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POLICY RESEARCH WORKING PAPER

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# Contingent Liability in Banking

## Useful Policy for Developing Countries?

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Could contingent liability  
systems play an important  
role in developing countries'  
banking systems?

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## Summary findings

Bank owner contingent liability has been important in the development of many industrial countries. Unlimited liability on bank owners was an important element in the success of Scottish banking, for example, and lasted until 1862, when banks were allowed to adopt a limited liability designation. As a result, Scotland was relatively free of the banking and monetary upheavals that occurred in Britain and the United States.

The unlimited liability provision effectively minimized the losses suffered by bank noteholders and other creditors. Actual losses from Scottish bank failures were well below those suffered by bank creditors in England. And Scottish banks were not prone to the bank runs and contagion effects typical of British and U.S. banks at the time. Scottish noteholders apparently had little incentive to “run” because of the effective coverage provided by unlimited liability.

Three factors were vital to the success of unlimited liability in Scotland:

- The identities of bank owners were made publicly available, and their level of wealth could be verified. So the degree of noteholder protection from liability could be assessed by adding up an owner’s wealth.
- Under Scottish bankruptcy law, owner liability extended to both personal and inheritable wealth. This intergenerational extension of liability expanded the bank creditors’ safety net.

- The transfer of ownership claims in private and provincial banks required that ownership first be dissolved before a new bank could be formed. This allowed the transfer of control to be monitored, minimizing adverse selection problems that might arise should ownership be transferred to people with less personal wealth.

A contingent liability system has three advantages:

- Because double liability imposes postclosure losses on bank stockholders, it increases incentives for banks to hold capital and decreases moral hazard incentives, such as a “go-for-broke” strategy.
- A contingent liability system can ameliorate asymmetric information problems between bank creditors and owners.
- Contingent liability can lead to more efficient capital formation if potential capital sources are predominantly in the form of fixed wealth, as is true in many developing countries.

But a free-rider problem arises when less-wealthy stockholders rely on the monitoring efforts of wealthier stockholders, who have more incentive to monitor. And in a free and anonymous exchange market, investors with less personal fixed wealth will outbid those with greater wealth, so the value of double liability could collapse over time, creating a role for supervisors to ensure that only credible bidders are allowed.

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# **Contingent Liability in Banking: Useful Policy for Developing Countries?**

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This paper was presented at a World Bank Seminar, "Financial History: Lessons of the Past for Reformers of the Present," and is a chapter in a forthcoming volume, Reforming Finance: Some Lessons from History, edited by Gerard Caprio, Jr. and Dimitri Vittas. The author wishes to thank the participants at that seminar and the editors for their comments.



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Bank owner contingent liability has been an important component in the developmental history of many industrial countries. For example, Scotland imposed unlimited liability on bank owners until 1862, when banks were allowed to adopt a limited liability designation. As a result, Scotland was relatively free of the banking and monetary upheavals that occurred in Britain and the United States. In addition, the United States conducted a long regulatory experiment with double liability, which started with the "free banking" movement in the early 1900s and was phased out as part of the post-Depression reforms of the 1930s.

Thus some form of contingent liability has been seen in the development of many industrial countries, suggesting that contingent liability systems might play an important policy role for many developing countries. This chapter traces the history of contingent liability in banking, with particular emphasis on Scotland and the United States. We discuss the potential advantages of contingent liability in a developing-country context as well as theoretical weaknesses and possible solutions.

We also argue that double liability and deposit insurance are not incompatible regulatory policies, even though federal deposit insurance was legislated in 1933 to replace double liability. In fact they coexisted prior to 1933—national bank notes carried a federal guarantee against loss at redemption. Further, in 1991 the Federal Deposit Insurance Corporation Improvement Act (FDICIA) legislated an early closure rule that was meant to impose greater regulatory discipline by enabling postclosure losses on bank stockholders, much as with double liability.

## **Unlimited Liability and Free Banking in Scotland**

White (1984) provides an extensive analysis of the history of unlimited liability in Scotland in the eighteenth and early nineteenth centuries. During this period Scottish banking featured a "free banking" approach with unregulated entry and a universal right to issue bank notes. In addition, unlimited liability to bank creditors was imposed on bank stockholders. Also during this period Scotland lacked a central bank, a national monetary policy, and formal bank supervision. Nonetheless, the economy developed from a largely agrarian to an industrial economy, without suffering the monetary upheavals and bank panics that characterized other developing countries at the time, such as Britain and the United States.

Unlimited liability of bank owners was an important element in the success of Scottish banking. The unlimited liability rule lasted until 1862, when banks were allowed to adopt limited liability. Throughout the first half of this history bank notes were the predominant form of bank liability, with deposit banking gaining in importance only as disposable income grew.

The unlimited liability provision effectively minimized the losses suffered by bank noteholders and other creditors. White (1984:41) reports that actual losses from Scottish bank failures were well below those suffered by bank creditors in England. In addition, Scottish banks were not prone to the bank runs and contagion effects that characterized British and U.S. banks at the time. Apparently, Scottish note holders had little incentive to "run" because of the effective coverage provided by unlimited liability. Scottish banks further reduced potential postclosure losses through branch banking and clearinghouse arrangements and through the lack of reserve pyramiding, which minimized spill-over effects. The low incidence of spill-over effects fostered competition among banks for the business of failed banks. Therefore the recycling of failed bank liabilities (that is, bank notes) was efficient, and the impact on the national money supply was minimized.

Three key factors were vital to the success of unlimited liability in Scotland. First, the identities of bank owners were made publicly available, and their level of wealth could be verified. Therefore the degree of noteholder protection from unlimited liability could be assessed by aggregating individual owner wealth. Second, under Scottish bankruptcy law bank owner liability extended to both personal and inheritable wealth. This intergenerational extension of liability expanded the safety net to bank creditors.

Finally, the transfer of ownership claims in private and provincial banks required that ownership first be dissolved before a new bank could be formed. This provision allowed the transfer of control to be monitored, minimizing adverse selection problems that might arise if ownership was transferred to people that held less personal wealth.

### **Double Liability in the United States**

Under double liability bank stockholders could lose twice on their bank investment. First, contributed capital was lost if the bank failed. Second, after a bank failure stockholders could be assessed up to the par value of their shares to satisfy creditor claims. The par value of extended liability was the "double" liability that bank stockholders faced. Initially, double liability was thought to provide adequate protection to bank creditors to cover most of their potential losses. Double liability became increasingly common in many states after 1837.

### *Bank Chartering*

Bank chartering in the new U.S. confederation began with the Bank of North America in Philadelphia, which was granted a perpetual charter in 1782 by the Continental Congress. The bank also issued the confederacy's first circulating paper money. Chartered banking subsequently developed rapidly, with

charters granted to the Massachusetts Bank (Boston) in 1784, the Bank of New York (New York City) in 1784, and the Bank of Maryland (Baltimore) in 1790.

During this early period in U.S. history banks were chartered by special legislative grants from individual states and the federal Congress. Charters were granted in limited supply and only by the chartering authority. This policy restricted access to banking in comparison to the free banking policies of Scotland. Bank charters were effectively grants of monopoly rights, which bank owners often protected by attempting to preclude the establishment of new banks in their area. Consequently, bank chartering became highly politicized, and in turn motivated the free banking movement in the early 1830s.

Valuable charters allowed banks to generate profits without excessive risk-taking, which gave banks an incentive to keep capital and reserve levels high to prevent regulatory loss of their charter. Saunders and Wilson (1995) call the resulting positive relationship between bank capital and charter value the "charter value hypothesis." Keeley (1990) provides evidence linking declining capital ratios to declining U.S. bank charter values since the 1960s, which, in turn, was linked to the deregulation of interstate banking restrictions. The conservative banking style induced by positive charter values also protected bank noteholders and other creditors from potential loss, much as unlimited liability did in Scotland at this time.

### *Free Banking*

Free banking in the United States originated in Michigan in 1837 and New York in 1838. One goal of this movement was to de-politicize the bank chartering process by allowing relatively free entry into banking. With entry came a large increase in the number of banks and greater competition among banks, allowing profits from banking to be shared more widely.

The increase in competition and erosion of charter values lowered incentives for banks to conservatively manage risk. "Wild cat" banking practices developed. Thus, it is not surprising that double liability had its roots in the free-banking period. Double liability offered bank creditors greater protection from loss and gave bank owners incentives to control risk-taking.

Several important features distinguished double liability from the unlimited liability practiced in Scotland. First, under double liability bank stock was, for the most part, freely traded by auction and by dealers in the United States, although many states required stockholders to be state residents (Klebaner 1992:14).

Second, stockholder liability was generally pro rata, implying that individual stockholders were not liable for the assessment shortfalls of other stockholders and were released from liability once their double liability was satisfied. This provision protected bank owners from each other, but lessened the incentives for bank owners to monitor other owners' wealth. The pro rata provision also made ownership claims more freely transferable, which created potential adverse selection problems.

### *National Banking Era*

Double liability was adopted for national banks when the National Banking Act of 1863 created a national banking system. The double liability provision was modeled on state statutes, and its adoption for national banks spurred further adoption by individual states. By 1930 only ten states had not adopted some variation of double liability. Colorado had adopted triple liability, and California banks were subject to unlimited liability.

During this period double liability coexisted with a federal guarantee of national bank notes. Bank notes were the predominate liability of national banks, much as in Scotland. Issuing banks were required to hold eligible Treasury bonds with the comptroller of the currency as collateral against their

note issue. If the bank failed and was closed, the comptroller would then pay off bank notes at par value, using the bonds held from that bank to satisfy claims. In addition, double liability assessments would be made against bank stockholders to defray any residual claims. Therefore, double liability and a federal guarantee of bank notes were used jointly to satisfy creditors. (In Scotland unlimited liability alone generally provided sufficient protection for bank liability holders.)

Although bank notes were the predominate form of bank liability during this period, deposit banking grew in importance, particularly as federal reserve notes replaced circulating bank notes after the creation of the Federal Reserve System in 1914. By the early 1930s deposits were the predominate type of bank liability. But depositors did not have the federal guarantee extended to bank noteholders, and therefore were only covered by double liability protection if the bank failed. As a final note, banks did hold collateral in the form of bonds against government deposits, which effectively made government deposit claims senior to general depositors.

### *The End of Double Liability*

The early 1930s witnessed the most severe banking and economic crisis in U.S. history. By 1933 most regulators realized that double liability had failed to protect depositors and foster a stable banking system. The federal guarantee afforded national bank notes had not been extended to depositors, despite several attempts to legislate federal deposit insurance since the Federal Reserve Act of 1913.

Accordingly, double liability was phased out and replaced by federal deposit insurance of bank deposits. The Banking Act of 1933 repealed double liability for all new common stock issues of national banks. The Banking Act of 1935 repealed double liability on existing shares of stock held by national banks as long as depositors were given six-months notice. States followed suit in repealing their own double liability statutes.

Double liability was abandoned for at least three reasons. First, it had failed to prevent bank runs and spill-over effects and provide banking stability, particularly during the 1930s. Second, double liability made recapitalization difficult during the 1930s. Previous panics were shorter and economic recovery occurred sooner, making recapitalization easier. The length of the recession in the 1930s and the nationwide scope of the banking crisis made bank stock that carried double liability difficult to issue. Therefore, double liability relief made sense at least temporarily, in that banks could recapitalize. Finally, it was felt that the double coverage of both federal deposit insurance and double liability was unnecessary, even though a form of double coverage—the federal guarantee of national bank notes—had existed earlier.

### **Advantages of Contingent Liability Systems**

A contingent liability system has three advantages. First, because double liability imposes postclosure losses on bank stockholders, it increases incentives for banks to hold capital and decreases moral hazard incentives, such as a "go for broke" strategy. Second, a contingent liability system can ameliorate asymmetric information problems between bank creditors and bank owners. Third, contingent liability can lead to more-efficient capital formation if potential capital sources are predominately in the form of fixed wealth, which is the case in many developing countries.

#### *Amelioration of Moral Hazard Incentives*

Banking systems operating under limited liability can be plagued by moral hazard problems and "go for broke" incentives, as shown by the large losses with the thrift crisis during the early 1980s. In contrast, the postclosure losses imposed under a contingent liability system (such as double liability) give banks, particularly financially distressed banks, incentives to hold more capital and to control risk-taking.

There is some evidence that double liability fostered a more conservative banking system. Macey and Miller (1992) argue that voluntary liquidation by banks was more common during the double liability period and minimized depositor and stockholder losses. In contrast, the current U.S. system of limited liability and fixed-rate deposit insurance gives bank stockholders fewer incentives to liquidate voluntarily, and the FDIC has become the major vehicle for recycling failed bank assets.

For example, between 1863 and 1912 there were 525 bank closures and 2,357 voluntary liquidations, indicating a high rate of asset recycling before bank failure occurred. Between 1913 and 1928 there were 125 national bank failures and 2,072 voluntary liquidations. Finally, during 1929-33 there were 1,280 national bank failures and 1,343 voluntary liquidations. These numbers suggest that bank failures might have been much more prevalent during the Great Depression without double liability.

Losses to national bank depositors during the double liability period averaged only 44 cents per thousand dollars of deposits (Macey and Miller 1992). In contrast, FDIC losses in 1985 equaled approximately \$1.20 per thousand dollars of bank deposits. Therefore, losses during the double liability period were fairly conservative.

#### *Sources of Bank Management Discipline*

As argued above, double and unlimited liability increased regulatory discipline on banks by imposing postfailure losses on bank stockholders. In addition, bank depositors and other creditors exerted discipline on bank management by requiring risk-based premiums for deposits and making the ominous bank run threat. But because liquidating bank assets to quell a bank run was potentially costly, bank runs could even threaten the solvency of solvent banks.

Both depositors and stockholders were sources of management discipline. An asymmetric information problem could arise between these groups. Typically, most bank depositors were thought to be uninformed about the true solvency of the bank. These uninformed depositors based withdrawal decisions on imperfect signals of bank solvency, such as long withdrawal lines. In contrast, informed depositors, such as large corporate depositors, could quickly withdraw funds if bank solvency was threatened. Because of this information asymmetry, double liability imposed the greatest threat of loss on those stakeholders most informed about the bank's condition—the stockholders.

One goal of federal deposit insurance in 1933 was to protect and stand in for uninformed depositors by limiting initial deposit insurance coverage to \$5,000. But because the rate charged to banks for deposit insurance coverage was fixed (non-risk based), it introduced the well-known moral hazard problem of deposit insurance. Arguably, if double liability had been retained as a complement to federal deposit insurance, the regulatory discipline of double liability would have offset the moral hazard incentives introduced with deposit insurance. Indeed, double liability had coexisted with the blanket federal guarantee of national bank notes without the moral hazard problems that arose in the 1980s with deposit insurance.

### *Capital Formation Advantages*

Contingent liability may allow more efficient capital formulation in developing countries if capital is mostly fixed wealth. In this case contingent liability can be viewed as a form of off-balance sheet capital (for example, land and other fixed assets), available to creditors if the bank closes. Arguably, off-balance sheet capital may be of equal or greater value to liability holders compared with on-balance sheet capital for several reasons. First, book asset values may not accurately reflect market asset values, while off-balance sheet capital may be easier to value. In addition, off-balance sheet capital may be of

higher quality than on-balance sheet capital if its value is less volatile. Finally, off-balance sheet capital may diversify the bank's asset portfolio and thereby reduce expected creditor losses.

Allowing part of a bank's capital to be held off-balance sheet may have other advantages. Because wealth in many developing countries is locked up as fixed assets, capital formation may be difficult and costly in that it would require costly liquidation of fixed assets, which would reduce available on-balance sheet capital. Therefore double liability enables a more efficient use of assets to form capital and attract depositors. Winton (1993) presents a formal proof of these assertions.

### **Free-Rider and Adverse Selection Problems**

Despite the advantages discussed above, contingent liability systems are also prone to adverse selection and moral hazard problems.

Stockholders' efforts to monitor management increases the equity value of the bank by increasing manager discipline. In addition, contingent liability increases the value of monitoring management performance. But because of decreasing returns to scale, monitoring incentives are greatest for the wealthiest stockholders. A free-rider problem thus arises in that less-wealthy stockholders will rely on the monitoring efforts of wealthier stockholders, who then bear the monitoring expense.

An adverse selection problem also arises when ownership claims can be freely and anonymously traded. Ownership claims have greater value to investors with less personal wealth because they have less to lose if the bank fails. In a free and anonymous exchange market investors with less personal fixed wealth will outbid those with greater wealth, and consequently the value of double liability will collapse through time. Eventually, the bank stock will be owned by investors with no fixed wealth, and double liability will erode to limited liability.

Furthermore, bank creditors have incentives to monitor the erosion of double liability. As erosion occurs, creditors will demand higher premiums as compensation for bearing greater risk. Ultimately, the erosion of double liability and the cost of higher premiums are born by owners who do not sell their claims. A transfer of wealth is thus created from nonselling to selling owners, giving rise to incentives to regulate ownership transfer.

Transferring ownership claims in Scotland required that the entire partnership be dissolved and then reformed. Dissolving the partnership allowed new owners to be evaluated and either approved or disapproved. In addition, the unlimited liability did not fully transfer with the change in ownership. Selling owners remained liable for a period after ownership transfer. These devices helped to prevent adverse selection problems and the erosion of unlimited liability protection.

In contrast, in the United States bank ownership shares could be freely and anonymously traded. But other devices were potentially useful for preventing erosion of the double liability claim. For example, bank stock during this period was relatively expensive compared with current bank stock prices, particularly when adjusting for inflation. Typical bank stock prices ranged from hundreds of dollars to thousands of dollars per share. In contrast, current U.S. bank stock prices range from \$20 to \$40. These high prices restricted bank ownership to wealthy individuals.

In addition, during this period bank stocks were thinly traded with large bid-ask spreads, implying that ownership claims were relatively expensive to trade. Bid-ask spreads in the range of 10 to 30 percent were common, implying that owners sold at, for example, a 30 percent discount relative to buyers, with the spread paying for inventory and transaction costs of the broker.

Because of high underwriting and other issue costs, most new stock issues took the form of subscription rights to current bank stockholders. Rights offers tended to further concentrate ownership

with current stockholders. Finally, many banks served as their own transfer agents and maintained stockholder lists. Therefore, ownership information was readily available to bank insiders.

There were thus implicit restrictions on ownership transfer during the double liability period, in terms of high stock prices and high bid-ask spreads. Rights offers also tended to keep ownership concentrated. As a result, banks tended to be closely held, with bank management also serving as major stockholders. The benefits of being closely held were seen in reduced agency costs.

### **Empirical Results**

Saunders and Wilson (1995) examined two measures of bank performance: the market-capital ratio—the ratio of market equity value (price per share times the number of shares) divided by the market value of assets (market equity value plus book value of debt)—and bank charter value—the ratio of the market value of assets to the book value of assets—which reflects expected future monopoly rents (table 6.1).

Capital ratios were approximately twice as high prior to 1933, when double liability was imposed, than after 1933. These high capital ratios reflected both the market discipline imposed by uninsured depositors and that imposed by stockholders under double liability. The reason for the decline in capital ratios after 1933 is somewhat ambiguous, since the reforms of the 1930s included both the repeal of double liability and the advent of deposit insurance, as well as a host of other reforms such as the Glass-Steagall Act.

Comparing the peak charter value measures both prior to and after deposit insurance, we see an overall decline. Therefore the regulatory costs of double liability and the limitations faced by banks during this earlier period, such as high underwriting costs, did not adversely affect their estimated charter values.

Finally, Saunders and Wilson (1995) find that the decline in bank capital ratios after the 1930s was, for the most part, not linked to the decline in charter values during this period. The authors theorize that the change in incentives with the elimination of double liability and advent of federal deposit insurance had a larger impact on bank capital structure decisions.

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**Table 6.1**

**Comparison of Peak Capital and Charter Value Ratios Before and After  
Federal Deposit Insurance, 1933**  
(percent)

<b>Period</b>	<b>Peak market- capital ratio</b>	<b>Peak charter value</b>
<b>Pre-1933</b>	27.9 (1902)	1.16 (1902)
	27.7 (1929)	1.19 (1928)
<b>Post-1933</b>	13.4 (1961)	1.09 (1961)



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