AFD Ep 465 Links and Notes - Federal Deposit Insurance [Bill/Rachel] - Recording Apr 9, 2023

- NOTE: APPARENTLY STEAGALL IS PRONOUNCED STEE-GALL, NOT LIKE EAGLE (two distinct syllables with equal stress)
- [Intro] The recent failure of Silicon Valley Bank and federal intervention to protect its previously uninsured accounts has brought renewed focus to the broader subject of Federal Deposit Insurance in US banking. However, contrary to popular belief, deposit insurance was not part of the New Deal and was not championed by President Franklin D. Roosevelt, although he did reluctantly sign it into law during the early New Deal era in mid-1933, just days after the First Hundred Days period ended. Today we'll talk a bit about that portion of the 1933 Banking Act and the debate both at the time and 90 years later, in the present day, about deposit insurance.
- Pre-1933 context
    - Deposit insurance was under discussion at least as far back as the 1880s federally, and in the pre-Civil War period there had also been some state programs to bail out failed banks, but these were often too quickly overwhelmed and exhausted (https://www.cambridge.org/core/journals/journal-of-policy-history/article/abs/man-in-the-street-is-for-it-the-road-to-the-fdic/E44E01BA48311F9D8F81736390916C85). As we have discussed in our 2021 series on American Money, bank failures were extremely common in the 19th century United States.
    - Notably, Nebraska Congressman William Jennings Bryan, three-time Democratic nominee for President, had proposed bank deposit insurance back in September 1893, 40 years before it was signed into law, as a measure to discourage the public from making bank runs during economic panics like the big one that happened in 1893. (See previous Cambridge.org journal link footnotes or also this one, p.538: https://www.jstor.org/stable/2119939) Throughout the 19th century, people suddenly calling in their money early and unexpectedly, whether in the realm of business loans or from their savings at banks, was one of the biggest sources of collapses for business and banks. This was not, however, necessarily an indicator of those entities actually being irresponsible or engaging in risky practices. Under the standard practice of "fractional-reserve banking," the bank is not holding your money in a vault, because they have lent it out or invested it elsewhere, and they only have a fraction of deposits on hand in cash. Therefore, sometimes a panic is just a panic and if money were not demanded ahead of expected timetables there wouldn't be an inability to pay out. If the federal or state governments were to create funds to backstop or insure people's ability to withdraw some of their money, they might not panic and simply leave it alone. Additionally, sometimes banks failed not because of irresponsibility but because they were the only entity providing loans and holding deposits for an entire agricultural county or region and then the crop failed. That was a big factor in 1893 especially. Congressman Bryan, who wasn't famous yet when he offered his plan in 1893, was not successful in seeing it adopted.
    - But in 1907, 14 years later, there was yet another financial panic and almost 500 commercial banks collapsed, many due to bank runs. This still did not prompt federal deposit insurance to be enacted, and most of the backstopping against further collapses had to come from private sources like J.P. Morgan (whose bank continues even to present-day to provide such interventions from the private sector side during crises). However, the 1907 crisis did prompt eight rural state governments to set up deposit insurance schemes, although this had an unintended effect in those states of undermining public confidence in national

banks without deposit insurance (https://www.jstor.org/stable/2119939). And the state schemes tended to fail in such a complete way when put under major stress that any future federal program would have to study them on what not to do, in terms of design and regulation requirements for participation. At any rate, the concept was still very much floating around. When William Jennings Bryan ran for president for a 3rd time in 1908, the following year, he was still campaigning for deposit insurance. You can actually hear an Edison Record recording of Bryan speaking on the topic for a couple minutes, which is available on YouTube and linked in our notes: https://www.youtube.com/watch?v=tSDkTcy8XOk

    - And a few years later when the Federal Reserve Act of 1913 was being drafted, there was a draft that included deposit insurance, before it was removed prior to passage. The lead sponsor of the Fed creation legislation (and an opponent of deposit insurance) was Congressman Carter Glass of Virginia, the House Banking Committee Chair, and he was still kicking around 20 years later, having moved up first to US Treasury Secretary under Woodrow Wilson, and then to the US Senate.
- The debate in 1933
    - You probably recognize Glass's name because the informal name of the eventual 1933 Banking Act was Glass-Steagall, although often people just use this to refer to a different provision of the legislation, concerning the separation of commercial and investment banking, which we're not getting into in this episode. But before Steagall got involved to water down the bill, Senator Glass had been working on banking reform legislation for several years during the Hoover Administration phase of the Great Depression. This, along with Glass's hostility toward FDR and anything remotely progressive, is one reason that the 1933 Banking Act is considered peripheral to the New Deal. Ironically, Glass himself was (like FDR) opposed to including the deposit insurance component that created the FDIC, or Federal Deposit Insurance Corporation. So, it is not associated with FDR, other than by virtue of having signed it unenthusiastically, but it perhaps also shouldn't be associated with Glass.
    - So why was deposit insurance controversial in the 1930s if it could and did successfully deal with the perennial problem of bank runs? There had been nearly 6,000 bank collapses in the US from 1921 to 1929 and almost 10,000 from 1929 to 1933, including a big wave of collapses in the month before FDR took office. (Wikipedia sources those stats to here, but I don't know from which one: https://www.fdic.gov/bank/historical/managing/) Before the creation of the FDIC, the usual solution to a bank run was to simply close the bank or all banks for an impromptu bank holiday in order to buy time for a rescue plan or to calm down panic. Indeed that was one of FDR's first executive actions. Although it's true, as we've said, that many bank runs occurred with banks that weren't actually in bad shape – and thus the public panic was the only thing putting them into crisis and insolvency – the flip side to consider is that indeed a lot of banks at the time were very poorly regulated and mismanaged. Deposit insurance was potentially going to put the government on the hook for risky practices and even malfeasance by such banks. It might even encourage such behavior, critics argued, including many bankers who regarded themselves as more prudent and safer than some of their peers around the country.
    - President Franklin D. Roosevelt said "We do not wish to make the United States Government liable for the mistakes and errors of individual banks, and put a premium on unsound banking in the future." This latter phrase was almost word for word the same line used back in 1908 by Republican William Howard Taft

against William Jennings Bryan, saying the deposit insurance concept “put a premium on reckless banking.” (https://www.nytimes.com/2013/03/24/business/deposit-insurance-and-the-historical-reasons-for-it.html) One common critique of deposit insurance as far back as 1829 debates in New York state was that depositors, as a kind of creditor to or investor in the bank, have a responsibility to keep an eye on the operations of a bank they put their money into and that without insurance this discipline helps keep the bankers honest. It’s not clear that this has ever really been true. Whether insured or uninsured, most depositors don’t really know what is going on with the financial activities and investments of their bank. And indeed the panic around bank runs could be argued to be a form of discipline when the bank’s internals are finally called into question publicly, as people attempt to vote with their dollars to leave, but obviously that means only the earliest withdrawals make it out and everyone else gets ruined, including the bank, which seems unhelpful all around. Yet the rather bizarre personal discipline angle remained, with FDR arguing almost up until he signed deposit insurance into law that it “would lead to laxity in bank management and carelessness on the part of both banker and depositor.”

- A lot of the idea of deposit insurance is to create enough of a sense of stability and protection to deter bank runs in the first place and not have to be tapped into. And that insurance did come with some additional regulation and oversight of these banks, including state-chartered commercial banks for the first time, to try to reduce the chances of outright misbehavior or excessive risk-taking.
- The FDIC also has various options for taking control of banks in crisis to reassure depositors that the firm will not go under and disappear with all their money. For example, one of the original problems for US banks in the early 1930s (unlike Canadian banks) was that by law they tended to be small and geographically isolated, which meant that if something went wrong with the financials or investments in securities they couldn’t draw on other branches with less exposure to balance out the failures, and they didn’t necessarily have connections to larger institutions with more capital who could bail them out privately or simply buy them out to plug a hole. Now the FDIC would be able to take over or guide the private takeover of a smaller, failing bank that didn’t have enough of its own capital to protect deposits. (Additionally the new law partially adopted the Canadian model for commercial banking to reduce the number of tiny, isolated banks.)
- Establishment northeastern, Chicago, and Mid-Atlantic bankers held the implicit assumption that under a mandatory nationwide deposit insurance system larger urban banks with less risk of collapse would essentially just be paying a tax for a bailout fund for small rural banks at much higher routine risk of failure.
- However, deposit insurance, which neither Glass nor FDR wanted because of the fear of moral hazard and because of their bases of support in Virginia and New York respectively, ended up in the final legislation anyway – as a concession to get that bank branching reform they did want passed. Congressman Henry B. Steagall of Alabama, the House Banking Committee Chair at the time, insisted on deposit insurance because it would protect small rural banks (and keep them a reasonably attractive place to deposit money) even if they didn’t end up branching or merging. Rural bankers and populists feared that widespread legalization of mergers and acquisitions in commercial banking would lead to banking trusts and monopolies as seen in so many other sectors – and worse it would probably mean credit and local reinvestment (as well as local taxes) drying

up in rural areas as distant parent banks pruned back on riskier or less profitable operations. Steagall was supported in this deposit insurance effort by Michigan Republican Senator Arthur Vandenberg and outgoing US House Speaker-turned-Vice President John Nance Garner (Cactus Jack) of Texas, who quickly took to his new job as de jure President of the Senate to start attaching banking measures his boss, President FDR, absolutely did not want. But FDR wasn't putting much energy into lobbying either way on the bill, and it was unclear up until it passed Congress whether he was going to sign it at all or perhaps pursue a much more radical reform of US banking, such as eliminating the chartering role of states completely or even as dramatic as outright nationalization by the public sector.

    - Deposit insurance and indeed Vandenberg's FDIC as an entity were originally only temporary in the 1933 Banking Act, as a concession to win approval from those who had opposed its inclusion in the first place, but it was fairly quickly made permanent anyway. The final bargain was that deposit insurance would begin in 1934, not immediately as Vandenberg had wanted, but there would be more regulations and greater integration into the Federal Reserve System of participating banks, which was a desirable outcome for those who had worried about the dangers of deposit insurance. That said, even some of these conditions didn't really survive many years.
    - Deposit insurance has become a cultural mainstay in the United States, especially with prominent signage in bank offices and declarations of FDIC membership in advertisements. Even so, it's hard to know for sure how much the stability of commercial banking since the Great Depression has been due to the existence of federal deposit insurance and how much can be chalked up to the other, unrelated reforms to the banking system, such as bank branching, which put more rural banks on a wider and more diverse footing, reducing their exposure to local economic disasters in the first place.
    - The FDIC was authorized by Congress in 1934 to insure accounts up to $2,500, which was roughly equivalent to around $50,000 today. That limit was doubled the next year and then not adjusted again until 1950. Periodically the limit was further raised over the years to account for inflation, but there was always a limit.
- The debate in 2023
    - Since a temporary measure in October 2008 (made permanent in the 2010 Dodd-Frank banking reforms), federal deposit insurance has covered up to $250,000. During the 2007-08 financial crisis, both the government and banks worked together to minimize the damage of bank failures. When securities and banking firm Bear Stearns suffered a run in March 2008, JPMorgan Chase bought Bear Stearns as part of a government-sponsored bailout. The government shut down Washington Mutual, then the largest savings and loan in the US, in September 2008, after they suffered a run. They were also bought by JPMorgan Chase. Just a day later, Wachovia suffered a "silent run", where large customers drew down their accounts below the $100,000 limit for FDIC deposit insurance. Wachovia was ultimately bought out by Wells Fargo. https://en.wikipedia.org/wiki/List_of_bank_runs#2000s But many types of banks and accounts still did not and do not fall under insured status and customers are expected to assume their own risk in leaving their money in those accounts. This came into question, however, in the past few months at time of recording, when the federal government decided to step in and halt a run on the Silicon Valley Bank by its own customers by insuring previously uninsured deposits. That marked such a departure from the basic assumptions of the program that it

revived all the dormant debates of earlier decades on whether or not the deposit insurance system is a good idea, goes too far, or doesn't go far enough…

- The FDIC's mandate has expanded suddenly and almost after the fact before now as well. The Savings & Loans crisis of the late 1980s and into the 1990s did end up with the FDIC having to step in with Savings & Loan institutions. *During the S&L crisis, which did not effectively end until the early 1990s, the deposits of some 500 banks and financial institutions were backed by state-run funds. The collapse of these banks cost at least $185 billion and virtually ended the concept of state-run bank insurance funds.* https://www.investopedia.com/terms/s/sl-crisis.asp#toc-savings-and-loan-crisis-aftermath There were Congressional reforms to the FDIC's authority in 1991 as part of this situation. *Congress enacted The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) to implement regulatory changes that would ensure the safety and soundness of both the banking and thrift industries (Mishkin 1997). The main overarching provisions of the act, which was implemented in 1994, include "prompt corrective action" and "least cost resolution." Additional sections of FDICIA include limitations on the ability of undercapitalized and critically undercapitalized institutions to borrow from the Fed, the annual or eighteen-month examination cycle requirement for banks, introduction of risk-based deposit insurance premiums, as well as improved and more uniform disclosures on savings accounts.*
  The least-cost resolution provisions require that the FDIC choose the resolution method that minimizes the cost to taxpayers of a bank failure. ***"This provision is generally understood to limit the FDIC's ability to absorb losses that would otherwise be borne by uninsured depositors and non-deposit creditors"*** *(Eisenbeis and Wall 2002). It is important to note that there is a systemic exception in FDICIA to the least-cost resolution of failed banks. Section 141 of the act "provides for an exception that preserves the potential for banks to be considered too big to fail" (Wall 2010). This "too big to fail" provision has come under a considerable amount of scrutiny in recent years.* https://www.federalreservehistory.org/essays/fdicia This was one of the more comprehensive periods of post-Great Depression debate on the issue of deposit insurance as a whole, but relatively few changes were made to the big picture despite these debates. Similarly there was some thought about significant revisions to deposit insurance during the 2008 crisis when commercial banks started failing again in noteworthy numbers and many non-commercial banks without deposit insurance protections were spectacularly collapsing, but the FDIC resisted expanding at that point, too. The deposit insurance fund did actually run out in 2009, not only because of demand but also because political pressure over the years had reduced insurance payments into the fund from banks that were supposedly well-capitalized. (https://www.nytimes.com/2013/03/24/business/deposit-insurance-and-the-historical-reasons-for-it.html) But the FDIC simply went into the red temporarily to solve this problem and levied more money from the insured banks until the fund went back into the black.
- March 2023 Silicon Valley Bank intervention
    - Last month there was a bank run on the California state-chartered commercial Silicon Valley Bank by its depositors. The FDIC and Federal Reserve stepped in suddenly, claiming there was a risk of contagion if it were allowed to collapse. Whether or not this is true, besides putting it into receivership and finding a buyer in another bank, one of the

mechanisms of the intervention ended up being a retroactive guarantee on previously uninsured deposits. This has obviously produced some controversies in the banking community and raises questions about the future of banking regulation and deposit insurance, and maybe even raises questions about the future of private banking at all. The FDIC estimated on March 26, 2023 that the cost of the failure of SVB to its Deposit Insurance Fund would be about $20 billion. On March 26, First Citizens Bank bought all of Silicon Valley Bridge Bank except for $90 billion of securities and other assets that remained in FDIC receivership. While the Federal Reserve promised that the FDIC's decision to cover all deposits wouldn't affect taxpayers, it's likely that banks paying more for deposit insurance will pass those costs onto customers in the form of higher interest rates on loans, or lower interest rates on checking and savings accounts.

    - Leftist analyst Nathan Tankus published an article addressing five of the major implications of the federal intervention to save SVB: https://www.crisesnotes.com/every-complex-banking-issue-all-at-once-the-failure-of-silicon-valley-bank-in-one-brief-summary-and-five-quick-implications/ That article gets into the question of whether the cap on deposit insurance creates a two-tiered system of the value of deposit money itself – and if so whether that is good or bad – and also gets into whether this question even matters if the federal interventions are going to just ignore nominal uninsurance.
        - Trashfuture recently interviewed him on the article: https://trashfuturepodcast.podbean.com/e/banking-with-the-abyss-feat-nathan-tankus/
- This is of course still an unfolding and evolving story, and so we will have to leave it there. But now you have more of the history in mind to consider as you see further news articles about the recent intervention at Silicon Valley Bank.

https://en.wikipedia.org/wiki/Federal_Deposit_Insurance_Corporation
https://en.wikipedia.org/wiki/1933_Banking_Act
https://en.wikipedia.org/wiki/Carter_Glass
https://en.wikipedia.org/wiki/Henry_B._Steagall
https://en.wikipedia.org/wiki/Arthur_Vandenberg#Senate_career_1928%E2%80%931935
https://en.wikipedia.org/wiki/Silicon_Valley_Bank