

MOMENTS IN HISTORY

ECONOMIC INSIGHTS FROM THE HISTORY OF THE FEDERAL BANKING SYSTEM

The Value of Examiner Asset Classifications: Protecting Uninsured Depositors and Creditors Since 1863

**Roger Tufts, Department of Economics, Office of the Comptroller of the Currency, and
Graham Tufts, Department of Economics, University of Michigan, Ann Arbor**

Since the 1863 start of the national system of federally chartered banks, the examiners of the Office of the Comptroller (OCC) have evaluated the quality of bank assets to ensure the solvency of those institutions. For the 70 years prior to the creation of the Federal Deposit Insurance Corporation (FDIC) in 1933, these evaluations were an important means of protecting uninsured depositors and creditors from losses. By 1945, the OCC had overseen 2,808 liquidations of national banks placed into receivership.¹ Our analysis examines whether the classifications of assets in these insolvent banks reflected the ultimate losses borne by uninsured depositors and creditors.²

The Creation of the Office of the Comptroller

The nation was in a crisis in 1863 as the Civil War entered its third year. To fund the war effort, Congress had passed the Legal Tender Act in February 1862, authorizing the Treasury to print paper currency (called greenbacks owing to the color of the ink) that was not redeemable in specie; that is, the holder of a greenback could not present the note and ask to be paid in gold or silver coin.

Critics at the time asserted that Treasury's printing of paper money (and declaring it legal tender) was unconstitutional because the Constitution permitted the government to mint money made only of metal.³ Eventually, owing to the weight of the argument that the nation faced an existential crisis, the critics relented.

¹ This is the year in which the last receivership that was the OCC's responsibility finally ended.

² The views expressed in this paper do not necessarily reflect the views of the Office of the Comptroller of the Currency, the U.S. Department of the Treasury, or any federal agency.

³ During the American Revolution, the Continental Congress had only one method of raising revenue: seigniorage, i.e., printing money. This worked initially, with the new Continental dollars financing the creation of an army, navy,

Figure 1: Treasury Secretary Salmon Chase on the front of a \$1 greenback, 1862



Source: National Numismatic Collection, National Museum of American History, Smithsonian Institution.

Though a few series of greenbacks were authorized (\$150 million the first year, with about \$450 million by the end of the war), Treasury Secretary Salmon Chase understood that continuing to print large amounts of nonredeemable paper money would become untenable. Inflation had already begun to erode the purchasing power of those notes. Because raising taxes was politically unpalatable, the Treasury Department needed a mechanism that enabled it to issue bonds to pay for war expenditures while not disrupting the bond market with an oversupply of directly issued securities.

and marine corps. But the amount of currency issued more than doubled in the 18 months between the signing of the Declaration and the end of 1777, leading to a 70 percent decline in value. By 1779 a Continental dollar was worth only 3 cents, relative to its value in 1775. This devaluation was the origin of the phrase "not worth a Continental." (Ben Baack, "Forging a Nation State: The Continental Congress and the Financing of the War of American Independence," *Economic History Review* 54, no. 4, [November 2001]).

The solution to this fiscal dilemma was the creation of a national banking system. The National Bank Act's original name clearly explains the function of these new federally chartered institutions: "An Act to provide a national currency, secured by a pledge of United States bonds, and to provide for the circulation and redemption thereof." That is, the Treasury would not issue bonds directly to the market, where they might be badly received. Instead, banks would purchase the bonds (which they would hold as assets) and would issue paper currency bearing their name (as their liability). The interest-bearing Treasury bonds fully secured the national bank's paper currency and, therefore in effect, the bonds were indirectly issued to the market in the form of the non-interest-bearing paper currency of national banks. In addition, national banks were required to hold a specified proportion of their outstanding currency as a specie reserve so that note holders could redeem their paper notes for specie on demand. An example of a \$20 bank note is shown in Figure 2.⁴

Figure 2: First OCC Comptroller Hugh McCulloch on a note issued by the Mellon National Bank of Pittsburgh.



Source: Author's collection.

Receiverships Under the Purview of the Office of the Comptroller

In simple terms, national banks had four sources of funding. In order of seniority, those sources were

1. the holders of the bank's currency notes that were fully collateralized by U.S. Treasury bonds.
2. secured creditors.
3. uninsured depositors and other uninsured creditors.
4. the common stock owned by investors.

The OCC examined every national bank twice each year to confirm that they were solvent and had adequate reserves to clear checks drawn on depositors' accounts and to redeem notes.

⁴ Notes were required to be signed by a bank's cashier and president, originally by hand. By the early 1900s, when this note was printed, that requirement had become too burdensome and was waived. Hugh McCulloch, in his autobiography, *Men and Measures of Fifty Years*, complained of the many evenings he spent signing the notes of the State Bank of Indiana, where he was president before becoming the first Comptroller.

Should a bank not redeem its currency in specie when a note was presented for payment, the law stated that the bank would be placed into receivership and all its currency would be redeemed immediately. And as the newly established federal supervisor of the national banking system, that task fell to the OCC. The OCC would declare that the bonds securing the notes were forfeited to the U.S. Treasury, would then sell those bonds to other banks, and pay the holders of the failed bank's currency in full. After the currency holders were paid and the notes destroyed (first by burning and later by "maceration"), the OCC would sell the bank's assets to pay uninsured depositors and other creditors (after paying the receiver's expenses). Any amount left over would be returned to shareholders.

Of the 14,497 national bank charters granted from 1863 through 1945, the OCC was called upon to complete 2,808 liquidations. OCC annual reports issued between 1864 and 1938 (when the OCC stopped publishing information on asset classifications) have data on an examiner's evaluation and classification of the assets in a bank's portfolio at the start of the receivership, how much the receiver was able to sell the assets for, and how much uninsured depositors and creditors received by the conclusion of the receivership. Toward the end of the historical period of this review, the classification categories of "good," "doubtful," and "worthless" were changed to "other assets especially mentioned (OAEM)," "substandard," "doubtful," and "loss."⁵

By focusing on the data measuring classified assets recorded at the start of receivership, we can shed light on the question of whether these examiners' classifications reflected the amounts ultimately returned to depositors and creditors.

⁵ Effective July 1, 1938, the OCC, in coordination with the Federal Reserve and FDIC, revised its regulation defining classified assets. The regulation stated:

The present captions of the classification units, namely, "Slow," "Doubtful," and "Loss" are to be abandoned. The classification units hereafter will be designated numerically and the following definitions thereof will be printed in examination reports:

- I. Loans or portions thereof the repayment of which appears assured. These loans are not classified in the examination report.
- II. Loans or portions thereof which appear to involve a substantial and unreasonable degree of risk to the bank by reason of an unfavorable record or other unsatisfactory characteristics noted in the examiner's comments. There exist in such loans the possibility of future loss to the bank unless they receive the careful and continued attention of the bank's management. No loan is so classified if ultimate repayment seems reasonably assured in view of the sound net worth of the maker or endorser, his earning capacity and character, or the protection of collateral or other security of sound intrinsic value.
- III. Loans or portions thereof the ultimate collection of which is doubtful and in which a substantial loss is probable but not yet definitively ascertainable in amount. Loans so classified should receive the vigorous attention of the management with a view to salvaging whatever value may remain.
- IV. Loans or portions thereof regarded by the examiner for reasons set forth in his comments as uncollectible and as estimated losses. Amounts so classified should be promptly charged off.

Fifty percent of the total of III above and all of IV above will be deducted in computing the net sound capital of the bank.

In 1949, "II," "III," and "IV" were replaced with more descriptive terms of "substandard," "doubtful," and "loss." About 40 years after that, the evolution of loan classification definitions continued with Banking Circular 127 (Rev) issued in April 1991. That circular had the modern regulatory definitions for classified assets ("substandard," "doubtful," and "loss") and was followed by Banking Bulletin 93-35, issued in June 1993, which described the common interagency definition of OAEM.

Examiner Asset Classifications and the Losses to Depositors

The data on bank failures (both state and national banks) over the 70 years before the FDIC was established indicate that, expressed as a percentage of total commercial bank deposits, the losses incurred by the depositors were only \$0.16 per \$100 (less than a fifth of a percentage point).⁶ Even during crisis years, the loss rate for depositors averaged only three quarters of a percentage point of industry deposits.

However, expressing depositor losses as a percentage of total deposits obscures the fact that losses borne by a failed bank's depositors were much greater. More complete information on depositor losses at national banks was published in the OCC's annual report of 1940. From 1864 to 1940, the deposits in 2,815 failed national banks (plus a small number of nonnational banks) totaled \$2.37 billion. The OCC reported the volume of deposits in failed banks grouped by the proportion of funds returned to depositors as "dividends." Table 1 shows those proportions.

Table 1: Proportion of Deposits in Failed Banks⁷ Returned to Depositors, 1864 to 1941

| Proportion of deposits returned to depositor | Number of failed national (and District of Columbia) banks | Deposits of those failed banks (millions \$) |
|--|--|--|
| Greater than 100 percent | 536 | 725.5 |
| 75 to 99.9 percent | 686 | 742.0 |
| 50 to 74.9 percent | 749 | 543.5 |
| 25 to 49.9 percent | 484 | 268.8 |
| Less than 25 percent | 363 | 93.1 |
| Total | 2,818 | 2,373.1 |

Source: OCC 1941 annual report.

The data in Table 1 indicate that the proportion of deposits returned to depositors was frequently greater than 50 percent. The most fortunate depositors received their entire balance, often with interest, from 536 banks (or nearly 20 percent of the failures).

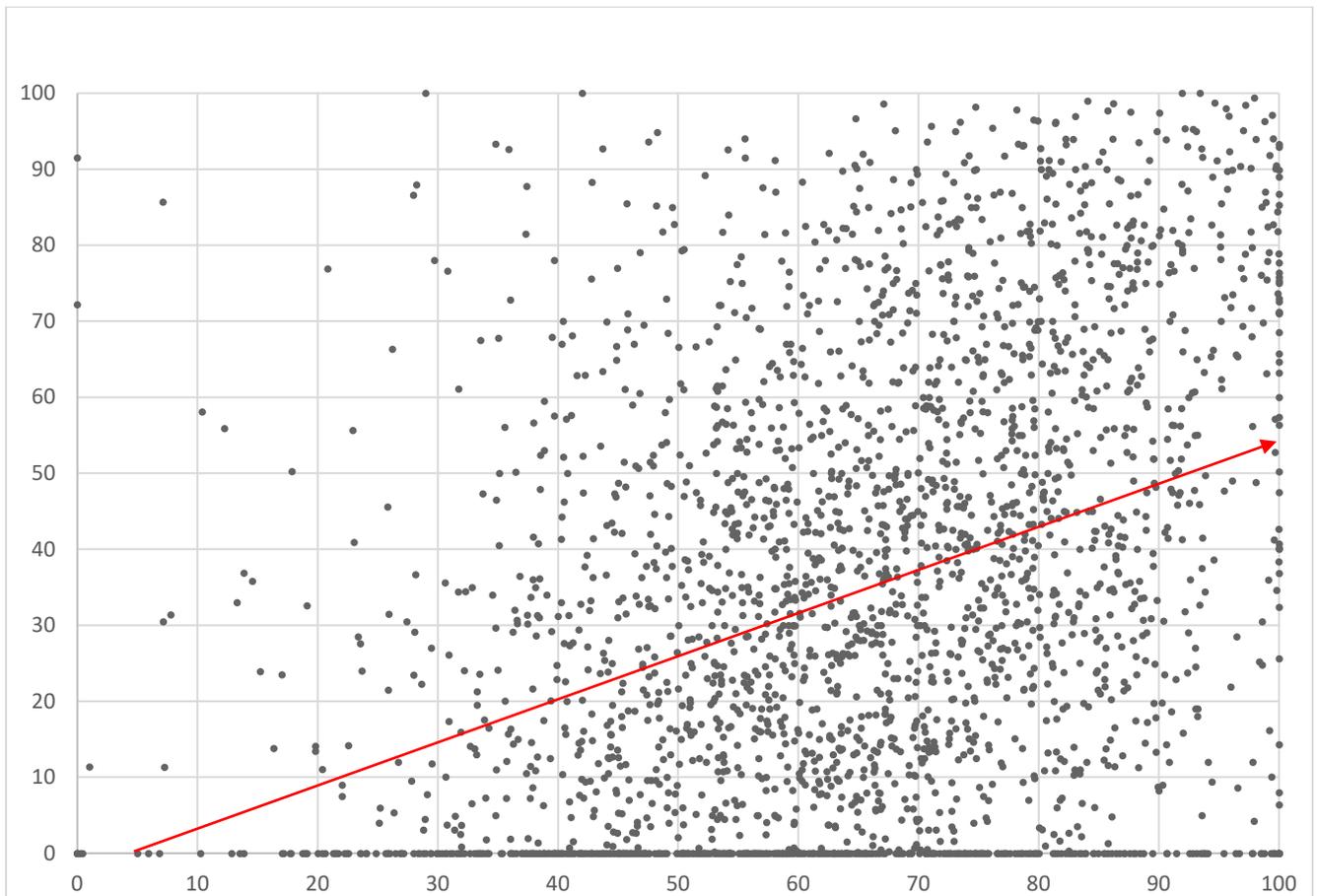
For 2,700 failed national banks, Figure 3 shows the correlation between examiners' estimates of assets classified as "doubtful" and "worthless" (on the horizontal axis) and loss severity, which is the proportion of depositors' funds that were not returned as dividends (on the vertical axis).⁸ Though "noisy," there is a strong statistical relationship between these two variables: classified assets and loss severity. The simple regression line (in red) suggests that a 10 percentage-point increase in classified assets was associated with a 5.5 percentage-point increase in loss severity. This result supports the conclusion that the depositors in the closed banks with higher proportions of classified assets suffered a higher percentage of losses on their deposits.

⁶ *Annual Report of the FDIC for the Year Ended December 31, 1940*, p. 69.

⁷ The data in this table include a small number of nonnational banks (i.e., District of Columbia institutions) that were insolvent and the receiverships were under the OCC's purview.

⁸ The count of bank failures in the Comptroller's 1945 annual report is higher than the number of data points in Figure 3. In contrast to Table 1 (which only reported loss severity), both the loss severity value and the bank's classified assets ratio were necessary if a receivership was to be included in Figure 3.

Figure 3: Correlation Between Classified Assets (X Axis) and Loss Severity (Y Axis)



Source: OCC annual reports from 1920 to 1945.

A particularly interesting feature of the data in Figure 3 is the large number of failures in which depositors suffered no loss. Of the 2,700 points in the plot, 546 (just over 20 percent of the failures) lie on the x axis.⁹ These 546 receiverships in which the depositors suffered no loss had a median classified assets ratio of 56 percent. In addition, the 25th percentile value of classified assets for this group was 43 percent and the 75th percentile value was 69 percent. Thus, half of the sample of failed banks, where depositors suffered no loss, had classified assets that fell between roughly 40 percent and 70 percent. More analysis might explain how such levels of classified assets did not cause any loss severity.

We have also reviewed data with respect to the outliers in the upper left portion of Figure 3 (with a low proportion of classified assets, but high depositor losses). In general, these banks were failures where

- the large majority of liabilities were secured creditors and little was left for depositors after those secured claims were paid;
- the OCC categorized the receivership as an “unfinished liquidation” and left the remainder of the work to the receiver (for example, to sell the assets and pursue the double liability assessment against the shareholders);

⁹ This is consistent with the data reported in Table 1.

- the receiver collected on a relatively small fraction of the assets classified as “good”; or
- the receiver collected a very low percentage of the shareholder double liability (often in the early years of the national banking system).¹⁰

Conclusion

We interpret the data discussed above to be significant evidence that OCC examiners have provided a valuable service to uninsured depositors and creditors since 1863. Though only partially correlated with depositor loss severities in individual bank failures, examiner assignments of “good,” “doubtful,” and “worthless” did reflect the extent of weakness in asset quality, and these assignments aligned with the dividends paid to depositors and creditors.

There are additional important factors affecting the loss severity imposed on depositors over this period that can be analyzed. The most important of these will likely be the extent to which the receiver collected on the double liability assessment that was pursued against the banks’ shareholders. This and the other factors such as the size, location, or date when the bank failed would be useful in shedding more light on the amounts depositors ultimately received. That analysis awaits.

¹⁰ Under double liability, the listed shareholders of a failed bank could be assessed an amount equal to their investment in that bank’s capital. Successful collections of shareholder assessments (i.e., a high proportion collected as a percent of the amount pursued by the receiver) would augment the values realized from the sale of the assets. Our initial review of this statistic indicates that there was significant variability across time and place in the receivers’ ability to collect on these double liability assessments.