Shaping the American Economy

The US Banking System: Origin, Development, and Regulation

by Richard Sylla

Currency note of one shilling, six pence, printed in the colony of New Jersey in 1776. (Gilder Lehrman Collection)

Banks are among the oldest businesses in American history—the Bank of New York, for example, was founded in 1784, and as the recently renamed Bank of New York Mellon it had its 225th anniversary in 2009. The banking system is one of the oldest, largest, and most important of our industries. Most adult Americans deal with banks, often on a fairly regular basis. Nonetheless, banks and banking seem rather mysterious. What do banks do? Why have they for so long been an integral part of our economy? Why, as in the financial crisis that commenced in 2007, do banks every so often get into trouble and create serious problems for the country?

Banks have two important economic functions. First, they operate a payments system, and a modern economy cannot function well without an efficient payments system. We make most of our payments by writing checks, swiping credit cards issued by banks or tied to them, and by paying bills via online banking. Most of the money stock of the country is in fact bank money; the rest of the currency is "legal tender" issued by the government, namely Federal Reserve Notes and coins. We have confidence in bank money because we can exchange it at the bank or an ATM for legal tender. Banks are obligated to hold reserves of legal tender to make these exchanges when we request them.

The second key function of banks is financial intermediation, lending or investing the money we deposit with them or credit they themselves create to business enterprises, households, and governments. This is the business side of banking. Most banks are profit-seeking corporations with stockholders who provide the equity capital needed to start and maintain a banking business. Banks make their profits and cover their expenses by charging borrowers more for loans than they pay depositors for keeping money in the bank. The intermediation function of banks is extremely important because it helped to finance the many generations of entrepreneurs who built the American economy as well as the ordinary businesses that keep it going from year to year. But it is inherently a risky business. Will the borrower pay back the loan with interest? What if the borrower doesn't repay the loan? What happens to the banking system and the economy if a large number of borrowers can't or won't repay their loans? And what happens if, in the pursuit of profit, banks do not maintain levels of reserves and capital consistent with their own stability?

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There were no modern banks in colonial America. Colonial Americans gave credit to each other, or relied on credit from merchants and banks in Great Britain. Money consisted of foreign coins and paper money issued by the governments of each colony.

There were no American banks as late as 1781, when young Alexander Hamilton, who would become the most financially astute of the founding fathers, wrote to Robert Morris, Congress's superintendent of finance, that "Most commercial nations have found it necessary to institute banks and they have proved to be the happiest engines that ever were invented for advancing trade." Hamilton recommended that a bank be founded, and a few months later Morris persuaded Congress to charter the new nation's first bank, the Bank of North America located in Philadelphia. Three years later, Boston merchants founded the Massachusetts Bank and Hamilton became a founder of the Bank of New York. When George Washington became our first president under the Constitution in 1789, these were the only three banks in the United States. They were local institutions, not part of a banking *system* in which banks routinely receive and pay out one another's liabilities.

Washington tapped Hamilton to be our first secretary of the treasury. In his first two years in office Hamilton moved quickly, and often controversially, to give the United States a modern financial system. He implemented the federal revenue system, using its proceeds to restructure and fund the national debt into Treasury securities paying interest quarterly. He defined the US dollar in terms of gold and silver coins; these would serve as reserves backing bank money as banks proliferated. And Hamilton founded a national bank, the Bank of the United States (BUS), a large corporation capitalized at $10 million, with 20 percent of its shares owned by the federal government and with the power to open branch banks in US cities.

Hamilton's policies induced others to fill out the other major components of a modern American financial system. The BUS prompted state legislatures to charter more banks—there were about thirty of these by 1800, more than 100 by 1810, 500–600 by the 1830s, and 1500–1600 on the eve of the Civil War. These banks were corporations, and the states also chartered many non-bank business corporations. Active securities markets emerged in the early 1790s when some $63 million of new US national debt securities and $10 million of BUS stock stimulated the development of trading markets in a number of cities and the establishment of stock exchanges in Philadelphia and New York. A distinctly modern US financial system did not exist in the 1780s but was firmly in place by the mid-1790s, after which it expanded rapidly to serve, even foster, the rapid growth of the US economy. The banking system was a key component of it.

Since most banks were business enterprises chartered by state legislatures, banking became highly politicized. A party in control of the legislature would grant bank charters to its backers and not those of the other parties. Banks also became sources of revenue: state governments invested in banks and earned dividends from them, they charged banks fees for granting charters of incorporation, and they taxed them. Individual legislators accepted bribes to help some banks get charters and to prevent other banks from getting them. By the 1830s, to get away from the politicization and corruption involved in legislative chartering, a few states began to enact "free banking" laws. These general incorporation laws made the granting of bank charters an administrative rather than a legislative function of government. This increased the access of Americans to banking. The result of free banking, according to banking historian Bray Hammond, was that "it might be found somewhat harder to become a banker than a brick-layer, but not much."

The BUS, the national or central bank, also proved to be politically controversial. Some thought it was unconstitutional and a threat to states' rights. Many state bankers resented its ability to compete with them, to regulate their ability to make loans, to branch across state lines, and to have the federal government's banking business to itself. When the BUS's charter came up for renewal in 1811, it was defeated by the narrowest of margins when the vice president broke a tie vote in the Senate. That weakened the ability of the government to finance the War of 1812. In 1816 Congress therefore chartered a second BUS, an even larger corporation than the first.

History repeated itself in the early 1830s when, after both houses of Congress voted to re-charter the BUS, President Andrew Jackson vetoed the bill and his veto could not be overridden. The second BUS, like the first, did a good job of regulating American banking and promoting financial stability. But Jackson thought it had too many privileges and was too friendly to his political opponents. The BUS federal charter expired in 1836. The United States would not again have a central bank until 1914 when the Federal Reserve Act went into effect.

Without a central bank to provide oversight of banking and finance, the expanding banking system of the 1830s, 1840s, and 1850s suffered from some major problems, even as it supplied the country with ample loans to finance economic growth. One problem was financial instability. Banking crises occurred in 1837, 1839–1842, and 1857, years when many banks had to suspend convertibility of their bank notes and deposits into coin because their coin reserves were insufficient. A good number of these banks failed or became insolvent when borrowers defaulted on their loan payments. The banking crises led to business depressions with high unemployment.

Another problem was a chaotic currency. In those days, the government provided only coins. Paper money—bank notes—was issued by just about every individual bank. By 1860 there were 1,500–1,600 such banks, most of which issued several denominations of notes. Hence, throughout the United States there circulated about eight to nine thousand different-looking pieces of paper, each with the name of a bank on it and a number of dollars which the named bank promised to pay in coin if the note were presented to it. It was costly, of course, to return a note of, say, a Georgia bank received in New York to the bank in Georgia, so such notes circulated at discounts the farther they were from the issuing bank. Note brokers earned a living by buying bank notes at a discount and returning them *en masse* to the issuing banks for payment in coin. This was not an efficient payments system for an expanding economy. Moreover, it was one in which counterfeiting of bank notes thrived because with so many different-looking notes in circulation, it was hard to tell a real one from a fake.

Abraham Lincoln's Union government during the Civil War solved the problem of a chaotic currency and at the same time the more pressing problem of how to finance the war. The solution, introduced in 1863, was to get the federal government back into the business of chartering banks. The new national banks, like free banks under earlier state laws, would issue a uniform national currency printed by the government and backed by US bonds. National banks had to purchase the bonds to back bank notes they issued, making it easier for the Lincoln administration to sell bonds and finance the war against the Southern confederacy. National bank currency would be safer than state bank notes—if a bank defaulted or failed, the US bonds backing them could be sold to pay off holders of the failed bank's notes. In effect, national bank notes were a liability of the federal government, not the bank. Discounts on bank notes, a problem of the previous era, disappeared, improving the national payments system.

The intent of the National Bank law was that the old state banks would convert to national charters. But not all of them did, so Congress in 1865 passed a prohibitive tax on state bank notes. That ended the issue of state bank notes. But it did not end state-chartered banking because many state banks could continue as deposit-taking banks without issuing notes. Shortly after the Civil War most US banks were national banks. But by the end of the nineteenth century, state banking had recovered sufficiently to rival national banking. The United States had what came to be called a "dual banking system" of national and state banks, and the system persisted into the twenty-first century. National bank notes, however, disappeared

in the 1930s, replaced by today's national currency, Federal Reserve Notes.

During the half century from 1863 to 1913, the country continued to be without a central bank. It had a uniform national currency and a better banking system than the one before 1863, but it was still prone to financial instability. Banking panics occurred in 1873, 1884, 1893, and 1907. The last was especially embarrassing because by 1907 the US economy was the largest in the world, as was the US banking system. There were about 20,000 banks in 1907, and there would be 30,000 by the all-time peak in the early 1920s. US bank deposits were more than a third of the total world deposits, and approximately the same as the combined deposits of German, British, and French banks, the next three largest systems. The European countries had central banks—bankers' banks—that could lend to banks under stress, and as a result they had fewer banking crises than did the United States.

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So in 1913, after three-quarters of a century without a central bank and a period punctuated by a number of banking crises, Congress created a new central bank, the Federal Reserve System (the Fed). The Fed was organized in 1914, and by the end of the year the twelve regional Reserve Banks, coordinated by the Federal Reserve Board in Washington, DC, were open for business. The new system was a decentralized central bank in keeping with the long American tradition of not wishing to have concentrated financial power in either Wall Street or Washington, DC.

The Fed further improved the payments system by operating a national check-clearing system. It also introduced Federal Reserve Notes, which gradually replaced national bank notes and Treasury-issued currency, making the national currency still more uniform. The Fed also had the power to expand and contract its currency and credit, which served to reduce seasonal fluctuations in interest rates, enhancing economic stability.

As we know from recent experience, the Fed did not eliminate banking crises. But crises were far less frequent than when there was no central bank. Indeed, there have been only two major banking crises in ninety-six years, 1930–1933 and 2007–2009. Or possibly three if we add the savings-and-loan (S&L) crisis of the 1980s, although S&Ls at the time of the crisis were not considered to be banks and had their own set of regulators. (In the wake of that crisis the S&Ls that survived essentially became banks.) Earlier in US history, in the forty years when the two Banks of the United States existed, there was only one banking crisis, in 1819. Compared to the seventy-eight-year period from 1836 to 1914, which witnessed seven banking crises, the two eras of central banking look pretty good: a crisis once every thirty to forty years on average, instead of once every eleven years. The presence of a central bank with a mandate to lend to solvent but illiquid banks and to the money and capital markets in times of stress enhanced financial stability and reduced the incidence of banking crises.

The Fed, however, rather infamously did little to prevent the failure of thousands of US banks in the period 1930–1933, a lapse that contributed to making the Great Depression of the same years the worst economic slump in American history. The reasons for the lapse are still not clear. Some historians contend that decisive action to prevent the contagious failure of so many banks was impossible because the leadership of the Fed was weak and divided. The Board in Washington disagreed with some of the regional Reserve Banks on what actions to take, and the regional banks disagreed with one another. Others say that the Fed thought it had to defend the convertibility of the dollar to gold, which led it to contract rather than expand credit during critical periods of the slide into the Great Depression.

In the wake of the Depression, President Franklin Roosevelt's "New Deal" administration sponsored a number of important banking reforms. Roosevelt's first action in March 1933 was to close all of the nation's banks, the so-called Bank Holiday, and then he assured the nation that when banks re-opened the public would not have to worry about their solvency. The Banking Act of June 1933, often called the Glass-Steagall Act because of its chief congressional sponsors, introduced federal deposit insurance, federal regulation of interest rates on deposits, and the separation of commercial banking from investment banking. The Banking Act of 1935 essentially created the Fed as we know it today. It strengthened the central bank's powers and made them less decentralized than they had been during the Fed's first two decades.

New Deal banking reforms ushered in a long period of banking stability lasting from the 1930s to the 1980s. That stability, however, was purchased at the cost of making American banking less competitive, less innovative, and more regulated than it had been before the 1930s. It became increasingly clear by the 1960s and 1970s that heavily regulated commercial banking was losing market share in finance to the less regulated and more innovative institutions and markets of Wall Street. An example of this was the money market mutual fund. It provided depositors with the option of earning the high, unregulated interest rates of Wall Street's money market instruments instead of the lower regulated rates that could be paid by commercial banks and S&Ls. That led bank depositors to withdraw funds from the banking system and place them in money market funds, a process called "disintermediation." The markets of Wall Street gained, and the banking system became a smaller and smaller component of the overall financial system.

Banks and their political supporters responded by calling for deregulation. The New Deal's ceilings on deposit interest rates were repealed in the 1980s. So were some of the regulations that prevented S&Ls from competing with banks. Congress removed long-standing restrictions on interstate banking in 1994. Bank mergers, once suspect for reducing competition, were increasingly allowed. Today the country has far few independent banks than in the past, about 8,000. But many of the remaining banks have a large number of branches and even more ATMs. Americans now are never

very far from a banking facility.

In 1999, Congress repealed the Glass-Steagall Act that had effectively separated commercial and investment banking. The business of banking, long stifled by regulation, suddenly became more exciting. Increasingly, banks were not limited in their lending by the size of their deposit bases. They could obtain more funding to make more loans and purchase new forms of securities by accessing the Wall Street and international money markets.

In retrospect deregulation may have led banking to become too exciting for its own good and that of the country. In the early 2000s, cheap credit led to a housing and commercial real estate boom that turned into a bubble. Assuming—contrary to historical experience—that home prices could not go down, banks and other lenders made numerous mortgage loans on liberal and increasingly innovative terms. They also increased their investments in mortgage-backed securities created by Wall Street banks. When, in the middle of the decade, house prices stopped rising and began to fall, increasing numbers of borrowers defaulted on their mortgage loans, causing steep drops in the values of mortgage-backed securities.

Banks holding mortgage loans and mortgage-backed securities were in trouble. The decline in the value of the assets—the loans and securities on their balance sheets—threatened to wipe out their capital and make them insolvent. Unlike the 1930s, depositors did not panic and rush to withdraw their funds from banks because now they were protected by federal deposit insurance. But money market lenders had no such insurance, and they began to refuse to lend to the banks. In 2007, and even more in 2008, market funding for banks dried up. Only massive interventions by the Fed and the US Treasury prevented a catastrophic banking and financial crisis on the order of that of the early 1930s. As we know, the crisis has been a bad one. But it could have been a lot worse if the Fed and other financial authorities had acted as they did in the Great Depression.

As this is written, Congress is in the process of reconciling differences between the financial reform bills that the House and Senate have passed. The outcome will lay the groundwork, as did the 1930s banking reforms, for the next chapter in the long history of the American banking system. Like the reforms introduced during the Lincoln administration in the 1860s and the Roosevelt administration in the 1930s, the reforms that are now emerging under the Obama administration are sure to increase government oversight of the banking system. But if history is any guide, these reforms will not put an end to banking crises.

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METADATA

Era: The New Nation, 1783-1815, The Great Depression and World War II, 1929-1945, Civil War and Reconstruction, 1861-1877, The Progressive Era to the New Era, 1900-1929, National Expansion and Reform, 1815-1860, The Rise of Industrial America, 1877-1900, 1945 to the Present

Sub Era: Creating a New Government, The Great Depression, The American Civil War, The Early Republic, The New Deal, The Politics of Reform, The Age of Jackson, The Age of Jefferson and Madison, The Gilded Age, Facing the New Millennium

Theme: Economics, Government and Civics, Reform Movements

Curriculum Subject: Economics, Government and Civics

Grade Level: 9, 10, 11, 12, 13+

Keywords: Banking, banking panics, corporations, depressions, deregulation, disintermediation, dual banking system, Federal Reserve notes, Finance, Great Depression, money, National Debt, Regulation, securities, stock

Coverage People: Alexander Hamilton, Andrew Jackson, Robert Morris

Coverage Events: Bank Holiday, Banking Act of 1935Banking Act of June 1933, Federal Reserve Act, Glass-Steagall Act, Great Depression, savings-and-loan crisis

Coverage Organizations: Bank of New York, Bank of North America, Bank of the United States, Fed, Federal Reserve Board, Massachusetts Bank, Wall Street