Origins of Deposit Insurance in the Middle West, 1834-1866

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Many people believe that the Federal Deposit Insurance Corporation was something hastily contrived in the midst of the banking crisis of 1933, but nothing could be further from the truth.[1] The act which established a nationwide system of deposit insurance in 1933 was the 150th such measure to be introduced in the Congress. The first attempt had been made in 1886, and similar attempts were made in almost every succeeding Congress. In addition, a total of fourteen states had established bank-obligation insurance plans prior to 1933; indeed, six such state plans had been adopted before the Civil War.

The first proposals for bank-obligation insurance[2] were made soon after the problem of bank failures became important. Not until 1809, after more than a quarter century of banking, did the failure of the Farmers Bank of Gloucester, Rhode Island, bring home to many people the realization that such an event was possible. Another five years were to pass before the first wave of bank failures took place in this country. It is indicative of the adaptability of early American banking that by the middle 1830's two different systems of bank-obligation insurance had been placed in operation.

In 1829 New York State established its safety fund system, under which participating banks paid assessments into an insurance fund maintained for the benefit of the creditors of participating banks which had failed.[3] In 1834 Indiana provided that individual banks were mutually to guarantee

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[1] The major part of the information contained in this article has been drawn from material gathered by the Division of Research and Statistics of the Federal Deposit Insurance Corporation in connection with its study of the history of bank-obligation insurance. Portions of this material have been published in the *Annual Report of the Federal Deposit Insurance Corporation, 1950*, pp. 63-101; *1952*, pp. 59-72; *1953*, pp. 45-67.

[2] The term *bank obligation* is here used to include circulating notes as well as deposits.

[3] "An Act to Create a Fund for the Benefit of the Creditors of Certain Monied Corporations, and for other Purposes," April 2, 1829, *General Statutes of New York* (Blatchford's ed.), *1829*, pp. 29-33.

the deposits and circulating notes of a participating bank which might fail.[4] The two insurance plans were apparently developed independently, although it appears that Indiana did take into account the very stringent—and unique for that time—bank examination provisions of the New York law.

The apparently independent development of these two pioneer insurance plans possibly reflected the very marked differences between the banking histories of the two states. When her safety fund act was passed New York's banking experience dated back to 1784, almost a half century.[5] During that time New York banks operated under individual charters, and the imminent expiration of a large number of these charters provided an opportunity for the introduction of bank-obligation insurance.

Indiana, on the other hand, had been without banks of any kind for some time prior to 1834 and, in addition, was faced with the problem of a state constitution which prohibited banking except by a state bank with branches.[6] The legislature nevertheless provided for the creation of independent banks but, in apparent deference to the constitutional prohibition, required that they be known as branch banks and that collectively they comprise the state bank. The president and board of directors of the state bank were essentially a supervisory authority, and their functions were thus similar to those of a present-day bank commissioner and banking board.

Each of the so-called branch banks had its own capital and officers and each paid earnings to its own stockholders. Thus, to the future confusion of many a historian, Indiana in

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[4] *Laws of Indiana*, 1833-1834, pp. 12-38.

[5] The "President, Directors and Company of the Bank of New York," the second bank to be organized in the United States after the Revolutionary War, began business in June, 1784.

[6] Two banks had been chartered in Indiana shortly before adoption of the state constitution in 1816, the Farmers and Mechanics Bank of Madison and the Bank of Vincennes. The former was apparently ably conducted but suspended operations temporarily 1824-1825. It was revived in 1832, but a bill to extend its charter, which was to expire on January 1, 1835, failed to pass the 1834-1835 session of the general assembly. The Bank of Vincennes failed somewhat earlier. Private banks may well have been in operation during this period but these were not banks of issue and are not treated here. John D. Barnhart and Donald F. Carmony, *Indiana* . . . (4 vols., New York, 1954), I, 300-313, especially 311. See Lewis B. Ewbank and Dorothy Riker (eds.), *The Laws of Indiana Territory, 1809-1816* (Indianapolis, 1934), 747-763, for the charters of the Madison and Vincennes banks. This is volume XX of the Indiana Historical *Collections* (Indianapolis, 1916-).

1834 may be said to have created a state bank which did no banking and branch banks which did the banking but were not branches.

Within seven years after the adoption of the New York system two other states had followed its lead: Vermont in 1831 and Michigan in 1836 created insurance systems identical with that of New York.[7] Thus at the time of the panic of 1837, which introduced one of the most severe depressions this nation has ever undergone, insurance systems were operating in four states: three of the New York variety and Indiana's mutual guaranty system. Six years later, when the depression had run its course, the Michigan system was found to have disintegrated, the insurance fund in New York had proved inadequate to meet all the claims of creditors of banks which had failed, and the Vermont system had been seriously weakened.

On the other hand, Indiana's banks, with only one exception, had come through the great depression successfully and the insurance system had worked well. By 1845 the Indiana banking system was without parallel in the West and ranked with the strongest in the nation.

Before continuing the account of the adoption of bank-obligation insurance by other states, it is important to inquire into the role of insurance in the successful operation of the Indiana banking system during the depression. In other words, would Indiana banks, and bank creditors, have fared just as well if there had been no mutual guaranty system? Probably not: without the insurance system the failure rate of Indiana banks would very likely have been as high as that of banks in Ohio, Illinois, and Michigan.

The most important reason for the successful operation of the Indiana banking system was the relationship between its insurance plan and bank supervision. It goes almost without saying that insurance of bank obligations can never be successful without thorough supervision; the trick is to assure that both can be had at the same time. Perhaps inadvertently, but more probably by design, Indiana solved this problem by making the supervisory body, the board of directors of the state bank, consist largely of representatives from each of

[7] "An Act Regulating the Chartering of Banks," November 9, 1831, *Laws of Vermont, 1831*, p. 16. "An Act to Create a Fund for the Benefit of the Creditors of Certain Moneyed Corporations," March 28, 1836, *Laws of Michigan, 1836*, pp. 157-165.

the participating banks. By itself, of course, this arrangement could have been disastrous, since one bank might have been willing to overlook the misdeeds of another, in return for the same favor to itself. But since the banks were also tied together in an insurance plan which provided for assessments to meet the obligations of a failing member, the result was that each bank could best protect its interests by seeing to it that no other bank reached a position which would endanger the rest. To put it another way, the insurance system gave each participating bank a stake in the sound operation of every other Indiana bank, while the supervisory structure gave it the power to enforce its interests.

There are many illustrations of the efficacy of this arrangement: in the type of examination given the banks, in the general attitude of supervisory officials toward unsafe and unsound banking, and finally in the action taken in the case of Indiana's one distressed bank. The records of the state bank system testify to the range and to the penetrating quality of the inquiries which examiners were to make of each bank. That the examinations themselves were excellently conducted is the testimony of one of the great bankers produced by the Indiana system, Hugh McCulloch, who became the first Comptroller of the Currency of the United States, following which he served as Secretary of the Treasury of the United States. In his early years McCulloch was cashier of the Fort Wayne branch bank and he later wrote that the examinations were "so searching and thorough that fraud and mismanagement could scarcely have escaped detection."[8]

To one who has studied the activities of banks during this period in all of the middle western states, the policy of the Indiana banks, as formulated by the supervisory officials, appears exceptional. To cite only a few examples: excessively large loans to directors and stockholders were carefully watched by the board and by Samuel Merrill, president of the state bank. One of his letters to a branch bank will serve to illustrate this attitude: ". . . though it may not be wrong to loan money to a director . . . for some useful object in the same manner as would be allowed to others . . . if Directors are suffered to renew their notes without curtailing, the reason for such proceeding should appear on the minutes . . .

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[8] Hugh McCulloch, *Men and Measures of Half a Century* (New York, 1888), 114.

but if you have inadvertently made allowances in these cases which should not have been, it would be well by Resolution of your board to condemn the practice and abandon it hereafter."[9]

Loans on real estate were another source of difficulty for early western banks, especially in this period because until the panic in 1837 a real estate boom of major proportions had flourished in the western states. Many western banks deliberately became involved in this boom, with its highly speculative overtones, but not the Indiana banks. The attitude of the president of the largest Michigan bank provides an interesting contrast with that of Merrill at this time. In 1836, at the height of the boom, the Michigan banker wrote: "Investment of money in the lands of Michigan is in my opinion one of the most certain sources of wealth the world offers . . . there is nothing visionary in this . . . lands judiciously selected may be fairly expected to rise one hundred per cent per annum."[10] It was at about this same time that Merrill advised the branch banks: ". . . as we have no difficulty in securing loans on . . . property not subject to such variations in price we reject in all cases where there is any suspicion of a high valuation and in general we take no town lots unless in very special cases."[11]

A final example of the effect of combining the insurance principle with a plan for effective supervision was the case of the Lawrenceburgh branch bank, which was placed in the hands of receivers in the fall of 1843. For some years previous to its financial difficulties, supervisory officials had criticized the management of the Lawrenceburgh bank. It is highly significant that when the bank was closed the action was taken at the insistence of the other banks, through their representatives on the board. This is shown by the fact that, shortly before the board took action in the Lawrenceburgh case, Merrill wrote to one of its officers: ". . . some

[9] Samuel Merrill to President of Bedford Branch Bank, March 3, 1840, Letterbooks of the State Bank of Indiana, MSS, Indiana State Library Archives, Indianapolis.

[10] Letter of September 20, 1836, in C. C. Trowbridge Letterbook, MSS, Burton Historical Collections, Detroit.

[11] Merrill to Officers of Lafayette Branch Bank, February 1, 1836, Letterbooks of the State Bank of Indiana.

members of the State Board are very fearful that my opinions are too favorable to your [bank] and that I am too much opposed to suspending. . . ."[12]

There is one interesting footnote to this Lawrenceburgh case. After the bank was closed it was decided that a loan or a deferred deposit—which of the two cannot be definitely determined from the evidence—would enable the bank to resume operations. Consequently, the necessary funds were contributed by the sound participating banks and, after a change in management, the bank reopened for business. Eventually it became one of the strongest banks in the system.

An analysis of the performance of the four insurance systems during the great depression of the late 1830's and early 1840's shows clearly that the results did not provide a test of the two types of insurance, insurance fund and mutual guaranty. What really accounted for the difference in performance was management and timing. For example, almost no type of insurance system could have survived in Michigan, since it would have been placed in operation less than twelve months before the panic. Furthermore, had New York's system received the quality of management that was given Indiana's it might have come through the depression with little difficulty.

However this may be, contemporaries saw only that of the four insurance systems Indiana's appeared to have worked best. Consequently it was the Hoosier example which was followed in the next stage of the development of bank-obligation insurance.

In 1845 Ohio was faced with the task of rebuilding her entire banking system. Out of a total of thirty-four banks operating at the beginning of the depression, only eight remained six years later. In many cases the banks had failed, while in others the charters had expired. Because the circulating notes of Indiana branch banks had formed a major part of the Ohio circulating medium during the depths of the depression, and also because of the evident success of the Indiana experiment, Ohio established a banking system which in many respects was quite similar to that of Indiana.[13] In

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[12] Merrill to Officers of Lawrenceburgh Branch Bank, June 11, 1843, Letterbooks of the State Bank of Indiana.

[13] "An Act to Incorporate the State Bank of Ohio and Other Banking Companies," February 24, 1845, *Laws of Ohio, 1845*, pp. 24-54.

particular, a state bank system was created under which, once again, it was the branch banks which did the banking while the state bank was given only supervisory powers. Ohio adopted this rather unusual structure not because of any constitutional requirement but simply because of the acknowledged strength of the Indiana system.

The bank-obligation insurance system which Ohio adopted in 1845 was also based largely on Indiana's; that is, participating banks were made mutually liable for any losses suffered by creditors of a bank which failed, although Ohio took from the New York system the idea of an insurance fund. However, under the Ohio insurance system, in the event of a bank failure participating banks were to be assessed for the requisite amounts as soon as creditors' claims were established and the banks were then to be repaid from the insurance fund. As a matter of fact, although there were ten instances of banks in serious financial difficulties during the twenty years Ohio's system operated, the insurance fund was never used in the manner intended. Protection of bank creditors was accomplished only through use of the mutual guaranty provision.

In 1858 Iowa, which until that time had prohibited banking, provided for the establishment of a banking system similar to that of Ohio and therefore that of Indiana.[14] It too provided for an insurance system, in this case one exactly like that operating in Ohio.

The Indiana, Ohio, and Iowa insurance systems all lasted until about 1866. During the time of their operation no insured creditor suffered any loss as a consequence of bank failure. This was a truly remarkable record for a period which is frequently characterized as a dark age in American banking.

The various systems came to an end in 1866 because most of the participating banks converted to national banks. They did so not because of any deficiencies in the insurance plan but because a prohibitive federal tax was levied upon state banknotes. This tax did not succeed in forcing some

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[14] "An Act to Incorporate the State Bank of Iowa," March 20, 1858, *Laws of Iowa, 1858*, pp. 89-106.

of the banks in large eastern cities to join the national banking system, since their business was largely, if not entirely, a deposit business. Yet it did succeed in forcing banks in the Middle West to become national banks.

It is thus apparent that bank-obligation insurance before the Civil War received its greatest impetus in the Middle West. Although the pioneering efforts of New York can hardly be ignored, the influence of Indiana clearly predominated in the development of bank-obligation insurance after 1845.