

Small and Large Bank Views of Deposit Insurance: Today vs. the 1930s

By William R. Keeton

The increase in bank failures in recent years has spurred intense debate among banks over the level of protection for depositors. Current law limits deposit insurance coverage to \$100,000 per account. But the FDIC's method of handling bank failures often protects deposits above this limit, especially at large banks. Small and large banks have recently advanced very different proposals for changing the level of protection for depositors. Small banks favor covering all deposits regardless of the amount. In contrast, large banks prefer imposing some loss on large deposits when a bank fails.

Small and large banks have not always differed so sharply on deposit insurance. In the 1930s, large banks strongly opposed the adoption of deposit insurance. Proponents tried to convince small banks it was in their interest to

support deposit insurance. But most small banks ignored this advice and sided with large banks against the plan.

Why is it that small banks now reject proposals by large banks to reduce coverage but joined in opposing deposit insurance in the 1930s? This article argues that small banks have always needed deposit insurance more than large banks and opposed the idea in the 1930s only because of special factors. The first section suggests small banks need deposit insurance more than large banks because the lack of diversification of small banks makes them more vulnerable to local economic shocks. The second section argues that this difference in need for deposit insurance explains why small banks now disagree with large banks over the level of coverage. The third section shows small banks also had more to gain from deposit insurance in the 1930s but nevertheless joined large banks in opposing the measure. The fourth section resolves the paradox, identifying the special factors that made small banks less sympathetic to deposit insurance in the 1930s than today.

William R. Keeton is a senior economist at the Federal Reserve Bank of Kansas City. James LeVoir, a research associate at the bank, assisted in the preparation of the article.

I. Why Deposit Insurance Benefits Small Banks More Than Large Banks

Under the deposit insurance system in effect since the 1930s, the FDIC guarantees or “insures” each bank deposit up to a specified limit. To cover the potential costs of honoring the guarantee, the FDIC also charges each insured bank a premium proportional to the bank’s deposits. Such an arrangement benefits small banks more than large banks because small banks are less diversified and, thus, more vulnerable to local economic shocks.

Vulnerability of small banks to local economic shocks

Small banks tend to have less diversified loans and deposits than large banks. Large banks can lend to a wide variety of businesses, either by setting up branches in different regions or using their size and reputation to attract national firms. Large banks can also use their branch networks or their size and reputation to attract deposits from a wide area. Most small banks have no branches, no outside reputation, and too few resources to meet the needs of national firms. Thus, in contrast to large banks, small banks must lend mainly to local businesses and raise funds mainly from local depositors. Moreover, small banks tend to be located in rural areas and smaller cities. In such areas, the local economy is also likely to be undiversified, that is, dependent on a single industry such as agriculture or energy.

Because small banks are undiversified, they face a greater risk of failure from local economic shocks. A downturn in the local economy makes it harder for local businesses and households to repay their loans. Thus, a small bank is more likely to suffer an unexpected increase in loan defaults than a large bank that lends to a wide variety of borrowers. Also, when

the local economy slows, a net outflow of funds may occur to other more prosperous regions. As a result, a small bank is more likely to suffer an unexpected deposit drain than a large bank with deposits collected over a wide area. Such deposit drains can force a bank to sell perfectly sound assets at a heavy loss. Thus, even if a small bank could survive the increase in loan defaults caused by a local economic downturn, the bank could fail because it was unable to meet deposit withdrawals.

How vulnerability to local economic shocks hurts small banks

Vulnerability to local economic shocks can hurt small banks by making it harder for them to attract risk-averse depositors. A risk-averse depositor is one who prefers a certain return on his investment to an uncertain return. Without deposit insurance, the dependence of small banks on the local economy would make the return on their deposits more uncertain. If the local economy prospered, a small bank could afford to pay higher deposit rates than a larger, more diversified bank. But if the local economy soured, the bank could fail and depositors could receive nothing. In principle, a depositor could reduce this uncertainty by spreading his deposits over banks in many different regions. But such diversification would be inconvenient for most depositors. Thus, to attract risk-averse depositors in the absence of deposit insurance, small banks would have to pay much higher deposit rates than large banks. Because of these higher rates, small banks would tend to earn lower profits than large banks.¹

Vulnerability to local economic shocks can also hurt small banks by increasing the chance of bank runs. Runs occur when depositors become worried about the safety of their funds and withdraw their money quickly to avoid a loss. Without deposit insurance, depositors of a small bank would have more reason to worry

about the safety of their funds than depositors of a large bank. In particular, depositors of a small bank would realize that local economic shocks could cause the bank to fail due to a large increase in loan losses or heavy drain in deposits. Having more reason to worry about the safety of their funds, depositors of a small bank would be more likely to panic and run, forcing the bank to sell its assets at a loss.² Thus, without deposit insurance, the shareholders of a small bank would risk losing some or all of their investment in the bank due to a run. And because runs increase the chance of failure, small banks would have an even harder time competing with large banks for deposits.

How deposit insurance limits these adverse effects

Deposit insurance enables small banks to compete with large banks for risk-averse depositors despite their greater vulnerability to local economic shocks. With deposit insurance, the return on deposits is guaranteed. Thus, depositors bear no more uncertainty at small banks than at large banks. In effect, deposit insurance shifts the uncertainty of returns at each small bank onto the FDIC, which can diversify away the risk of local economic shocks by insuring banks throughout the nation.³

Deposit insurance also eliminates runs by panicky depositors. Because depositors are certain of receiving the full return on their investment with deposit insurance, they have no reason to withdraw their money to avoid a loss. Thus, deposit insurance reduces the likelihood of small banks having to sell their assets at a heavy loss to meet sudden withdrawals. Of course, large banks also benefit from the elimination of bank runs. But since small banks would be more susceptible to runs than large banks without deposit insurance, the benefit to small banks is greater.

II. The Current Controversy

After many years of wide acceptance, the deposit insurance system has come under growing attack. A crucial issue is how much protection depositors should receive. The S&L debacle and the sharp increase in bank failures since the early 1980s have been cited as evidence that the overall level of coverage is too high to restrain bank risk-taking. And most observers agree that coverage is greater at large banks than small banks, putting small banks at an unfair disadvantage. The controversy over coverage provides a good test of the argument in the previous section. In particular, if small banks need deposit insurance more than large banks, they should favor greater protection for depositors than large banks.

Current levels of coverage

Under the current system, the effective level of coverage depends on two factors—the statutory insurance limit and the way the FDIC handles bank failures. The deposit insurance law guarantees all domestic deposits up to \$100,000. However, in recent years, the FDIC has handled failures in ways that protect uninsured deposits as well as insured deposits, especially at large banks.⁴

The FDIC can handle bank failures in three ways: payoffs, purchase and assumption (P&A) transactions, and open-bank assistance. In a payoff, the FDIC lets the bank fail and then pays off the bank's insured deposits.⁵ Under this approach, uninsured depositors suffer at least a partial loss, because they must share the proceeds from the bank's remaining assets with the FDIC. In a P&A, the FDIC pays a healthy bank to assume all the failed bank's deposits. This method prevents uninsured depositors from suffering any loss whatsoever. Finally, under certain conditions, the FDIC can provide open-bank assistance to a failing bank—financial aid to keep

the bank open. The terms of the agreement usually require the bank's shareholders to take a substantial loss. As in a P&A, however, uninsured depositors are fully protected.⁶

At small banks, the FDIC has applied these methods in a way that partially protects deposits above the statutory limit. In recent years, the FDIC has used P&As and open-bank assistance to handle the majority of small bank failures. Thus, large depositors at small banks have a good chance of being paid in full in the event of failure. But the FDIC sometimes uses payoffs to resolve small bank failures. Over the 1984-89 period, for example, the FDIC used payoffs in 23 percent of the failures of banking organizations under \$1 billion in assets. Consequently, large depositors at small banks cannot be sure their funds are safe.

At large banks, the FDIC's procedures have fully protected all deposits. The FDIC has relied solely on P&As and open-bank assistance to handle failures of banks with more than \$1 billion in assets. For some large banks, such as Continental Illinois and First Republic, the FDIC has even promised in advance that no depositor will suffer any loss. Thus, under the current system, large depositors enjoy greater protection at large banks than at small banks. This preferential treatment of depositors at large banks is often described as the "too big to fail" policy. But the term is inaccurate because the FDIC does not mind letting a large bank fail and then doing a P&A to protect large depositors. A more accurate term would be "too big to default."

The current system has been attacked on two grounds. First, critics argue that the high overall level of coverage encourages excessive risk-taking. According to this argument, depositors at both small and large banks are too well protected from loss to care what banks do with their money. As a result, banks can take greater risk without depositors demanding higher rates.⁷ Second, critics argue that the system unfairly discriminates against small banks.

Uninsured funds are a much smaller share of total funds at small banks than at large banks. Critics claim the "too big to fail" policy prevents small banks from competing for such funds by making them safer at large banks.⁸

Small and large bank views

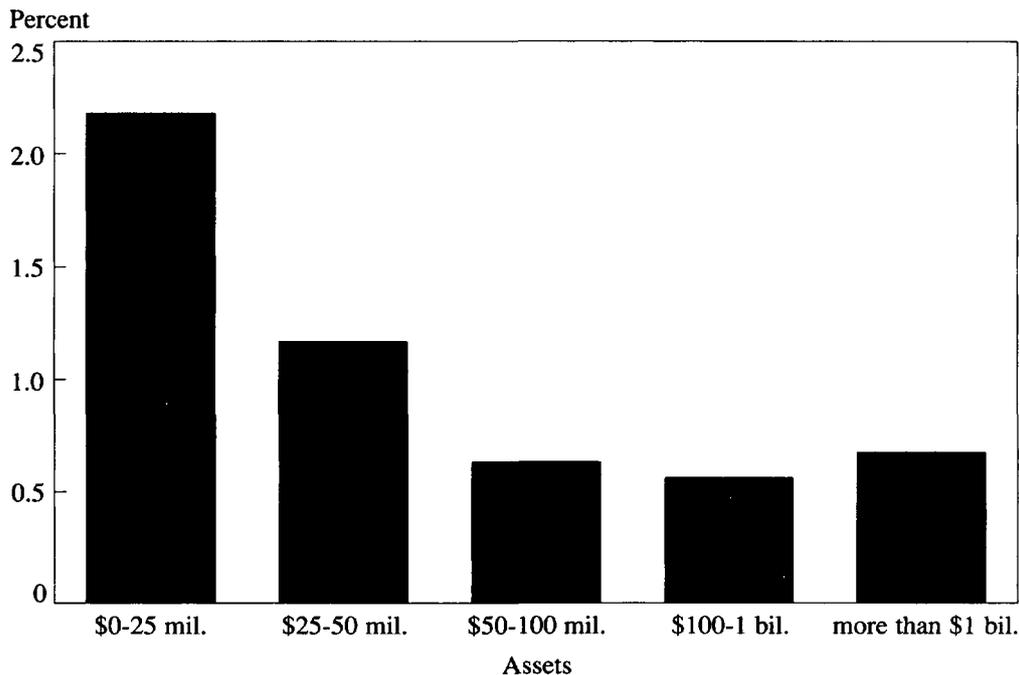
Small and large banks agree the current system needs to be changed, but they differ sharply on how to do it. The Treasury Department recently requested comments on deposit insurance reform for a study mandated by Congress. In response, large banks have recommended a decrease in coverage, while small banks have urged an increase.

Large banks believe depositors should be exposed to greater loss. The Association of Reserve City Bankers (ARCB), the major trade association representing large banks, has not yet advanced a specific proposal for changing insurance coverage. However, the group urges a return to "the original intent of only insuring small deposits" (ARCB 1990). According to the ARCB, the statutory limit should never have been raised to \$100,000 and should under no circumstances be raised further. Furthermore, deposits above the statutory limit should be unprotected at banks of all sizes.⁹

Small banks believe all depositors should be fully protected from loss. The major trade association for small banks is the Independent Bankers Association of America (IBAA). The IBAA wants Congress to eliminate the \$100,000 statutory limit on domestic deposits and to fully insure all foreign deposits (IBAA 1990). This approach would formalize the de facto coverage of large domestic deposits and foreign deposits at large banks. More importantly, it would extend the same coverage to small banks.

The American Bankers Association (ABA), representing the industry as a whole, has advanced a plan closer to the large bank view than the small bank view. Specifically, the ABA

Chart 1
Average Failure Rate, 1984-89
 By Size of Banking Organization



Note: The failure rate for each category is the average number of failures per year divided by the average number of organizations at midyear. Open-bank assistance is counted as a failure. Also, banks belonging to the same holding company are treated as a single organization. In a few cases, some banks in a multibank organization failed while others did not. In such cases, the organization was considered to have failed if the failed banks accounted for most of the organization's banking assets.

Source: FDIC and Reports of Income and Condition.

proposes that the degree of protection be reduced by forcing uninsured depositors to take a partial loss, or haircut, whenever a bank fails (ABA 1990). The haircut would be the same percentage at all banks, regardless of size, and would be set just high enough to allow the FDIC to break even over the long run. Based on the FDIC's past recovery rate on failed banks' assets, the ABA estimates the haircut would have to be somewhere between 5 and 15 percent.¹⁰

Why small banks disagree with large banks

Why do small banks favor greater protec-

tion for depositors than large banks? The main reason, as suggested earlier, is that small banks need deposit insurance more than large banks to offset their lack of diversification. The recent pattern of failures tends to confirm that small banks today face greater risk of local economic shocks than large banks. The increase in bank failures since the early 1980s has been associated with large disparities in economic performance among regions and industries (Bovenzi and Nejezchleb 1985). As Chart 1 shows, banks under \$50 million in assets have failed at higher rates than larger banks during this period. With the advent of interstate banking, large banks will be able to diversify further, increasing their edge

over small banks.¹¹ Thus, faced with a choice between fully covering deposits at all banks or partially covering deposits at all banks, small banks have more reason than large banks to favor full coverage.

Two other factors reinforce this difference of opinion over the level of coverage. First, large banks could benefit greatly if a reduction in coverage curbed bank risk-taking. If risk-taking fell, Congress would be more likely to grant new powers like securities underwriting—powers large banks are more eager to obtain than small banks. Second, small banks worry that any reduction in coverage would apply only to them. According to this view, regulators would be too worried about disrupting the financial system to let depositors at large banks suffer losses. Instead, they would find ways to prop up large banks and keep them from failing.

III. The 1930s Controversy

Today's controversy over deposit insurance is not the first. In the early 1930s, there was a heated public debate about whether to adopt deposit insurance. How did small and large banks view the issue? If small banks indeed need deposit insurance more than large banks, they should have supported the proposed law more than large banks, just as they favor higher coverage than large banks today. Paradoxically, however, small banks joined large banks in opposing the legislation.

Background of the original law

Although federal deposit insurance had been proposed before the 1930s, it began to be considered more seriously after the upsurge in bank failures in the early years of the Great Depression. The principal advocate in Congress was Representative Henry Steagall. In the spring of 1932, Steagall persuaded the House to approve a plan for federal deposit insurance. But

key senators like Carter Glass opposed the idea, preferring a plan that would pay off depositors more quickly without protecting them against loss. Thus, the Steagall bill died.

Pressure for a deposit insurance bill increased in early 1933 when a banking panic spread throughout the country. Upon assuming office in March, President Roosevelt declared a nationwide banking holiday to halt the panic. But Roosevelt strongly opposed federal deposit insurance as a solution to the nation's banking problems. In May, Representative Steagall and Senator Glass introduced companion bills to reform the banking system. Glass reluctantly accepted Steagall's deposit insurance plan, believing it was the only way to pass other more necessary reforms. But given Roosevelt's strong opposition, prospects for the plan were highly uncertain. Pressure from the public and key advisers finally convinced Roosevelt to go along with the idea. As a result, a modified version of Steagall's plan was included in the Banking Act of 1933, which was signed into law in June.

The 1933 act established both a temporary plan to begin in six months and a permanent plan to go into effect later. The temporary plan guaranteed deposits up to \$2,500. In contrast, the permanent plan fully guaranteed deposits up to \$10,000 and partially guaranteed deposits above that amount. Premiums were to be proportional to total deposits under the permanent plan. Also, banks could be assessed as much as necessary to cover the FDIC's costs. Finally, all banks belonging to the Federal Reserve System had to participate, and other banks could participate only if they joined the System within a specified period.

The law was hotly debated. On the one hand, the public demanded a program to protect their deposits from further bank failures. Some public officials and economists were also convinced deposit insurance was needed to revive stagnant bank lending and lift the economy out of the Depression.¹² On the other hand, many

officials and economists believed deposit insurance would encourage excessive risk-taking and force sound banks to subsidize reckless banks. Some also feared enactment of deposit insurance would divert attention from other more fundamental reforms—reforms ranging from interstate banking to nationalization of the industry.

Small and large bank views

Some researchers have suggested that large banks in the 1930s opposed deposit insurance while small banks supported it. According to one author, “The small banks wanted federal deposit insurance. The large banks, particularly those in the money centers, didn’t need deposit insurance” (Benston 1982). Comparing Steagall’s plan to insure deposits with Glass’s plan to merely pay off depositors faster, another author writes,

In these two versions of the bill lay the alignment of large and small banks . . . Glass’s program, the more conservative, would win whatever support was available from the big banks [while] Steagall’s bill represented the broader guarantee position of the small-bank men. (Kennedy 1973)

And another author claims that “the driving force behind the deposit insurance legislation . . . was the overwhelming support from community bankers throughout the nation” (Golembe 1990).

This interpretation of small and large bank views is only partially correct. It is true that large banks opposed federal deposit insurance. It is also true that some small banks supported the idea. Contrary to the conventional wisdom, however, most small banks opposed the plan.¹³

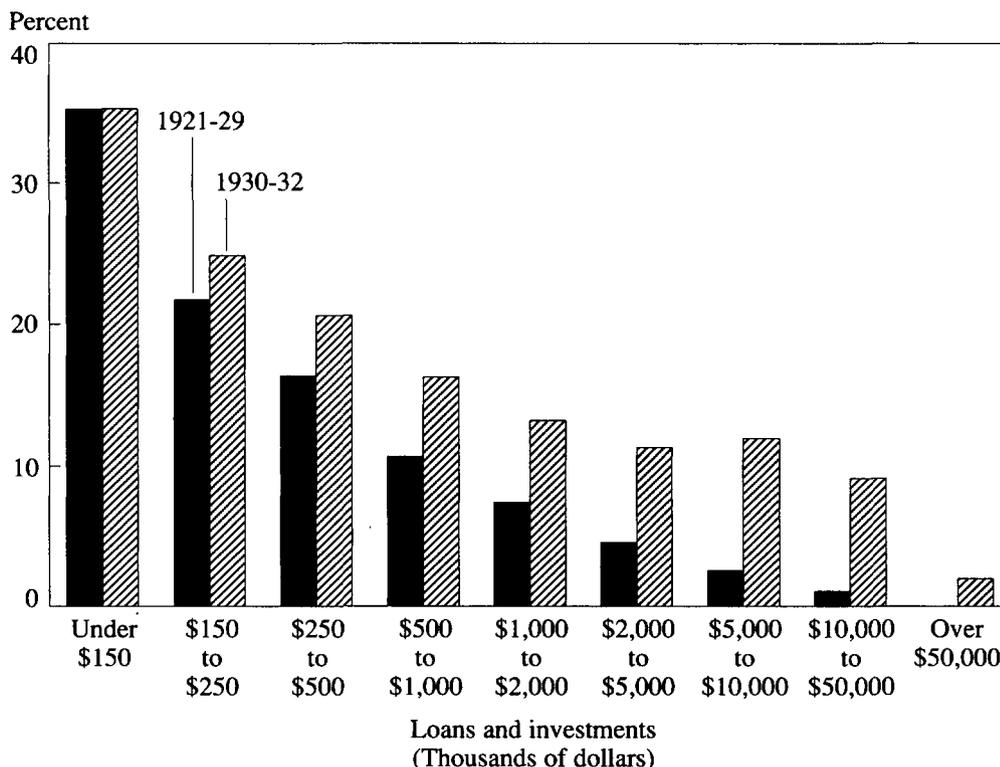
Large banks were especially vocal in their opposition to federal deposit insurance. As today, the leading trade association for large banks was the ARCB. The ARCB strongly opposed the deposit insurance provisions of the Banking Act of 1933 and sent a telegram to President Roosevelt expressing their disap-

proval (ARCB 1933; Schroeder 1962). Also, throughout 1932 and 1933, many representatives of large banks spoke out against federal deposit insurance in magazine articles, public hearings, and letters to politicians.¹⁴

Because small banks did not have an established trade group in the 1930s, their views on deposit insurance must be gleaned from other sources. The strongest evidence of small bank opposition to deposit insurance is the position taken by banking associations in states with many small banks. Kansas, Missouri, and Oklahoma were three such states. While the Banking Act of 1933 was before Congress, the associations of all three states expressed strong opposition to federal deposit insurance (Hubbard and Davids 1969; Kansas Banker 1933; and Oklahoma Banker 1933).¹⁵ Further evidence of small bank opposition to federal deposit insurance comes from informal surveys conducted in 1933 in Texas and Nebraska, two other states dominated by small banks. All but 11 of the 628 banks responding to the Texas survey opposed federal deposit insurance (Grant and Crum 1978). And two-thirds of the banks polled in Nebraska were against the idea (Hughes 1956).

Small bank opposition to deposit insurance also surfaced at the annual meetings of the ABA, the trade association for the entire banking industry. Throughout the 1930s debate, the ABA took a strong stand against federal deposit insurance. The group passed resolutions against the plan at its annual meetings in 1932 and 1933 and urged Roosevelt to veto the legislation (Commercial and Financial Chronicle 1932 and 1933; FDIC 1984). Because the ABA represented both small and large banks, its actions do not prove that small banks opposed deposit insurance. But the ABA’s state-chartered banks, which were mostly small banks, passed a strong resolution of their own against deposit insurance (Commercial and Financial Chronicle 1933).¹⁶ And an observer of the 1933 meeting of the ABA reported that opposition to the recently enacted

Chart 2
Total Failure Rate, 1921-29 and 1930-32
 By Size of Bank



Note: The failure rates for each category equal total failures in the two periods divided by the number of banks in June 1920 and June 1930, respectively.

Source: Federal Reserve Committee 1933b and Federal Reserve Bulletin 1937.

deposit insurance plan was as “marked among country bankers as among those in metropolitan cities” (Burns 1974, p. 125).

Why the small bank view is so surprising

The fact that small banks need deposit insurance more than large banks suggests that small banks should have supported the plan in the 1930s instead of joining with large banks in opposing it. The opposition of small banks is all the more surprising because several factors should have made the plan especially appealing to them.

First, small banks had failed at much higher rates than large banks in the 1920s and early 1930s, underscoring their vulnerability to local economic shocks and bank runs. Chart 2 shows total failure rates by size of bank for the 1920-29 and 1930-32 periods. The inverse relationship between size and failure rate is especially strong for the 1920s, when agriculture was in depression but the nation as a whole was prospering. The relationship is not quite as strong for 1930-32, when the economic downturn was nationwide. But even in this period, some industries and regions suffered much more than others, putting particular strain on undiversified banks.

Thus, the failure rate for 1930-32 still decreases steadily with size up to \$2 million.¹⁷

A second reason small banks should have favored deposit insurance was that it appeared likely to reduce public pressure for branch banking (Golembe 1960). In the 1930s, most states still prohibited or severely restricted branching. The high failure rate of small banks in the 1920s and early 1930s had convinced many experts that the only way to make banks safe was to allow them to branch over a wider area—within Federal Reserve districts or even nationally. That way, it was claimed, banks could grow larger and diversify their loans and deposits more easily. Small banks strongly opposed branching, believing they would be unable to compete with large branch banks. Key supporters of deposit insurance like Henry Steagall argued that a big benefit of deposit insurance to small banks would be to satisfy the public's demand for safety, thereby reducing demands for branching.¹⁸

A third reason small banks had for strongly supporting deposit insurance was that the cost was to be subsidized by large banks. Under the permanent plan, the amount each bank had to pay to cover FDIC losses depended on its total deposits. But since large banks had more customers with accounts over the insurance limit, a smaller percentage of their total deposits would be insured than of small banks' deposits (Emerson 1934). Also, unlike today, there was no reason to believe the FDIC would provide de facto coverage of large banks' uninsured deposits. Thus, the effect of the plan was to force large banks to pay a higher premium per dollar of insured deposits than small banks. This difference in effective premium rates should have further increased small banks' support for the plan.

IV. Resolving the Paradox

The benefits of deposit insurance to small

banks appear to have been at least as great in the 1930s as today. Why is it, then, that small banks favor higher levels of coverage than large banks today, but sided with large banks against deposit insurance in the 1930s?

One reason so many small banks might have opposed federal deposit insurance in the 1930s was that the original law required all insured banks to join the Federal Reserve System within three years. At the time, most small banks were state-chartered banks outside the Federal Reserve System.¹⁹ Some of these banks feared they would not meet the financial qualifications for Federal Reserve membership and would be denied insurance. A bank in this situation would be sure to lose most of its deposits to insured banks, ending up worse off than without the plan. Other state-chartered banks were clearly strong enough to join the Federal Reserve but did not want to join. These banks preferred to remain under state banking laws and supervision and avoid all federal control.²⁰

This reason for opposing federal deposit insurance is no longer relevant because Congress soon dropped the requirement to join the Fed. Many banking experts believed that forcing state nonmember banks into the Federal Reserve System would reduce the rate of failures by improving bank supervision and regulation. But there was great political support for maintaining a dual banking system where banks could choose between state or federal regulation. As a result, Congress postponed the deadline for joining the Fed and finally eliminated the requirement altogether in 1938.

A second factor that might have helped turn small banks against deposit insurance was that the original plan was to be self-financed. Although the U.S. government made an initial contribution, it was under no obligation to bail out the FDIC in hard times. Instead, insured banks were subject to unlimited assessments to cover FDIC losses. These provisions of the law caused both small and large banks to worry they

would have to pay for the excesses of a reckless minority. With depositor discipline weakened, reckless banks would be able to take excessive risks. Such risk-taking could cause the FDIC to suffer heavy losses, requiring burdensome assessments on sound banks. Small bank concern on this score was reinforced by the unfavorable experience of state insurance plans. Following a wave of bank failures in 1907, eight states mostly in the Midwest and Southwest adopted their own deposit insurance plans for state-chartered banks.²¹ When the rate of bank failures surged in the 1920s, most of the state plans suffered heavy losses and subjected healthy banks to stiff assessments (White 1983). Supporters of deposit insurance argued that the federal plan would be more successful due to greater diversification and closer supervision of insured banks. But the poor performance of the state plans made such a bad impression that many small banks were unconvinced.

Today small banks have less need to worry about paying for the excesses of reckless banks. In 1935, before the permanent plan went into effect, Congress set a maximum annual premium of 1/12 of 1 percent of deposits. With that change, banks no longer face unlimited liability for FDIC losses.²² Another important difference from the 1930s is that the U.S. government now stands firmly behind the FDIC. Congress removed any doubts in 1982 when it pledged the "full faith and credit" of the government to protecting insured deposits. This guarantee further reduces the chances that sound banks will have to pay for the excesses of reckless banks. As the S&L bailout makes clear, taxpayers now bear most of that risk.

A final reason small banks might have looked less favorably on deposit insurance in the 1930s was that the plan represented a radical change. During the hearings, one Congressman suggested bankers opposed deposit insurance because they are "essentially a conservative people . . . and are just naturally opposed to a

change in the status of things" (U.S. House of Representatives 1932, p. 213): Whether or not this characterization was fair, the 1933 law clearly represented a leap into the unknown for most small banks. After 50 years of experience with federal deposit insurance, small banks have much less reason to fear a move to full coverage. Such a change would not constitute a sharp break with the past, but rather, one more step in the steady expansion of the program.

V. Conclusions

This article contends it is rational for small banks to favor deposit insurance more than large banks. Deposit insurance makes up for small banks' vulnerability to local economic shocks, making it easier for them to compete with large banks for risk-averse depositors who want a certain return. Deposit insurance also eliminates bank runs, which are more of a problem for small banks because their uninsured depositors have more reason to worry about the safety of their funds.

Small banks' greater need for deposit insurance helps explain the current split between small and large banks over the level of coverage. Both sides agree that reform is needed. But small banks would fully insure deposits at all banks, while large banks would force all large depositors to bear some risk. This difference in views is exactly what one would expect, given the greater vulnerability of small banks to local economic shocks.

Since small banks were just as vulnerable to local economic shocks and bank runs in the 1930s, they should also have favored deposit insurance more than large banks then. Surprisingly, however, small banks joined large banks in opposing deposit insurance. Some of this opposition may have reflected uneasiness about the revolutionary nature of the plan. But small banks also objected to two key provisions of the plan that were later dropped—compulsory

membership in the Fed and unlimited liability for FDIC losses. Today deposit insurance no longer poses any threat to the dual banking system. Moreover, banks can rest assured they will not have to pay most of the bill if the FDIC

gets into trouble. Thus, on closer examination, small banks may have good reason to look more favorably on deposit insurance now than they did in the 1930s.

Endnotes

¹ In economic jargon, vulnerability to local shocks forces small banks to pay a "risk premium" on their deposits. The risk premium is the additional expected return risk-averse depositors require to compensate for uncertainty in the return.

² Another reason depositors of small banks may have more concern about the safety of their funds is that the banks' assets tend to be less liquid. Most of their loans are to local borrowers with no outside reputation, making the loans hard to sell in a hurry to raise cash. As a result, small banks are more likely to fail than large banks if, for whatever reason, a large fraction of depositors suddenly decide to withdraw their money.

³ In other words, deposit insurance eliminates the risk premium that small banks would otherwise have to pay on their deposits. This effect would benefit small banks more than large banks even if small banks had to pay the FDIC a higher premium per dollar of insured deposits to compensate for their greater risk of failure from local economic shocks.

⁴ For more thorough treatments of the FDIC's methods of handling bank failures, see FDIC 1989 and Secura Group 1989.

⁵ Instead of paying off insured deposits directly, the FDIC sometimes pays another bank to take over the deposits. Such transactions are called insured deposit transfers but are essentially the same as payoffs.

⁶ The three methods also affect the degree of protection to creditors other than depositors. In payoffs and open-bank assistance, such creditors are treated the same as uninsured depositors. Thus, they are unprotected by payoffs and fully protected by open-bank assistance. Until very recently, general creditors were also fully protected by P&As because the acquiring bank had to assume the failed bank's nondeposit liabilities as well as its insured and uninsured deposits. However, in the Financial Institutions Reform and Recovery Act (FIRREA) passed last year, Congress authorized "pro rata" P&As in which the acquiring bank assumes only the failed bank's deposits. In such transac-

tions, uninsured depositors are fully protected but general creditors are not.

⁷ Although a few studies have found that risky banks have to pay higher rates on large uninsured deposits than safe banks, the evidence is controversial and the difference in rates is small at best (Gilbert 1990). Large depositors do sometimes withdraw funds from banks that appear on the verge of failure, such as Continental Illinois in 1984. But critics of the current system argue that such withdrawals come too late to deter banks from taking risk.

⁸ Adding to the inequity, according to some critics, is that large banks pay no premiums on their foreign deposits—deposits that are fully protected under the "too big to fail" policy. Under this system, small banks pay a higher premium per dollar of true coverage than large banks. The critics believe this difference in effective premiums is too large to be justified by any difference in the two groups' risk of failure.

⁹ Individual large banks have also put forth plans to enforce the statutory limit more strictly. See, for example, Huertas and Strauber 1986, which gives the Citicorp view.

¹⁰ The same haircut would be applied to general creditors as to uninsured depositors. Also, the settlement with uninsured depositors and general creditors would be final. In other words, if the FDIC recovered more than average from a failed bank's assets, it would keep the surplus. And if the FDIC recovered less, it would absorb the loss. After applying the haircut, the FDIC would choose the least costly way to dispose of the bank—whether that be a payoff, a P&A, or a capital infusion to let the bank reopen.

¹¹ Many states will soon allow holding companies from anywhere in the nation to set up bank subsidiaries, and bills have been introduced in Congress to permit nationwide branching. Note also that if the FDIC imposed losses on all large deposits, large banks would have more incentive to exploit their opportunities for diversification so as to reduce their risk. Thus, the gap in diversification between small and large banks would probably widen.

¹² According to this view, the economy was locked in a

vicious circle only deposit insurance could break. As long as people feared for the safety of their funds, they would keep their money out of banks. And as long as people kept their money out of banks, banks would be unable to lend. The most prominent economist endorsing this view was Irving Fisher (U.S. House of Representatives 1932, pp. 143-54).

¹³For another example of the conventional interpretation, see White 1982 and 1983. All the authors cited offer little or no evidence to back their claim that small banks supported federal deposit insurance. In the most thorough study of bankers' views to date, Burns 1974 emphasizes the widespread nature of bank opposition without trying to distinguish between small and large banks. During the 1930s debate, supporters of deposit insurance contributed to the impression that only large banks opposed the idea, in an effort to exploit popular sentiment against large banks.

¹⁴Among the more prominent large bankers who spoke out against deposit insurance were Percy H. Johnson of the Chemical Bank and Trust Company of New York (Burns 1974, p. 67), Winthrop W. Aldrich of the Chase National Bank (Burns 1974, p. 87), and Guy Emerson of the Bankers Trust Company (Emerson 1934).

¹⁵In principle, the three banking associations could have opposed deposit insurance because the largest banks in each state imposed their wishes on smaller banks. However, this possibility seems unlikely, given that all three associations had previously endorsed the small bank view against branch banking.

¹⁶In 1930, 68 percent of all state-chartered banks in the nation had loans and investments less than \$500,000, while only 36 percent of all national banks were that small (Federal Reserve Committee 1933b). Corresponding figures for state and national banks in the ABA are not available, but there is no reason to believe the relative sizes were different.

¹⁷The role of local economic shocks in the 1930-32 bank failures is discussed by Chandler 1970. He argues that deposit drains from the most depressed regions to other

regions account for many of the failures. It is possible that some small banks in rural communities were unconcerned about their high risk of failure because they faced less outside competition for local deposits than small banks today. However, the 1932 hearings on the Steagall bill contain many references to depositors steadily shifting funds from small rural banks to large city banks in search of greater safety (U.S. House of Representatives 1932).

¹⁸For the same reason, prominent advocates of branching like Comptroller of the Currency John Pole strongly opposed deposit insurance. It should be noted, however, that preserving small banks was not the only reason Steagall and other politicians supported deposit insurance. During the Congressional hearings and debates, supporters of deposit insurance stressed mainly the need to stimulate the economy by restoring confidence in the banking system (U.S. House of Representatives 1932 and Congressional Record 1933).

¹⁹Of the 13,315 banks in 1930 with loans and investments under \$500,000, 78 percent were state nonmember banks, 20 percent were national banks, and 2 percent were state member banks (Federal Reserve Committee 1933a and 1933b). Membership in the Federal Reserve has always been compulsory for national banks.

²⁰Some small banks and their political allies were so strongly opposed to any form of federal control that they also opposed the original House version of the plan. That version did not require state nonmember banks to join the Fed but did require the FDIC to certify that they were sound enough to become insured.

²¹The states were Kansas, Nebraska, South Dakota, North Dakota, Oklahoma, Texas, Mississippi, and Washington.

²²In passing FIRREA last year, Congress raised the premium to 0.15 percent of deposits and authorized the FDIC to increase the rate still further if the insurance fund fell below a designated level. However, under no circumstances can the premium exceed 0.33 percent of deposits or go up more than 0.075 percentage points in one year.

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