bank?**
   Split Supervision though increased Cooperation
3. **More than one agency?**
   More agencies---one for each segment of industry:
   OCC, FR, FDIC, SEC, FRHBB….+ States
   Opportunities for Regulatory Arbitrage
   “Competition in Laxity” & Regulatory Capture
4. **Political Independence /Transparency /Oversight**:
   More agencies→independent but less transparency and less oversight
5. **Philosophy of Supervision?**
   End of Market Discipline & Market Valuation→Discretion-Based Supervision

The New Deal, 1933-1970

1. Entry	Regulatory Discretion
2. Capital Requirements	Regulators Examine Capital Adequacy—No Rules--Discretion
3. Limits on Economies of Scale	Branching & Mergers Limited
4. Limits on Economies of Scope & Diversification	Banks Narrowly Re-Defined; Glass-Steagall Act
5. Limits on Pricing	Regulation Q
6. Liability Insurance	Deposit Insurance Ends Double Liability
7. Disclosure	Fewer Call Reports
8. Examination	Intrinsic Soundness Not Market Value
9. Supervision & Enforcement	Regulatory Forbearance

New Deal, 1933-1970: Golden Age?

- Why so few bank failures?
- Macroeconomic Stability, 1945-1970
- Number of bank failures: tiny
  - Weak banks eliminated in 1930s
  - WWII→Conservative asset mix
- Anti-Competitive Regulation
  - Huge Costs to Households & Business

- Deposit Insurance Coverage Rises
- Capital to Asset Ratio Falls →Moral Hazard
- Set-Up for Banking Crises of 1980s and 2000s

Bottom Line: Why did pre-New Deal Supervisory Regime work?: Set correct incentives—even though flawed regulations