ZOMBIE BANKS AND THE DEMISE OF NEW YORK'S SAFETY FUND

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INTRODUCTION

In the wake of the savings and loan crisis of the 1980s several scholars have turned to historical experiences with deposit insurance to determine whether S&L-type crises are inevitable [Calomiris, 1989; 1990; Grossman, 1992; Wheelock, 1992a; 1992b; Wheelock and Kumbhakar, 1994; White, 1981]. Most have developed models and empirical tests in which moral hazard takes center stage. Moral hazard manifests itself in the presence of deposit insurance because bank creditors, being fully guaranteed against loss, lose their incentive to monitor a depository's risk-taking and exact interest premiums from high-risk institutions. Having escaped the penalties of the market, bankers engage in high-risk behavior. In doing so, they increase the likelihood they will have recourse to the insurer. In the absence of regulations that attenuate their incentives, banks rationally exploit the subsidy to risk taking and fall victim, more often than uninsured banks, to the insured-against contingency.

It is well known that most state-sponsored deposit insurance schemes fell victim to moral hazard.[1] With the exception of Kane [1989a], the compounding effects of regulatory forbearance have been less diligently explored. Regulatory forbearance is a variant of the classic principal-agent problem. Bank regulations are instituted to protect the deposit insurer (the principal) from excessive claims. Regulatory agencies (the agents) are then formed to insure the banks' compliance with the regulations. If banks engage in behavior that places the insurer at excessive risk, the regulators are charged with either correcting bank behavior or, in the extreme, closing them. But regulators often find it in regulators' best interest not to correct or close an offending or insolvent bank. Closings are expensive and unpopular, and tarnish the regulators' reputations. From the regulators' point of view, a better alternative is to keep troubled banks afloat through their watch and pass on the problems to the next generation of regulators. Such actions conflict with the best interests of the insurer. Knowing that regulators are unwilling to strictly discharge their duty, banks often take excessive and inefficient risks.

While many scholars recognize how these incentive problems explain the savings and loan debacle, few know that America's first experiment with deposit insurance — New York's Safety Fund, founded in 1829 — ended nearly as disastrously for much the same reasons. Moral hazard certainly played its part, but regulatory forbearance was a significant contributory factor. There were too few regulators to oversee the state's banks effectively, and when problems were uncovered, the regulators either ignored them or acted too slowly to check the losses imposed on the insurer. In the

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end, the Safety Fund was bankrupted by eleven failures just twelve years after its inception.

THE NEW YORK SAFETY FUND SYSTEM

Following the financial panic of 1819, Governor Dewitt Clinton called on the legislature to reform New York's banking system. It was not until 1827 that the legislature finally enacted some modest reforms. While the legislators dithered and delayed, the state's banking system moved toward potential crisis. In 1828, forty banks were operating in New York, but the charters of 31 of them were due to expire within the next four years. All 31 petitioned the 1828 legislature for charter extensions, but a deep-seated dissatisfaction with the existing system lingered and none of the petitioners secured a renewal. In 1829, twenty-nine of the previously unsuccessful petitioners tried again and 37 petitions for new banks were laid before the legislature [Chaddock, 1910, 259]. Both the legislature and the new governor, Martin Van Buren, recognized that the time was ripe for change.

Several proposals were brought forward. One suggested a modification of the existing system of exacting bonus payments (bribes paid to the state in return for a charter) from successful applicants. Van Buren argued that such a system was "condemned by experience" since it had led to logrolling, bribery, and fist-fights in the Assembly hall [Lincoln, III, 1909, 241; Hammond, I, 1852, 334]. Another proposed a state-owned, statewide branch bank modeled after several southern banks. A third proposed bond-secured note issue, coinsurance of bank liabilities, and regulatory supervision and examination.[2] Van Buren favored the last because it made "all the banks responsible for any loss the public may sustain by failure of any one or more of them" [Lincoln, III, 1909, 243].

The legislature adopted the coinsurance and examination portions of the proposal.[3] The insurance system, known as the Safety Fund, imposed annual assessments of one-half of one percent of a bank's paid-in capital until each bank had paid in a total of three percent. Should a bank failure deplete the fund's reserves, the state comptroller could call additional assessments not exceeding one-half percent of total bank capital per year until the fund was restored to three percent. Bank creditors — principally note holders since notes in circulation exceeded deposits by about 2 to 1 — were insured in full and in the event of a failure were to be reimbursed by the fund [*Albany Argus*, 6 April 1829; Fenstermaker, 1965, Table B-20].

The moral hazard problem inherent in a fixed-rate insurance scheme did not go unnoticed. Several contemporaries argued that the plan created the potential for weak or disreputable banks to engage in riskier activities than if they faced market discipline. Albert Gallatin observed:

> ... with the laudable intent to protect the community against partial failures, a 'safety fund' has been established by law ... which is applicable to the payments of the notes of any that may fail. This must have the tendency to encourage excessive issues of paper, which could not be sustained if resting only on the credit of the bank by which they are made. [1960, 317-18]

Although Gallatin, and others, focused on the tendency and ability of insured banks to issue more notes than would an uninsured bank of equal size and reputation, they probably also recognized that higher circulation-to-capital ratios implied riskier investment and reserve strategies, increasing the probability that a bank would make a claim upon the fund.

Possibly in recognition of this, the legislators created a bank commission of three members — one appointed by the governor, two elected by the banks themselves — whose duties included quarterly inspections of each insured bank. If the commissioners were convinced that a bank had acted fraudulently, had violated the state's usury law, or was insolvent, they were required to close it.[4] The Act also imposed stringent restrictions. Loans were capped at 250 percent of capital (reduced from the 1827 restriction of 300 percent). Note issues were capped at 200 percent of capital. But another clause eliminating double liability for stockholders may have done more to magnify the moral hazard problem than the supplemental restrictions did to mitigate it [*Albany Argus*, 6 April 1829].[5]

The Safety Fund exhibited relative calm and grew rapidly between 1829 and 1837. The combined capital of the original 27 Fund banks was slightly less than $8 million. By 1837, 90 Fund banks had a combined capital in excess of $32 million, total assets in excess of $82 million, and more than 86 percent of all demand liabilities issued by New York banks were insured [ibid., 290-91; NYS Assembly, 1838, 50-51].[6] New York was not alone in witnessing a rapid increase in banking facilities in this period, though New York's increase was greater than most. From 1829 to 1837 in Massachusetts the number of banks nearly doubled and banking assets more than doubled. In Pennsylvania, the number of banks similarly increased 61 percent and banking assets grew 77 percent [Fenstermaker, 1965, Appendix B]. If anything, new bank charters in New York constituted a series of catch-up measures. In 1829, where New York had 40 banks, Massachusetts already had 66, and in 1837 even with 90 banks, New York still had 40 fewer than Massachusetts.

Rapid growth of the system was a source of both pride and concern for the commissioners. As early as 1832 they noted that specie reserves may have been less than prudent. Between 1826 and 1832 specie reserves fell from 17 to 14 percent of circulation, considerably lower than the 32 percent held by Pennsylvania banks in the latter year [ibid; Chaddock, 1910, 275]. Between 1832 and 1836 loans and discounts increased 182 percent while bank capital increased 141 percent, and banks were loaned in the aggregate nearly to the extent allowed by law. The aggregate loan-to-capital ratio, capped at 250 percent, in 1836 stood at 234 percent [NYS Assembly, 1836, 14, 46-47].

A large proportion of those loans had been used to finance western land speculation but, the commissioners argued, the banks had been neither active participants in nor catalysts of the speculation. The commissioners noted, but did not limit, these risky activities. Indeed, other than moral suasion, the Safety Fund Act had not given

them the power to limit or control such risky activities. They failed, however, even to use moral suasion. Although they advised caution and prudence, the commissioners implicitly condoned the banks' activities by noting the potentially large profits from such ventures. Questions concerning the judiciousness of such loans, they wrote, lay outside the scope of their investigations [ibid, 4-11].

In the same year the bank commissioners noted various imprudent banking activities, a special legislative committee reported:

> That some [banks] have over-reached the bounds of prudence is too evident to be denied; but it is confidently believed that so far as these institutions or any of them have been guilty of illegal or other improper practices, they have not been of such a character as to impair their solvency.... [NYS Assembly, 1837b, 6-7]

Their optimism proved unfounded. In the very month the committee reported, three Buffalo banks were deemed insolvent and their operations suspended.

A shortcoming in the original act became apparent upon the banks' closures. Creditors could seek recovery from the Safety Fund only after the complete liquidation of a failing bank. In the interim, note holders incurred losses as notes of the closed banks depreciated. Notes of the Bank of Buffalo, for example, fell from a 1 percent discount in February 1827 to "no sale" (100 percent discount) in late April and early May [*Shipping and Commercial List*, 25 February and 29 April 1837].[7] Legislators hurriedly pushed through an amending act in 1837 instructing the state comptroller to take any actions thought necessary to maintain the value of the closed banks' notes. Thereupon, the comptroller instructed canal authorities and tax collectors to accept these banks' notes [Root, 1895, 289-92]. Between May and June, canal and treasury authorities received about $64,500 of the three banks' notes. These actions restored public confidence. By July notes of the Bank of Buffalo traded at a 5 percent discount and returned to par by August [*Shipping and Commercial List* 29 July and 26 August 1837]. Before liquidation proceedings commenced, however, all three bank retrenched, bought their notes back from the comptroller, got the injunctions lifted, and renewed operations [Golembe, 1960, 190].

The first failure having recourse to the Fund was that of the City Bank of Buffalo in February 1840. A second failure occurred in December 1840. The Fund promptly met the demands of these failures, but was depleted by more than one-half [Root, 1895, 292-93]. In September 1841 the Commercial Bank of New York failed and further reduced the fund. Although the Fund's reserves then stood in excess of $360,000, the comptroller reported that only $60,000 of that sum could be used to redeem notes. The 1829 Act had earmarked one-third of the total fund (about $300,000) for the indemnification of bank creditors other than note holders, principally depositors. When, in November 1841, the Bank of Buffalo failed with a circulation rumored to be in excess of $290,000, the comptroller reported that he lacked the authority to redeem its notes [ibid, 293].

Within weeks a fifth bank failed with a circulation of about $140,000 [NYS Assembly, 1840, 38-39]. The comptroller immediately issued a call for the first supple-

TABLE 1
Payments Required from Safety Fund to Reimburse Creditors of Failed Banks (in thousands of dollars)

Failed Bank	Date of Failure	Circulation Reported Prior to Failure	Actual Note Redemptions	Payments of other debts	Receipts from Asset Sales	Balance Paid by Safety Fund
City Bank of Buffalo	2/1840	$268.9	$317.1	$0	$100	$217.1
Wayne County Bank	12/1840	144.3	113.1	16.1	0	129.2
Commercial Bank of New York City	9/1841	121.4	139.8	146.1	7.2	278.8
Bank of Buffalo	11/1841	195.8	435.5	149.2	0	584.8
Commercial Bank of Buffalo	11/1841	246.7	186.9	424.5	5	606.4
Commercial Bank of Oswego	12/1841	216.1	163.2	78.4	2.4	239.1
Watervliet Bank	3/1842	114.5	134.1	77.5	13.3	198.3
Clinton County Bank	4/1842	167.8	71.9	156.3	0	228.2
Bank of Lyons	9/1842	80.8	52.9	40.1	3.8	89.0
Lafayette Bank	2/1842	71.6	0	0	0	0
Oswego Bank	10/1842	94.5	0	0	0	0
Totals		$1,723.3	$1,614.6	$1,088.1	$131.6	$2,570.9

Column totals may not sum to individual values due to rounding.
Source: Root [1895, 295]; Chaddock, 1910, 332]

mentary assessment of one-half percent of each remaining bank's capital, adding nearly $162,000 to the fund. By the end of 1842, another six banks failed and the Safety Fund was effectively bankrupted [Root, 1895, 292-93].

Table 1 reports the final burden upon the Fund from the eleven failures occurring between February 1840 and September 1842. The net burden exceeded $2.5 million, with more than half the amount arising from the failure of the three Buffalo banks enjoined in 1837 but allowed to reopen after modest reorganizations. Evidence presented in the next section will show that more timely closings and liquidations may have saved the Fund from a significant portion of those costs. As with savings and loans in the 1980s, mis-priced liability insurance and regulatory forbearance allowed these long-troubled banks to gamble for resurrection.

ZOMBIE BANKS, REGULATORY FORBEARANCE, AND SAFETY FUND LOSSES

In his 1843 message to the legislature, Governor Bouck mused on the broken Safety Fund:

> The facts developed in relation to the insolvent banks, show that there has been, in some instances, great abuse in their management, and reckless disregard of moral obligation. How it should have happened that a bank could so improperly conduct its affairs as to cause a total loss to the stockholders, and leave no assets for the redemption of its bills in circulation, and yet escape the timely observation of the Bank Commissioners, I am unable to imagine. It may have resulted from the want of proper means for ascertaining the real condition of the banks. But whatever may have been the cause, it is quite evident that the appointment of the Commissioners has not answered all the valuable ends which were anticipated from the measure. [Lincoln, IV, 1909, 33-34]

He need not have wondered; the contributory factors were a combination of moral hazard and, as he believed, lax oversight. Inadequate oversight capabilities and regulatory forbearance contributed to the losses sustained by the Fund. Had the commissioners been given greater power, been given sufficient resources, and closed insolvent banks in a more timely manner, claims upon the Fund would have been considerably smaller. Ultimately, the collapse of three long-troubled banks — banks the commissioners had once enjoined and allowed to reopen — accounted for 55 percent of the charges placed upon the Fund. In at least one other case as well, the commissioners were reluctant and reticent in closing troubled banks, demonstrating a repeated pattern of regulatory forbearance.

In the insurance literature, moral hazard refers to the well-known phenomenon that persons or institutions insured against some risk are more likely than those not insured to be victimized by that risk [Grubel, 1971, 100]. The reason is that those so insured take fewer precautions to avoid a risk. With fixed-rate bank liability insurance, moral hazard arises because neither shareholders nor creditors bear the full cost of additional risk taking. Creditors do not demand risk premia (i.e., higher deposit interest rates) because the bank's liabilities are guaranteed in full. Shareholders favor any strategy that increases the variance of expected pay outs, since they hold residual claims on the bank's earnings and the insurance eliminates downside risk. Bank managers then face an incentive to increase their institution's risk exposure. Much to the insurer's chagrin, "these actions are expected, economically rational behavior of persons," facing sharply reduced expected costs of falling victim to their own behavior [ibid., 102]. These economically rational actions become particularly attractive once a bank's net worth is depleted, since the combination of deposit insurance and the failure of regulators to close a bank promptly provides bank managers with the ability and the time to pursue long-shot resurrection strategies.

Although the recent experience of the savings and loan industry brought moral hazard problems into sharp relief, it was recognized long before. During the NYS Assembly debates in 1829, several members believed that the system would "put a premium on reckless banking and encourage the unscrupulous" [Chaddock, 1910, 266]. Much as troubled thrifts in the 1980s were able to attract deposits to fund risky portfolios because depositors bore no downside risk, it was argued that Safety Fund banks could issue excessive volumes of notes to fund similarly high-risk ventures because "public scrutiny and watchfulness which now serve to restrain or detect malconduct" would disappear [ibid, 265].

Final judgments about risk-taking would require individual bank data, but aggregate data suggests that New York's banks were somewhat riskier than banks in neighboring states. Loan-asset ratios in New York and neighboring states were quite similar, averaging about 70 percent. This implies that in the event of failure about 30 percent of a bank's assets were easily recoverable (i.e., specie, government bonds, etc.). While the ratios were similar, it was the composition of a bank's loans between low- and high-risk that mattered. Such information is no longer extant, but reports from New York's bank commissioners expressed concerns about the high-risk nature of many banks' loans. A more telling measure of risk-taking and the risks passed on to the public can be seen in capital-to-note ratios. Assuming a bank's capital is intact and its stockholders solvent, this measures how many times over a bank's stockholders could reimburse noteholders.[8] In 1837, New York's ratio stood at 295 percent — a remarkable figure by modern standards, but far below that of contemporaries. The ratio among Pennsylvania's banks was 699 percent; in New Jersey it was 741 percent; Massachusetts, 746 percent; and Maryland, 752 percent [Fenstermaker, 1965, Appendix B].

Given the increased risk exposure of Safety Fund banks and the absence of effective market monitoring, the appropriate regulatory response was to close troubled banks before they significantly increased their risk exposure. In several cases, however, the regulators responded too slowly or not at all. Losses imposed in the insurer were not the result of ineptitude, moral turpitude, or gross incompetence among bankers. Losses arose because bankers cleverly and rationally exploited a subsidy to risk taking.

The inability or unwillingness of the Safety Fund commissioners to respond quickly created, to borrow a term coined by Edward Kane, two types of banks — the living and the living dead. Kane [1989a] called the latter *zombie banks* because they enjoyed an "unnatural life-in-death experience, in that if they had not been insured, the firm's creditors would have taken control from the stockholders once it had become clear that their enterprise's net worth was exhausted" [ibid., 4]. Zombie banks avoided the finality of death through the black magic of blanket liability guarantees.

Kane [1989b] defines regulatory forbearance as "leniency and indulgence in enforcing a collectible claim against another party." The result is that the insurer is left "on the hook for the bulk of future losses" generated by the risk-subsidized institutions. Extant evidence demonstrates that the New York bank commissioners' policy of forbearance ran deep. Under the terms of the original act, the commissioners were charged with investigating and supervising members. To follow through on that charge,

they were given the run of each bank . The commissioners had access to some (but not all) ledgers, minutes of board and stockholder meetings, the vaults, and could take sworn testimony from officers and directors.

With access to such information, they may have recognized problems in many cases, but very often could do nothing about them. The commissioners were not given the authority to enjoin particular activities — like the mass of high-risk real estate loans uncovered in the mid-1830s — even if those activities placed the bank, and ultimately the Fund, at risk.[9] Their only remedy was to close a bank if they found it insolvent. In many instances, such an action may have seemed extreme given the limited time they had to investigate any bank. At its peak, the Safety Fund banks employed only three commissioners to inspect the 90 Safety Fund bank four times each year. It is not surprising that commissioners rarely instituted their only remedy of requesting closure when questions about a bank's viability arose. Instead, they extended to a suspect bank the benefit of the doubt.

An alternative explanation of leniency is that commissioners were subject to pressure toward forbearance by banking officials and the governor; two of the three commissioners served two-year terms at the pleasure of the bankers themselves and the third at the pleasure of the governor. If the commissioners closed a bank, other bankers would fear for their own bank's continuance and vote them out of office. If the closing reflected poorly on the governor, he had an incentive to replace his appointee. In addition, the commissioners had a myopic incentive to have their watch proceed with few negative incidents. Their performance as bank commissioners would probably be viewed negatively by both the public and political allies if their decisions led to losses for the Fund.[10]

Whether as a result of institutional myopia, an impossible work load, or honest error, New York's bank commissioners failed to achieve the goals set for them. Two cases of complete failure stand out. The commissioners had ample warning that these banks teetered on the precipice of failure, but stopped short of closing them in a timely manner.

In an 1841 report to the legislature concerning the failure of the Wayne County Bank in Palmyra, the commissioners reported:

> During the greater part of [its history], the bank had a reputation of being managed in such a way as to produce large profits for its stockholders, although it appears that soon after its establishment [in 1830], the improper practices sometimes adopted, with a view to these profits, were the frequent subject of complaint and reprehension on the part of many who had dealings with it .... [NYS Assembly, 1841b, 4]

But the commissioners were without authority to close a bank not shown to be insolvent or overtly fraudulent in its actions. Even in issues of fraud and illegality, the commissioners proved remiss in their charge and reluctant to close offending banks. Had they investigated the basis of "complaint and reprehension," they may have learned that the bank's cashier forced borrowers to pay interest premiums to a third party unconnected to the bank; such premiums surely violated the state's usury law. Even had the practice been uncovered earlier, the commissioners argued that they would have been powerless to stop it. The bank's actions, they argued, did not constitute prima facie evidence of illegal behavior because "the usurious interest was neither received by, nor agreed to be paid to, or for the benefit of the bank" [ibid, 7]. It is difficult to determine for whose benefit, other than the bank's or its officers, the interest was intended.

The commissioners recognized the bank was insolvent, or nearly so, at least seven months before it was closed. In May 1840 they found the bank "had been grossly mismanaged, and would suffer a considerable loss on its discounted bills — yet the extent of this loss, and the probable worthlessness of a large amount of the paper of the bank, seemed to be unknown to ... the new officer in charge ...." Instead of determining for themselves the extent of its losses, they accepted the new cashier's reassurances that expected losses would not exceed a sum which would reduce the capital of the bank by more than $25,000 *after* exhausting its retained earnings. Despite believing the bank to be in serious trouble, the commissioners allowed it to continue without additional investigation.

During its September 1840 investigations, following detailed questioning of the bank's cashier and president about the quality of its loans, the commissioners concluded that its losses were not so great as to justify its closure. They took further comfort from statements by the cashier that new management had taken several steps to allow the bank to "gradually recover from its depressed and embarrassed condition" [ibid, 7].

By December 1840, the bank's condition had deteriorated further and the commissioners had no alternative but to close it. Table 1 shows that the eventual cost to the Safety Fund resulting from the failure of the Wayne County Bank amounted to nearly $130,000 and that sales of the bank's assets yielded nothing. Under almost any reasonable scenario, it is unlikely that the bank's condition had deteriorated so dramatically in just three months. If it had, the actions spoken of by the new cashier must have been so risky that the commissioners could not have easily overlooked them. The likely scenario is that the commissioners (and the bank's management) hoped that a few successful high-risk ventures would pull the bank from its "embarrassed condition."[11]

Similar questions about the resolve with which the commissioners discharged their functions also surrounded their dealings with the Buffalo banks. More than one-half of the guarantees made good by the Fund resulted from Buffalo bank failures. The commissioners mentioned actions taken against them in the last paragraph of their 1838 report, but made no mention of subsequent investigations in either 1839 or 1840 [NYS Assembly, 1838, 13].[12] Evidence from other sources demonstrated that the commissioners pursued a policy of forbearance.

An *Albany Argus* editorial appearing shortly after the failure of the City Bank of Buffalo said:

> ... 'the bank went into operation in a lame and crippled condition; that it has been lame and crippled ever since;' that it started in fraud and

> corruption, was one of a litter of political banks, and the present state officers found it lame and crippled when they came into office .... He [the state comptroller] says that he *knew* that such was its condition. And ... what was the course of the federal state officers in relation to it? Why they threw into this bank ... EIGHTY THOUSAND DOLLARS *of the money of the people* ... when no prudent bank or broker would loan it a dollar! [6 February 1840]

The *Albany Argus* later revealed that state officials had deposited a combined $340,000, largely canal receipts, in the three Buffalo banks and claimed that these banks had been authorized as state depositories not out of their solidity, but from their political affiliations.[13]

Reports forwarded by the bank's receiver also demonstrated the degree to which political partisanship may have clouded the commissioners' judgements. Of the loans made by the City Bank of Buffalo, nearly $200,000 (about one half of the total) was considered "bad" or uncollectible. Another $112,000 was considered doubtful and, of the total $406,000 in loans outstanding, about $140,000 might eventually be realized. The bank's directors owed more than $102,000, which the receiver believed to be a total loss. Another $225,000 in assets were held in real estate in either fee simple or on bond, but the receiver estimated that the properties would bring only $150,000 at auction. Although the bank was not closed until February 1840, the receiver was "fully convinced that the City Bank was not only insolvent in November [1839]," but that it had a net worth deficiency of about $200,000. After liquidation began in earnest, the receiver revised the estimated shortfall to $350,000. It eventually amounted to $217,000 [NYS Assembly, 1841b, 4-23].

Similar (non)actions taken by the commissioners following the closing of the other Buffalo banks further demonstrate their haphazard or careless oversight. Table 1 shows that the assets of the Bank of Buffalo and the Commercial Bank of Buffalo were completely uncollectible upon failure. The Safety Fund was ultimately called upon to make good on nearly $1.2 million of the banks' liabilities — banks that in 1840 had combined total assets of only $1.4 million. Despite their reliance upon the sworn testimony of bank officers, conscientious, even if overworked, examiners who did not recognize the poor quality of the banks' assets or the degree to which their capital was impaired is difficult to imagine.

It was the bank commissioners' wont, however, to underestimate losses sustained by the banks under their charge. In 1839, they estimated the *total* losses accumulated by all 89 New York State banks amounted to only $200,000, or less than one-half percent of all loans outstanding. Although this was recognized as optimistic, they were confident that only a handful of banks might sustain losses of a magnitude that would impair the banks' capital [NYS Assembly, 1839, 6]. Commissioners' optimism proved unfounded as the guarantees ultimately made good by the Fund exceeded their estimate by 12.5 times. For those people today who paid even passing attention to the thrift crisis of the 1980s, all this has a hauntingly familiar ring.

CONCLUDING REMARKS

Marx [1964, 1] asserted that all great historical events reappear in one form or another; initially as tragedy, later as farce. While it may be an overstatement to characterize the savings and loan crisis of the 1980s as farce, it certainly did not have the tragic character of New York's Safety Fund. To the authors of the Safety Fund Act, bank liability insurance was an unknown. All they had were experiences with what had not worked. Later deposit insurance systems cannot fall back on that excuse. That deposit insurance is always and everywhere wrong-headed and doomed from its inception is not a prescriptive conclusion. Far from it. Given the difficulties (and costs) depositors face in gathering and processing information on the riskiness of their depositories, deposit insurance may be cost minimizing. For insurance to succeed, insurers must devise organizational and remunerative systems that align the interests of its agents with its own. New York's Safety Fund failed to do so; but so did the FSLIC.

The more fundamental problem may not reside so much in the nature of deposit insurance, but in why it was (and is) needed in the first place. Bank liability insurance was necessary in antebellum New York because politicians doled out favors in the form of bank charters which promulgated small, poorly capitalized banks. Such a system fueled public distrust and discontent. As the number of banks increased, the public was asked to discriminate among ever more bank notes of widely different quality. And as Charles Dunbar noted: "A currency which imposes upon the public the burden of attempting to discriminate between numerous banks on the basis of solvency is a source of constant dissatisfaction and inevitably leads to persistent demands for legislative correctives" [1929, 65]. The Safety Fund, like several subsequent legislative correctives, "actually produced quite the opposite effect" [Calomiris, 1990, 293].

NOTES

I would like to thank Richard Grossman, Michael Haupert, Steve Horwitz, seminar participants at Ball State University, the Federal Deposit Insurance Corporation, Lafayette College, and two anonymous referees for many useful comments and criticisms.

1. Calomiris [1989; 1990] provides an extensive discussion of both antebellum and postbellum American experience.
2. Antebellum banks issued promissory notes payable in specie on demand that circulated as money. Unlike modern banks that create deposits when a borrower receives a loan, antebellum banks gave borrowers a handful of bank notes.
3. The coinsurance and examination requirements were both quite novel. Golembe [1960, 183] argued that, given the general dissatisfaction with the existing system, the novelty of the requirements may have been the moving force behind their being adopted.
4. There was some inconsistency between a casual reading of the Safety Fund Act and the bank commissioners' interpretation of it. The Act required that a bank be closed upon determining it insolvent. In their 1831 report to the legislature, the commissioners stated that they were obliged to close a bank whose capital was impaired by one-half [New York State Assembly, 1831, 31]. All subsequent references to New York State documents will be abbreviated NYS and either Assembly or Senate depending on the source.

5. Most states, including New York before 1829, had imposed double liability on stockholders. If a bank failed, stockholders not only lost their initial investment, but stood liable to an amount equal to their shareholdings. These laws effectively doubled the capital cushion and helped to protect bank creditors from loss.
6. State-chartered banks that had been chartered prior to the Fund's establishment and who had not yet come up for renewal were not subject to Safety Fund requirements.
7. With each bank issuing its own notes that circulated as currency, most of which circulated within a relatively narrow circle around the bank, people at distant locations found it hard to judge the quality of these notes. In response, independent businessmen, known as note brokers, made markets in bank notes, monitored bank activities, and stood ready to buy notes of distant banks at a discount from par. The brokers then returned the notes to the issuing bank and demanded redemption in gold or silver. Brokers profited from the difference between the price paid for the note and its redemption value less transportation, transaction and risk costs.
8. The calculations include the double liability imposed on stockholders in other states and the simple liability imposed on stockholders of Safety Fund banks. Double liability meant that stockholders were liable to an amount equal to their shareholdings. The measure is relevant and meaningful because many states gave note holders first lien on a failed bank's assets.
9. The commissioners inability to issue cease and desist orders is similar to restrictions faced by Federal Home Loan Bank Board investigators prior to 1966. I thank an anonymous referee for pointing this out.
10. Kane [1989b, 39-41] and [1991, 15-23] argued that the same incentives motivated the policy of regulatory forbearance by FSLIC officials in the 1980s.
11. Kane [1989a] argues that FSLIC officials followed strategies of overlooking high-risk ventures by insolvent thrifts in similar hope that they would grow out of their insolvencies.
12. It is telling indeed that the commissioners pushed the discussion of an important event, like the closing of three prominent banks, to the closing paragraph of their report.
13. Antebellum banks commonly identified closely with one political party or another. Bank charters were granted by legislative act and obtaining one usually required political clout and close affiliation with the majority party.

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