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

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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. National Banking Era 1864-1913
2. Early Federal Reserve Period, 1914-1932
3. New Deal, 1933-1970
What Are Today’s Key Issues


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.”

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

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<tr>
<th></th>
<th>National Banks</th>
<th>State Banks</th>
<th>Trust Companies</th>
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<tbody>
<tr>
<td>1890</td>
<td>3,484</td>
<td>2,534</td>
<td>255</td>
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<tr>
<td>1905</td>
<td>5,664</td>
<td>7,920</td>
<td>1,115</td>
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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
- BUT these panics are primarily Liquidity Events NOT Solvency Events---even if a bank failure started a panic, no large system-wide losses from bank insolvencies.
Costs of Bank Failures

- 1864-1913: 501 National Bank insolvencies
  - 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?
- 1864-1913: 2,373 National Bank voluntary liquidations---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.
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 Competition

- Examination: OCC charges for examination—FR Banks absorb the cost.
- Number of OCC Examiners rise—cope with failures
- Capital to Asset Ratio Declines.

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<thead>
<tr>
<th>Year</th>
<th>No. of Examiners</th>
<th>No. of Banks</th>
<th>Banks per examiner</th>
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<tbody>
<tr>
<td>1915: OCC</td>
<td>103</td>
<td>7,597</td>
<td>74</td>
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<tr>
<td>1925: OCC</td>
<td>221</td>
<td>8,054</td>
<td>36</td>
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<tr>
<td>1925: Fed</td>
<td>21</td>
<td>1,472</td>
<td>70</td>
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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

- (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
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<th>The New Deal, 1933-1970</th>
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<td><strong>1. Entry</strong></td>
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<td><strong>2. Capital Requirements</strong></td>
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<td><strong>3. Limits on Economies of Scale</strong></td>
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<td><strong>4. Limits on Economies of Scope &amp; Diversification</strong></td>
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<td><strong>5. Limits on Pricing</strong></td>
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<td><strong>6. Liability Insurance</strong></td>
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<td><strong>7. Disclosure</strong></td>
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<td><strong>8. Examination</strong></td>
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<td><strong>9. Supervision &amp; Enforcement</strong></td>
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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