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More Important than Currency or Gold: How the Federal Deposit Insurance Corporation Bolsters Confidence in the American Banking System

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Introduction

First a few words about the title of this paper: Franklin Roosevelt delivered 30 fireside chats during his long presidency, the very first of which occurred on Sunday, March 12, 1933, just 8 days after his inauguration. The topic of his first chat was the banking crisis which surely was on everyone's mind, given that FDR had declared a "Banking Holiday" the previous week that closed every bank in the country.

The fireside chat sought to explain the crisis, outline plans to reopen the banks, and calm people's understandable anxiety. FDR finished his chat by saying:

"After all there is an element in the readjustment of our financial system more important than currency, more important than gold, and that is the confidence of the people. Confidence and courage are the essentials of success in carrying out our plan. You people must have faith; you must not be stampeded by rumors or guesses. Let us unite in banishing fear. We have provided the machinery to restore our financial system; it is up to you to support and make it work. It is your problem no less than it is mine. Together we cannot fail."

The fireside chat was a huge success. It has been said that Capitalism was saved in that eight-day period culminating in Roosevelt's fireside chat. No substantial runs on banks occurred after the banks were reopened; confidence seemed to have been restored. But if confidence of the people is really more important than currency, more important than gold, steps were needed to sustain the confidence FDR had created. After all, a person cannot be expected to be fired with courage when his assets have been frozen or when he has well-founded doubts about the institution to which he has entrusted the savings of a lifetime.

Responsibility for sustaining confidence in the American banking system has fallen largely on a Government agency called the Federal Deposit Insurance Corporation or FDIC. How that agency came to be and how it bolsters confidence in the banking system is the subject of this paper.

Runs on the Banks

We'll start and end the paper in the same place: The fictional town of Bedford Falls, the setting for Frank Capra's masterpiece movie "It's a Wonderful Life," in which George Bailey (Jimmy Stewart)

postpones his dreams of travel and building things in order to sort out the affairs of the family business, the Bailey Brothers' Building and Loan.

The scene in the movie that concerns us is the one in which George and his new bride Mary (Donna Reed) are departing on their honeymoon when they notice a crowd has formed in front of Bailey Brothers' Building and Loan. When George learns the depositors have panicked and want their money in cash, he manages to weather the bank run by using his considerable charm and the $2,000 he and Mary had saved for their honeymoon.

George satisfies all the depositors with two dollars to spare and goes on to learn the film's great lesson about what matters in life. But the scene about the bank run raises some questions.

First, could George have really weathered the bank run with $2,000 cash and some pleas for reason? This depiction of a bank run is pure "Capra-corn." Likely George would have failed because bank runs tend not to involve a dozen or so neighbors willing to take just enough cash go get by. Bank runs can involve thousands of people who want all their money right now.

The bigger question is why a bank run was even necessary. People didn't know it at the time, but all that was needed to bolster people's confidence in the banking system was deposit insurance. Since the FDIC began providing deposit insurance on January 1, 1934, no depositor has lost a single cent of insured deposits from the failure of their bank. But we're getting ahead of ourselves. Let's go back and think about banks, the banking system, and the history of deposit insurance.

To establish a good point of departure for a paper like this, it is helpful to acknowledge that the readers begin with a good deal of knowledge about the subject and not to dwell on things they already know. Based on an unscientific but random sample of people around town, the following summary statement emerged concerning what they knew about deposit insurance.

- Deposit insurance was a New Deal program initiated by FDR and supported by bankers
- To stop a wave of bank failures that occurred suddenly in the aftermath of the 1929 stock market crash
- The FDIC provides deposit insurance to make banks safe
- The insurance level has increased gradually over the years to whatever it is now.
- Deposit insurance has been an unqualified success.

What makes this summary statement useful as a point of departure is that it is false in every detail. The rest of this paper will explain why.

<u>Deposit insurance: a New Deal program initiated by FDR and supported by bankers?</u>

Deposit insurance was implemented as a result of the Glass-Steagall Act of 1933, also known as the Banking Act of 1933. But deposit insurance was not a new idea in 1933. The discussion about deposit

insurance goes back at least to 1809 when the Farmers Bank of Gloucester, Rhode Island failed. A wave of failures five years later fueled demands for banking reform, and states started looking for solutions.

In 1829, New York became the first state to adopt a deposit insurance program. From 1831 to 1858, five additional states adopted insurance programs. But by 1865 all six insurance programs had failed.

A second wave of state-sponsored deposit insurance programs occurred between 1908 and 1917 when eight states adopted programs. All eight became insolvent by 1930.

State sponsored deposit insurance programs did not work mainly because the states could not build insurance pools fast enough or big enough to avoid being overwhelmed when banks failed, and the states could not back their programs with the full faith and credit of their governments.

At the Federal level a total of 150 proposals for deposit insurance were made in congress between 1886 and 1933. All failed to get the necessary support for passage.

The Glass-Steagall Act can hardly be classed as a new deal measure. It was the only important piece of legislation to come out of the New Deal's famous 100 days which was neither requested nor supported by the Roosevelt administration. FDR himself was opposed to the idea of deposit insurance, as was his Treasury Secretary Woodin. They believed a system of deposit insurance would be unduly expensive, would unfairly subsidize poorly managed banks, and would eventually fail just as the defunct state-level deposit insurance programs had. After Glass-Steagall passed both houses of Congress and went to conference committee to resolve differences, FDR sent a note threatening to veto the measure unless changes were made. No changes were made, but FDR signed the measure into law because it had huge public support. Ironically, FDR later took credit for Glass-Steagall.

As to banking industry support for deposit insurance, the opposite was the case. The President of the American Bankers Association declared that deposit insurance was "unsound, unscientific, and dangerous." As Glass-Steagall approached passage, the American Banking Association tried to kill it by urging its member banks to telegraph FDR immediately to request his veto of the legislation. In 1933 bankers were held in even lower regard than they are today, so their opposition to Glass-Steagall may have helped it become law.

So if the FDR administration and the banking industry were opposed to deposit insurance, how did it come about?

Deposit insurance was purely a creature of Congress, driven by two influential leaders, Senator Carter Glass of Virginia and Representative Henry B. Steagall of Alabama.

Carter Glass was Chairman of the Senate Banking and Currency Committee. Glass had served as Treasury Secretary from 1918 to 1920, and Roosevelt asked Carter Glass to be his Treasury Secretary but he refused. Carter Glass is considered the father of the Federal Reserve, having written much of the law that created it. Glass was not a proponent of deposit insurance, but he include it in the Senate version of the bill because of popular support and in order to gain support for other banking reform measures included in the same bill.

Henry B. Steagall was Chairman of the House Committee on Banking and Currency. He was among the biggest supporters of deposit insurance and had managed to get a deposit insurance bill passed by the House in 1932 but it did not become law because no similar bill had been introduced in the Senate.

Senator Carter Glass Representative Henry B. Steagall

In mid-May both Senator Glass and Representative Steagall introduced banking reform bills that included deposit insurance provisions. A major problem with both bills was that they included a one-year delay in implementation to January 1935 insisted upon by FDR who threatened to veto the bill otherwise. The delay was intended to give the banking insurance fund time to accumulate enough money to keep the fund solvent.

Two other key leaders who helped create deposit insurance were Vice President John (Cactus Jack) Garner and Senator Arthur Vandenberg.

Vice President John Garner Senator Arthur Vandenberg

Vice President Garner was the only supporter of deposit insurance in the Roosevelt administration, but he had been unsuccessful in trying to get FDR's support. On March 3d when FDR arrived in Washington for his inauguration, Garner, who was Speaker of the House at the time, made a last appeal. Again Roosevelt refused his consent. "It won't work, Jack. The weak banks will pull down the strong."

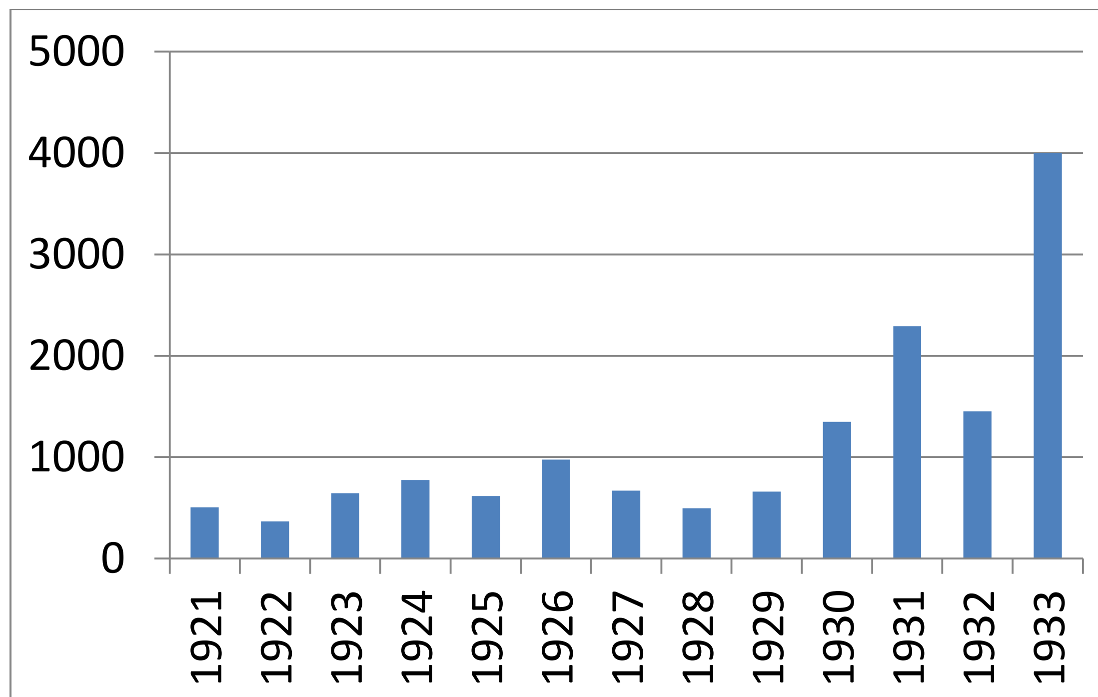
Besides lacking presidential support, the bills moving through the congress still stipulated a one year delay in implementation. Garner found unexpected support from a stalwart and respected Republican, Arthur H. Vandenberg of Michigan. Garner and Vandenberg conspired to amend the Senate version of the bill to create a temporary deposit insurance fund to begin in January 1934. Vandenberg opposed the delay in implementing the fund because "the need is greater in the next year than for the next hundred years."

Despite his opposition to the bill and his inability to remove the Vandenberg amendment, Roosevelt bowed to public pressure and signed the measure, known as the Banking Act of 1933, on June 16th 1933.

Key provisions of the bill included creation of the FDIC, imposition of an assessment scheme on banks to fund the fund, a pledge of full faith and credit to back the insurance plan, and an initial $289 million to create the fund ($150 million from the Treasury and $139 million from the Federal Reserve). By the way, FDIC repaid the $289 million by 1948 and in 1950 and 1951 paid an additional $81 million to the Treasury for interest foregone on the initial contributions from the Treasury and Federal Reserve.

<u>Deposit Insurance designed to stop a wave of bank failures that occurred suddenly in the aftermath of the 1929 stock market crash?</u>

As shown in the following graph, bank failures did not occur suddenly in the aftermath of the 1929 stock market crash. An average of more than 600 banks per year failed between 1921 and 1929. More banks failed in 1924, 1926 and 1927 than failed in 1929. The stock market crash in 1929 was but the thunderclap in a storm that had been gathering for quite some time. Moreover, the bulk of the bank closures occurred more than a year after the crash and may have been President Roosevelt's fault.



Banking conditions deteriorated rapidly during the winter of 1932 and 1933, approximately the period between FDR's election in November and his inauguration in March. Among other factors, FDR's

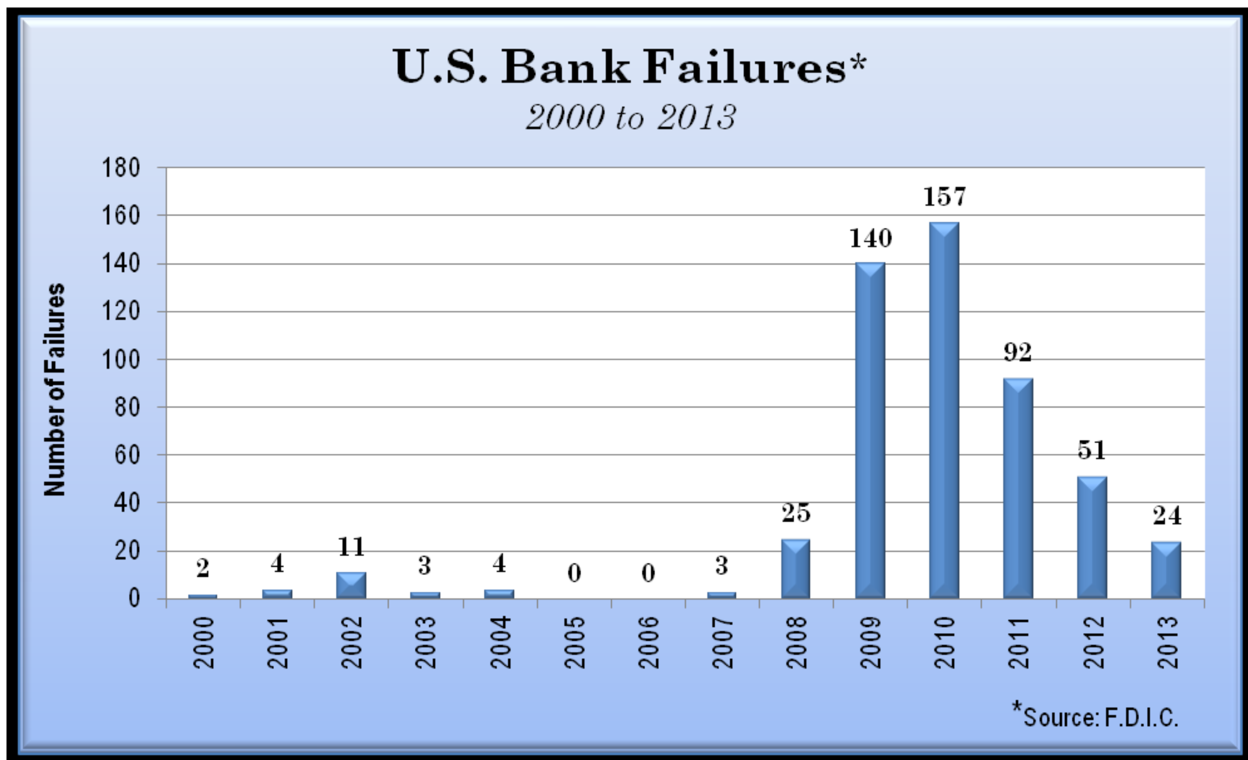
election itself helped to trigger the crisis. Three reasons have been suggested for this. First, FDR had campaigned against the deficit spending of Herbert Hoover and vowed to correct this by cutting federal spending by 25 percent. Though he never carried out such a plan and in fact did the opposite, the business sector feared his promised cuts would make things worse. Second, a false rumor circulated that FDR intended to nationalize the banks and seize all deposits. Third, a rumor circulated that FDR planned to devalue the dollar by increasing the price of gold. FDR did in fact devalue the dollar, but not until 1934.

Does the FDIC provide bank insurance to make banks safe?

FDIC insurance is basically a guarantee that depositors will not lose their funds. If the bank where they keep their money fails, the FDIC guarantees that they will receive the full amount of those funds, up to the insurance limit, from the FDIC's insurance fund.

Banking is a competitive business. The FDIC's oversight of the industry is not designed to stifle competition or to prevent the failure of banking businesses that cannot compete effectively. Banks fail, and when they do the bank's stockholders and the holders of any bonds the bank may have issued will lose their money, as neither the Glass-Steagall Act nor the FDIC exist to protect them.

The following chart shows that banks still fail almost every year, and fail in substantial numbers when financial crises strike.

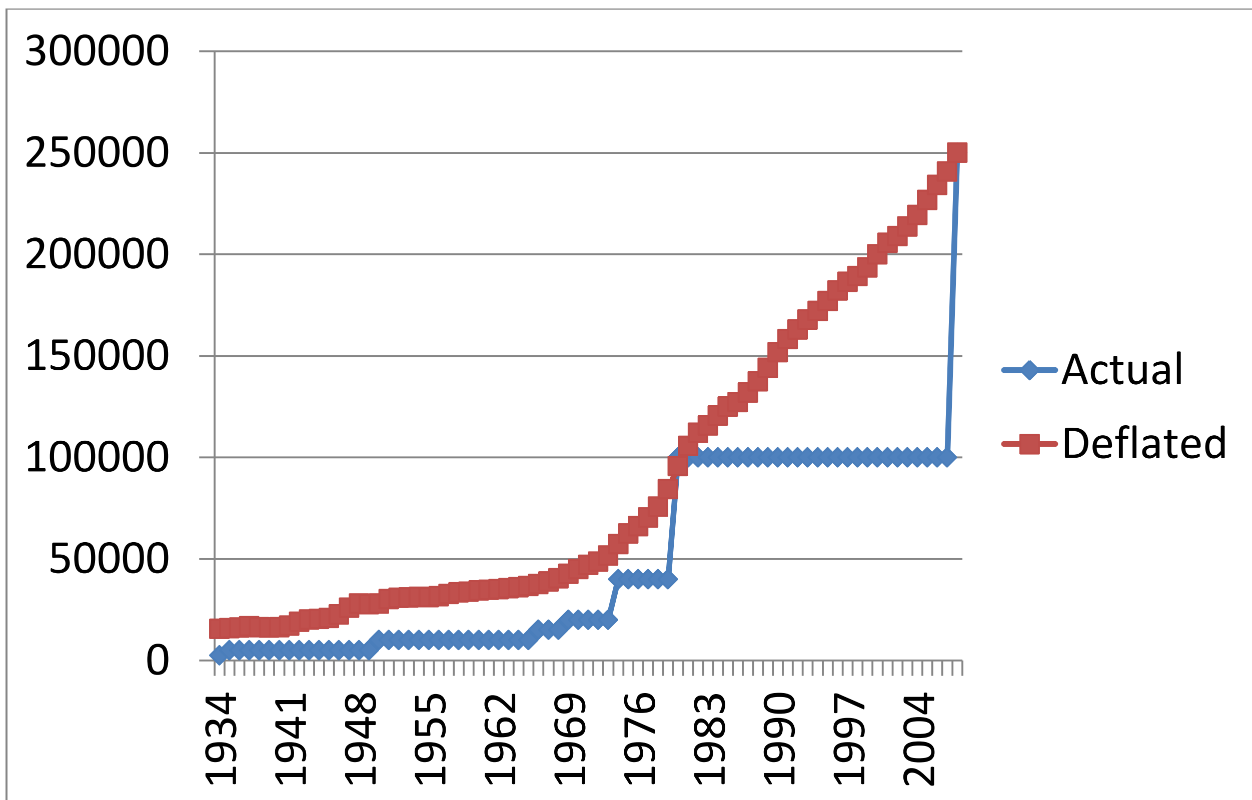


As a regulator, FDIC does what it can to prevent losses by inspecting and regulating banks. But the FDIC does this for the depositors and to protect the insurance fund, not to protect the banks from failure.

The 2009 bank failures included First Centennial Bank in Redlands that was closed by regulators on January 24, 2009.

Has the insurance level increased gradually over the years?

The initial limit on deposit insurance was set at $2,500 per depositor per insured bank in 1934, and was raised to $5,000 in 1935. Gradual increases occurred in 1950 ($10,000), 1966 ($15,000) and 1969 ($20,000). Large increases occurred in 1974 ($40,000) and 1980 (100,000). During the financial crisis of 2008 the limit was temporarily raised to $250,000. With the passage of the Wall Street Reform and Consumer Protection Act in 2010, the FDIC insurance limit of $250,000 was made permanent.



Looking at the history of deposit insurance limits, it is hard to see the limits increasing gradually. Instead, they seem to stay static for long periods and then increase dramatically. The reason for this is that limit increase decisions are political rather than programmatic. The 1980 increase was made to help banks compete with money market mutual funds; the 2008 increase was made to stop a run on Washington Mutual and other banks that were in trouble at the time.

The 150 percent increases that occurred in 1980 and 2008 are especially striking. Even adjusting for inflation by displaying $250,000 in then-year dollars, the current level is at an historic high except for the $100,000 limit set in 1980. Except for a few years after 1974 and 1980, the $250,000 limit in then-year dollars is three to six times higher than the limit in effect at the time.

The insurance limit may be inconsequential since there is no limit on the number of banks where these accounts can be established. The City of Redlands, for example, has over $20 million in FDIC insured accounts.

Has deposit insurance been an unqualified success?

The FDIC has certainly been an unqualified success in protecting Americans' deposits. Since the start of FDIC insurance on January 1, 1934, no depositor has lost a single penny of insured funds as a result of a bank failure. The FDIC almost always pays insured depositors within a few business days of a closing, usually the next business day. Payment is made either by providing each depositor a new account at another insured institution or by issuing a check to each depositor.

Moreover, the FDIC was an immediate success in restoring the public's confidence in the banking system. Only nine banks failed in 1934 compared to over 9,000 in the preceding four years. Despite handling 370 bank failures from 1934 through 1941, the FDIC's fund balance grew to $554 million. Post 1941 the fund continued to grow as annual bank failures exceeded single digits only rarely between 1940 and 1980. By 1987 the insurance fund had grown to $18.3 billion.

Perhaps the FDIC's greatest success is its longevity. Dramatic changes in the banking industry and some severe financial crises have tested the FDIC, but it remains strong and extremely popular.

For all that it has accomplished, however, the FDIC does have its detractors. An internet search of FDIC yields 12.6 million results, and among those are plenty of gripes. Local bankers interviewed for this paper had some not-entirely-positive thoughts as well. Criticism of FDIC focuses on four issues: cost, regulation, risk, and the unintended consequences inherent in any insurance system.

The first issue is cost. Deposit insurance is not free. Each FDIC member bank is assessed a small percentage of all deposits. The percentage is small, but the total cost is very large because FDIC insures over 6,000 banks with deposits of over $12 trillion. Quarterly net revenues for FDIC average around $40 billion. These costs are eventually passed on to consumers, even if the consumers don't realize it. The fact is that FDIC is a large federal agency employing over 7,000 people and administering an entitlement program that the public has come to expect.

The second issue falls under the category of burdensome government regulation. Deposit insurance is simply not possible without supervision, and supervision brings heavy amounts of reporting, paperwork, audits, and compliance with an ever-growing list of regulatory requirements. Banking is among the most heavily regulated industries in our country, in part because the FDIC is on the hook when losses occur.

Risk is an issue because there is no true bank insurance fund any more than there is really a Social Security Trust Fund. Bank assessments are paid into the Treasury and become a credit due to the FDIC, but that credit consists of US Government bonds. The Treasury has to find the cash to pay amounts the FDIC owes. The full faith and credit of the US Government is the only real asset supporting the deposit insurance program. Although FDIC has a $100 billion line of credit with the Treasury, there is virtually no limit to the amount at risk.

If you think this sort of risk is not a serious issue, consider the case of FDIC's defunct sister agency, the Federal Savings and Loan Insurance Corporation (FSLIC). The FSLIC was completely overwhelmed by the Savings and Loan crisis of the 1980s. Its fund balance was depleted and the Federal Government had to pay out an additional $132 billion (nearly $400 billion in 2016 dollars). The FSLIC was dissolved and its responsibilities transferred eventually to the FDIC in1995.

The most interesting issue with deposit insurance, and the one that most concerns our local bankers, relates to moral hazard, an insurance industry term that means people behave differently when their

assets are insured. This was pointed out to me by a local banker who said “Deposit Insurance takes character out of the equation.” Think about it: If every account is insured, then every account is equal except for the amount of interest it pays. And if every account is equal, then every bank is equal except for convenience factors such as banking hours and location which, let’s face it, are quickly becoming irrelevant.

As one banker said to me, in quite un-banker-like language, “there are two kinds of money: Core money which comes from loyal local customers with whom the bank has a relationship, and whore money that moves from bank to bank chasing slightly higher interest rates.”

To help you better understand the concept of moral hazard as it applied to insured deposits, imagine the following scenario. You have $100,000 to invest in a certificate of deposit and you are trying to decide between two banks. The first bank is the Friendly Neighborhood Bank of Redlands. You know this bank very well. It is located in town, contributes to local non-profits, pays taxes to support local schools, and has responsible managers who are active in the community. The bank is rated highly, has a strong balance sheet, and mostly loans money to local consumers and businesses.

The second bank is the Shaky Bank of the Internet. It exists only in cyberspace, pays no property tax, and is owned by a consortium of Bernie Madoff and the Wolf of Wall Street. The Shaky bank is poorly rated, is on FDIC’s list of problem banks, and mostly loans money to tobacco companies, pornographers, and South American dictators.

So, which bank gets your $100,000? Oh, in case this matters to you, the Shaky Bank pays exactly twice as much interest as the Friendly Neighborhood Bank, 3 percent vs. just 1.5 percent, meaning the Shaky Bank pays $3,000 per year vs. just $1,500 for the Friendly Neighborhood Bank of Redlands. Here’s another fact you might want to consider: both banks are insured by the FDIC.

If you find this choice perplexing from a moral hazard standpoint, imagine now that the money is not yours. You are a financial advisor or institutional investor with a fiduciary responsibility for investing other people’s money. Do you even have a choice?

By the way, if you find the description of the Shaky Bank far-fetched, you might want to consider the case of Doral Bank. Doral Bank, with $5.9 billion in assets and $4.1 billion in deposits, was among the 8 banks that failed in 2015. Before it failed, the bank was under several FBI fraud investigations, its balance sheet was found to have been pumped up with non-existent assets, its stocks were manipulated to let some investors sell just before the closure, and one bank officer was murdered in what the FBI described as a gang style assassination. Yet up until the day of its closure Doral Bank was offering FDIC insured Certificates of Deposit paying above market rates. Owners of those CDs lost not one penny when the bank failed because the investments were insured. The FDIC estimates that the cost to the Deposit Insurance Fund for Doral Bank’s failure will be $748.9 million.

<u>Back to Bedford Falls</u>

Let’s return to the fictional town of Bedford Falls where our story began, and to the subject of bank failures which is where deposit insurance began. Imagine you are in the Bailey Brothers’ Building and Loan office worried about your deposits. If this happened today, you would thank your lucky stars for deposit insurance. But there was no deposit insurance then, so what would you have done?

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Background of the Author

Born in Chicago and raised in Southern California, Robert Dawes has lived in Redlands on and off since 1987. His residency in Redlands was interrupted twice: He and his family moved to Germany for three years and later to Washington DC for four years. In addition, Robert spent four months on a special assignment in Baghdad where he served as the Inspector General for the Coalition Provisional Authority.

Robert is a Certified Public Accountant and has a Masters in International Business. Before his retirement in 2008, he served as Auditor General of the US Air Force at the Pentagon.

Robert takes great pleasure in serving the Redlands community. He is President of the Redlands Conservancy, Treasurer of the Redlands Community Music Association, and an active member of three other non-profit organizations.

In 2012, Robert was elected as Redlands City Treasurer. His four year term will end in November of 2016.

As City Treasurer, Robert is responsible for investing the city's available funds in a variety of fixed-rate securities. Through his investing activities he became curious about the Federal Deposit Insurance Corporation, the subject of his current Fortnightly paper.

Abstract

In its ninth decade, deposit insurance remains an integral part of the nation's financial system. Administered by the Federal Deposit Insurance Corporation (FDIC), deposit insurance protects the savings of millions of Americans up to the deposit insurance level. Despite Roosevelt administration and banking industry opposition, deposit insurance was implemented as a result of the Glass-Steagall Act of 1933, also known as the Banking Act of 1933. But deposit insurance was not a new idea in 1933. State government and congressional efforts to establish deposit insurance programs began over 100 years before Glass-Steagall. The initial limit on deposit insurance was set at $2,500 per depositor per insured bank in 1934, and was raised over time to $250,000, generally as a result of banking crises. The FDIC has been an unqualified success in protecting Americans' deposits. Since the start of FDIC insurance on January 1, 1934, no depositor has lost a single penny of insured funds as a result of a bank failure. Moreover, the FDIC was an immediate success in restoring the public's confidence in the banking system. Only nine banks failed in 1934 compared to over 9,000 in the preceding four years. For all that it has accomplished, the FDIC does have its detractors. Issues include cost, burdensome regulations, risks, and unintended consequences inherent in any insurance system.