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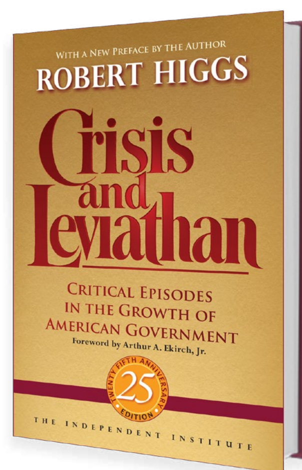

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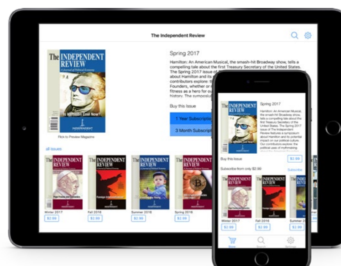

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Mutual Deposit Insurance

Other Lessons from the Record

✦

JAMES E. HARTLEY

In the wake of the savings and loan crisis, many proposals to reform the deposit insurance system have been made. Bert Ely (1999) has advocated one of the more sweeping proposals: move to a system of private insurance in which banks would guarantee each other's deposits. In introducing this proposal, Ely notes, "[T]hree successful state deposit insurance plans operated in Ohio, Indiana, and Iowa prior to the Civil War (Calomiris 1989, 15–19). Those three plans are the historical precursors to the cross-guarantee concept" (242).

Ely's proposal is very similar to one made by Charles Calomiris (1989), who came to the proposal after a look back at the liability insurance plans adopted in fourteen states before the Great Depression. Six of those plans were implemented in the antebellum era, the other eight between 1907 and the Great Depression. Examining the record of these plans, Calomiris argues that only three of them can be considered successful: the antebellum plans in Indiana, Ohio, and Iowa.

The plans adopted in those three states closely resembled one another and differed from the plans used in all of the other states. Calomiris argues that the successful plans succeeded because they were mutual insurance plans: the banks were insured not by a state-run agency or insurance fund, but rather by one another; each bank in the insured system was responsible for meeting the obligations of any one of the other banks in the system should it fail. Moreover, in this mutual insurance plan, the banks exercised regulatory power over one another.

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In light of this historical experience, Calomiris concludes that, in considering reform proposals for contemporary deposit insurance, legislators should profit from the lessons of the successful plans. In particular, he argues for a system in which the banks would be tied together in some sort of regulatory arrangement, each having the responsibility and the power to regulate the others and each liable, either directly or indirectly via required insurance premiums, for the activities of other banks in the system.

As noted, Ely's proposal is broadly similar and explicitly relies on Calomiris's account as a historical justification of the proposal. Calomiris's proposal has also garnered wider attention. It has made its way into both undergraduate (Mayer, Duesenberry, and Aliber 1996, 181) and graduate (Freixas and Rochet 1997, 262) money and banking textbooks, as well as into a Congressional Budget Office (1990) study. Calomiris's work has also been more widely cited with approval in works that range from proposals for reform after the savings and loan crisis (for example, see Wallison 1990) to a study of the Japanese deposit insurance program (Fries, Mason, and Perraudin 1993) and a *Harvard Law Review* article on bank holding companies (Jackson 1994).

The proposal has not gone unnoticed by legislators. Congressman Tom Petri (R-Wisc.) has introduced a bill that would abolish the current deposit insurance system and replace it with a "cross-guarantee" system. Ely helped write Petri's bill and describes the legislative proposal in his work (see Ely 1999; Petri and Ely 1994, 1995).

Notwithstanding the impact of Calomiris's work on this subject, important questions remain unanswered in his account of the successful deposit insurance plans. Of the eight states that adopted insurance plans after 1907, none adopted the sort of system used earlier in Indiana, Ohio, and Iowa. If those antebellum schemes were so successful, why did no state adopt such a system in later years? Why did they all adopt plans much closer to that used in antebellum New York, which Calomiris argues was a comparative failure? Moreover, none of the three states that Calomiris argues had successful insurance plans before the Civil War adopted any sort of insurance plan after 1907. Why would states with historically successful insurance plans fail to adopt any insurance plan at all in the later period? It seems remarkable to assume that legislators failed to notice a successful government plan that existed a mere half-century earlier. Indeed, early in the Great Depression, Indiana commissioned a study of its financial institutions (Study Commission for Indiana Financial Institutions 1932). In its review of the history of the state, the resulting report provides a glowing discussion of the antebellum Indiana State Bank. Nevertheless, when later in the report the commission discusses potential solutions for the problem of bank failures, including a discussion of "guaranty of bank deposits," it does not even mention the antebellum Indiana deposit insurance system.

In view of the foregoing questions, a look back at the complete record of the banking systems in Indiana, Ohio, and Iowa seems warranted. Such an examination reveals a number of details about those systems that are not included in Calomiris's account. It is not surprising that Ely and others, having read Calomiris's discussion of

the banking systems in these states, would be led to believe that the mutual deposit insurance plan of those systems accounts for their stability. Moreover, it is not surprising that some lawmakers, after reading Calomiris's and Ely's proposals, would believe that the historical record provides ample evidence of the benefits of mutual deposit insurance and would therefore propose legislation to reform deposit insurance along the lines of the similar systems Calomiris describes as having existed in antebellum Indiana, Ohio, and Iowa.

However, a more complete account of the banking systems in antebellum Indiana, Ohio, and Iowa might lead one to conclusions different from Calomiris's. We shall see that the banking systems in those states were unique in more ways than just the mutual insurance plan Calomiris mentions. If we consider the systems as a whole, it is not clear that their mutual insurance accounts for their success, nor is it clear that the positive aspects of these systems gave rise to greater benefits than costs, because even though the systems did provide soundness, they did so at significant cost. Similarly, it is not clear that these plans provide any reliable lessons for designing a deposit insurance plan for the modern economy; instead, the main lesson may actually be that this sort of system restrains competition, fosters political corruption, and severely limits economic and financial development and growth.

The problems of the antebellum banking systems in Indiana, Ohio, and Iowa do not prove, of course, that proposals such as Calomiris's mutual deposit insurance or Ely's cross-guarantee system would be failures in practice. However, as Ely's remarks show, one of the principle arguments in favor of those proposals is that similar plans were previously "successful" in history. My wider-ranging discussion of these plans raises questions about reliance on the historical record as support for the present-day proposals. Instead, the lesson may simply be that government attempts to create banking cartels give rise to undesirable outcomes.

The Legend of Mutual Deposit Insurance

Before we examine the historical record, it is worth recalling the tale of the mutual deposit insurance plans as told by Calomiris (1989), who relied primarily on unpublished work by Carter H. Golembe and Clark Warburton (1958) at the Federal Deposit Insurance Corporation.[1]

In 1834, Indiana became the first state to adopt such a plan. In it, separately owned and operated banks were called "branches" of the State Bank of Indiana. The banks were regulated by a board of directors, most of whom the banks themselves appointed. The board had the authority to investigate, regulate, and even close the banks in the system. The mutual insurance provision obligated each bank

1. The Federal Deposit Insurance Corporation (1952, 1953) published two discussions of the antebellum mutual deposit insurance plans, which presumably drew largely on the work of Golembe and Warburton (1958).

to cover the liabilities of other banks. Because of this mutual responsibility, the state board imposed regulations, such as rules about dividend payments and loan provisions, intended to limit excessive risk taking. The coupling of mutual liability with the strong regulatory power of the board, Calomiris argues, made for a successful institution.

Calomiris counts the system a success because during its thirty years of operation no insured bank failed, although one was briefly suspended because of irregularities of its loan portfolio. In each banking crisis during the life of the insurance plan, the State Bank retained its soundness. It performed "admirably" during the crisis that began in 1837, although it did suspend convertibility of its paper into specie from May 1837 to August 1838 and again from November 1839 to June 1842. It survived both the regional crisis of 1854–55 and the national crisis of 1857 without suspending convertibility. This performance compares favorably with that of the free banks of Indiana that cropped up in the wake of a free-banking law passed in 1851: fifty-five of the ninety-four free banks failed in the 1854–55 crisis; fourteen of the thirty-two free banks failed in the 1857 crisis.

Ohio adopted a system similar to Indiana's in 1845. The Ohio and Indiana plans differed primarily in that the former provided for a "safety fund" into which banks deposited money to be used to pay off the liabilities incurred by the system. The Board of Control in Ohio had "virtually unlimited authority over individual banks" (Calomiris 1989, 16). It imposed assorted regulations designed to ensure the safety of the system, including a limit on the amount of notes that could circulate relative to capital and a 30 percent reserve requirement on notes.

The Ohio system was put to a serious test in 1857, when a nationwide financial panic began with the failure of the Ohio Life Insurance and Trust Company. Although many Ohio banks had substantial deposits in that institution, only one Ohio bank (not a branch of the State Bank) failed in the crisis, and no general specie suspension occurred. The relative success in weathering the crisis sprang from the "wise and timely" activities of the Board of Control, which transferred the assets of the failed company to its depositor banks and instructed healthy banks to make immediate loans to troubled institutions (Calomiris 1989, 17).

Alongside the insured system, Ohio had well-established independent banks and newly created free banks. Even the noninsured banks made it through the panic of 1857 in good shape; Ohio had the lowest bank failure rate in the North. Calomiris attributes the success of the noninsured banks to the "contagious" nature of the Ohio insurance plan and to unspecified aid from insured banks to uninsured banks.

In 1858, Iowa became the third state to adopt a mutual guaranty insurance plan, virtually identical to Ohio's. Iowa had no noninsured banks and, during the seven-year life of its mutual guaranty system, no bank failures. Two of the banks did experience difficulty—one because of fraud and one because of "portfolio deterioration"—but the problems were resolved, and no losses resulted. Although the Iowa system

never faced the test of a financial crisis, Calomiris argues it likely would have fared as well as the Ohio system had in 1857.

The Indiana, Ohio, and Iowa systems all came to an end in the mid-1860s, following enactment of the National Banking Act of 1863, which, as amended in 1865, imposed a prohibitively high 10 percent tax on notes issued by state-chartered banks. In the wake of that enactment, most banks in the nation, including the banks in the successful insurance plans, switched to national charters to avoid the tax.

On the basis of the preceding record, Calomiris concludes that it is important to give to the banks themselves both the incentive to regulate and the authority to do so. He attributes the success of these historical insurance plans to their having done both.

Others have also found the record of the bank insurance systems in these states to have been quite good; the literature on the history of banking is replete with enthusiastic reviews of them. For example, the Indiana system has been described as "phenomenally successful" (Hepburn 1915, 146); "one of the most distinguished and honored financial institutions in the country" (Hammond 1957, 621); "one of the great banks of the country" (Knox 1903, 694); and "a monumental bank, of which the nation may well be proud, and fit to be compared with the most illustrious the world has ever seen" (White 1896, 386).

Other Lessons from the Record

Calomiris concludes his 1989 article by noting, "The goal of this paper has been to help current policy makers start paying attention to history" (28), and I seek the same objective here. The preceding whirlwind tour of the mutual guaranty plan does present an attractive image. However, this plan was only one part of state bank systems that had many other unique features. Looking at each system as a whole, we find it less than obvious that the mutual guaranty provisions account for its soundness. Moreover, a more comprehensive overview of each system reveals that the banking cartels created by these three states entailed substantial social costs.

Indiana

Mutual guaranty banking existed in Indiana from 1834 to 1863, under two distinct banking systems. The first system, named the State Bank of Indiana, was erected in 1834. The State Bank consisted of a central board of directors, known as the Board of Control, and thirteen distinct "branches," each independently capitalized and managed.[2] Each branch appointed one member of the Board of Control, and the legislature appointed five members.

Each of the thirteen branches received a separate territory in which it operated as the sole provider of bank services. This monopoly power was legislatively man-

2. In 1834, only ten branches were set up; the number had increased to thirteen by 1838.

dated; there could be no more than one bank in each specified three-county area (Esarey 1912, 253). Moreover, no banks other than the branches of the State Bank were constitutionally allowed.

The initial capital of each branch had to be paid in specie. To ensure that sufficient specie was raised, the state paid half of the capital and made loans to private individuals to enable them to pay specie. As a result, the state provided $1.3 million of the initial $1.6 million in capital. That the capital was all specie was highly unusual (Conant 1915, 386). In essence, the State Bank created a set of monopolies of banking services and provided their initial capital.

On paper, the Board of Control was remarkably powerful, having the ability to regulate the branches minutely and to close them for any irregularities. Moreover, it was authorized to inspect the branches at will and was required to do so at least every six months.

In practice, however, the Board of Control was not so powerful. One commentator noted that it "used toward its branches the language of a weak, indulgent, and incapable parent who scolds her children, indeed, and threatens and then lets them do pretty much as they please" (qtd. in Dewey 1910, 140). The most notable example of this laxness was that the branches made loans to their own officers and owners. In 1838, the president of the State Bank, James Merrill, wrote to the Lafayette branch: "to have directors generally *large borrowers* receiving *special favors of the Cashier and each other* . . . at the expense of the bank . . . such acts are of a character not to be tolerated" (qtd. in Golembe 1952, 39, emphasis in original). Yet these acts were tolerated. In 1840, the Lawrenceberg branch was threatened with suspension for "allowing its own directors to hold office while their notes were under protest" (Golembe 1952, 37). The Lawrenceberg branch was not suspended, however, until 1843 for such offenses. Merrill similarly chastised the Bedford branch for such activities (Golembe 1955). This problem was widespread: in 1840, it was reported that loans to stockholders amounted to 37 percent of the total loans made by the State Bank branches and 45 percent of loans to people other than the state itself (Esarey 1912, 262).

As Naomi Lamoreaux (1994) has argued in a study of insider lending in New England banks, extensive loans to insiders may have the result of increasing the soundness of a bank. Banks with high levels of insider lending have an incentive to restrict the amount of funds they raise through deposits. Because raising funds from depositors creates a risk of having those funds withdrawn, the bank's borrowers are at risk that their loans will not be renewed. Bank directors who have borrowed extensively from the bank will be particularly attuned to this risk and therefore be less willing to accept deposits, perhaps even "deliberately restrict[ing]" the number of deposits (Lamoreaux 1994, 67–69). In the New England states Lamoreaux studied, the ratio of deposits to liabilities was between 10 and 22 percent (65). In comparison, the State Bank of Indiana in 1840 had a deposit to liability ratio of 4.5 percent (Harding 1895). As Harding put it, "It is thus clear that the use of deposit accounts as a

credit function had practically no use in the bank. It is even doubtful that the deposits, small as they were, had the nature of credit; part of them, assuredly, were merely deposits of money for safe keeping" (1895, 28).

Lamoreaux further argues that the insider lending that New England banks practiced had little or no adverse consequence. If credit were unduly restricted, new banks would be created to serve those unable to get credit at existing banks. Of course, this inference presumes that new banks can arise, but in the New England states Lamoreaux studied, "such barriers [to entry] as did exist were not very high" (1994, 55). However, she notes that the lack of adverse consequences of insider lending is not universal and that, in particular, as "practiced by banks with a substantial degree of monopoly power, [insider lending] has served to reduce competition and has thus had a constraining effect on economic growth" (9). As I discuss later, such constraints on economic growth were quite evident in antebellum Indiana.

The nationwide banking crisis of 1837 forced the State Bank to suspend specie payment. It resumed payment in 1838 but in 1839 suspended it again. These suspensions clearly violated the bank's charter. After the 1837 suspension, the legislature determined that the charter had been violated but decided not to revoke the charter at that time. It did threaten, however, that any future suspension would in itself constitute a forfeiture of the charter—a threat that was not carried out when the bank suspended specie payment in 1839 (Harding 1895, 17).

The second suspension ended only when the legislature threatened to revoke the bank's charter if it did not resume specie payment within six months (Harding 1895, 18). The bank met the deadline. That it seems to have done so with little trouble prompts one to wonder why a legislative order was required to bring about a resumption of normal operations. The answer may lie in the bank's activities during the suspension. The 1839–42 suspension proved a highly profitable time for the branches (Esarey 1912, 260). The bank took advantage of the suspension to increase its note circulation dramatically. After the legislature ordered the bank to resume specie payment, the bank began systematically buying back great volumes of its own circulating notes. Between December 1841, before the legislature ordered the bank to resume specie payment, and July 1842, after the bank had resumed payment, the total amount of notes circulating fell by 36 percent (Harding 1895, 19, 110–11).

After resuming specie payments, the State Bank spent the next decade in perfect safety as the monopolist of banking services in the state. During that time, the state became starved for both credit and circulating money.

The State Bank had been established originally because the legislature saw a great need for more money in the state, which was rapidly growing (Esarey 1912, 247–48), yet the State Bank consistently failed to provide enough circulation. Between 1836 and 1854, although the population of the state grew by 113 percent, the number of acres being taxed by 300 percent, and the total property value in the

state by 350 percent, the State Bank increased the amount of circulation by only 75 percent (Esarey 1915, 408). By 1852, it was estimated that only half of the notes being used in the state had been provided by the State Bank; the rest had come from other states (Esarey 1912, 282).

The State Bank's lending activities were not much better. Merrill had correctly foreseen these activities in his first report to the legislature: "A *bank* has been established and not a *loan office*" (qtd. in Golembe 1952, 103, emphasis in original). Discount privileges were generally limited to those needing short-term trade credit. As a result, those needing funds "to buy stock to fatten, or to buy up produce for shipment" were accommodated disproportionately (Esarey 1912, 266). Others in the state—which is to say, almost everyone—had no ability to get discounts. The bank's lending procedures emphasized "withholding its aid from all schemes uncertain in their results" (Harding 1895, 14).

Moreover, the available discounts were largely confined to the towns containing branches (Helderman 1931, 51). Such parochialism would not have mattered if the branches had been located in the cities of greatest demand, but as the state developed, the location of commercial activity changed to towns that were "hardly known" in 1834 (McCulloch 1888, 124). The obvious solution was to create new branches, and the legislature had, in fact, authorized three new branches. However, the State Bank steadfastly refused to establish them. The rationale for its opposition is not difficult to divine in the one case actually debated. The legislature had authorized the creation of a fourteenth branch at Logansport. However, the opposing vote of only one existing branch sufficed to disallow any proposed branch, and Lafayette provided the sole opposition to the Logansport branch. The city of Logansport lay in the Lafayette District, so the creation of a new branch there would necessarily have divided the Lafayette District in two.

These State Bank activities are hardly surprising given its monopoly power; it was able to keep its profits high by restricting its activities. However, the state as a whole had an increasing demand for banking services to meet the needs of its growing economy. As a result, constituents placed great pressure on legislators to liberalize banking in the state, and the lawmakers responded in 1852 by passing one of the most unrestrictive free-banking laws in the country.

The laxness of the Indiana free-banking law is the stuff of legends. The Indiana governor complained in 1852, "The speculator comes to Indianapolis with a bundle of bank notes in one hand and his stock in the other. In twenty-four hours he is on his way to some distant part of the Union to circulate what he calls a legal currency, authorized by the Legislature of the State of Indiana. He has nominally located his bank in some distant part of the State, difficult of access, where he knows that no banking facilities are required, and intends that his notes shall go into the hands of persons who will have no means of demanding their redemption" (qtd. in Sumner 1896, 444). Or consider this case:

> An enterprising gentleman, whose cash capital did not exceed ten thousand dollars, in connection with two others who were utterly impecunious, bought, mostly on credit, fifty thousand dollars of the bonds of one of the Southern States. These bonds he deposited with the [Indiana] treasurer and as soon as they could be engraved he received an equal amount of notes, with which he paid for the bonds. This transaction being completed, more bonds were bought and paid for in the same manner; and this operation was continued until the financial crisis of 1857 occurred; at which time this bank, which had been started with a capital of ten thousand dollars, had a circulation of six hundred thousand dollars, secured by State bonds, on which the bank had for two or three years been receiving interest. (McCulloch 1888, 125)

Given this sort of dealings, it is hardly surprising that, as Calomiris notes, the majority of Indiana free banks failed during the financial crises of the 1850s. Similarly, Arthur Rolnick and Warren Weber's (1982, 1983) examinations of the Indiana free banks found that nearly one-third not only failed in less than one year of operation but also did not have sufficient assets to redeem their notes at par. Rolnick and Weber also examine three other states: the comparable figures are 4 percent in New York, 1 percent in Wisconsin, and 44 percent in Minnesota. Comparing Indiana and Minnesota, we can also note that Indiana had 104 free banks, Minnesota only 16. Hence, it does seem that Indiana's free-banking law gave rise to a particularly large number of unsound banks. Moreover, the State Bank seems to have played an active role in pushing many of those free banks over the edge by its policy of collecting the bank notes of the smaller free banks and persistently returning them for redemption (Esarey 1915, 412; Helderman 1931, 53; Sumner 1896, 447).

However, although the number of banks failures was large, their economic impact was relatively small. Rolnick and Weber show that the losses to note holders in Indiana were only between eleven and fifteen cents on the dollar (1983, 1089). As Bray Hammond puts it, "much of the loss was like that which is sustained when one writes a check for $1,000,000, signs it, and puts it in the fire" (1957, 620). McCulloch, who was at one time president of the Bank of the State of Indiana and therefore intimately involved with the banking in the state, summed up the situation by noting: "No bank in the United States, the capital of which was a cash reality, and whose managers were not thieves or the borrowers of its money, has ever failed. All bank failures are fraudulent, either by mismanagement or deception in regard to capital, and all who are responsible for such failures are betrayers of trusts, and should be punished as criminals" (1888, 131–32).

With the original charter of the State Bank of Indiana due to expire in 1857, the legislature took up the task of authorizing a new bank. The Indiana Constitution of

1851 forbade the state to own any part of a bank, so simply reauthorizing the State Bank was not an option. The upshot was the chartering of the Bank of the State of Indiana. The process was "one of the most noted legislative scandals of the state's history" (Esarey 1912, 289).

The amount of graft and corruption associated with the establishment of the Bank of the State was staggering. Many legislators voted for the charter "upon the promise of stock, equivalents in money, or pledges as to the location of branches" (Knox 1903, 699). When the branches were set up, the books were manipulated to ensure that select people received all the stock (Esarey 1912, 246), which they subsequently sold at great profit. And so on. One legislator complained that the whole process was simply a case of "Tickle me Tommy, do! do! do! You tickle me, and I'll tickle you" (Esarey 1912, 289). A legislative committee looked into the matter and determined that the new charter should be revoked, but the speculators were strong enough to prevent such revocation (Knox 1903, 699).

The Bank of the State began operation in 1857 and shut down in 1863. During that time, it faced one extraordinary crisis, the nationwide bank panic of 1857. Calomiris notes that to the bank's credit it did not suspend specie payment during the crisis. However, as he and Larry Schweikart have noted elsewhere, "Bank suspension was not necessarily a sign of weakness. . . . Indeed the failure to suspend in response to persistent statewide bank runs can have far more serious consequences than a suspension" (Calomiris and Schweikart 1991, 823). Was the failure of the State Bank of Indiana to suspend specie payments in 1857 a sign of strength or weakness? After reading bank president Hugh McCulloch's account, one has no doubt: the weakness of the bank's political position, not the strength of its operations, kept it from suspending payments:

> My position was a trying one. The charter was very valuable, and it became subject to forfeiture upon the failure of the bank to meet its obligations in coin. The manner in which it had been obtained precluded any well-grounded hope that a suspension of specie payments would be sanctioned by the legislature. There was really no alternative. Specie payments must be maintained, or the charter would be forfeited. . . . There was, however, apparently great danger that some of the branches might be unable, without assistance from other branches, to redeem their notes in coin. I received each day at my office at Indianapolis, by telegraph or messenger from each branch, a statement of its redemption and of its coin and other cash means. For three or four weeks the calls upon the branches were so continuous and heavy that it seemed probable that their entire collection would be sent home; but this extremity was never reached. In the fifth week of the panic there was an improvement in the financial outlook. . . . The crisis had been passed—the charter was safe. (1888, 134–35)

Thus, although the bank did not suspend specie payment, it is clear that McCulloch would have preferred to suspend but could not do so because of the political fragility of the bank's charter. The decision against suspension did not rest on a belief about the relative strength of the bank.

Ohio

Structurally, the State Bank of Ohio was patterned after the State Bank of Indiana. Ohio's system, created in 1845, allowed for both State Bank branches and independent banks. However, competition was far from unfettered; the number of banks of any type allowed in each county was restricted, the limits ranging from one to six banks.

Not surprisingly, many of the problems that arose in Indiana also appeared in Ohio. The banking system in Ohio did not grow with the state, leaving too little bank capital and currency to meet the state's demands. In 1851, the *Cincinnati Gazette* complained that whereas the city's economy was rapidly growing, no increase of the number of banks was allowed (Huntington 1915, 436). In 1853, the Cincinnati Chamber of Commerce went so far as to pass a resolution encouraging the importation of out-of-state banknotes to help alleviate the shortage of currency (*Hunt's Merchants' Magazine* 29 [1853], 738, reprinted in Calomiris and Schweikart 1988, 28). In response to these problems, the legislature passed a free-banking law to allow for a more expansive banking system. Thirteen free banks started, but none was created after 1853, when a new state constitution, widely believed to require every new bank to be approved in a statewide vote, took effect.

In addition to the problems common to the Indiana and Ohio systems, some unique problems arose in Ohio. The Ohio banks used more effectively their privileged positions to collude. The most dramatic example was their success in defying the state legislature. Throughout the 1850s, the legislature tried to increase taxation of the banks. The banks argued (and the state supreme court later upheld their argument) that raising their taxes violated their charters. However, while the case was winding its way through court, most of the banks simply refrained from paying their taxes. In 1853, the auditor of the state remarked, "But few of the banks of Ohio have paid the taxes assessed against them under the provisions of the Act of April 13, 1852. This delinquency is not a matter of accident, but is attended by circumstances which betray the existence of a conspiracy to trample upon and override the very authority which gave the conspirators their corporate existence" (qtd. in Knox 1903, 683).

This refusal to pay tax prompted the legislature to pass what was dubbed the "Crowbar Law," which authorized county officials to enter a bank by force and seize sufficient sums to pay the tax. The law was actually put into force at one of the branches of the State Bank, the Commercial Bank of Cleveland. Later, the state supreme court also declared the Crowbar Law to be unconstitutional.

The collusion among the Ohio banks involved more than defying what they considered unjust laws. Some of it supported less noble causes—notably, avoiding redemption of their notes. Banks obviously wanted to keep their notes circulating, but in order to do so, redemption had to be prevented. Because they were unable to prohibit redemption legally, their next best alternative was to circulate the notes far away, thereby making redemption difficult. The branches of the State Bank of Ohio systematically helped each other in this regard by swapping notes. So, for example, a branch in Cleveland would circulate notes from a branch in Columbus, while the Columbus branch provided the same service for the Cleveland branch (Huntington 1915, 451). Similarly, before issuing notes, the banks would often obtain the customer's promise to refrain from circulating the notes within a large radius of the location of issue (Huntington 1915, 451).

Calomiris concludes that the feather in the Ohio system's cap was its success in weathering the crisis of 1857. He argues that the mutual insurance provisions of the branches of the State Bank of Ohio enabled those banks, as well as the independent banks, to survive the crisis, with only one failure. However, contemporary observers offered a different explanation for the "success" of the Ohio system in weathering the crisis. Hugh McCulloch, the president of the Bank of the State of Indiana, noted, "It is true that the State Bank of Ohio continued nominally to redeem its notes, but only nominally. Its capital was locked up in the Ohio Life and Trust Company, and it was so crippled by the failure of that bank that even the brokers forbore to return its notes" (1888, 133).

The brokers and others refrained from returning the notes of the State Bank of Ohio during the crisis for another reason as well: doing so was dangerous. As the *Daily Ohio Statesman* reported, the banks were "resisting specie payment by the interposition of hired mobs. Within the last month citizens have been driven from the banks and threatened with physical violence in Mansfield, Springfield, Marietta, Xenia and Piqua, for daring to ask specie for notes on these banks" (Huntington 1915, 472n.; several other newspapers reported similar events).

For a general evaluation of the State Bank of Ohio, we need look no further than the state's voters. In 1856, a measure similar to the 1845 banking law was submitted to the electorate for a vote. It was defeated. Then the Ohio Supreme Court ruled that the state constitution did not prohibit the creation of free banks without a statewide vote; hence, the free-banking law, which had long been regarded as dead, was actually still in force. In 1857, the voters were again asked to approve a measure that would have incorporated the State Bank of Ohio and its branches, with no provision for independent banks. This measure also met defeat at the polls. From these votes, the policymakers of Ohio concluded that the citizens desired a more open banking system than that allowed by the state bank system (Huntington 1915, 464–66).

Iowa

The State Bank of Iowa existed only briefly. Banking was constitutionally prohibited in Iowa from 1846 until 1857, when a new constitution eliminated the prohibition. Two banking laws were enacted in 1858: one created the State Bank of Iowa and the other allowed for free banking. The State Banking Law was patterned after the laws of Ohio and Indiana. The Free-Banking Law was so restrictive that no banks were ever created under its provisions. Therefore, from 1858 to 1865, the State Bank of Iowa was the only bank in the state. The law authorized as many as thirty branches, no two of which could be in the same town, but only fifteen were ever established (Preston 1922, 87).

The short life of the State Bank of Iowa makes it difficult to evaluate its merits thoroughly. Moreover, during its operation, no banking crises occurred. However, many of the same traits that characterized the Indiana and Ohio systems began to develop in the Iowa system.

As in Indiana, the lending policy of the State Bank of Iowa was not designed to meet the demands of the majority of the population. The bank imposed a four-month limit on the maturity of all loans, an especially strict limitation in an agricultural state, effectively eliminating all demand for loans from the agricultural sector. As in Indiana, the loan policy seemed geared toward giving loans to particular segments of the community (Erickson 1971, 104).

The State Bank of Iowa also performed poorly in providing currency. It issued so little currency that notes from other states constituted a large part of the currency used for transactions, while State Bank notes were hoarded (Preston 1922, 113). Moreover, in an attempt to force people to use specie for small transactions, the legislature limited the number of small notes that the State Bank could issue. Still a less-developed state at the time, Iowa suffered from a shortage of specie of any sort (Erickson 1971, 101).

The result of these policies was the continued heavy use of out-of-state notes. In 1864, supporters of the State Bank took a drastic measure to enhance the bank's monopoly of the currency used in the state: they persuaded the legislature to outlaw the use of out-of-state notes in Iowa. The fine was five dollars per note used (Erickson 1971, 114). Notes issued by the authority of the U.S. Congress were exempted. An amendment that would have allowed the circulation of the notes of the State Banks of Ohio and Indiana was voted down, indicating that the legislature sought to protect the State Bank of Iowa, not to ensure that only currency issued by institutions deemed to be sound would be used.

A similar indication of the monopolistic tendencies of the State Bank of Iowa pertains to the admission of new branches. The bank never comprised more than fifteen branches—not because it lacked applications from people interested in forming

other branches, but because it turned down all such applications. It rejected two separate applications from prospective bankers in Waterloo and Cedar Falls on the grounds that establishing branches in Black Hawk County was of "doubtful expediency" (Preston 1922, 106). This rationale is surprising when Black Hawk County is compared to counties that contained branches. In 1860, Black Hawk County had a larger population than Pottawatomie County (Council Bluffs branch); a larger cash value for farms than Pottawatomie County; more people employed in manufacturing firms than Washington (Washington branch), Jackson (Maquoketta branch), and Mahuska (Oskaloosa branch) Counties; and a larger amount of capital invested in manufacturing firms than Johnson (Iowa City branch), Mahuska, Henry (Mount Pleasant branch), Washington, Pottawatomie, and Jackson Counties (U.S. Census Bureau 1864a, 1864b, 1865). Clearly the State Bank was in no rush to increase the number of its branches.

The State Bank of Iowa also revealed an inkling of the incestuous political relations that marred the Bank of the State of Indiana. Because no banks had been organized under Iowa's free-banking law, in 1860 the legislature passed a bill to relax slightly the requirements for creating such banks. Governor Kirkland vetoed the bill, justifying his action by arguing that relaxing the restrictions on free banking would result in a dangerous situation for the state if it gave rise to a large issuance of notes (Gue 1903, 34). It is not certain, however, that the governor was wholly disinterested: before becoming governor, he had served as a director of the State Bank branch in Iowa City and as president pro tem of the State Bank itself (Clark 1917, 119). Moreover, he was a large shareholder in the Iowa City branch (Clark 1917, 119; Erickson 1971, 161).

Calomiris concludes his discussion of the Iowa system by noting that "its close resemblance to Ohio's plan makes it likely that it would have done as well as Ohio" (1989, 17). Given the Ohio record I described earlier, this statement is not the high praise that Calomiris intended it to be.

The Soundness Criterion

The banking histories of the states that adopted mutual insurance plans are far from commendable. We can conclude, however, that if a state creates a monopoly or near-monopoly banking system with banks that make very few loans, take virtually no risks, become heavily involved in political maneuvering, concoct intricate means of avoiding accountability, and actively subvert other types of banks, then the banks created have a good chance of surviving.

Calomiris's conclusions about the effectiveness of the state bank system are widely shared. Indeed, most of the sources for the stories I have just told also conclude that the state bank system was a huge and noteworthy success. Why, then, do my conclusions differ so radically from the estimations made by previous examiners of this system?

An intriguing answer to this question can be inferred from Richard Sylla's (1971–72) discussion regarding the literature on the history of banking. Sylla argues that for a long time that literature was dominated by writers who interpreted the history of banking as a "quest for soundness." In this quest, banking systems that enhanced soundness were deemed successful, on both economic and moral grounds. A well-known by-product of the quest-for-soundness tradition was the received wisdom that free banking resulted in unmitigated disaster in the nineteenth-century United States.

This received wisdom on free banking has been seriously challenged of late by researchers (in particular Rockoff 1974, 1975) who have sloughed off the quest-for-soundness tradition. If soundness is the sole or even the main criterion by which a banking system is judged, then free banking was indeed truly disastrous. The new literature on free banking, however, considers more than simply the soundness of banks. When one includes issues such as whether the banking system enhances economic growth, free banking looks quite different.

So if Sylla is correct that earlier banking historians measured success solely by the soundness of a bank, then it is not surprising that they offered such enthusiastic commendations of the state bank system. That system was, if nothing else, sound. However, as people began to expect more from a bank than that it remain open for business, the criteria for a good banking system changed. The result has been a great deal of rethinking of the free-banking experience. The same sort of rethinking seems merited with regard to the state bank experience.

What, then, should we make of mutual deposit insurance? Insofar as the primary argument in favor of it thus far has been that it worked in antebellum Indiana, Ohio, and Iowa, as Calomiris's description of these systems shows, my more wide-ranging account here seriously weakens the case. The more complete record of these systems illuminates, for example, the monopoly nature of the banks, their negative effects on economic and financial development, and the political corruption they fostered. Nor is it clear that mutual deposit insurance was responsible for bank stability in these states. It is clear, however, that these systems contained many undesirable features and generated many undesirable outcomes. Mutual deposit insurance may or may not be a good policy, but the historical record of the state banking systems does not provide a prima facia case in favor of it.

Indeed, an examination of the state banking system could lead to a different policy conclusion than the one Calomiris and Ely reached. The experience of these states shows that governments should steer clear of cartelizing the banking system. The state banking system severely limited competition between banks, which retarded financial development. In this way, this system resemble the banking system set up after the bank failures of the Great Depression, when legislators limited bank competition in an attempt to make banks sounder. The system they created did promote soundness (bank failures fell dramatically), but at the cost of driving financial devel-

opment largely beyond the banking system (Short and Robinson 1998, 216–22). Recent legislation (such as the Gramm-Leach-Bliley Act) has begun to overturn Depression era banking laws, as legislators have realized that limiting bank competition produces undesirable outcomes.

Viewed in this way, the experience of the state bank system argues against allowing banks to form cartels in order to regulate and insure each other. Such collusion would be little more than another example of the goings-on famously described by Adam Smith:

> People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices. It is impossible indeed to prevent such meetings, by any law which could be executed, or would be consistent with liberty and justice. But though the law cannot hinder people of the same trade from sometimes assembling together, it ought to do nothing to facilitate such assemblies; much less to render them necessary. ([1776] 1976, 144)

As Calomiris has argued, it is useful for legislators to look to history to guide them in making laws. Obviously, it is important that the history consulted be complete and that the lessons drawn be in agreement with the complete record. Although ignoring the past may condemn us to repeat it, drawing the wrong lessons from history is scarcely any better.

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