

*State Banking*  
AND *the Dawn* OF *the*  
*U.S. Economy*



THE STATE BANK.

By: *Tim Todd*



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# Foreword

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The consolidation of the United States' banking system has been nearly continuous during my 35-year career with the Federal Reserve. Today, with around 5,000 institutions, our nation has less than one-third of the number of banks that we had when I started at the Fed as a young bank examiner in 1982. Across this period, we have seen the largest 20 banks grow to the point that they hold around 80 percent of all industry assets while the share held by community banks has been eroded from 45 percent in 1982 to only 13 percent today.<sup>1</sup>

Living and working in a region where small banks are major providers of credit, I have for some time been concerned about this trend. Community banks hold more than 40 percent of the industry's small loans to businesses and there are indications that the lending to small businesses may be even more substantial than previous data has suggested.<sup>2,3</sup> Beyond businesses, these banks are also the key providers of farm credit and lend importantly for commercial real estate and residential home purchases.

It has been my view that our nation's economy has benefitted enormously from a diversity of banking institutions providing financial services to the full range of American families and businesses. The consolidation of these services into the hands of a relatively small number of institutions, I believe, may have a significant negative effect on our economy in the medium and long run, particularly as it relates to the access to capital. It is also a trend that is very much at odds with the traditional American values related to the consolidation of power and influence.

With discussions continuing regarding the factors that may have contributed to this trend, and questions about the path forward, it is our hope that a history of the earliest days of the United States banking system may prove a worthy contribution to the ongoing and important dialogue.

While other countries may accept a banking system composed of only a few large banks, Americans at the time of our nation's founding and in the years that followed very clearly recognized the value of having banks firmly planted within their communities that were serving their needs. The resulting system, including institutions of various sizes and chartered by both state and federal authorities, I believe, has been very much to our national benefit. Importantly, this decentralized structure has allowed for the experiments, and

1. *Measured by assets.*

2. *FDIC Quarterly, Second Quarter 2017.*

3. *"Community Bank Small-Business Loans Are Undercounted: FDIC survey." American Banker. Nov. 1, 2017.*

sometimes the failures, that are necessary in creating the efficient, dynamic financial system that was the foundation for creating in the United States the world's most vibrant economy. This is successful capitalism. Before we allow this structure to fade we may be well served to understand and more fully appreciate its roots.

A handwritten signature in black ink, reading "Esther L. George". The signature is written in a cursive style with a large, prominent "E" and "G".

Esther L. George  
President and Chief Executive Officer  
Federal Reserve Bank of Kansas City



*Recent years have seen not only regulatory reform but discussions about the overall structure of the United States' banking system.*

# Introduction

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The post-2008 era has been awash in proposals seeking to improve the stability of the U.S. financial system. While the Dodd-Frank Wall Street Reform and Consumer Protection Act approved in 2010 made the most sweeping reforms since the Great Depression, discussions about additional changes, or rolling back some of the Act's provisions, began almost immediately.

The “financial system” is a broad territory. It encompasses institutions, markets, services and instruments, each of their own size, scope and risk potential. While recent years have seen a large number of innovations in each of these areas, traditional banks remain at the foundation of this system, offering a range of services including, importantly, serving as a necessary source of credit for many individuals and businesses.

Given this critical role, the banking system has understandably received significant attention within the reform discussions. While there are many aspects worthy of exploration, a couple of issues often are raised regarding the structure:

- Some have suggested that the United States would be better served without what is known as “dual banking.” Under this system, banks are able to be chartered by either the federal government or by their respective states. Critics say this system, in use more than 150 years, has outlived its usefulness.
- Another discussion has focused on the large number of community banks in the United States. These banks primarily are in rural areas or serve specific communities within large cities. Critics argue that these institutions may be more vulnerable to issues associated with concentration risk and have only a limited capacity for diversification when compared against larger banks.

These questions are far from settled and the list of supporting evidence and counter-arguments is lengthy.

Those seeking to reduce the number of institutions and curb state banking often point to Canada, where the banking system is the purview of a handful of large institutions, which has a long record of financial stability.

Others believe the current U.S. system, encompassing both small and large institutions,

has contributed significantly to making the United States home to the world's largest and most diverse economy. While very large banks may be able to offer a wide range of services, they note that smaller community banks have been a key source of capital for budding entrepreneurs and small businesses. Meanwhile state-chartered banks, operating under state regulation, have been the source of numerous innovations, including interest-bearing checking accounts and the installation of the country's first automated teller machines.

Amid discussions of these issues, it may be helpful to consider some of the relevant early history of the U.S. banking system, which can reveal a couple of fundamental issues influencing the development of the earliest state and community banks and which, in many ways, remain unsettled today:

### *Access to credit*

While each state had its own particular trials and challenges, as the sketches of individual state experiences in this brief history attempt to make clear, a core issue in almost every case was a demand for credit from those who did not have access to the financial system. How the individual states sought to meet these needs through innovations at the local level provides an example of one of the strengths of the dual banking system – allowing states to act as something of an incubator for solutions.

### *The rejection of consolidated power and influence*

Skepticism about the motivations of those with power can be traced to the authority Old World institutions wielded over the colonists. Within the United States, the first banks may have been the earliest U.S. institutions to receive a skeptical eye from their fellow Americans, because the banks served almost exclusively those who were wealthy, engaged in mercantile activity and lived in Atlantic Coast cities. As early as the 1800s, those living in what later would become known as “flyover country” were seeking ways to mitigate the power and influence of the East Coast, and East Coast banks, on their lives. Local banks were one way to perhaps limit not only the bank influence, but also the reach of the federal government.

While the current era of dual banking did not begin until the creation of national banks in the 1860s, a brief consideration of the events in this earlier period may provide some perspective on the dawn of American finance that might be beneficial to those seeking a more comprehensive understanding of this structure.

*Note: This volume focuses on issues related to the establishment of the early banking system, but is not a comprehensive history of banking in the United States. As such, while it does include a discussion of numerous related issues pertaining to the financial system and the economy, many topics are not within the relatively constrained scope of this work.*

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*“The business of banking, in its widest sense, is to collect in banks or masses the capital of a community, that which either is money or can readily be turned into money, and upon the capital so collected to build up, by proper management and machinery, a credit which will extend and enlarge the usefulness to the community of its actual moneyed capital.”*

– JOHN JAY KNOX

A HISTORY OF BANKING IN THE UNITED STATES

1900<sup>4</sup>

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*“The pioneers bring their labor with them, there is land in abundance, but capital is the missing ingredient without which the other factors, however abundant, are not very productive. The great economic problem is, therefore, to induce capital to flow from older centers of accumulation to these new areas of deficit.”*

– THOMAS CARVER

1932<sup>5</sup>

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4. Knox, John Jay. *“A History of Banking in the United States.”* Bradford Rhodes & Co.: New York, N.Y., 1900.
5. From the foreword of Sparks, Earl Sylvester. *“History and Theory of Agricultural Credit in the United States.”* Thomas Y. Crowell Co.: New York. 1932.

# The Question of Money

For the earliest Europeans on North America's shores, banking and financial systems were a world away. While the first colonists were staking their claims and establishing settlements in the New World, back in the Old World, England was laying the groundwork for a modern financial structure, establishing both the Bank of England and active securities markets in the 1600s.

These systems were not replicated in the colonies. This was, to a large degree, intentional. To be viable, the American colonies had to develop in a way that was complementary to – and not competitive against – the established European economies.<sup>6</sup> As one writer described it, the British government was attempting to “keep America economically bound in swaddling clothes.”<sup>7</sup>

As a part of this, the British effectively prevented the colonies from paralleling what was happening in other parts of the world, notably in regard to gold and silver specie. Although specie was used widely in many countries for payment, little was available in the colonies and when it did arrive on colonial shores – generally as a result of trade with the colonies of other nations – most was soon pledged to purchase British goods or pay taxes to the British government. What remained available locally could only be had at a steep premium and was especially highly coveted by those directly involved in international trade.



*Colonial notes were issued in denominations that may seem unusual to modern Americans. This \$8 note, which could be redeemed for bills of exchange, gold or silver, was issued in Maryland in 1774.*

Left to their own devices, the colonists were forced to construct a rudimentary financial system, including currencies. Initially, colonial commerce often was conducted through either a direct barter system with an exchange of goods or a

barter currency known as “country pay,” which might involve items such as bacon, fish or musket balls serving as “money.”<sup>8</sup> Another form of “money” could be made of warehouse receipts. For example, a farmer

6. Shammass, Carole. “Consumer Behavior in Colonial America.” *Social Science History*. Cambridge University Press: Vol. 6, No. 1. (Winter 1982).
7. Davis, Joseph Stancliffe. “Essays in the Earlier History of American Corporations Number IV.” Harvard University Press.: Cambridge, Mass., 1917.
8. Sparks, Earl Sylvester. “History and Theory of Agricultural Credit in the United States. Thomas Y. Crowell Co.: New York, N.Y., 1932.

could deposit tobacco crops or other nonperishable items into a merchant's warehouse and receive a receipt which then could function as currency.<sup>9</sup> In cases where these options were not accepted by the merchant, colonists could seek to obtain credit informally, usually with a literal handshake agreement pledging that the bill would be paid later – often at the time of harvest when a farmer might be able to sell crops and then acquire gold or silver specie or other items the merchant desired that could be used as payment.

Another form of facilitating commerce involved the creation of “banks” that operated well beyond the means of the typical colonist. They were private associations that served only the wealthy – to the point that it was reflected in the name of one Massachusetts bank: “Bank of Credit, Lumbard, and Exchange of Moneys by *persons of approved integrity, prudence and estate* in this country (emphasis added).”<sup>10, 11</sup> Their operations involved transfers of credit among the bank's members, thereby facilitating trade within a constrained group, as was the case with “The Fund at Boston In New England” in 1681.<sup>12</sup> These institutions, however, were generally short-lived.

### *The printing press*

As opposed to the other forms of primitive “money,” actual currencies in colonial America were primarily created through a couple methods. One was through the use of “land banks,” colonial government-sponsored entities that lent against property mortgages with bills of credit that moved into circulation. This system developed as a modification of established systems used in other countries, such as the Bank of Amsterdam, which gave credit for gold or silver deposits.<sup>13</sup>

Land banks, however, were not a viable option in all areas of the United States. For example, in parts of North Carolina where available land was plentiful and easy to claim, there was little interest in lending against it.<sup>14</sup> In other regions, however, land banks were extremely successful. In Pennsylvania, for example, a government land bank created in 1723 generated enough interest income from

9. Knox, John Jay. “A History of Banking in the United States.” *Bradford Rhodes & Co.: New York, N.Y., 1900.*

10. Bodenborn, Howard. “State Banking in Early America, A New Economic History.” *Oxford University Press: New York, N.Y., 2003.*

11. Lumbard is drawn from “Lombards,” which were Italian pawn shops.

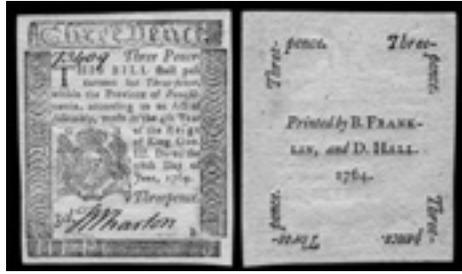
12. Bayles, W. Harrison and Allaben, Frank. “A History of Banks and Banking and of Banks and Banking in the City of New York.” *Journal of American History*, Vol. 10, No. 2., 1921.

13. Bayles, W. Harrison and Allaben, Frank. “A History of Banks and Banking and of Banks and Banking in the City of New York.” *Journal of American History*, Vol. 10, No. 2., 1921.

14. Thayer, Theodore. “The Land-Bank System in the American Colonies.” *The Journal of Economic History*. Vol. 13, No. 2 (Spring 1953).

its outstanding loans to pay all colonial government costs for more than 25 years.<sup>15</sup>

A type of currency creation that often was used to excess involved the direct government issuance of bills of credit as a means of paying government expenses. Massachusetts began issuing bills to meet its funding needs in 1690 – about 70 years after the arrival of the Pilgrims – and other colonies soon followed its lead in “currency finance.”<sup>16</sup> These bills were designed as government IOUs with the government promising future tax revenues to the bearers at the time of bill redemption. Redemption rates, however, were exceptionally low with the bills serving as the de facto currency.<sup>17</sup> As government officials recognized the low risk of actual redemptions, they became increasingly willing to issue bills. While this may have appeared to be risk-free from the redemption perspective, during periods of high government expenses – wars – they were also creating a pile of inflationary kindling that could quickly ignite. In Massachusetts, prices rose by more than 600 percent between 1720 and 1750 – around twice the level that the United States saw from 1950 to 1980 – and annual inflation was more than 19 percent from 1745 through 1749 amid rampant currency issue to fund the colony’s fight against the French in King George’s War.<sup>18</sup>



*Benjamin Franklin’s publishing business with partner David Hall printed Pennsylvania currency. The spelling of “Pennsylvania” was incorrect on some notes, possibly in the hopes of preventing counterfeiting.*

“The desire for the emission of bills of credit spread like an epidemic,” reads one history.<sup>19</sup> “As a successful means of postponing (the levying of) taxes, it became very popular: for the

colonists all had a great aversion to being taxed, either by the mother country or by their own colonial governments.”

Richard E. Sylla, an economist who has written extensively on U.S. financial and economic history, calls the overall colonial currency experience a “near perfect example of monetary innovation.”

15. Ferguson, E. James. “Currency Finance: An Interpretation of Colonial Monetary Practices.” *The William and Mary Quarterly*, Vol. 10, No. 2. (April 1953).

16. Ferguson, E. James. “Currency Finance: An Interpretation of Colonial Monetary Practices.” *The William and Mary Quarterly*, Vol. 10, No. 2. (April 1953).

17. Sylla, Richard. “Monetary Innovation in America.” *The Journal of Economic History*. Cambridge University Press on behalf of the Economic History Association: Vol. 42, No. 1. (March 1982), pp. 21-30.

18. Smith, Bruce D. “Money and Inflation in Colonial Massachusetts.” *Quarterly Review*. Federal Reserve Bank of Minneapolis. Winter 1984.

19. Bayles, W. Harrison and Allaben, Frank. “A History of Banks and Banking and of Banks and Banking in the City of New York.” *Journal of American History*, Vol. 10, No. 2., 1921.

“The results, we know, were sometimes quite inflationary, especially in New England. The side effect of monetary innovation is in no way surprising ... What is surprising is that the inflationary side effects of colonial monetary innovations have received disproportionate attention from historians. The beneficial effects – the removal of what otherwise would have been most serious constraints on colonial economic growth and development – are often downplayed or ignored. Colonial monetary innovation was a rational, purposive activity motivated by perceived economic opportunities and directed toward utility maximization.”<sup>20</sup>



*In February 1776 the Continental Congress issued \$4 million in notes. That the notes could be redeemed in Spanish dollars speaks to the wide availability of the foreign currency in the colonies.*

The problems, however, were substantial, especially during the Revolutionary War. As the fighting drew on, and its costs escalated, the national and state governments accelerated bill creation and, conversely, the value of the bills sank. The Continental Congress had authorized issuance of the continental dollar in 1775, but by War’s end it was virtually worthless, requiring more than \$160 worth to buy a mere \$1 in gold or silver.<sup>21</sup>

As Pulitzer Prize-winning financial historian Bray Hammond explained, the reality soon became that anyone “who accepted (government) payment in revolutionary bills was making an inordinate contribution to the cause of independence ... (because) the money he received would not buy the equivalent of what he had sold.”<sup>22</sup>

This encouraged the eventual creation of what was known as the Pennsylvania Bank – an entity created by Congress and financed by about 100 Philadelphia merchants that purchased rations and other items for the army.<sup>23</sup>

“Three millions of rations were provided in this way, besides three hundred barrels of rum,” reads an 1882 banking history.<sup>24</sup> “It was thought that these supplies could not have been obtained but by the assistance of the bank, so that it was universally esteemed as having been of

20. Sylla, Richard. “Monetary Innovation in America.” *The Journal of Economic History*. Cambridge University Press on behalf of the Economic History Association: Vol. 42, No. 1. (March 1982), pp. 21-30.

21. Chernow, Ron. *Alexander Hamilton*. Penguin Books: New York, N.Y., 2004., p. 201

22. Hammond, Bray. “Banks and Politics in America from the Revolution to the Civil War.” Princeton University Press: Princeton, N.J., 1957, p. 41.

23. Knox, John Jay. “A History of Banking in the United States.” Bradford Rhodes & Co.: New York, N.Y., 1900.

24. Lewis, Lawrence Jr. “A History of the Bank of North America.” J.B. Lippincott & Co.: Philadelphia. 1882, pp 22-23.

most essential service to the country.”

Robert Morris, an organizer of the effort, later led the creation of the Bank of North America, which might be considered something of a starting point for banking in a more modern sense on the North American continent. The Bank was established by the Continental Congress in 1781 as a mechanism for producing a common currency and also helping to address lingering war finance problems.<sup>25</sup> In the pre-Constitution era, there were questions about the Continental Congress’ ability to approve what was essentially a national charter. The Bank soon sought and was granted a charter by the Commonwealth of Pennsylvania.<sup>26</sup> Its success, however, was limited. Its notes were not as widely accepted as Morris had hoped, and its connection to the Continental Congress ended.

### *Merchant banks*

One of the key challenges facing the Bank of North America would be recognizable to bankers from any era: risk management. In the case of the earliest continental and American banks, a key means for mitigating risk was to specialize nearly exclusively in short-term credit, almost always less than 60 days. While these types of loans may have protected the banks and aligned well with the credit demands of early merchants, there remained a sizable population that needed long-term credit to match their business and income cycles. In the earliest days, this group was almost exclusively farmers.

Functionally, the Bank of North America’s loans were handled in a manner very similar to the way credit was supplied by the earliest associations and later by banks. The loans were not amortized, but were instead actually were “discounts” with an amount of interest deducted up front from the value of the pledged collateral. In the Bank of North America’s case, the discounts could only be obtained for less than 45 days with the loan based on the sale of actual goods. It did

25. James, F. Cyril. “The Bank of North America and the Financial History of Philadelphia.” *Pennsylvania Magazine of History and Biography*. Vol. 54. Issue 1. (January 1940.) pp. 56-83.

26. *The Bank was also granted charters by other states to allow it to conduct business.*

27. Hammond, Bray. “Long and Short Term Credit In Early American Banking.” *The Quarterly Journal of Economics*, Oxford University Press: Oxford. Vol. 49, No. 1. (Nov. 1934).



*The second Bank of North America building in Philadelphia pictured in the early 1900s.*

not lend on mortgages nor offer longer-term credit. From a practical perspective, this meant that the Bank offered no viable credit options for farmers.<sup>27</sup>

It would be too simplistic to paint early bankers as an active nemesis to the farmers (although many did paint that picture). The lending structure primarily was a reflection of the early bankers' own business experiences: Merchants were the group that needed credit *and* the group that could most readily supply it, thus the first bankers were merchants. Conversely, while agricultural interests also had credit needs, their collective ability to provide long-term capital on a regular basis was limited by the seasonal nature of crop production. As a result, farmers were not as likely to be as directly engaged in the business of providing credit.<sup>28</sup>

To fully appreciate the high-degree of involvement merchants had in running these early banks, it is helpful to understand the process by which loans were generally made.



*Robert Morris authored the Bank of North America's charter and served as Superintendent of Finance of the United States.*

Rather than having a credit decision made by a loan officer, each individual lending decision went before a bank's entire board of directors. At the Bank of Massachusetts, for example, directors met twice weekly to consider discounts, voting in turn by placing a white or black ball in a box to represent their position on a request for credit. A single director could, very literally, blackball any request.<sup>29</sup> Some version of this process, remained in place well into the 1800s when it finally became apparent that it was no longer functionally possible to address daily changes in market conditions. Rather than reviewing each request individually, directors began reviewing aggregate lending.<sup>30</sup>

For most of these merchant-directors, banking was what Thomas Willing, president of the Bank of North America, called "a pathless wilderness" in a then-new type of business.<sup>31</sup>

"In this situation, we adopted the only safe method to avoid confusion," he said. "Educated as merchants, we resolved to pursue the road we were best acquainted with."<sup>32</sup>

Rather than having a credit decision made by a loan officer, each individual lending decision went before a bank's entire board of directors. At the Bank of Massachusetts, for example, directors met twice weekly to consider discounts, voting in turn by placing a white or black ball in a box to represent their position on a request for credit. A single director could, very literally, blackball any request.<sup>29</sup> Some version of this process, remained in place well into the 1800s when it finally became apparent that it was no longer functionally possible to address daily changes in market conditions. Rather than reviewing each request individually, directors began reviewing aggregate lending.<sup>30</sup>

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28. Hammond, Bray. "Banks and Politics in America from the Revolution to the Civil War." 1957, Princeton University Press, Princeton, N.J. p. 75.

29. Hammond, Bray. "Banks and Politics in America from the Revolution to the Civil War." 1957, Princeton University Press, Princeton, N.J. p. 75.

30. Bodenborn, Howard. "State Banking in Early America, A New Economic History." Oxford University Press: New York, N.Y., 2003.

31. Hammond, Bray. "Banks and Politics in America from the Revolution to the Civil War." 1957, Princeton University Press, Princeton, N.J. p. 66.

32. Hammond, Bray. "Banks and Politics in America from the Revolution to the Civil War." 1957, Princeton University Press, Princeton, N.J. p. 66.

In response to farmer criticism of the Bank of North America, Morris argued that while the Bank did not provide long-term credit, it still benefitted farmers by providing credit to merchants who, in turn, were spending money with the farmers.<sup>33</sup>

“(H)ow are discounts injurious to agriculture? I say they are used on many occasions for the express purpose of encouraging agriculture, in affording to those that want to purchase the produce of the country the means to make such purchases when they could not otherwise accomplish them,” Morris told the Pennsylvania General Assembly.<sup>34</sup>

He also attempted to argue that, technically, the Bank did not discriminate against the farmers and that they could obtain credit from the Bank under the Bank’s terms. Critics saw such a claim as nonsense.

In the words of Robert Whitehill, a Pennsylvania lawmaker: “(Morris) has said that farmers or millers may be accommodated by loans at the bank, but can any farmer in Lancaster or Cumberland derive benefit from loans for 45 days?”<sup>35</sup>

Clearly, they could not.

The Bank’s state charter was revoked in 1785, and then restored in 1787 with significant restrictions.<sup>36</sup> The Bank, however, continued to operate during this two-year period and had received charters from other states.

33. Hammond, Bray. “Long and Short Term Credit In Early American Banking.” *The Quarterly Journal of Economics*, Oxford University Press, Vol. 49, No. 1. (Nov. 1934).

34. Carey, Matthew. “Debates and Proceedings of the General Assembly of Pennsylvania on the Memorials Praying a Repeal or Suspension of the Law Annulling the Charter of the Bank.” Carry and Co., Seddon and Pritchard: Philadelphia, 1786.

35. Carey, Matthew. “Debates and Proceedings of the General Assembly of Pennsylvania on the Memorials Praying a Repeal or Suspension of the Law Annulling the Charter of the Bank.” Carry and Co., Seddon and Pritchard: Philadelphia, 1786.

36. *The Bank of North America became a model for two other institutions with its design largely replicated by the Bank of New York and the Bank of Massachusetts, which both opened in 1784.*



*Alexander Hamilton, the nation's first Treasury secretary, proposed the creation of the first national bank. The First Bank of the United States filled some duties associated with a central bank, but also included some commercial banking components.*

# *The National Bank ...*

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The alliance of sovereign states that was formed under the Articles of Confederation in 1781 may have been an appropriate arrangement during the War but began to fray in peace. Divisions started to emerge among the states. Paper money produced by the Continental Congress had caused rampant inflation, many individuals were broke and both the national government and many states were burdened with massive amounts of war debt. To address these problems, a more unified national government structure was formed under the United States Constitution, which was ratified in July 1788.

Two years later, in 1790, Treasury Secretary Alexander Hamilton proposed the creation of a national bank. This bank would issue a national currency, serve as the government's bank and fiscal agent, and also broadly offer banking services. Viewed from a modern perspective, Hamilton's creation was a partial forefather to the Federal Reserve – a hybrid filling some central bank responsibilities (including such duties as serving as the government's bank) but also including some commercial banking components. The bank was seen as a means of helping the country address the still-lingering War debt while extending credit to both the government and business, and expanding the money supply, which could boost the economy.

Structurally, the First Bank of the United States was a private institution, with 80 percent of it owned by shareholders and the rest held by the federal government. The structure was explicitly designed by Hamilton as a restraint against the type of runaway government currency issue that had proven problematic during the colonial period and the War. As Hamilton explained with one of his more well-known remarks, “The stamping of paper is an operation so much easier than the laying of taxes that a government in the practice of paper emissions would rarely fail in any such emergency to indulge itself too far in the employment of that.”

## *Two views of the America to come*

Hamilton's broader philosophical views for the new nation were firmly based in one of the era's two leading oppositional political ideologies. As a Federalist, Hamilton envisioned an America of mercantile activity and industry. Creating this type of a nation required the same degree of banking and credit that had been the “engines ... for advancing trade” in many of the world's then-leading cities and countries including Venice, Genoa, Hamburg,



*Thomas Jefferson did not support the Federalist vision of America's future. He was a leader among those who favored states' rights and authority at the local level over a more centralized structure.*

Holland and England.<sup>37</sup>

The oppositional view of the country's future was held by Democratic-Republicans who envisioned a pastoral, agrarian continent. Many in this group viewed banks skeptically and, in some cases, as a danger and moral risk to be avoided. As author and historian Ron Chernow describes it, leading Democratic-Republicans "... (Thomas) Jefferson and (James) Madison had a nearly visceral contempt for market values and tended to denigrate commerce as grubby, parasitic, and degrading."<sup>38</sup>

The Democratic-Republican views of the noble farmer and the comparatively immoral business owner may have been characterized best in 1769 by Benjamin Franklin, likely with a sense of jest:

"(T)here seem to be but three ways for a nation to acquire wealth. The first is by war, as the Romans did, by plundering their conquered neighbors. This is robbery. The second by commerce, which is generally cheating. The third by agriculture, the only honest way, wherein man receives a real increase of the seed thrown into the ground, in a kind of continual miracle wrought by the hand of God in his favour, as a reward for his innocent life and his virtuous industry."<sup>39</sup>

The two ideologies had similarly disparate ideas regarding how to most effectively structure government. Hamilton and the Federalists favored more centralized control, such as a national government. The Democratic-Republicans, meanwhile, were proponents of states' rights with the authority remaining at the local level.

"Jefferson and the (Democratic-) Republicans saw Hamilton and the Federalists to be replicating eighteenth-century Great Britain, with its monarchical centralization, its political corruption and disenfranchisement of most people, its squalid cities and factories, its speculators and stockjobbers, its high taxes, and its imperialistic, militaristic adventurism," Sylla wrote.<sup>40</sup> "(The Democratic-Republicans) preferred the future to be like the past. The United States would be a decentralized republic mainly of planters and farmers with only a

37. Hamilton, Alexander to Morris, Robert, April 30, 1781.

38. Chernow, Ron. *Alexander Hamilton*. Penguin Books: New York, N.Y., 2004.

39. Franklin, Benjamin. "Positions to be Examined." April 4, 1769.

40. Sylla, Richard. "Hamilton and The Federalist Financial Revolution, 1789-1795." *The New York Journal of American History*, 65, No. 3 (Spring 2004).

thin overlay of commerce, factories and urban life, and with governments close to the people.”

Hamilton, meanwhile “had faith that the U.S. ... Constitution, with its dual sovereignty of state and federal governments along with its checks and balances within governments, offered adequate protection against British vices.”<sup>41</sup>

### *Final approval*

Although Hamilton was able to get his bank legislation through Congress, support for the measure came almost entirely from congressmen serving regions north of the Potomac River, while those in the agricultural South were opposed.

The approved bill then lingered on President George Washington’s desk. As a farmer who was sympathetic to the agricultural interests, Washington was believed to be strongly influenced by Secretary of State Jefferson’s views and Jefferson strongly opposed the bank. Eventually, Hamilton authored a 15,000-word report about the Bank and its constitutionality that convinced Washington to sign the bill, despite Washington’s own reservations and opposition from members of his cabinet.

The First Bank of the United States opened Dec. 12, 1791 in Philadelphia with a 20-year charter.

*41. Sylla, Richard. “Hamilton and The Federalist Financial Revolution, 1789-1795.” The New York Journal of American History, 65, No. 3 (Spring 2004).*



*By 1794, the United States had begun to expand westward, growing from a few colonies hugging the coast and toward the center of the North American continent.*

## ... *And The State Banks*

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Article 1, Section 10 of the United States Constitution prevented states from issuing currencies. The prohibition reflected not only the turmoil created by widespread state issue in the past, but also problems related to exchange rates among the various currencies.

“Had every State a right to regulate the value of its coin, there might be as many currencies as states,” James Madison wrote in *Federalist 44*. The result, he feared, was that “animosities (would) be kindled among the States themselves.”

For states, the prohibition was a stark reversal and especially problematic for state governments that had come to rely on currency finance instead of tax increases or reduced government spending. It also encouraged the development of state-chartered banks as a sort of the next-best option for the states from a fiscal perspective. Unlike the state governments, banks retained the ability to create money and state governments that took an ownership stake in a bank could share in bank profits as well as receive tax revenue generated by the bank. Additional benefits included the functional, with the bank handling the state accounts; and the economic, where a local source of credit had the potential to boost local businesses.

At the state level, even staunch Democratic-Republicans who opposed banking on moral or ideological grounds, had reason to support state banking after the chartering of the First Bank of the United States. The bank issue related very closely to questions about the authority of the federal government versus individual state governments. With the national bank now in place, some Democratic-Republicans believed a state-chartered bank might be the best way to prevent federal overreach into state-level financial and economic issues. State-chartered banks were obviously under state authority, which meant they were beyond federal control. Functionally, this meant the federal



*Massachusetts Congressman Fisher Ames, a Harvard graduate and former teacher, was a Federalist leader in the First United States Congress. Voters supported his election over Samuel Adams.*

government could not inspect nor regulate their operations.

As might be expected, the adoption of state banking by some Democratic-Republicans was met with opposition from some ardent Federalists, who believed only the national bank was necessary.

Fisher Ames, a Massachusetts congressman and leading Federalist, wrote to Hamilton urgently seeking to have the national bank offer credit at lower interest rates as a way to “overpower the state banks by giving borrowers better terms.”<sup>42</sup>

State bankers and state officials were fearful of such a strategy.

“(T)his measure (creating the Bank of the United States) is a violation of the constitution ... by interfering with state rights,” Richard Johnson, a Kentucky congressman, later told his counterparts.<sup>43</sup> “This corporation can send a branch bank to any part of the United States, without consulting the states or the citizens of the states.”<sup>44</sup>

The result, he worried, was a national bank that encouraged “moneyed aristocracy in the United States.”

### *Access to credit*

The states moved forward with their plans. By 1794, three years after the creation of the First Bank of the United States, the nation was home to 16 state-chartered banks.

The earliest bankers, like generations to follow, served as intermediaries between savers and borrowers. During this period the role of bankers was sometimes characterized as serving savers who were “highly risk-averse” and businesses that were “moderately risk-averse.”<sup>45</sup>

These banks were not without political challenges. Just as the national bank had led to questions among states protecting state interests, within the states there were significant concerns voiced by rural residents who sought to protect rural interests and feared the state banks would serve only the cities, particularly when it came to the access to credit.

Any farmer in this era who wanted to make an argument with a banker that agriculture presented a significant business opportunity could offer a veritable wagonload of evidence.

First, there was the size of the potential market. The vast majority of

*42. Letter from Fisher Ames to Alexander Hamilton. July 31, 1791.*

*43. Clarke, M. St. Clair and Hall, D.A., eds. “Legislative and Documentary History of the Bank of the United States.” Gales and Seaton 1832.*

*44. One year after its opening, the First Bank of the United States opened Branch offices in the nation’s most important cities: Boston, New York, Charleston and Baltimore. Additional Branches were opened later, including Norfolk, Va. (1800); Savannah, Ga. (1802); Washington, D.C. (1802); New Orleans (1805).*

*45. This point is made in Larson, Henrietta. “Jay Cooke: Private Banker.” Cambridge. Harvard University Press, 1936. This point is also referenced in Bodenhorn, Howard. “State Banking in Early America, A New Economic History.” Oxford University Press: New York, N.Y., 2003.*

Americans – perhaps nearly 95 percent – would have been considered rural residents in the early 1790s and many of them were farmers.<sup>46</sup> Additionally, while there is little doubt that many farms operated on a very small level, any romanticized visions of these farmers as self-contained producers with no engagement in commerce are likely inaccurate for many reasons:

- From a practical sense, complete self-sufficiency would have required not only an exceptionally wide range of skills (from farming through the production of cloth and metalwork) and a wide range of farm production efficiencies that were unlikely given the available technology.<sup>47</sup>
- Additionally, analysis of import levels even during the pre-Revolutionary period suggests significant spending by all colonists, including farmers, on clothing and foodstuffs (including, notably, tea) on a per person basis.<sup>48</sup> An array of items smuggled into the country, and thus not documented, would only push the imported allocations per-person even higher.
- Farmers also produced the goods that were sold in not only the cities but that also moved into the export market for transport overseas.
- Finally, many of the most prominent individuals at the time of the Revolution and in the years that followed were farmers. Among them, most notably, were Washington and Jefferson. Even today, both men consistently rank near the top in lists ranking the presidents by their estimated net worth on an inflation-adjusted basis.<sup>49</sup>

So, why weren't all the early banks eager to lend to farmers?

As with the Bank of North America, much of this was likely related to the early bankers' backgrounds. As Hammond described it, to these individuals "the establishment of a bank did not inaugurate a new practice ... but continued an old one under better arrangements."<sup>50</sup> And the old practice often did not include farmers.

It is important to know that while farmers may have been the most visible group to struggle with the access to credit, they were not alone in the challenge. The same issues affected any borrower seeking credit on terms longer than the 60 days – sometimes less – that banks were willing to lend. Notably, some historians believe that problems urban artisans had in accessing

46. Zelinsky, Wilbur. "Changes in the Geographic Patterns of Rural Population in the United States, 1790-1960." *Geographical Review*. Vol. 52, No. 4. (Oct. 1962).

47. Shammas, Carole. "How Self-Sufficient Was Early America?" *The Journal of Interdisciplinary History*. The MIT Press: Vol. 13, No. 2 (Autumn 1982).

48. Shammas, Carole. "How Self-Sufficient Was Early America?" *The Journal of Interdisciplinary History*. The MIT Press: Vol. 13, No. 2 (Autumn 1982).

49. <https://www.fool.com/investing/2016/11/20/the-10-richest-us-presidents.aspx>

50. Hammond, Bray. "Long and Short Term Credit In Early American Banking." *The Quarterly Journal of Economics*, Oxford University Press, Vol. 49, No. 1. (Nov. 1934).

credit from Federalist bankers led to that group's substantial support of Jefferson over Federalist incumbent John Adams in the 1800 presidential election.<sup>51</sup>

### *State banks*

The individual states had a wide range of experiences with banking, including a few that predated the Revolutionary War. While some states put forward similarly-structured banking systems, others were innovative with initiatives that sought to address the specific needs of their populations.

“Underlying this ... was the nation’s decentralized, federal polity which provided wide enough latitude for each state to experiment and develop a banking system appropriate to its needs,” Bodenhorn wrote.<sup>52</sup> “Wide differences in geography, climate, crop production, manufacturing capability, population density and a host of other relevant variables meant that the most preferred or effective banking system in Rhode Island would bear little resemblance to the most preferred or effective system in far away Louisiana or Missouri, or perhaps, even neighboring Connecticut.”

As in the creation of any new system, mistakes were made. In his detailed history of world banking published in 1896, prominent economist and banking expert Charles Conant notes that early banking in the United States faced a number of challenges.

“The economic development of the country between the Revolution and the Civil War was in an experimental stage as well as its political development. The rules of sound banking had not yet been worked out even in the older countries of Europe ... but to ordinary sources of error and risk were added in the United States the elements of experiment and uncertainty in every department of human activity. The Englishman or Frenchman might not be a good banker, but he could at least form an intelligent estimate of the volume of trade with which he had to reckon and the conditions under which it was carried on. His problem was simply to work out, according to sound rules, a mathematical problem for which the necessary elements were known. With the American, on the other hand, every element was an unknown quality.”<sup>53</sup>

This, of course, presented any number of challenges. From a structural perspective the primary issues were usually the same and related to the access to capital by a wide range of borrowers and the importance of local autonomy and control. The following

51. Wright, Robert E. “Artisans, Banks, Credit, and the Election of 1800.” *The Pennsylvania Magazine of History and Biography*. Vol. CXXII, No. 3 (July 1998).

52. Bodenhorn, Howard. *A History of Banking in Antebellum America*. Cambridge University Press: New York, N.Y., 2000.

53. Conant, Charles. *A History of Modern Banks of Issue*. G.P. Putnam’s Sons. The Knickerbocker Press. New York and London. 1896.

are some of the key state-level examples from this period.<sup>54</sup>

## Massachusetts

Massachusetts was home to two competing banks in the 1740s.

It also was especially active in currency finance, issuing more bills of credit than any other colony. By 1765, Massachusetts loan offices had put 168 British pounds in circulation per capita. Comparatively, New York had issued a mere 3.5 pounds per capita.<sup>55</sup> Meanwhile, in hopes of securing a bank, state officials in 1782 offered a charter to the Bank of North America only

weeks after the institution opened, believing a branch office was the fastest route to establishing a bank.<sup>56</sup> At the time, credit in the Boston area was provided almost exclusively by wealthy merchant-bankers with excess capital and a willingness to hold a few deposits.<sup>57</sup>



*A 12-pence note issued by the state of Massachusetts in 1776. By this point, Massachusetts had a long history with currency dating to the first issue in 1690.*

*54. It should be noted that the nomenclature of state banks includes ample opportunity for unintentional error. For example, South Carolina was simultaneously home to the “Bank of South Carolina,” the “State Bank of South Carolina” and the “Bank of the State of South Carolina” in the early 1800s that were all state-chartered institutions. Written commentary and documents, particularly those from the period when the banks were founded, are not always clear about the institution being referenced. For example there are obvious cases where the “Bank of South Carolina” was sometimes referred to as the “State Bank.” Similar naming conventions were used in other states as well. Every effort been made to avoid any inaccuracies that may result from this issue.*

*55. Bodenhorn, Howard. “State Banking in Early America, A New Economic History.” Oxford University Press: New York, N.Y., 2003.*

*56. Bodenhorn, Howard. “State Banking in Early America, A New Economic History.” Oxford University Press: New York, N.Y., 2003.*

*57. Bodenhorn, Howard. “State Banking in Early America, A New Economic History.” Oxford University Press: New York, N.Y., 2003.*

In 1784, six months after the Treaty of Paris ended the Revolutionary War, Massachusetts chartered the first post-War bank. The Massachusetts Bank largely replicated the structure of the Bank of North America. Like most early banks, lending was limited to short-term borrowing with a 60-day loan requiring physical collateral and a 30-day maximum for all other loans.

Overall, the post-War economy in Massachusetts was a shambles. The government’s own financial difficulties left it

unable to fully reimburse soldiers for their War service. What payment these soldiers did receive was in depreciated currency. Meanwhile, the merchant bankers began pressuring their borrowers to repay existing debts in specie while limiting further extensions of credit, demanding instead they receive payment in hard currency at the time of any transaction. Eventually, debt collectors began to take land and other property from farmers in western and central Massachusetts – areas where the financial difficulty was the most acute – and some individuals were jailed for debt and nonpayment of taxes.

“There was no property exempt from seizure ... except the clothes on the debtor’s back,” reads an account by historian Jonathan Smith.<sup>58</sup> “The officer could take the bed on which the debtor slept, the last potato in his cellar and the only cow or pig in his barn to satisfy the execution. There was no homestead exemption. Property at the execution sale brought nothing approaching its real value, and the debtor could only look on while the sheriff sold the house over his head and the last mouthful of his provisions for the winter at a fifth of their real value, knowing at the end he would be turned into the streets with his family.”



*Daniel Shays was an American officer in the Revolutionary War, who fought at Lexington and Bunker Hill. He is more well known, however, for his role in Shays Rebellion.*

The farmers responded with what became known as Shays’ Rebellion, an armed uprising led by former Revolutionary War Capt. Daniel Shays.

While some have referred to the group as “tax delinquents, debtors and miscellaneous malcontents,” Hammond notes that their arguments were valid.

“There was plenty to reprobate in their behavior ... but their protest against the loss of property in consequence of conditions they could not help was reasonable,” Hammond wrote. “No effort of theirs could fetch (the) silver and gold with which to pay taxes and debts, and the dearth of legal tender was not a thing for which they should be punished.”

Eventually, a militia of about 1,200 funded by private merchants faced about 1,500 of Shays’ men near Springfield, Mass., in 1786. Warning shots were fired by the militia, killing a handful of the rebels and injuring about 20. The rebels scattered and the rebellion was finally ended by early 1787. This incident and similar occurrences in other regions contributed substantially to support for abandoning the Articles of Confederation and in favor of the stronger national structure created by the Constitution.

*58. Smith, Jonathan. “The Depression of 1785 and Daniel Shays’ Rebellion.” *The William and Mary Quarterly*. Vol. 5, No. 1. (Jan. 1948).*

The Massachusetts Bank struggled throughout this period but survived. Histories suggest that the Bank focused its business primarily in the eastern portion of the state. Its insistence on short-term credit made it of little use for farmers with little in the way of collateral. However, when Massachusetts chartered its second bank, the farmers' cries were heard. When the Union Bank of Boston was chartered in 1792 it was required to do 20 percent of its lending with farmers in amounts of at least \$100 but less than \$1,000, secured by real estate for periods of up to one year.<sup>59</sup>

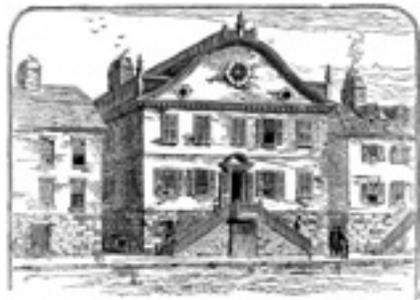
According to an early account, "the influence of the state government was specially turned to secure for the country people opportunities in the way of credits that they did not possess, and if the Boston banks of that day had shown themselves willing to undertake the work they could unquestionably have absorbed .... the larger part of the banking business of all the New England States."<sup>60</sup>

## *Rhode Island*

Like Massachusetts, Rhode Island also was active in currency finance, issuing its first bills in 1709 with numerous additional issuances continuing through the late 1700s.<sup>61</sup>

An attempt to create a bank in 1784 failed when organizers were able to secure only \$30,000 of \$150,000 in planned capital.<sup>62</sup> In 1791, the state chartered its first bank, the Providence Bank, with \$400,000 in capital.<sup>63</sup> Rhode Island leaders hoped to eventually attract a branch of the national bank, but believed that the first step was to strengthen the state economy, which required the formation of a local bank.

"(B)y our exertions, and favoring a good and substantial foundation for the commercial, manufacturing and mechanical rising



*By chartering the Providence Bank, Rhode Island officials hoped they were taking a step toward improving the state's economy.*

59. Davis, William Thomas. "Professional and Industrial History of Suffolk County, Mass., Vol. II." *The Boston History Company*. Boston, Mass. 1894.

60. Davis, William Thomas. "Professional and Industrial History of Suffolk County, Mass., Vol. II." *The Boston History Company*. Boston, Mass. 1894.

61. Dean, Sidney, Ed. "History of Banking and Banks from Venice to the year 1883." Pelham Studios: Boston. 1884.

62. Stokes, Howard Kemble. "Chartered Banking in Rhode Island, 1791-1900." *Preston & Rounds Co.: Providence, R.I.* 1902.

63. Dean, Sidney, Ed. "History of Banking and Banks from Venice to the year 1883." Pelham Studios: Boston. 1884.

generation, (Rhode Island) may in time become no inconsiderable capital, but without a spring to promote our young men in business here, they must and will continue to go to such places as will aid them with the means of business,” wrote John Brown, a wealthy merchant and later congressman who established the bank with his brother Moses.

The Bank’s charter included provisions designed to limit the control and influence of wealthy shareholders with a voting structure that gave smaller shareholders a disproportionately high voting weight.<sup>64</sup>

Also unique to the state: Rhode Island law permitted early banks, including the Providence Bank, the ability to engage in what was known as “the bank process” against delinquent debtors. Through this process, bank officers could order a court clerk to issue writs of execution and attachment against debtors who were 10 days overdue on their payments. This process essentially allowed banks to seize property without going through a lengthier legal proceeding and was not a right available to other types of creditors such as private lenders.<sup>65</sup>

While this system received ample criticism later, Rhode Island Historian Howard Kemble Stokes argued that it is important to understand the motivations behind the bank’s creation and the goals of its owners. Writing nearly a century after the Bank was founded, Stokes noted that the Bank’s ownership, rather than being tightly held by a few large investors, was a large group of small shareholders and that the Bank’s purpose was to improve the state’s economic conditions. Thus the shareholders were not necessarily there because they thought they could get rich.

“(F)rom the point of view of the investor, the incorporators of the Providence Bank were to a predominant degree the trustees of the interests of the community.”<sup>66</sup>

Additionally, it is also important to recognize that the Bank was only extending credit for a maximum of 30 days, meaning that the 10-day delinquency window equaled at least one-third of the period of most loans.

“The public demanded that the bank notes should be redeemable in cash on demand, the bank in return asked that the public pay cash on demand ... on its matured notes,” Stokes wrote.<sup>67</sup> “Strict punctuality on part of the one could only be maintained by strict punctuality on part of the other. The ‘bank process’ enabled the bank to enforce that punctuality upon others which others demanded of it.”

64. Stokes, Howard Kemble. *Chartered Banking in Rhode Island, 1791-1900.* Preston & Rounds Co.: Providence, R.I., 1902.

65. Stokes, Howard Kemble. *Chartered Banking in Rhode Island, 1791-1900.* Preston & Rounds Co.: Providence, R.I., 1902.

66. Stokes, Howard Kemble. *Chartered Banking in Rhode Island, 1791-1900.* Preston & Rounds Co.: Providence, R.I., 1902.

67. Stokes, Howard Kemble. *Chartered Banking in Rhode Island, 1791-1900.* Preston & Rounds Co.: Providence, R.I., 1902.

The Providence Bank was followed in 1795 by the Bank of Rhode Island and by two additional banks in 1800.<sup>68</sup> By 1826, the state was home to 44 banks with more than \$10 million in capital.<sup>69, 70</sup> The “bank process,” coupled with no restrictions on currency issue, no tax requirements – Rhode Island never took an ownership position in its banks other than to purchase some bank stock for a school fund – and limited liability on bank owners, made the nation’s tiniest state one of its most heavily banked in the early United States.

As Stokes explained, “Rhode Island was not among the first states to undertake the role of a banker, but it drank deeper and longer.”<sup>71</sup>

## New York

Two competing bank proposals were made in New York State, with one finally becoming the state’s first chartered bank about a month after Congress chartered the First Bank of the United States.

Both institutions were the creations of exceptionally prominent early Americans. The Bank of New York started business in 1784 as a private bank under articles of association drawn up by Hamilton. Separately, and prior to the start of Hamilton’s initiative, Robert Livingston, who helped write the Declaration of Independence, led an initiative to establish what he called the Bank of the State of New York.



*Robert Livingston was involved in numerous key events in U.S. history, including negotiating the Louisiana Purchase and administering the presidential oath of office to George Washington.*

The two proposals had a fundamental difference. While Hamilton proposed a “money bank” that would issue notes and do business in gold and silver specie, Livingston proposed a land bank. Not surprisingly, and in a reflection of events that occurred in other colonies, Hamilton’s proposal was viewed more favorably by city dwellers and merchants – to the point that it even united political rivals in a common cause – while upstate farmers and rural residents preferred Livingston’s plan.<sup>72</sup>

68. Dean, Sidney, Ed. “History of Banking and Banks from Venice to the year 1883.” Pelham Studios: Boston. 1884.

69. Dean, Sidney, Ed. “History of Banking and Banks from Venice to the year 1883.” Pelham Studios: Boston. 1884.

70. Stokes, Howard Kemble. “Chartered Banking in Rhode Island, 1791-1900.” Preston & Rounds Co.: Providence, R.I., 1902.

71. Stokes, Howard Kemble. “Chartered Banking in Rhode Island, 1791-1900.” Preston & Rounds Co.: Providence, R.I., 1902.

72. Chernow, Ron. *Alexander Hamilton*. Penguin Books: New York, N.Y., 2004., p. 201.



*The Bank of New York was on the northeast corner of Wall and William Streets in New York City in the late 1790s.*

Both groups were heavily critical of their opponents. Money bank supporters believed a land bank would do little for metropolitan merchants and would be unable to gain public trust. Those in favor of a land bank, meanwhile, feared that the money bank would serve only city interests and provide little, if any, service to rural residents.

A critic of the money bank argued that its supporters were Tories – the name given British loyalists – “that have suffered to remain among us.”

“The Tories of New York know that the Land Bank has sufficient capital of cash to answer all good purposes; but they know it would not answer their purposes. The only plausible reason ... (is that) the profits would be greater to the proprietors.”<sup>73</sup>

Conversely, a published “letter from a gentleman in Philadelphia to his friend in New York,” argued strongly against the land bank proposal, citing land bank experiences in Pennsylvania.

“A land bank was strongly urged here by some men of great landed property, but it was laughed at by the merchants and every other class of citizen except only the farmers and utterly put to shame.”

Further, the writer went on to essentially threaten that “if New York should make such a misstep in policy (and create a land bank), they ought to expect the neighboring states will avail themselves of their error ... I am fully of opinion that an explicit and full declaration of the body of your merchants that they will not deposit [sic.] their money in a land bank.”<sup>74</sup>

It was Hamilton’s view that the land bank was a “wild and impracticable scheme ... (that) stands in our way.”<sup>75</sup> The money bank, he believed, could be an important step toward resolving currency problems, providing some structure to the system and establishing consistent exchange rates in a city flooded by an assortment of currencies including both foreign and domestic.<sup>76</sup> With the support of New York Gov. George Clinton, rural legislators were able to delay the chartering of either bank for seven years before they finally were defeated and the money bank won the charter.<sup>77</sup>

<sup>73</sup>. *New York Journal*, March 25, 1784.

<sup>74</sup>. *New York Packet*, March 3, 1784.

<sup>75</sup>. *Hamilton letter to Governor Morris*, March 21, 1784.

<sup>76</sup>. Chernow, Ron. *Alexander Hamilton*. Penguin Books: New York, N.Y., 2004., p. 201.

<sup>77</sup>. Bodenborn, Howard. “State Banking in Early America, A New Economic History.” Oxford University Press: New York, N.Y., 2003.

## *Vermont*

In Vermont, while petitioners sought banks for years, most residents opposed both the idea of banking and the issuance of paper currency. In an attempt to address debt repayment issues, Vermont lawmakers approved an act mandating that creditors accept payment in kind in place of currency or specie.

Vermont gained statehood in 1791, the same year that the First Bank of the United States was chartered. Public opposition to a state bank began to dissolve in the years that followed, although there are indications that the transition was not the result of viewing banks more favorably, but attempting to head off competition, particularly from banks being created in neighboring states. In 1803, state lawmakers considered petitions to create two banks, one to serve a constituency on each side of the Green Mountains.

The initiative failed on the grounds that “banks demoralize people by gambling and concentrate the wealth in the hands of the few and are useless to the many, since they give credit only to the rich.”

Although these first initiatives failed, bank supporters continued to stress the public benefits that locally-based banks could offer.

“There is not in the state any bank or public office where the temporary wants of our citizens may be supplied with loans of money at a low rate of interest, and for a term of time convenient to the borrower,” reads one 1804 commentary.

Lawmakers eventually were swayed and the Vermont State Bank charter was approved in 1806.

## *Pennsylvania*

Pennsylvania, already home to the Bank of North America and the First Bank of the United States, chartered another, the Bank of Pennsylvania, in 1793. This bank, which had no connection with the similarly-named institution mobilized during the Revolutionary War, was chartered to serve as the commonwealth government’s bank while also making credit available to the broad public – something the Bank of North America had not done as it continued to serve only the affluent.

“Most of the . . . inhabitants and many of the state’s legislators, perhaps rightly, considered the Bank (of North America) of little practical use,” Bodenhorn wrote.

The Bank’s exclusive clientele prompted one Pennsylvania farmer – who pointed out that he fought for Independence unlike “many . . . made gentry (who) were not to be found”

– to rhetorically ask who the bank served: “Is it the farmer? Oh no, ’tis your Philadelphia gentlemen, your Philadelphia speculators, your Philadelphia merchants who ride in their coaches while we follow our plow. These are the men who are the favorites of government? Shame upon you legislators! Will a few sycophant dinners and poisoned bottles of wine make you sell your country to these harpies? I hoped better things.”<sup>78</sup>



*The Bank of Pennsylvania was designed by prominent early American architect Benjamin Henry Latrobe.*

Structurally, the Bank of Pennsylvania was similar to the First Bank of the United States. In terms of serving the state government, it functioned very well. As a partial owner, the commonwealth received enough income from dividends to help meet government costs without implementing a direct tax for 40 years.<sup>79</sup>

As a public lender, however, the Bank of Pennsylvania fell short of its intended goals.

For Pennsylvanians, this was something of a repeat of what had happened two decades earlier with the Bank of North America. In this instance, however, a group of Pennsylvania merchants jointly petitioned the state to grant a charter to another bank, The Philadelphia Bank, which had operated as an unincorporated association since 1803. The Bank of Pennsylvania’s Board of Directors were outraged by the charter request and sent a letter to the Pennsylvania General Assembly urging a rejection of the proposal, arguing that “the increase of banking institutions in the city of Philadelphia is calculated materially to injure the property of the state in the Bank of Pennsylvania, and the interest of the community at large.”

Many Pennsylvanians, however, felt otherwise, arguing that limited access to bank credit was creating problems and, potentially, introducing economic risks.

“The cup has not been full, but rather that its emptiness has occasioned a frequent resort of many of our best merchants to private money lenders; and that to the usurious griping of this class of people, is to be referred . . . the numerous failures that have of late years

*78. Dunlap’s American Advertiser (Philadelphia, Pa.), Jan. 24, 1793. The writer is anonymous and identifies himself only as “A Man for a Loan Office.”*

*79. Hammond, Bray. “Banks and Politics in America from the Revolution to the Civil War.” Princeton University Press: Princeton, N.J. 1957.*

happened among us,” reads a commentary in the Dec. 30, 1803 edition of the Philadelphia-based *Aurora General Advertiser*. The state ended up granting the charter request in 1804.

The Pennsylvania banking environment previously had been a “cruel and oppressive monopoly,” wrote a commentator. “(The) Philadelphia Bank ... has brought things to an equality – and the existence of these two banks, particularly since the establishment of the latter, has produced a more accommodating and less persecuting disposition.”

## *South Carolina*

Some might be surprised to learn that South Carolina saw more Revolutionary War fighting than any other colony. In addition to a key British victory in 1780 at Charleston, the state was the site of more than 200 battles and innumerable other skirmishes.

“During the Revolution, South Carolina had been raided and ravished by the British army from the mountains to the seacoast. Industries had been destroyed; homes and factories had been burned and livestock and farm implements either destroyed or stole. At the close of the war, therefore, the people found themselves bankrupt and their resources exhausted,” reads a South Carolina history.

Among the war’s casualties was the colony’s first bank. The Land and Loan Bank of the Carolinas was organized in 1712 by the Proprietary Government and was the first public land bank in the colonies. It was credited with playing an important role in increasing the values not only of land, but also South Carolina’s agricultural products.<sup>80</sup>

In the War’s aftermath, and with the old bank destroyed in 1775, a group of Charleston merchants launched an effort in 1783 to establish a new bank, but the effort failed to attract the hoped-for \$100,000 in start-up capital and was abandoned.<sup>81</sup> Eventually, The Bank of South Carolina was founded in 1792 in Charleston as an unchartered institution. It and another institution known as the State Bank of South Carolina, which had been operating without a charter, were chartered under a single act in 1801, each with \$1 million in capital.<sup>82</sup> Both banks appear to have focused on business lending.

“(A)lthough they may have included among their customers planters of the seacoast and mechanics of the city, there is no evidence whatsoever that they promoted the agricultural interests of the state. Their business seemed to have been confined to

80. Williams, George W. “History of Banking in South Carolina from 1712 to 1900.” *Walker, Evans & Cogswell Co.: Charleston, S.C., 1903.*

81. Clark, W.A. “Banking Institutions Organized in South Carolina Prior to 1860.” *Historical Commission of South Carolina. The State Company: Columbia, S.C. 1922.*

82. *Journal of Commerce and Commercial Bulletin*, “A History of Banking in all the Leading Nations, Vol. 1.” Misc. authors. *The Journal of Commerce and Commercial Bulletin*.: New York, N.Y., 1896.

the port city,” wrote W.A. Clark, a long-time South Carolina banker who got his start in the 1800s.<sup>83</sup>

In 1812, South Carolina chartered another institution, the Bank of the State of South Carolina. Unlike the South Carolina banks chartered in 1801, the new bank was wholly state-owned and specifically designed to address mortgage borrowing. Under the charter, the Bank was required, to the degree possible, to conduct real property lending “apportioned among the election districts throughout the State, in proportion to the number of representatives of the State Legislature in each election district.”



*The State Bank of South Carolina was one of the first banks in that state.*

in early South Carolina and other Southern states is complicated by a unique farm business and financing structure that was widely used during that period. These states utilized a “factorage” system where individuals doing business as “factors” served as a middleman for all aspects of farm business. In this structure, which had a centuries of history in England before developing in North America, a factor provided not only credit and other financial services to farmers, but also marketed farm produce on the behalf of farmers in port cities such as New Orleans. Finally, they also delivered back to the farms any necessary finished goods that the farmers might need from these cities. The system became especially popular while trade with England was halted during and after the War of 1812.<sup>86</sup>

As historian Larry Schweikart notes in his book about early banking in the American South, it is unclear if the bank met this goal. It appears most of the business done from the Bank’s Charleston office involved commercial borrowers, although later branches did engage in agricultural loans.<sup>84</sup>

“The conflict over bank ... charters merely highlighted the rural-urban, planter-coastal rivalries,” Schweikart wrote. “In South Carolina, the business groups clearly recognized that rural credit was fraught with dangers, in terms of both inflationary potential and illiquid security.”<sup>85</sup>

Any modern-day understanding of the agricultural credit conditions and rural banking services

83. Clark, W.A. “Banking Institutions Organized in South Carolina Prior to 1860.” *Historical Commission of South Carolina. The State Company: Columbia, S.C. 1922.*

84. Schweikart, Larry. “Banking in the American South from the Age of Jackson to Reconstruction.” *Louisiana State University Press: Baton Rouge and London, 1987.*

85. Schweikart, Larry. “Banking in the American South from the Age of Jackson to Reconstruction.” *Louisiana State University Press. Baton Rouge and London, 1987.*

“The factor was the ‘factotum’ of our business life, our commission merchant our banker, our bookkeeper, our adviser, our collector and disbursing officer, who honored our checks and paid our bills,” one Southerner wrote.<sup>87</sup> “Many of the planters did not really always know what money they possessed. One year’s accounts would overlap another’s and sometimes years would pass before the accounts were balanced and settlement made.”

The word “factotum,” is from the Latin “Dominus factotum” that means “one who controls everything.” Not surprisingly, there is significant criticism of the system ranging from the impact on individual farmers and the influence on crop planting decisions to, more broadly, on the development of the southern economy, to the point that it may have played an important role in determining which cities eventually evolved into urban centers and which withered away from a lack of growth.<sup>88</sup>

## Virginia

In Virginia, opinions about banking were somewhat conflicted. While there were those who believed banks would be beneficial to the state’s economy, many Virginians including state officials, were extremely concerned about encouraging an oligarchy. As a result, the state was a comparative latecomer to the world of



*The Bank of Alexandria was chartered only a few months before Virginia’s second bank, the Bank of Richmond.*

86. Woodman, Harold D. “King Cotton and His Retainers: Financing and Marketing the Cotton Crop of the South, 1800-1925.” University of Kentucky Press: Lexington, Ky, 1968.

87. Quoted in Woodman, Harold D. “King Cotton and his Retainers: Financing and Marketing the Cotton Crop of the South, 1800-1925.” University of Kentucky Press. Lexington, Ky, 1968. Also partially quoted in Bodenborn, Howard. “State Banking in Early America, A New Economic History.” Oxford University Press: New York, N.Y., 2003.

88. Bodenborn, Howard. “State Banking in Early America, A New Economic History.” Oxford University Press: New York, N.Y., 2003.

89. Starnes, George T. “Sixty Years of Branch Banking in Virginia.” *Journal of Political Economy*. Vol. 36, No. 4 (Aug 1928) pp. 480-500.

90. Knox, John Jay. “A History of Banking in the United States.” Bradford Rhodes & Co.: New York, N.Y., 1900.

91. *Journal of Commerce and Commercial Bulletin*, “A History of Banking in all the Leading Nations, Vol. 1.” Misc. authors. *The Journal of Commerce and Commercial Bulletin*.: New York, N.Y., 1896.

structured banking.<sup>89</sup>

Still, the state had a lengthy history with the institutions. There are early commonwealth records showing the passage of acts to restrict banking activities – relating to such issues as the punishment of usury, for example – and reports of a bank in Richmond as early as 1730.<sup>90</sup> There was at least a consideration of establishing a loan office in 1765 and later initiatives in the 1770s.<sup>91</sup> The state’s first chartered bank, The Bank of Alexandria, was chartered in 1792, followed by the

Bank of Richmond later the same year, although opposition continued.

The state's views on banking were described by John Pope, a United States Senator from Kentucky, during a discussion on the charter of the First Bank of the United States in the early 1800s.

“(T)hey were a few years (ago) frightened at the very name of a bank. As soon as they heard of one, they began to write books, make speeches, and pass resolutions to lay this ghost of tyranny,” Pope said.

He added that it took the work of Virginia Senator Richard Brent to finally convince the state's lawmakers “that the little bank of Alexandria would not sweep away their liberties.”<sup>92</sup>



*Virginian Richard Brent held a number of elected positions, serving as a U.S. Senator, congressman and also in the Virginia Senate.*

within its own jurisdiction.<sup>93</sup>

In 1804, officials took steps that eventually forced the closing of private banking associations in the state and, separately, chartered The Bank of Virginia. With \$1.5 million in capital, the Bank was 10 times the size of the Bank of Alexandria when it was created, five times the size of the Bank of New York when it was chartered and rivaled the Bank of North America.

Structurally, the Bank was viewed as something of a compromise between those demanding a local source of credit and those concerned about the state's endorsement of privilege on a corporation.<sup>94</sup> Reflecting Hamilton's charter for the Bank

Virginia's political views on banking began to change around 1800 when, as Bodenhorn notes, Virginians saw faster export growth in other states, notably Maryland, and believed there was a strong link between growth and the access to credit. Additionally, the state's central location resulted in a wide array of bank notes from other states being used as payment to Virginia merchants. Creating a bank in Virginia, it became apparent, might address some of this problem by at least giving the state a bank

92. Clarke, M. St. Clair and Hall, D.A., eds. “Documentary History of the Bank of the United States.” Gales and Seaton 1832.

93. Starnes, George T. “Sixty Years of Branch Banking in Virginia.” *Journal of Political Economy*. Vol. 36, No. 4 (Aug 1928) pp. 480-500.

94. Bodenhorn, Howard. “State Banking in Early America, A New Economic History.” Oxford University Press: New York, N.Y., 2003.

of the United States, the state took a one-fifth ownership stake, providing it with a degree of control. In addition to the state appointing one-fifth of the board (and sharing in one-fifth of the profits), the charter included numerous other provisions favoring the state and other shareholders, including:

- The state could inspect the bank at the state's discretion,
- The bank had to provide an annual report,
- Directors were required to maintain records and make those records available to shareholders,
- The bank was required to provide at an annual shareholders meeting a statement of debts which had remained unpaid for a period three times the original credit.<sup>95</sup>

To address the issue of credit access, in addition to the Richmond headquarters, the Bank had branch offices in Fredericksburg, Lynchburg, Norfolk and Petersburg. Additionally, communities had the ability to seek the establishment of local agencies that would, in turn, be affiliated with the closest branch office.<sup>96</sup>

### *Innovations in providing access to credit*

Ideally, the Virginia branch model would provide a potential solution for the problem of rural credit access. Many Virginia small towns, especially those along rivers, wanted banks but suffered from not having sufficient locally-available capital to support an independent institution. In theory, under the branch model, capital from across a broad region would flow into a central reservoir from where it then could be deployed statewide.<sup>97</sup> Evidence suggests, however, that the system did not function as would-be rural borrowers might have hoped. The Bank of Virginia was criticized on a number of fronts, including the inequality of discounts, which seemed to benefit wealthy city dwellers at the expense of the rural residents. Other criticisms focused on the high pay of bank officials – bank cashiers earned a reported \$3,000 annually, about twice the salary of a judge.<sup>98</sup>

Henry Banks, a writer who had believed strongly in creating the Bank, later expressed his regrets at lending his support.

“The Bank of Virginia was established against violent prejudices. No man wrote half so much as I did to insure its adoption. I knew that it might become a terrible and oppressive engine,

95. Gruchy, Allan G. “A Sketch of Virginia Banking History.” *Southern Economic Journal. Southern Economic Association. Vol. 4, No. 2 (Oct. 1937). pp-165-179.*

96. Bodenhorn, Howard. “State Banking in Early America, A New Economic History.” *Oxford University Press: New York, N.Y., 2003.*

97. Starnes, George T. “Sixty Years of Branch Banking in Virginia.” *Journal of Political Economy. Vol. 36, No. 4 (Aug 1928) pp. 480-500.*

98. Howison, Robert Reid. “A History of Virginia. Vol. II.” *Drinker and Morris: Richmond. Va., 1848.*

but I thought that patriotism, prudence and justice would operate in giving it the most useful direction. In this I have been greatly disappointed.”<sup>99</sup>

About the Bank’s directors, he believed that “no men ever forfeited public expectations with less credit to themselves or less usefulness to their country.”<sup>100</sup>

The following year, Virginia chartered another bank. The Farmers Bank of Virginia was created with essentially the same structure – it was based in Richmond with branches in Fredericksburg, Lynchburg, Norfolk, Petersburg and Winchester. However, it appears the reference to farmers in the title was a marketing ploy to win the support of rural residents and not related to any real interest in agricultural credit.<sup>101</sup> In 1817, a group including “citizens, planters and farmers” petitioned the state to investigate the Lynchburg branch for “partial and unjust administration ... in granting accommodations to the inhabitants of the town of Lynchburg, in preference to those of the country.”<sup>102</sup> In response, at least five state lawmakers traveled to Lynchburg, but they were unable to reach a conclusion regarding the accusations.<sup>103</sup>

### *Community engagement*

Meeting local credit demands was not simply a matter of having an office in a particularly location: The institutions actually had to be willing to make the credit available. That banks were resistant was partly the result of the history of banking on the North American continent. Hamilton and others had viewed banking as a tool for assisting the government and industry, which, at that time, was “something small, new and specially deserving.”<sup>104</sup>

The basic banking model also worked well in providing short-term credit of 30 to 60 days. Long-term credit, of course, entailed additional risk – both credit risk, where the borrower might not be able to repay debts, and possibly inflation risk over the period of the loan, which meant that the dollars received in repayment would be worth significantly less than their value at the time of the loan. Some states included provisions within the charter limiting the length of loans. For example, the state-owned South Carolina bank could not extend credit beyond a year, in other

99. Starnes, George T. “Sixty Years of Branch Banking In Virginia.” *Journal of Political Economy*, Vol. 36, No. 4 (Aug. 1928) pp. 480-500.

100. Starnes, George T. “Sixty Years of Branch Banking In Virginia.” *Journal of Political Economy*, Vol. 36, No. 4 (Aug. 1928) pp. 480-500.

101. Starnes, George T. “Sixty Years of Branch Banking In Virginia.” *Journal of Political Economy*, Vol. 36, No. 4 (Aug. 1928) pp. 480-500.

102. *Journal of the House of Delegates of the Commonwealth of Virginia, 1818-1819.*

103. *Journal of the House of Delegates of the Commonwealth of Virginia, 1818-1819.*

104. Hammond, Bray. “Banks and Politics in America from the Revolution to the Civil War.” Princeton University Press: Princeton, N.J., 1957.

states, the limits were significantly shorter.<sup>105</sup>

Hammond writes that around 1800, banks apparently began to realize that to remain viable they needed to take on the additional risks associated with longer-term lending.<sup>106</sup>

## *More banks*

Chartering a second bank, as happened in Virginia, was not something officials in many states had planned on doing. Initially, state officials believed that competition could be dangerous and that a monopoly was actually preferable, according to economist Anna Schwartz.

“The founders of commercial banking ... doubted seriously that several banks in one community could get along together, especially that the initial bank could survive if one more intruded upon its domain,” Schwartz wrote in an analysis of competitive banking in early Philadelphia.<sup>107</sup>

Similarly, in the minds of many rural residents, creating another state bank – and the likely behind-the-scenes political machinations involved in obtaining the charter – was not viewed favorably.

As Hammond explained it, “To the agrarians, the multiplication of bank charters was an extension of privilege rather than a division of it.”<sup>108</sup>

In many ways, the rural skepticism found credence in reality. For example, although Pennsylvania was aggressive in chartering banks, those institutions still served a clientele that was primarily affluent individuals or well-established city merchants. Meanwhile, Pennsylvanian’s artisans and manufacturers continued to have difficulty securing short-term credit at reasonable rates.<sup>109</sup>

As a result, in 1809 the state was petitioned and ended up chartering another Bank. Unlike the previous institutions, which were formed by merchants, The Farmers and Mechanics Bank of Philadelphia, was an initiative led by a mixed group of merchants, manufacturers and mechanics.<sup>110</sup> The resulting institution reflected the background of its founders. The charter required that a majority of its directors be “farmers, mechanics, and

105. Dewey, Davis R. “State Banking Before the Civil War.” Government Printing Office: Washington, D.C., 1910.

106. Hammond, Bray. “Banks and Politics in America from the Revolution to the Civil War.” Princeton University Press: Princeton, N.J., 1957, p. 41.

107. Schwartz, Anna J. “The Beginning of Competitive Banking In Philadelphia, 1782-1809.” Money in Historical Perspective. National Bureau of Economic Research. University of Chicago Press. 1987.

108. Hammond, Bray. “Banks and Politics in America from the Revolution to the Civil War.” Princeton University Press: Princeton, N.J., 1957.

109. Bodenborn, Howard. “A History of Banking in Antebellum America.” Cambridge University Press.: New York, N.Y., 2000.

110. Schwartz, Anna J. “The Beginning of Competitive Banking In Philadelphia, 1782-1809.” Money in Historical Perspective. National Bureau of Economic Research. University of Chicago Press. 1987.

manufacturers actually employed in their respective professions.”<sup>111</sup> Additionally, the Bank was required to lend an amount equivalent to 10 percent of its capital to farmers on long-term mortgages at 6 percent annual interest.<sup>112</sup>

### *Taking matters into their own (farm) hands – Maryland*

Maryland’s first two state-chartered banks, the Bank of Maryland and the Bank of Baltimore, focused almost exclusively on Baltimore merchants.<sup>113</sup> These banks had emerged after a previous proposal in 1784 had been rejected amid strong rural opposition that the then-proposed bank’s plans for short-term credit and high interest rates would have left farmers unable to borrow and pulled capital out of the rural areas and into the city.<sup>114</sup>

“To be a country man and a farmer is at all times sufficient to insure a man the refusal of a loan from the city banks,” wrote one early 1800s Maryland resident.<sup>115</sup>

Another said that “the accommodations which the existing banks in Maryland have been able to grant have been confined almost exclusively to the aid of the mercantile and moneyed interests of the town in which they are established. Farmers and planters have very seldom obtained any aid from them ... (and) it is well known, cannot obtain loans from any individuals on any security at any rate of interest, hence agriculture, the true legitimate bottom of our commerce, is dwindling.”<sup>116</sup>

In response, a partnership organized and opened the Farmers Bank of Maryland without a state charter 1804.<sup>117</sup> The effort was not smooth as the existing banks fought against the emergence of this new rival, reportedly threatening potential Farmers Bank investors that they would no longer be customers if they supported the new institution.

According to one newspaper commentator, opposition by the existing banks was a clear sign that the “stockjobbing gentry of Baltimore ... (fear) that the Farmers Bank would place the cultivators of the soil and country store-keepers too much out of their reach.”<sup>118</sup>

The bank was headquartered in

111. Hammond, Bray. *Banks and Politics in America from the Revolution to the Civil War.* Princeton University Press: Princeton, N.J., 1957.

112. Bodenborn, Howard. *A History of Banking in Antebellum America.* Cambridge University Press: New York, N.Y., 2000.

113. *A third Maryland bank, the Union Bank of Maryland, was also developed around the same time as the Farmers Bank. It was Baltimore-based and seen as a means of helping the city restore some of the commodity export business that had been lost to rivals in Virginia, Pennsylvania and New York.*

114. Bryan, Alfred Cookman. *History of State Banking in Maryland.* The Johns Hopkins Press: Baltimore, Md. 1899.

115. *Republican Star (Easton, Md.) Aug. 6, 1805.*

116. *Republican Star (Easton, Md.) Sept. 4, 1804.*

117. Bodenborn, Howard. *State Banking in Early America, A New Economic History.* Oxford University Press: New York, N.Y., 2003.

118. *Republican Star (Easton, Md.) Aug. 6, 1805.*

Annapolis, and operated in the eastern Maryland community of Easton. It later added a branch to the west in Frederick. The Bank's charter request was approved by state lawmakers in 1805.

Interestingly, the Farmers Bank claimed it was the first in the United States to pay interest on deposits, paying 4 percent on deposits held for at least six months with 3 percent paid on demand deposits.<sup>119</sup> Regardless of the validity of the interest income claim, Bodenhorn writes that the Farmers Bank did forge something of a road map for how to establish a bank. Others soon began forming partnerships and opening banks first and then seeking to charter the institutions later.<sup>120</sup> Of the 11 banks eventually chartered in Maryland before 1812, half were started as private partnerships that sought charters after they were operational.<sup>121</sup> The state made it illegal to form banks in this manner in 1817, thereby blocking businesses with a large amount of capital from engaging in banking activities without a charter.<sup>122, 123</sup>



*The Farmers Bank of Maryland's Articles of Association required that they be published in 10 newspapers across the state.*

Rural banking took on more prominence in Maryland in the years that followed. After chartering the City Bank of Baltimore in 1812, the state chartered 19 country banks through 1835, although the majority would not be deemed a success with many unable to generate sufficient startup capital and others closing within a few years.<sup>124</sup>

- 119. Bryan, Alfred Cookman. "History of State Banking in Maryland." *The Johns Hopkins Press: Baltimore, Md.* 1899.
- 120. Bodenhorn, Howard. "State Banking in Early America, A New Economic History." *Oxford University Press: New York, N.Y., 2003.*
- 121. Knox, John Jay. "A History of Banking in the United States." *Bradford Rhodes & Co.: New York, N.Y., 1900.*
- 122. Knox, John Jay. "A History of Banking in the United States." *Bradford Rhodes & Co.: New York, N.Y., 1900.*
- 123. Bryan, Alfred Cookman. "History of State Banking in Maryland." *The Johns Hopkins Press: Baltimore, Md.* 1899.
- 124. Bodenhorn, Howard. "State Banking in Early America, A New Economic History." *Oxford University Press: New York, N.Y., 2003.*
- 125. Bodenhorn, Howard. "State Banking in Early America, A New Economic History." *Oxford University Press: New York, N.Y., 2003.*

Despite these efforts, Bodenhorn notes that farmers continued to complain about a lack of available credit and favoritism that the banks showed toward Baltimore merchants. It is unclear if the problem was related to a lack of institutions, interest rates, or issues of collateral.<sup>125</sup>



*The First Bank of the United States building was completed in 1797. The building still stands today at 116 S. Third St. in Philadelphia.*

# The End of The National Bank

The First Bank of the United States was unable to gain the public's support and came under heavy criticism in 1811 during congressional deliberations on the issue of extending its charter. By the time of the charter renewal debate, the Bank's opponents held the political majority while Hamilton, the Bank's creator and defender, had been killed seven years earlier by Aaron Burr.

"It would ... be less objectionable if the Bank of the United States diffused its benefits equally throughout the different states. But instead of this equal and just distribution, it will be found to be confined and partial in its operations; its benefits will be principally confined to the sea ports; it can only be made to operate indirectly upon the agriculturalist and manufacturer," Kentucky Congressman William T. Barry told his House counterparts during deliberations.<sup>126</sup>

Barry was also among those who saw the issue of the national bank as a part of the debate about rights of individual states, telling his counterparts that "state rights require the guardianship of the constitution; they are not, I trust, to be left to the mercy of a bank directory."<sup>127</sup>

The First Bank had lived up to some of the promise of its supporters, but the fears of some of its critics also were realized. While it had improved the nation's financial standing, one writer noted that "it was also observed that the stockholders in the Bank soon became the



*Years after serving as a congressman from Kentucky, William Barry was later Postmaster General and, finally, the U.S. ambassador to Spain.*

most firm and unflinching supporters," of the president.<sup>128</sup>

A significant issue – and source of outrage for many Americans – was foreign ownership interest in the Bank. In 1811, the Bank had a total of 25,000

126. Clarke, M. St. Clair and Hall, D.A., eds. "Documentary History of the Bank of the United States." Gales and Seaton 1832.

127. Clarke, M. St. Clair and Hall, D.A., eds. "Documentary History of the Bank of the United States." Gales and Seaton 1832.

128. Hildreth, Richard. "The History of Banks: To Which is Added the Advantages and Necessity of Free Competition in the Business of Banking." Hilliard, Gray & Co.: Boston, Mass. 1837.

shares outstanding, nearly three quarters of which were held by foreign investors. Most of the U.S. government's share – initially a 20 percent stake in the Bank – had been sold to British financier Alexander Baring.<sup>129</sup> The remaining 7,000 shares were held by U.S. citizens who, under the charter, had the ability to elect directors and control the institution. Foreign shareholders were not permitted to vote and, as a result, may have had little practical control over the Bank. However, many Americans were angered by the principle of foreign ownership and, perhaps more so, by the paying dividends of around 8.5 percent annually to the foreign investors.<sup>130</sup>

Outside of congressional halls, the Bank's opponents were far more vocal than the Bank's supporters. State lawmakers in Massachusetts, Pennsylvania, Maryland, Virginia and Kentucky, which also were among the more well-established states at that time, "instructed" their U.S. senators to vote against the measure.<sup>131, 132</sup>

State banks, which were now emerging nationwide, were frustrated because the national bank was a competitor for deposits. These banks were eager to step in when that competitor was removed. During charter renewal deliberations for the First Bank, Thomas Gold, a New York congressman, compared these state banks to "wreckers hovering on the coast," while the "United States' Bank is going down."

"Preparations are (being made) for celebrating the nuptials of these State damsels, who, with little modesty, attend in the ante chamber, eager to rush into the arms of patronage in the Treasury."<sup>133</sup>

The combination of these factors was too much for the Bank to overcome. The charter renewal failed and the First Bank of the United States closed March 3, 1811.

129. Dean, Sidney, Ed. "History of Banking and Banks from Venice to the year 1883." Pelham Studios: Boston. 1884.

130. Clarke, M. St. Clair and Hall, D.A., eds. "Documentary History of the Bank of the United States." Gales and Seaton, 1832.

131. Hammond, Bray. "Banks and Politics in America from the Revolution to the Civil War." Princeton University Press: Princeton, N.J., 1957, pp. 209-213.

132. Note that, prior to 1913, senators were elected by state legislatures.

133. Clarke, M. St. Clair and Hall, D.A., eds. "Documentary History of the Bank of the United States." Gales and Seaton 1832. p. 225.



**BANK NOTE EXCHANGE.**

CORRECTED WEEKLY.

U. S. bank notes, not payable in New-York	par
City of New-York and New-York State Notes	par
New-York city notes	par
Jacob Barker's Exchange bank	25 p. c. dis.
Jacob Barker's notes filled up with red ink, and payable in country notes,	60 do.
Farmer's and Mechanic's bank of Albany	par
N. Y. State bank at Albany	par
Bank of Albany	par
Bank of Troy	par
Farmers' Bank of Troy	par
Mohawk Bank	par
Lansingburgh bank	par
Bank of Newburgh, if not signed with red ink,	par
Do. signed with red ink	par
Do. payable at Utica	par
Orange County notes	par
Catskill	par
Columbia bank at Hudson	par
Middle District	par
Genesee County bank	par
Auburn bank	par
Bank of Geneva	par
Central bank at Cherry-Valley	par
Chenango bank	par
Columbia receivables	par
Utica banks	par
Utica Insurance Company	par
Utica branch at Cananagus	par
Oswego bank at do.	par
Otsego bank at Utica	1 par
Jefferson county bank	1 do.
Hamilton bank	2 do.
<i>New-Jersey Notes.</i>	
Jersey bank	par
Banks in Newark	par
State bank at Elizabethtown	par
State bank at New-Brunswick	par
Bank of New-Brunswick	par
State bank at Paterson	par
State bank at Morristown,	par
Sussex bank	par
Trenton banking company	par
State bank at Trenton	1 do.
State bank at Camden	1 do.
Farmer's bank at Mount-Holly	1 do.
Cumberland bank	1 x 1 1/2 do.
<i>Connecticut.</i>	
Bridgewater bank	par
Eagle bank at New-Haven,	par
Hartford bank do.	par
Middletown bank	par
Phoenix bank at Hartford	par
Derby bank	par
<i>Massachusetts.</i>	
Boston Banks	1/2 do.
Springfield bank	1 x 1 do.
Hampshire bank at Northampton	do. do.
Salem banks	do. do.
Worcester bank	1 x 1 do.
Other Massachusetts notes	do. do.
New-Hampshire notes	do. do.
State of Maine	do. do.
[The notes of the country banks in Maine are at present quite unsalable.]	
<i>Rhode-Island.</i>	
Providence bank	1 x 1 p. c. dis.
Washington bank at Westerly	do. do.
Other Rhode-Island Notes	do. do.
<i>Vermont.</i>	
Brattleboro bank	1 x 1 1/2 do.
Windsor	do. do.
Brattleborough	do. do.

*With numerous currencies in circulation, the value of money could become complicated. While a currency might trade at par value in one city, it might be accepted only with a discount in another. This problem could be especially substantial in a large city where consumers who came from across a large geographic area to do business brought local currencies with them. As a result, newspapers printed tables detailing local values.*

# The First Boom

When the First Bank's charter expired, the United States was home to 89 state banks with an aggregate capital of \$52.6 million.<sup>134</sup>

Now, without the national bank, state banking exploded.

In the words of William Short, a U.S. diplomat from that period, the banking system became a “hydra head . . . under the corruption of state legislatures.”<sup>135</sup> In the three years ending in 1812 – essentially the final years of the First Bank's tenure – 41 new state banks were chartered.<sup>136</sup> Conversely, in the four years that followed, at least 120 banks were chartered, including more than 40 in Pennsylvania alone in 1814.<sup>137</sup>

In Massachusetts, state officials responded quickly, chartering The State Bank.

“In consequence of the expiration of the charter of the United States Bank, and the probable need of additional banking capital to alleviate the distress and embarrassment, which it was thought might result from the expiration of existing charters, certain anti-Federalists or Democrats petitioned the legislatures for a charter for the State bank with a capital of \$3 million. After great opposition, the bill for its incorporation was passed by a small majority,” reads one account.<sup>138</sup>



*William Short was an early American diplomat and former secretary to Thomas Jefferson. Short considered Jefferson his second father.*

134. Dean, Sidney, ed. “History of Banking and Banks from Venice to the year 1883.” Pelham Studios: Boston. 1884.

135. Letter from William Short to Thomas Jefferson, June 21, 1815, available through the Founders Online website of the National Archives and Records Administration.

136. Hildreth, Richard. “The History of Banks: To Which is Added the Advantages and Necessity of Free Competition in the Business of Banking.” Hilliard, Gray & Co.: Boston, Mass. 1837.

137. Dean, Sidney, ed. “History of Banking and Banks from Venice to the year 1883.” Pelham Studios: Boston. 1884.

138. Stone, Edwin A. “A Century of Boston Banking.” Press of Rockwell and Churchill: Boston, Mass., 1894.

The bank boom reflected an environment significantly different than the catalysts that drove bank development in the Old World.

As Hammond notes, European banking emerged because of supply – wealthy families, who in some cases had gained their riches over generations sought a means for generating additional income from their

wealth. For these families, lending was an attractive opportunity.

U.S. banking, meanwhile, was demand driven – Americans needed capital and there were precious few sources of excess funds from which to borrow. Banks emerged to fill that gap.

“It was in dearth ... and not in abundance that American banking had its genesis,” Hammond wrote.<sup>139</sup> “Needs were great, means were few, and men were resourceful. The impulsion to which they responded was that of demand ... and their response was to club together their scanty funds ... and form institutions that should do for them collectively what they could not do so well severally.”

The result was comparatively rapid and continual growth in the number of state banks in the United States. In 1800, the 16 states of the United States were home to 24 banks, including four in both Connecticut and New York, and five in Massachusetts.<sup>140</sup> This was in addition to private banks that opened during this period. Accurate data on the size of these institutions in the early 1800s is difficult to obtain, but what is believed to be one of the more accurate surveys – an 1818 report by Treasury Secretary William Crawford – pegged U.S. banking capital at \$21.3 million in 1800, up from \$2.5 million a decade earlier.<sup>141</sup>

By 1820, the number of state banks had swollen to 266 with an additional 66 branches operating in 23 states, the District of Columbia, and the territories that would become Michigan and Missouri.<sup>142</sup> Total banking capital at state banks was estimated at \$137 million.<sup>143</sup> Most of the banks were in the mid-Atlantic and New England regions with fewer banks in the South and West.<sup>144</sup>

## *Large banks and community banks*

From a more generalized perspective, banks in the United States during the early 1800s fell into one of two general categories – city banks and country banks. In aggregate, an argument could be made that neither type was well suited to look out for the best interests of those who were not already established financially or engaged in business as a merchant.

139. Hammond, Bray. *Banks and Politics in America from the Revolution to the Civil War*. Princeton University Press: Princeton, N.J., 1957, p. 69.

140. Weber, Warren E. “Early state banks in the United States: How many were there and when did they exist?” *Quarterly Review*. Federal Reserve Bank of Minneapolis. Sept. 2006.

141. Knox, John Jay. *A History of Banking in the United States*. Bradford Rhodes & Co.: New York, N.Y., 1900.

142. Weber, Warren E. “Early state banks in the United States: How many were there and when did they exist?” *Quarterly Review*. Federal Reserve Bank of Minneapolis. Sept. 2006.

143. Knox, John Jay. *A History of Banking in the United States*. Bradford Rhodes & Co.: New York, N.Y., 1900.

144. Weber, Warren E. “Early state banks in the United States: How many were there and when did they exist?” *Quarterly Review*. Federal Reserve Bank of Minneapolis. Sept. 2006.

In New York City there were a handful of banks that were considered comparatively tight with credit.<sup>145</sup> In their book *“Gotham,”* an exhaustively-detailed history of early New York City, authors Edwin G. Burrows and Mike Wallace write that New York bankers generally followed the banking theories of Isaac Bronson, a Revolutionary War veteran who was one of the most prominent bankers of the early 1800s.

Bronson strongly favored a clear delineation between commercial and investment banks, a division that did not exist at that time, and an end to the lending practices being used by some state banks.<sup>146</sup>

“To his way of thinking, banks should provide only short term credit (not longer than 90 days) and accept only the best collateral (actual goods in transit) [sic],” the authors write.<sup>147</sup> “Nor should banks give their money to farmers, manufacturers, and other high-risk borrowers; that was a job for independent investors.”

These banks, located not only in New York City but in other parts of the mid-Atlantic region, were generally larger and formed by individuals who viewed the banking business primarily from the perspective of investors or savers.<sup>148</sup>



*Isaac Bronson was a surgeon during the Revolutionary War but later became a successful banker. Among his accomplishments was helping to found New York Life and Insurance and Trust.*

145. Burrows, Edwin G. and Wallace, Mike. *“Gotham, A History of New York City to 1898.”* Oxford University Press: New York City, 1999. p. 444.

146. Venit, Abraham H. “Isaac Bronson: His Banking Theory and the Financial Controversies of the Jacksonian Period.” *The Journal of Economic History*, Vol. 5, No. 2 (November 1945), pp. 201-214.

147. Burrows, Edwin G. and Wallace, Mike. *“Gotham, A History of New York City to 1898.”* Oxford University Press: New York City, 1999. p. 444.

148. Wright, Robert E. “Bank Ownership and Lending Patterns in New York and Pennsylvania.” *Business History Review*, 73. (Spring 1999), pp. 40-60.

149. Walters, Raymond Jr. “The Origins of the Second Bank of the United States.” *Journal of Political Economy*, Vol. 53, No. 2 (June 1945), pp. 115-131.

150. Hammond, Bray. *“Banks and Politics in America from the Revolution to the Civil War.”* Princeton University Press: Princeton, N.J., 1957, pp. 227.

151. Wood, John. *“A History of Central Banking in Great Britain and the United States.”* Cambridge University Press: Cambridge. N.Y. 2005. p. 127.

At the other end of the spectrum were the country banks. They were more numerous and in some cases they were issuing paper currency at levels beyond what they could support.<sup>149</sup> According to one analysis, bank notes in circulation increased from around \$28 million to \$68 million between 1811 and 1816 with an implied even greater increase in loans.<sup>150</sup> Meanwhile, the metallic reserve ratio fell from 42 percent to 28 percent.<sup>151</sup>

John C. Calhoun, then a congressman from South Carolina, said the excess

of currency in circulation was “visible to the eye, and almost audible to the ear; so familiar was the fact, that this paper was emphatically called ‘trash’ or ‘rags,’” that he estimated had been issued by 260 different banks.<sup>152</sup>

*The Philadelphia Gazette* blamed the “wretched policy of our governments” for creating more banks than could handle “the business of the whole civilized world.”

“Those institutions, attending more to their temporary, than their permanent interests, and with greater fondness for ... large dividends than public advantage, have inundated the country with issues of paper .... Far beyond the public exigencies.”<sup>153</sup>

Hammond describes banking during 1791 through 1816 as “an adolescence” where banks were “experimenting energetically (and) ... some of the experiments turned out to be very bad.”<sup>154</sup>

“Bank credit was to Americans a new source of energy, like steam, and it was not to be known in advance of experience under what conditions it would work well or ill.”<sup>155</sup>

If a New York bank offered an investment opportunity for the wealthy, banks in some areas of the country at that time might have best been considered similar to investment clubs for local merchants. A handful of merchants owned the banks and the bulk of their lending was within that group or with their friends. Banks in parts of New England, for example, regularly practiced insider lending with more than one-half of their loans going to directors, stockholders, business partners, political friends and family members.<sup>156</sup>

Regardless of their structure or type, public distrust of banks continued, as evidenced by an article about New Jersey lawmakers approving six bank charters in 1812. The article from the Washington, D.C.-based *National Intelligencer*, suggests that rather than six individual pieces of legislation, the banks could have been chartered under a single act, “enabling sundry farmers to exchange their farms for paper, sundry industrious tradesmen to forsake their certain and honest pursuits to become speculators and gamblers; and for spreading over a larger surface the passions of avarice, idleness, usury, and extravagance, for discouraging domestic industry and changing the habits and property of those several neighborhoods and incidentally, the whole state.”<sup>157</sup>

152. Clarke, M. St. Clair and Hall, D.A., eds. “Documentary History of the Bank of the United States.” Gales and Seaton 1832. p. 632.

153. Article attributed to *Philadelphia Gazette* printed in *The Adams Sentinel*, Adams County, Pa. Nov. 15, 1815.

154. Hammond, Bray. “Banks and Politics in America from the Revolution to the Civil War.” Princeton University Press: Princeton, N.J., 1957, p. 195.

155. Hammond, Bray. “Banks and Politics in America from the Revolution to the Civil War.” Princeton University Press: Princeton, N.J., 1957, p. 195.

156. Wright, Robert E. “Bank Ownership and Lending Patterns in New York and Pennsylvania.” *Business History Review*, 73. (Spring 1999), pp. 40-60.

157. *The National Intelligencer*, Feb. 8, 1812.





*Among the most prominent events occurring during the War of 1812 was the burning of the White House.*

# New Challenges at War and at Peace

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Issues related to currency, banking and the budding U.S. financial system became increasingly complex, and challenging, after the United States declared war against Great Britain, beginning the War of 1812.

More than two centuries after the fighting ended, the War is still something of an enigma. Its causes, even today, remain under a degree of debate. Noted historians have referred to it as “ludicrous and unnecessary” and the result of “fumbling and small-minded statecraft.”<sup>158</sup> Much of the fighting was along the shores of Lake Erie and the War ended in something of a stalemate with each side retaining its previous boundaries. Even the War’s most historically significant events – the penning of “The Star Spangled Banner” and the burning of the White House by British soldiers – sound more like something that may have occurred during the Revolutionary War than during this later conflict.

Despite a relative lack of prominence in U.S. history books, events surrounding the War of 1812 serve as a sort of starting point for an important transition in the development of the U.S. economy, particularly as it relates to the country’s then-nascent manufacturing sector.

When the United States initiated a pre-war trade embargo in late 1807, the country generally was an exporter of commodities and an importer of finished goods from Britain and other European countries. As the embargo took hold, it and the subsequent war left the United States isolated from established economies and its most substantial trading partners. U.S. exports in 1808 fell to about one-fifth their pre-embargo level on a dollar basis while imports dropped by more than one-half.<sup>159</sup> Reports from that time mention as many as 500 ships sitting in port at New York City’s docks.<sup>160</sup>

“(H)ow shall I describe the melancholy dejection that was painted upon the countenances of the people, who seemed to have taken leave of all their former gaiety and cheerfulness?” wrote John Lambert in his published journal of travels through early America. “The coffee-house slip, the

158. Hofstadter, Richard, as quoted in “The War of 1812: When the U.S. Invaded Canada – and Failed.” *Time Magazine*, June 18, 2012.

159. United States Census Bureau. “Bicentennial Edition: Historical Statistics of the United States, Colonial Times to 1970.” Available online at: [http://www.census.gov/library/publications/1975/compendia/hist\\_stats\\_colonial-1970.html](http://www.census.gov/library/publications/1975/compendia/hist_stats_colonial-1970.html)

160. “Lambert’s Travels through Canada and the United States.” As appeared in *The Antijacobin Review and True Churchman’s Magazine*, Dec. 1814, p. 540.

manances of the people, who seemed to have taken leave of all their former gaiety and cheerfulness?” wrote John Lambert in his published journal of travels through early America. “The coffee-house slip, the

wharfs and quays along South Street presented no longer the bustle and activity that had prevailed there five months before. The port, indeed, was full of shipping, but they were dismantled and laid up. Their decks were cleared, their hatches fastened down, and scarcely a sailor was to be found on board. Not a box, bale, cask, barrel or package, was to be seen upon the wharfs. Many of the counting houses were shut up or advertised to be let; and the few solitary merchants, clerks, porters and laborers that were to be seen, were walking about with their hands in their pockets.<sup>161</sup>

The impact on U.S. commodity producers was substantial. In 1811, the United States was the world's fourth-largest cotton producing nation.<sup>162</sup> However, as a result of the embargo, on a weight basis exports of raw cotton tumbled to less than one-fifth their pre-embargo level.<sup>163</sup> Meanwhile, the domestic wholesale prices for raw cotton began to slide, eventually falling to less than one-half the pre-embargo level.<sup>164</sup>

Some of the continent's first factories were developed to fill the gap. Led by the Boston Manufacturing Company, which built looms similar to those in Britain, capitalists in New England began constructing mills that produced textiles from southern cotton and local wool. In 1814, at the height of what might be considered a U.S. textile manufacturing boom, 43 new textile factories were established in the U.S. – a vast jump from three years earlier when only nine new factories opened. With embargoes keeping foreign buyers out of the cotton markets, U.S. manufacturers in 1814 were able to buy a pound of cotton for 14 cents and produce approximately 4 yards of cotton sheeting, which they could sell for around 23 cents per yard. The result was a gross margin of more than 80 percent.<sup>165, 166</sup>

Analysis from 1800 and 1810 shows that the number of workers employed in textile manufacturing increased from around 1,000 to 10,000 during the 10-year period while the number of iron and steel manufacturers increased from around 1,000 to 5,000.<sup>167</sup>

### *Impact on banks*

From a financial perspective, the United States had again entered a war ill

161. "Lambert's Travels through Canada and the United States." As appeared in *The Antijacobin Review and True Churchman's Magazine*, December 1814, p. 540.

162. *Merchant's Magazine Commercial Review*, Volume IV (March 1841) p. 215.

163. United States Census Bureau. "Bicentennial Edition: Historical Statistics of the United States, Colonial Times to 1970."

164. United States Census Bureau "Historical Statistics of the United States, Colonial Times to 1970."

165. Cotton market analysis from Lebergott, Stanley, "The Americans, An Economic Record." 1984. W.W. Norton Co. Inc., New York, N.Y. Pp. 126-129.

166. Note that there was a brief increase in U.S. foreign trade after the United States adjusted policies in 1810 to resume trade with both Britain and France. The United States resumed a British embargo in 1811 and in 1812 a British blockade prevented most shipments into or out of the United States.

167. United States Census Bureau. "Bicentennial Edition: Historical Statistics of the United States, Colonial Times to 1970."

prepared. While the financial difficulties of the Revolutionary War may have been unavoidable, in this instance, pre-war analysis had been inaccurate. Initially, the government expected that it would be able to pay for the war strictly through borrowing. An early report by Treasury Secretary Albert Gallatin projected war costs at about \$10 million and argued that the government would easily find willing lenders among investors holding idle capital as a result of the trade embargo. The analysis, however, was horribly off target: the war was more expensive than projected, borrowing costs were higher and the amount of idle capital was lower. Additionally, the government entered the war already substantially in debt.<sup>168</sup> The bottom line: Rather than a \$10 million war, by the end of the fighting the national debt had nearly tripled from \$45 million in 1811 to \$127 million four years later.<sup>169</sup>



*John Jacob Astor built a fortune in the fur trade and then expanded his business empire. At the time of his death, he was the wealthiest man in the United States.*

In 1813, with the government badly in need of funding, it turned to a syndicate led by John Jacob Astor and Stephen Girard. The group bought \$13 million in government bonds at a steep discount and resold them retail at a profit. The following year, the syndicate agreed to pay another \$10 million on government bonds contingent on another substantial discount in price and an additional promise: there would be an effort to create a new national bank for the United States that the syndicate believed was necessary to curb speculation.<sup>170</sup> The demand reflected a plea from 150 New York business leaders who petitioned the government in 1814.<sup>171</sup>

168. Balinky, Alexander. "Gallatin's Theory of War Finance." *The William and Mary Quarterly*, Vol. 16, No. 1 (January, 1959), pp. 23-82.

169. Wood, John. *A History of Central Banking in Great Britain and the United States*. Cambridge University Press: Cambridge, N.Y. 2005. p. 127.

170. Burrows, Edwin G. and Wallace, Mike. *Gotham, A History of New York City to 1898*. Oxford University Press: New York City, 1999. p. 425.

171. Hammond, Bray. *Banks and Politics in America from the Revolution to the Civil War*. Princeton University Press: Princeton, N.J., 1957, pg. 231.

## *The Second Bank of the United States*

Plans for the Second Bank progressed slowly in Congress. Some of those who might have been in favor of a Bank had little appetite for revisiting the issue,

meanwhile those opposed to the idea worked to stall the legislation. The urgency, however, changed when the British, whom many in the United States believed were preparing to make peace, instead landed on the Patuxent River and marched from Maryland to Washington, D.C. shelling Baltimore and burning the White House in August 1814. The public uncertainty caused a run on the banks with consumers seeking to exchange paper currency for specie.<sup>172</sup>

In response, Philadelphia banks suspended specie payments with banks in many other areas of the country following suit over the next two weeks.<sup>173, 174</sup> While the individual banks either could not, or simply would not, make specie payments, they did remain open and conducted business with notes and checks. The overall turmoil, however, presented a challenge that the United States was ill-suited to address since it required federal action which was now not possible after the failure of the First Bank's charter renewal.<sup>175</sup>

As a result, the value of the currency began to fluctuate. While currency in New England – where some banks operated without suspension – was worth 100 cents on the dollar, it was worth only 93 cents in New York, 85 cents in Philadelphia and as little as 75 cents in Washington.<sup>176</sup> Complicating the problem was that banks in some of these areas were institutions that had stepped in to handle government accounts after the First Bank's elimination. These banks were generally not up to the responsibility in many cases, particularly related to instances where the government needed immediate funds. In the role as the government's bank, Hammond wrote that the state banks were “a poor substitute at best and, in the existing circumstances (during the suspension), they were nearly useless.”<sup>177</sup>

When Alexander Dallas took over as Treasury Secretary in October 1814, nearly \$2 million in Treasury obligations were past due in Philadelphia, New York and Boston. Meanwhile, to meet its obligations the Treasury was forced to borrow more money, creating the another episode of the now-familiar problem of a depreciating currency.<sup>178</sup>

In the turmoil, Congress began to reconsider the Bank issue.

172. Wood, John. “A History of Central Banking in Great Britain and the United States.” Cambridge University Press: Cambridge, N.Y. 2005. p. 126-127. Note that specie payments were not suspended in New England where there had been little interest in buying government debt due to opinions on the embargo.

173. Hunt's Merchants Magazine and Commercial Review. Vol. 3 July-December 1842, p. 91.

174. Specie payments in Baltimore and Washington had been suspended immediately.

175. Hammond, Bray. “Banks and Politics in America from the Revolution to the Civil War.” Princeton University Press: Princeton, N.J., 1957, p. 228.

176. Hammond, Bray. “Banks and Politics in America from the Revolution to the Civil War.” Princeton University Press: Princeton, N.J., 1957, p. 228.

177. Hammond, Bray. “Banks and Politics in America from the Revolution to the Civil War.” Princeton University Press: Princeton, N.J., 1957, p. 229.

178. Hammond, Bray. “Banks and Politics in America from the Revolution to the Civil War.” Princeton University Press: Princeton, N.J., 1957, p. 229.

Among its supporters was President James Madison who, as a member of Congress, had opposed the First Bank on constitutional grounds. His views, however, had changed.

The Second Bank and a national currency, he said, were “essential ... that the benefits of a uniform national currency should be restored to the community. The absence of the precious metals will, it is believed, be a temporary evil; but until they can again be rendered the general medium of exchange, it devolves on the wisdom of Congress to provide a substitute.”<sup>179</sup>

After a lengthy legislative process that continued well past the end of the war, the Second Bank of the United States opened Jan. 7, 1817 with a 20-year charter. The institution had much in common with its predecessor, although it was larger with \$35 million in capital compared against \$10 million at the First Bank. Like the First Bank, the Second Bank was 80 percent owned by stockholders with 20 percent owned by the government. The government appointed five of the Second Bank’s 25 directors.



*The headquarters for the Second Bank of the United States in Philadelphia was completed in 1824.*

It is interesting that, from a geographic perspective, support for the Second Bank’s creation was largely absent from the regions that had supported the creation of the First Bank 25 years earlier. In 1791, the North had essentially created the First Bank of the United States despite opposition from the South and rural areas. In 1816, however, the Second Bank’s strongest support was found overwhelmingly in the South and Western United States. In fact, in the House of Representatives, the New England states (New Hampshire, Massachusetts, Rhode Island, Connecticut, Vermont) voted against the Bank charter, 13-

21,<sup>180</sup> while Southern and Western representatives (North Carolina, South Carolina, Georgia, Kentucky, Tennessee, Ohio, Louisiana)

were overwhelmingly in favor of the

179. *Annual Message to Congress, Dec. 5, 1815.*

180. *The total vote in the House was 80-71. Vote totals can be found at: Clarke, M. St. Clair and Hall, D.A., eds. “Documentary History of the Bank of the United States.” Gales and Seaton 1832, pp. 681-682, 712.*

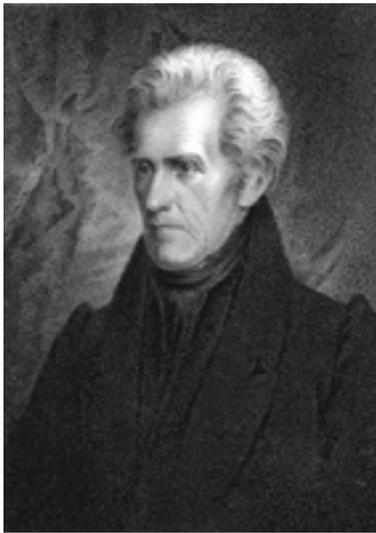
Bank, 32-12. Voting trends were similar in the Senate where half of the 12 “no” votes were by senators from New England and New York State.<sup>181</sup>

Some, but not all, of this behavior is a reflection of political party affiliations in both periods. However, the 1816 vote appears to be more regionally-motivated with those representing agricultural constituents supporting the Bank because it was viewed as a means of improving credit access in these remote areas.<sup>182</sup>

However, rather than helping to resolve ills plaguing the financial system, the Second Bank of the United States became embroiled in a political battle with Andrew Jackson, the populist war hero who had been elected president in 1828.

Several factors are believed to have contributed to Jackson’s opposition to the Bank, ranging from his own experiences with banking to a belief that the institution violated the rights of individual states, among other concerns.

The state issue resonated particularly well with bankers in some regions who were once



*President Andrew Jackson's battle against the national bank was one of the more prominent events of his presidency.*

again were concerned about a larger national institution’s potential power and influence within their communities. The Second Bank, which was both a commercial bank and the de facto central bank, had a federal charter allowing it to open branches anywhere without state permission. In some states, attempts to block or limit the operations of the Second Bank as a commercial institution included taxation on the Bank. In Maryland, such an effort by the state ended up going before the Supreme Court, which ruled against the state in the matter, upholding the constitutionality of the Second Bank.<sup>183</sup>

Jackson’s anti-bank message also was well received by those in his populist political base. While many of these individuals had supported the initial creation of the Bank as a way to improve credit access in their communities, they came to believe the Bank was a powerful tool for established financial interests in

181. Clarke, M. St. Clair and Hall, D.A., eds. “Documentary History of the Bank of the United States.” Gales and Seaton 1832. p. 706.

182. Howe, Daniel Walker. “What Hath God Wrought: The Transformation of America, 1815-1848.” Oxford University Press: New York. 2007. p. 85.

183. *McCulloch v. Maryland*, 1819.

the Northeastern United States. Notably, concerns about the Bank were “extremely prevalent” in areas of the South and West throughout the Bank’s history.<sup>184</sup>

This political battle, known as the “Bank War,” ended with Jackson vetoing legislation that would have extended the Bank’s charter in 1832. Although the Bank would continue to serve customers after its federal charter expired in 1836, it was not an institution of anywhere near the scope of what it had been previously, nor what its founders had intended.

184. Catterall, Ralph C.H. *The Second Bank of the United States.* The University of Chicago Press: Chicago, Ill., 1903, p. 164.



*The Suffolk Bank acted as a brokerage for bank notes that came into Boston from outlying communities. The “Suffolk System” helped Boston business owners by eliminating currency discounts that presented challenges in many large cities.*

# State Banks During and After The Second Bank

State banking systems continued to grow and evolve during the tenure of the Second Bank. Although estimates vary, around the time that the Second Bank was established the United States and its territories were home to more than 200 banks and numerous affiliated branch offices.<sup>185</sup>

“The developing American economy generated a demand for money that grew even faster than it did in the colonial era, and banks met the demand,” Sylla wrote.<sup>186</sup>

This period included what is sometimes referred to as America’s first economic crisis. The panic of 1819 came amid a rebalancing of foreign trade in the aftermath of the War of 1812, loose money and credit policies by banks, and a rise in real estate values and inflation amid speculation and the westward expansion. This situation was made worse by the Second Bank of the United States. In July 1818, the Bank had demand liabilities outstanding of more than \$22.3 million but held only \$2.4 million – a specie/deposit ratio of around 11 percent compared against what the lawmakers who created the Bank expected to be a standard specie/deposit ratio of 20 percent.<sup>187</sup> In October, the Treasury called on the Bank to deliver \$2 million in specie to pay off foreign debt obligations related to the Louisiana Purchase in 1803. The Bank, in turn, called in loans it had made to state banks. These banks, in turn, demanded payment from their borrowers.<sup>188</sup>

“Nervous lenders, including the (Second) Bank, insisted on stronger collateral; this reminder of reality ruined the fun and threw the speculation into reverse,” wrote historian H.W. Brands.<sup>189</sup> “Land prices plummeted, causing everything erected upon them to collapse as well. Banks called in their loans and savers hoarded, driving prices still further down.”

Nationwide, approximately one out of every 10 banks in the United States closed

185. Weber, Warren E. “Early state banks in the United States: How many were there and when did they exist?” *Quarterly Review. Federal Reserve Bank of Minneapolis*. September 2006.

186. Sylla, Richard E. “Monetary Innovation in America.” *The Journal of Economic History. Cambridge University Press on behalf of the Economic History Association*. Vol. 42, No. 1. (March 1982), p. 21-30.

187. Hammond, Bray. “Banks and Politics in America from the Revolution to the Civil War.” *Princeton University Press: Princeton, N.J.*, 1957, pp. 258.

188. Burrows, Edwin G. and Wallace, Mike. “Gotham, A History of New York City to 1898.” *Oxford University Press: New York City*, 1999. p. 444.

189. Brands, H.W. “The Money Men: Capitalism, Democracy and the Hundred Years’ War Over the American Dollar.” *Atlas Books. W.W. Norton and Co.: New York City*. 2006. p. 66.

during this period with the most substantial declines occurring in Ohio and Pennsylvania.<sup>190</sup> Additionally concerning, from the perspective of bank note holders and depositors, were suspensions where healthy banks refused to convert these liabilities to specie.

In response to the turmoil, New York lawmakers began discussions on reforming the state's banking system. Those discussions eventually led to the 1829 passage of the Safety Fund Act, which created the nation's first insurance program for bank noteholders and depositors. Under the Act, member banks paid six annual assessments of one-half of 1 percent of their capital stock into a pool that would be used to reimburse creditors of a failed member institution. If the pool was depleted, additional assessments would be implemented to maintain a fund at 3 percent of aggregate bank capital.<sup>191</sup> As a protection to the fund members, the legislation also created a board of commissioners that could inspect each member bank quarterly and seek court injunctions in cases of fraud, charter violation or insolvency.<sup>192</sup> Vermont followed the New York model, creating a similar system in 1831.

### *The Suffolk System*

As Bodenhorn points out, New York's goal of increasing confidence in the financial system was similar in intent to that of what was known as the Suffolk System that had been established earlier in New England.<sup>193</sup>

As has been noted, the broad range of notes issued by individual banks had the potential to complicate commerce. While notes might trade at par in the community of an issuing bank, there was generally a discount in their value the farther away from the bank that the note was used. The discount reflected some amount of risk related to the solvency of the distant issuing bank and also the cost of delivering the note back to the bank where it could be redeemed for the full value of specie. In much of New England, commerce flowed towards Boston, which resulted in a wide range of "foreign money" from country banks moving into the city. In 1803, Boston's banks sought to address this problem by jointly agreeing to stop accepting "foreign" notes, which they believed were restricting demand for the notes they issued. Rather than forcing the currency out of the city, the move instead fostered the rise of currency brokers. These were individuals

190. Weber, Warren E. "Early state banks in the United States: How many were there and when did they exist?" *Quarterly Review*. Federal Reserve Bank of Minneapolis. Sept. 2006.

191. Bodenhorn, Howard. "A History of Banking in Antebellum America." Cambridge University Press: New York, N.Y., 2000.

192. Bodenhorn, Howard. "State Banking in Early America, A New Economic History." Oxford University Press: New York, N.Y., 2003.

193. Bodenhorn, Howard. "A History of Banking in Antebellum America." Cambridge University Press: New York, N.Y., 2000.

and firms that profited by purchasing the country bank notes in the city at a discount and then delivering them back to the issuing country bank for full redemption.<sup>194</sup>

The Suffolk Bank was chartered in Boston in 1818 and the following year began acting as a brokerage for bank notes. By 1825, the Bank was operating a note-clearing business where it cleared notes at par for banks that were a part of their Suffolk System. System member banks in Boston were required to hold at least a non-interest-bearing deposit account with Suffolk, while banks outside of Boston were required to hold a second account that could be used for note redemptions. By 1836, nearly 300 New England banks were a part of the system.<sup>195</sup> The system was extremely beneficial for Boston business owners who, unlike their counterparts in New York, Philadelphia and other major cities, did not have to deal with issues related to discounting.<sup>196</sup>

### *The western states*

That innovations such as the Safety Fund and the Suffolk System would emerge in New York and New England is not at all surprising. Overall, as Conant notes in his banking history, the early banking systems established in both of these areas – the earliest centers of accumulation for excess capital – generally were more successful than the initial efforts made in some of the western states.<sup>197</sup> In these states, while the country and its banking system were entering a new stage of development, the challenges remained very similar to those that confronted the first banks: the demand for credit by a broad range of borrowers and the desire for local control that would be more locally engaged than banks operating in distant cities. The following are some of the notable state-level experiences from this period.

194. Rohnick, Arthur J.; Smith, Bruce D.; Weber, Warren E.; “Lessons from a Laissez-Faire Payments System: The Suffolk Banking System (1825-58)” Review. *Federal Reserve Bank of St. Louis*. May/June 1998.

195. Rohnick, Arthur J.; Smith, Bruce D.; Weber, Warren E.; “Lessons from a Laissez-Faire Payments System: The Suffolk Banking System (1825-58)” Review. *Federal Reserve Bank of St. Louis*. May/June 1998.

196. Lake, Wilfred S. “The End of the Suffolk System.” *The Journal of Economic History*. Cambridge University Press on behalf of the Economic History Association. Nov. 1947.

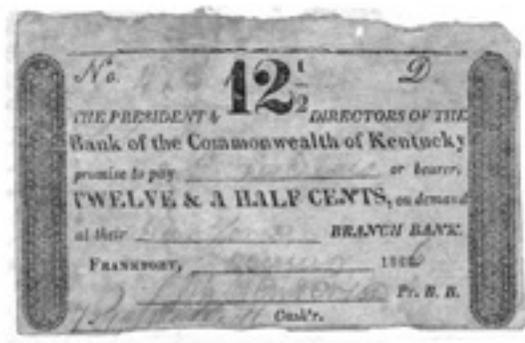
197. Conant, Charles. “A History of Modern Banks of Issue.” G.P. Putnam’s Sons. *The Knickerbocker Press*: New York and London. 1896.

198. <http://lexhistory.org/wikilex/kentucky-insurance-company-1802-1818>.

199. Griffith, Elmer C. “Early Banking in Kentucky, Proceedings of the Mississippi Valley Historical Association for the Year 1908-1909.” *The Torch Press*: Cedar Rapids, Iowa, 1910.

### *Kentucky*

In Kentucky, banking started with insurance. The Kentucky Insurance Company was chartered by the state in 1802 under the guise of providing coverage for riverboats and barges on the Ohio and Mississippi rivers.<sup>198</sup> While insurance was offered, the company’s charter, which may have been poorly understood by state officials, also created a de facto bank.<sup>199</sup>



*The Bank of the Commonwealth of Kentucky was one of numerous banks to gain a Kentucky state charter in the early 1800s.*

Kentucky banking.<sup>201</sup>

In the words of a later analyst, this first bank west of the Alleghenies “reeked of eastern corruption and favored certain sectors of society – those with money over those with land.”<sup>202</sup> The company’s stock was owned by merchants who received semi-annual dividends of 8 percent and Lexington merchants filled its board.<sup>203, 204</sup>

The state made at least two attempts in the years that followed to alter the charter. After those efforts were unsuccessful, the state chartered the Bank of Kentucky in 1806. Structurally, the Bank’s design was similar to the First Bank of the United States. The state retained an ownership stake in the Bank and the state legislature appointed one-half of the board’s 12 directors. However, state lawmakers also retained the right to fill the entire board if it felt such action was appropriate.<sup>205</sup> Additional safeguards included limitations on the Bank’s business and required regular reports to state officials.<sup>206</sup>

From a lending perspective, this Bank was charged with a goal of providing

Kentucky Insurance was able to issue notes and make loans at 6 percent interest.<sup>200</sup>

“We are told that the company was incorporated by its promoters chiefly for banking business, but realizing the public was bitterly opposed to bank notes the disguise of an insurance company was taken to avoid possible opposition,” reads one history of

200. Griffith, Elmer C. “Early Banking in Kentucky, Proceedings of the Mississippi Valley Historical Association for the Year 1908-1909.” *The Torch Press: Cedar Rapids, Iowa*, 1910.

201. Griffith, Elmer C. “Early Banking in Kentucky, Proceedings of the Mississippi Valley Historical Association for the Year 1908-1909.” *The Torch Press: Cedar Rapids, Iowa*, 1910.

202. Friend, Craig T. “Merchants and Markethouses: Reflections on Moral Economy in Early Kentucky.” *Journal of the Early Republic*, Vol. 17, No. 4 (Winter 1997).

203. Knox, John Jay. *A History of Banking in the United States.* Bradford Rhodes & Co.: New York, N.Y., 1900.

204. Friend, Craig T. “Merchants and Markethouses: Reflections on Moral Economy in Early Kentucky.” *Journal of the Early Republic*, Vol. 17, No. 4 (Winter 1997).

205. Friend, Craig T. “Merchants and Markethouses: Reflections on Moral Economy in Early Kentucky.” *Journal of the Early Republic*, Vol. 17, No. 4 (Winter 1997).

206. Griffith, Elmer C. “Early Banking in Kentucky.” *Proceedings of the Mississippi Valley Historical Association for the Year 1908-1909.* *The Torch Press: Cedar Rapids, Iowa*, 1910.

low-cost credit to farmers. Initially, the Bank engaged in mercantile and manufacturing lending – which reflected the background of bank officials – rather than focus solely on farm lending which, in isolation, would create an undiversified and illiquid portfolio.<sup>207</sup> While much of the lending in this case went to established borrowers, lending patterns gradually were altered as new opportunities emerged.

In terms of addressing the issues surrounding Kentucky Insurance’s banking business, the new bank secured a virtual monopoly of state business, leading to opposition that fueled the eventual chartering of an unprecedented 46 banks with \$9 million in total capital on Jan. 26, 1818.<sup>208</sup> A detailed banking history published in 1900 under the name of former Comptroller of the Currency John Jay Knox, Jr. and co-authors offered some details about these rookie bankers.

“The directors of the newly-created banks were ... men destitute of experience or knowledge in financial affairs, and in some instances, devoid of common honesty. During the summer of 1818, the state (of Kentucky) had been flooded with their paper. The tendency to speculation, rife at the time, was encouraged by the facility with which loans could be obtained. The money was expended in all kinds of rash enterprises.”

## Ohio

Ohio achieved statehood in 1803, but, for nearly a decade after that, Ohioans were “occupied literally in getting out of the woods.”<sup>209</sup> The dense forests and the rugged Allegheny Mountains posed substantial logistical road-



*The Ohio River provided Cincinnati with the ability to ship goods to New Orleans and a degree of economic freedom from cities along the Atlantic Coast.*

blocks to trade with the East Coast. These geographic challenges may have only been rivaled by

the degree of distrust that some Ohioans felt toward those living along the Atlantic.

“The balance of trade is largely in (the East Coast’s) favor, while in fact few individuals on our side gain any emolument,

207. Bodenborn, Howard. *A History of Banking in Antebellum America.* Cambridge University Press: New York, N.Y., 2000.

208. Royalty, Dale. “Banking and the Commonwealth Ideal in Kentucky, 1806-1822.” *The Register of the Kentucky Historical Society*, Vol. 77, No. 2 (Spring 1979).

209. Huntington, Charles Clifford. *A History of Banking and Currency in Ohio Before the Civil War.* *Ohio Archaeological and Historical Quarterly*. July 1915.

and society at large (is) deeply injured,” reads a letter that “A Citizen of Belmont” wrote to a Chillicothe, Ohio, newspaper in 1805.<sup>210</sup>

The letter writer was especially concerned about banking in Ohio, which he believed served only to increase the state’s vulnerability to the whims of East Coast financial interests.

A week later, another letter writer argued that Ohio banks were the key for breaking the hold that the Atlantic cities had on those living in what would become the central U.S.

“This is the only way to turn the balance in our favor,” reads the second letter.<sup>211</sup>

“If ... we are to decline the Atlantic trade and open a communication with New Orleans, the sooner the better. Let us immediately organize our bank. All the advantages derived from the system we shall then be certain to enjoy. And this will, in effect, be the very means of obviating ... the unprofitable Atlantic trade.”

The Ohio River provided an opportunity for shipping Ohio goods, including whisky, beef, pork and lumber, from Cincinnati to New Orleans. Not surprisingly, most of the first Ohio banks were in river communities or nearby towns.

Similar to what occurred in Kentucky, the first Ohio “bank” was not something state officials may have intended to charter. The Miami Exporting Company, named for the region of southwest Ohio, was incorporated in 1803 to transport agricultural products to New Orleans. Its charter, however, allowed for banking functions. Shares were offered for \$100 each, with \$5 payable in cash and the rest paid in “produce and manufacturers” in two scheduled periods over the following year.<sup>212</sup> Total banking capital was \$200,000.<sup>213</sup>

By 1807, the firm had shed its other operations and was solely a bank.<sup>214, 215</sup>

In 1808, the state chartered two banks, at least one of which had likely operated for some period as an association before gaining state approval. In both cases, interest rates on loans were capped at 6 percent and; with the second charter, the state included some provisions through which it hoped to regulate the redemption of bank notes.<sup>216</sup>

In the aftermath of the First Bank of the United States, Ohio banking business boomed. The Exporting Company issued shares to more than double its capitalization. By 1814, the state had chartered four additional banks.<sup>217</sup> Over

<sup>210</sup>. *The Scioto Gazette (Chillicothe, Ohio)*, Sept. 16, 1805.

<sup>211</sup>. *The Scioto Gazette (Chillicothe, Ohio)*, Sept. 23, 1805.

<sup>212</sup>. Huntington, Charles Clifford. “A History of Banking and Currency in Ohio Before the Civil War.” *Ohio Archaeological and Historical Quarterly*. July 1915.

<sup>213</sup>. Huntington, Charles Clifford. “A History of Banking and Currency in Ohio Before the Civil War.” *Ohio Archaeological and Historical Quarterly*. July 1915.

<sup>214</sup>. Knox, John Jay. “A History of Banking in the United States.” *Bradford Rhodes & Co.: New York, N.Y., 1900.*

<sup>215</sup>. Huntington, Charles Clifford. “A History of Banking and Currency in Ohio Before the Civil War.” *Ohio Archaeological and Historical Quarterly*. July 1915.

<sup>216</sup>. Huntington, Charles Clifford. “A History of Banking and Currency in Ohio Before the Civil War.” *Ohio Archaeological and Historical Quarterly*. July 1915.

<sup>217</sup>. Huntington, Charles Clifford. “A History of Banking and Currency in Ohio Before the Civil War.” *Ohio Archaeological and Historical Quarterly*. July 1915.

the three-year period, overall bank capital in Ohio swelled from \$895,000 to more than \$1.4 million.<sup>218</sup> Additionally, there was some number of unauthorized “banks” ranging from some completely fraudulent schemes to credible firms that later sought and gained state approval.<sup>219</sup>

When the Ohio population more than doubled in the decade following 1810 – jumping from around 230,000 to nearly 600,000 – available currency and credit was “wholly inadequate for the wants of the people. The cry for money that could be borrowed ... was heard on all sides.”<sup>220</sup>

According to a local newspaper account, by 1818 there were 23 chartered banks in Ohio.<sup>221</sup> To address the problematic currency flood seen in other states, in early 1816, Ohio lawmakers passed legislation that prevented note issuance unless authorized by law. This legislation, which was implemented ahead of the problems in nearby Kentucky, punished officers of violating banks with a potential year in prison and a \$5,000 fine.<sup>222</sup>

“The flood of immigrants after the war of 1812 had increased the amount of transport and gave big impulse to enterprise of all kinds,” reads one early Ohio history.<sup>223</sup> “Steamboat



*The development of Ohio's banking system related closely to the ability to export goods on the Ohio River. The Miami Exporting Company may have been created to ship farm commodities, but it was soon engaged in banking.*

building and town making advanced rapidly. The sale of lands put a lot of money into circulation. Mercantile importations filled the country with foreign goods. Both town and country partook of the advantages of the boom. Industry was rewarded, markets were enlarged, and the products of the country were purchased at liberal prices. The farmers felt with as much force as the mechanic and the merchant of the city the pleasing prosperity of those halcyon days.”

- 218. Huntington, Charles Clifford. “A History of Banking and Currency in Ohio Before the Civil War.” *Ohio Archaeological and Historical Quarterly*. July 1915.
- 219. Huntington, Charles Clifford. “A History of Banking and Currency in Ohio Before the Civil War.” *Ohio Archaeological and Historical Quarterly*. July 1915.
- 220. Huntington, Charles Clifford. “A History of Banking and Currency in Ohio Before the Civil War.” *Ohio Archaeological and Historical Quarterly*. July 1915.
- 221. *Portsmouth Ohio Gazette*, Aug. 12, 1818 via Huntington, Charles Clifford. “A History of Banking and Currency in Ohio Before the Civil War.” *Ohio Archaeological and Historical Quarterly*. July 1915.
- 222. Huntington, Charles Clifford. “A History of Banking and Currency in Ohio Before the Civil War.” *Ohio Archaeological and Historical Quarterly*. July 1915.
- 223. Huntington, Charles Clifford. “A History of Banking and Currency in Ohio Before the Civil War.” *Ohio Archaeological and Historical Quarterly*. July 1915.

## Louisiana

Arguably no state has as colorful – or flamboyant – a history as Louisiana. Originally a French colony and later under Spanish control, Louisiana already had a lengthy and challenging financial history before gaining statehood in 1812.

Currency and commerce under French control was “a succession of gross blunders and outrages, which kept the currency always at a discount . . . and upset and disturbed all values,” according to an early New Orleans history.<sup>224</sup> The system may have improved slightly under Spanish authority, with an increase of silver specie from Mexico, but then deteriorated again after the region was returned to France before the sale to the United States.<sup>225</sup>



*The design of the Louisiana State Bank incorporated a courtyard into the structure.*

From the New Orleans perspective, no matter who had been in charge, they were “devoted . . . to fleecing the colonists as much as possible.”<sup>226</sup> “With American rule came a complete change.”<sup>226</sup> In 1804, a year after the Louisiana Purchase, the territorial government created the Louisiana Bank in New Orleans. In something of a reflection of the region, the Bank’s president, Evan Jones, was an American while its secretary and second in command was, Paul Lanusse, a Creole. Additionally, advertisements seeking employees noted that workers should be fluent in both English and French.<sup>227</sup>

Interestingly, the Bank’s leadership specifically rejected an attempt by the Bank of the United States to make the Louisiana Bank a New Orleans branch of the Philadelphia-based institution. The Louisiana Bank directors feared the national bank sought to control their finances and expressed their views on the offer in a strongly-worded resolution that emphasized “(T)he Louisiana Bank being owned altogether by inhabitants of this country, all the profits which it may make will be divided among them and remain in this country.”<sup>228</sup>

224. Rightor, Henry, editor. “Standard History of New Orleans, Louisiana.” *The Lewis Publishing Company: Chicago, Ill., 1900.*

225. Rightor, Henry, editor. “Standard History of New Orleans, Louisiana.” *The Lewis Publishing Company: Chicago, Ill., 1900.*

226. Rightor, Henry, editor. “Standard History of New Orleans, Louisiana.” *The Lewis Publishing Company: Chicago, Ill., 1900.*

227. *Orleans Gazette and Commercial Advertiser*. March 19, 1806.

228. Rightor, Henry, editor. “Standard History of New Orleans, Louisiana.” *The Lewis Publishing Company: Chicago, Ill., 1900.*

The Bank of the United States separately opened a Branch in New Orleans. Meanwhile, additional local banks were created in the years that followed including the Bank of Orleans and the Louisiana Planters' Bank, the latter of which specialized in agricultural credit.<sup>229</sup>

After Louisiana gained statehood, the Louisiana State Bank was chartered with a comparatively massive \$2 million in capital – 25 percent of it from the state – and five branch locations. The branches were the first banks outside of New Orleans in the state and each held \$100,000 in capital. The state later chartered the Bank of Louisiana with \$4 million in capital, one half from the state, to focus on farm lending.<sup>230, 231</sup>

## Indiana

Like Louisiana, banking in Indiana pre-dated statehood. During its tenure as a territory, Indiana was home to a handful of private banks while the state relied on currency from Ohio, the then-functioning national bank and Spanish milled dollars. The territorial government chartered two banks in 1814: the Bank of Vincennes with \$500,000 in capital and the Farmers and Mechanics Bank of Madison with \$750,000. Both banks could issue bills.<sup>232</sup>

After Indiana gained statehood in late 1816, the state banned the creation of additional banks and on Jan. 1, 1817 made the Bank of Vincennes the state bank with additional powers, a doubling of its capital and the opening of three branches.<sup>233</sup>

Although Indiana officials may have believed banning the creation of new banks would protect the state's financial system, the Bank of Vincennes failed horribly as the state's official bank. Not only did the Bank flood the state with bills, it refused to redeem notes, paid large dividends to stockholders and there was at least one case of embezzlement. In 1821, the state filed suit to annul the charter with the case finally reaching the Supreme Court, which sided with the state. Depositors and bill holders received nothing. At the time it closed, the Bank had \$34 in its vault.<sup>234</sup>

229. Rightor, Henry, editor. "Standard History of New Orleans, Louisiana." *The Lewis Publishing Company: Chicago, Ill., 1900.*

230. Knox, John Jay. "A History of Banking in the United States." *Bradford Rhodes & Co.: New York, N.Y., 1900.*

231. Bodenhorn, Howard. "State Banking in Early America, A New Economic History." *Oxford University Press: New York, N.Y., 2003.*

232. Knox, John Jay. "A History of Banking in the United States." *Bradford Rhodes & Co.: New York, N.Y., 1900.*

233. Knox, John Jay. "A History of Banking in the United States." *Bradford Rhodes & Co.: New York, N.Y., 1900.*

234. Knox, John Jay. "A History of Banking in the United States." *Bradford Rhodes & Co.: New York, N.Y., 1900.*

In 1834, after being inundated by currency from Michigan used by contractors to pay workers involved in state improvement projects, the state chartered the State Bank of Indiana with \$1.6 million in capital, half coming from the state.

From an access to credit perspective, the state wanted to encourage lending to

“farmers and those engaged in buying and selling farm produce and livestock.” In relation to this, there were prohibitions against the Bank lending more than \$300 to a merchant and more than \$500 to a manufacturer.<sup>235</sup>

An early state history provides substantial detail on the lending process.

“The applicant for a loan was required to state fully his financial condition, for what he intended to use the money, the financial condition of the men he proposed to offer as endorsers, and then the (Bank) directors would take the matter under advisement. They would make inquiries in the neighborhood of the party desiring the loan, as to the personal habits of the proposed borrower and as to the characteristics of his wife and family, so far as industry and economy were concerned. When the reports from these inquiries would be received, the (Bank) directors would hold a solemn meeting and pass upon the application for the loan.”



*Indiana created an innovative banking structure where branch locations served specific districts within the state.*

Structurally, the Bank had a unique design. Officially, it was based in Indianapolis with 10 branch locations assigned to specific districts.<sup>236</sup> In reality, however, the structure was something of a workaround to circumvent the letter of the law under the state’s prohibition on independent banks. Each of the so-called “branches” essentially was its own institution with its own capital, officers and stockholders. The “Bank” president and directors acted somewhat similarly to a state banking commissioner with a degree of oversight responsibility.<sup>237</sup> A separate, but noteworthy component of this structure was that each of the “branches” was required to guarantee the deposits and notes of the others, thereby creating another type of insurance on bank obligations known as a mutual guarantee system. This system was different from the insurance on bank obligations created in 1829 in New York – and later copied in Michigan and Vermont – where each state bank was required to contribute to an insurance fund. In 1845, Ohio created a

235. Smith, William Henry. *The History of the State of Indiana Vol. II.* The B.L. Blair Company: Indianapolis, Ind. 1897.

236. *Indiana Past and Present. Vol. 1, No. 1.* April 1914.

237. Golembe, Carter H. “Origins of Deposit Insurance in the Middle West, 1834-1866.” *Indiana Magazine of History. Volume 51, Issue 2. 1955.*

system similar to the Indiana model.

Notably, by most accounts the Indiana structure fared better than its counterparts when faced with the challenges posed by the Panic of 1837. Like many crises, this Panic was caused by multiple factors including, notably, land speculation in the West and a mandate from President Jackson that land purchases from the government must be made in specie – thereby draining gold and silver from the banking system. Other factors included a reduction in credit from British lenders to large American borrowers, including some banks, and a growing trade imbalance with Europe.<sup>238</sup> Banks suspended specie redemptions nationally in 1837 for a year (longer in some areas) and a depression continued until 1843. By some accounts, assets of state chartered banks fell by nearly half and as many as one-quarter of all banks chartered in 1837 were forced to close.<sup>239</sup> Particularly hard hit were then-western states. By the mid-1840s, Michigan was left with four banks, down from a pre-crisis peak of 34.<sup>240</sup>

“(W)hen the depression had run its course, the Michigan system was found to have disintegrated, the insurance fund in New York had proved inadequate to meet all the claims of creditors of banks which had failed, and the Vermont system had been seriously weakened,” wrote economist and banking analyst Carter Golembe.<sup>241</sup>

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

238. Howe, Daniel Walker. *“What Hath God Wrought: The Transformation of America, 1815-1848.”* Oxford University Press: New York. 2007. p. 85.

239. Rosseau, Peter L. “Jacksonian Monetary Policy, Specie Flows, and the Panic of 1837.” *The Journal of Economic History*. Published by Cambridge University Press on behalf of the Economic History Association. Vol. 62, No. 2. June 2002.

240. Weber, Warren E. “Early state banks in the United States: How many were there and when did they exist?” *Quarterly Review*. Federal Reserve Bank of Minneapolis. September 2006.

241. Golembe, Carter H. “Origins of Deposit Insurance in the Middle West, 1834-1866.” *Indiana Magazine of History*. Volume 51, Issue 2. 1955.



*Banking in Canada started with the establishment of the Bank of Montreal in 1817. The Bank's headquarters moved to Toronto in 1977.*

# Canadian Comparison

One potential way to gain some perspective on the emergence of the American banking system during this early period is to compare it against countries that were in a similar state of development at the same time. The most obvious example, of course, would be Canada, which also shares a common ancestor in the British.

In making comparisons between the two countries, however, it is important to recognize that while the United States and Canada may have similarities, there also are significant cultural differences. They have two distinct national histories, which are reflected in the structures of their respective financial systems.

## *Under control*

Unlike the United States where Americans took up arms in the fight to excise foreign rule, Canada gained its independence only gradually across several generations, finally becoming an independent nation in the 1860s. Canada, however, did not shed the last remnants of British rule until more than a century later in 1982.



*The region known as "Upper Canada" is generally located along the Great Lakes. The area to the east, meanwhile, is known as "Lower Canada."*

The British wanted very much to keep Canada and they were successful. Accomplishing this required careful management in the face of challenges presented by a uniquely divided population in two colonies known collectively as "The Canadas." In general terms, settlements along the St. Lawrence River and the Great Lakes in what was known as the "Province of Upper Canada" had a stronger British heritage, spoke English and welcomed British loyalists fleeing the United States after the Revolutionary War. To the east, was the more heavily-populated "Province of Lower Canada," which had a large French population and her-

<sup>242</sup> The terms "Upper" and "Lower" are relative to the headwaters of the St. Lawrence River, which flows in a northeastern direction from the Great Lakes toward the Atlantic. As a result, "Upper Canada" is geographically located to the southwest of "Lower Canada."

itage that remains apparent even today.<sup>242</sup>

Keeping a check on a French population that was essentially big enough to take control of both provinces required a stronger centralized governance structure.

That structure also was reflected in the Canadian banking and financial system.

Initial banking efforts in Canada can be traced to the apparently short-lived Canada Banking Company in 1792, but the real beginning of Canadian banking came in 1817 with the establishment of the Bank of Montreal.<sup>243</sup>

While the Bank's charter was based on Hamilton's design of the First Bank of the United States, the Canadian environment overall was decidedly more constrained.<sup>244</sup> As a result, the Canadian system that emerged from what might be considered a similar Hamiltonian foundation was significantly different than what happened in the United States.

In almost any discussion of the early economic and financial developments in the United States, much of the credit is deservedly given to Hamilton. While agriculture remains a key component of the U.S. economy, Hamilton's overall economic vision for America generally prevailed over Jefferson's, due in no small part to his own work. His understanding of how financial systems provided the basis for both the Dutch Republic and, later, the British, to foster the world's most advanced economies was acutely important to the creation of similar structures in the United States and, in turn, providing a foundation for the development of the then-nascent U.S. economy into what it became.

"In response to Hamilton's actions, others reacted to complete the U.S. financial revolution," Sylla wrote. "U.S. states, so as not to cede the ground of banking to the new federal government, chartered more new banks that furnished credit to borrowers."<sup>245</sup>

They were followed by other developments, including securities markets, the creation of insurance companies and government policies.

That was not the path that Canada immediately followed.

For example, 20 years after the opening of the Bank of Montreal, Canada had expanded to only 14 banks while the United States was home to approximately 600.<sup>246</sup> Arguments can and

have been made about the potential risks of the large number of banks in the United States, but it is also worth recognizing that in early U.S. history these banks provided a critical function for economic development by making credit widely accessible for many worthy borrowers.

243. Shortt, Adam. "The Early History of Canadian Banking." *Journal of the Canadian Bankers' Association*. 1896.

244. Davies, Phil. "The way of the North." *The Region*. Federal Reserve Bank of Minneapolis. Sept. 1, 2009.

245. Sylla, Richard E. "Political Economy of Financial Development: Canada and the United States in the Mirror of the Other, 1790-1840." *Enterprise & Society*. Vol. 7, No. 4. December 2006.

246. Sylla, Richard E. "Political Economy of Financial Development: Canada and the United States in the Mirror of the Other, 1790-1840." *Enterprise & Society*. Vol. 7, No. 4. December 2006.

Conversely, Canadian banks dealt with only a limited base of borrowers, generally were more restrictive with credit policies and were entirely prohibited from real estate lending.<sup>247</sup>

“Canada’s few banks served the business elites that had been instrumental in their chartering, but they did little to provide financial services for most Canadians,” Sylla wrote.<sup>248</sup> “Unsurprisingly, in comparison to the United States, Canada in these years experienced little economic growth or development.”

From the United States’ perspective, the key difference between the designs of the two countries’ financial systems is the populist sentiment that runs throughout United States history and is reflected throughout the nation’s institutions and governance systems.

The populist views that fueled the American Revolution were not completely absent north of the border, however. Armed attempts at rebellion in both 1837 and 1838 were quickly quelled. Similarly, populist sentiments also were overwhelmed in the area of banking. Not all early Canadians were in polite agreement with the country’s banking systems or believed it had the capacity to serve their interests, but they could not change the environment. Multiple petitions for banks were made during this period and rejected by legislatures in authority over both Upper and Lower Canada.

“The commerce and agriculture of this Province labor under many inconveniences and discouragements from the quantity of specie in circulation being greatly inadequate to its necessities and increasing population; from thence enterprise and industry languish, and the natural advantages arising from a fertile soil, large and navigable rivers, and most valuable and extensive fisheries, in the river, bays and Gulf of St. Lawrence, remain almost dormant and unimproved,” read one petition presented to the House of Assembly of Lower Canada in early 1808.<sup>249</sup>

The creation of the Bank of Montreal was soon followed by the creation of a few others and while there was some momentum toward a rapid expansion of banking in the

1830s (albeit at a lesser scale than in the United States) it was essentially brought to a halt by the government.<sup>250</sup> The result was the continuance of a system composed of a few very large and powerful banks and not a large number of diverse institutions.<sup>251</sup>

247. Davies, Phil. “The way of the North.” *The Region. Federal Reserve Bank of Minneapolis. Sept. 1, 2009.*

248. Sylla, Richard. “Political Economy of Financial Development: Canada and the United States in the Mirror of the Other, 1790-1840.” *Enterprise & Society. Vol. 7, No. 4. December 2006.*

249. Shortt, Adam. “The Early History of Canadian Banking.” *Journal of the Canadian Bankers’ Association. 1896.*

250. Conant, Charles. “A History of Modern Banks of Issue.” *G.P. Putnam’s Sons. The Knickerbocker Press: New York and London. 1896.*

251. Davies, Phil. “The way of the North.” *The Region. Federal Reserve Bank of Minneapolis. Sept. 1, 2009.*

## Economic development

A comparison of the resulting economic situation in both countries can be somewhat stark.



*In addition to his role in Canada, John Lambton, the first Earl of Durham, was also involved with British efforts to colonize New Zealand.*

While the United States economy was quickly emerging, “it is certain, at least, that from 1820 to 1830, the Province of Lower Canada was not far advanced,” reads one early history. “In commercial activity and general economic development it was much inferior to the State of New York on its southwestern border, and the comparison with Ohio in the later years of the decade would have been distinctly unfavorable.”<sup>252</sup>

While this apparent weakness cannot all be blamed on the banking system, it is notable that an 1839 report by John Lambton, the first Earl of Durham and Governor and the high commissioner of British North America, stated “the entire wholesale and a large portion of the retail trade of the province . . . are in the hands of a numerical minority of the population.”<sup>253</sup>

This type of restricted control was very much the type of thing the American system sought to prevent.

To the west in Upper Canada, Lambton found worse economic conditions. “A very considerable portion of the province has neither roads, post offices, mills, schools or churches,” he wrote. “The people may raise enough for their own subsistence and may even have a rude and comfortless plenty, but they can seldom acquire wealth.”<sup>254</sup>

As Sylla notes, while both Canada and the United States were essentially equal in terms of standards of living in the mid-18th century, by the middle of the 19th, the United States was far advanced.<sup>255</sup>

“(T)he U.S. financial revolution, significantly if perhaps not solely, ignited modern economic growth in the United

252. Breckenridge, Roeliff Morton. “The Canadian Banking System 1817 – 1890.” Columbia College: Toronto, Canada. 1894.

253. *Report on the Affairs of British North America, from the Earl of Durham, Her Majesty’s High Commissioner, etc., Montreal, 1839.*

254. *Report on the Affairs of British North America, from the Earl of Durham, Her Majesty’s High Commissioner, etc., Montreal, 1839.*

255. Sylla, Richard. “Political Economy of Financial Development: Canada and the United States in the Mirror of the Other, 1790-1840.” *Enterprise & Society*. Vol. 7, No. 4. December 2006.

States,” Sylla wrote of this period.<sup>256</sup>

“The system was there to finance the country’s domestic and foreign commerce, its transportation and industrial revolutions, its westward movement, and its wars. It quickly became such an integral components of the country’s economic infrastructure that most Americans, then and later, assumed it was always there. They did not realize that it was something really quite new – and quite rare – in the history of nations.”<sup>257</sup>

256. Sylla, Richard. “Political Economy of Financial Development: Canada and the United States in the Mirror of the Other, 1790-1840.” *Enterprise & Society*, Vol. 7, No. 4. December 2006.

257. Sylla, Richard. “Financial Systems and Economic Modernization.” *Remarks at the 61st annual meeting of the Economic History Association. The Journal of Economic History*. Published by Cambridge University Press on behalf of the Economic History Association. Vol. 62, No. 2. June 2002.



*President Andrew Jackson's fight against the Second Bank of the United States reflected a populist concern about the risks associated with a monolithic and consolidated financial system.*

# Conclusion

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*“We remain a nation characterized by a large number of smaller community banks – just as we are a nation characterized by a diversity and small average size of our nonfinancial businesses.”*

– ALAN GREENSPAN, FORMER FEDERAL RESERVE CHAIRMAN

MARCH 22, 1997<sup>258</sup>

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The creation of a system of large banks and small community banks, along with the ability to experiment at the state level, was a direct response to Americans’ demand for credit that was coupled, in some areas, with a traditional American skepticism toward consolidated power – in this case, particularly as it relates to the ability to control credit. As Hammond writes this spirit was particularly evident in President Andrew Jackson’s attack on the Second Bank of the United States and his ability to garner public support.

“The ambitious, farm-born entrepreneur, envious of the rich and set to become rich, wanted credit for his enterprises; his banks wanted to provide it. But the ‘aristocratic’ (national) bank situated in conservative Philadelphia restricted bank lending,” Hammond wrote.

Jackson and the “entrepreneurial rebels attacked what they called the monopoly and the tyranny” of the Bank.<sup>259</sup>

The accompanying end of federal restraint on the monetary system created numerous problems in the decades that followed – Hammond notes the result for farmers was the antithesis of what they had hoped.<sup>260</sup> Eventually, provisions that Jackson had eliminated began to be restored under Abraham Lincoln. Later, the nation saw the creation under Woodrow Wilson of the Federal Reserve as the nation’s central bank, with additional regulatory developments and structures created in the years that followed.

Although this evolution continues even today, currently under the forces of tech-

nology and consolidation, the same concerns that were so apparent in early U.S. history remain.

“Our (financial) regulatory system has been designed and evolved to reflect

258. Greenspan, Alan. *Remarks at the Annual Convention of the Independent Bankers Association of America*. Phoenix, Ariz., March 22, 1997.

259. Hammond, Bray. *Banks and Politics in America from the Revolution to the Civil War*. Princeton University Press: Princeton, N.J., 1957, pp. 740-741.

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core American values, such as checks and balances, dispersion of power, and a balance of national interests with local control,” said John Ryan, president and chief executive officer of the Conference of State Bank Supervisors, during a 2013 speech.<sup>261</sup>

Ryan, whose career included a fellowship with the European Union and work on international banking issues at the House Banking Committee, noted three points about what he referred to as “a truly American” banking system during his remarks:

- Under the system, federal and state governments can focus on their strengths;
- The system balances a strong national framework with the ability of states to solve problems and provide for their citizens in ways that best serve local needs;
- The system provides access to financial services and credit for almost all segments of the population.

“We can all point to many examples of (the system’s) failings. But some of the perceived failings are truly great attributes. The ability to allow for orderly failure, to allow for market discipline while protecting depositors has been our banking system’s greatest and most underappreciated strength. Put simply, from where state (banking) regulators sit, we don’t see another model that meets our economic needs as well as the dual banking system,” Ryan said.

“Furthermore, without the unique dynamic of small diverse institutions, our system quickly starts to lose its distinction and value. Community banks represent far more than just ... (a) percent of assets. They represent what has made our system unique, our banking system dynamic, and our economy out perform all others.”

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The logo features a stylized eagle with its wings spread, perched atop a shield with vertical stripes. The shield is surrounded by a laurel wreath. The entire emblem is rendered in a light brown or tan color.

# *Why Community Banks Matter*

*Esther L. George*

PRESIDENT *and* CHIEF EXECUTIVE OFFICER  
FEDERAL RESERVE BANK *of* KANSAS CITY

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FEDERAL RESERVE BANK OF NEW YORK COMMUNITY BANKING CONFERENCE  
NEW YORK, N.Y.  
APRIL 6, 2017



# Why Community Banks Matter

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Community banks have an important connection with the Federal Reserve. Across the 12 Federal Reserve Banks, some 68 bankers serve as directors on either Reserve Bank or Branch boards and nearly all of them are community bankers. These individuals bring important perspectives to our work. I appreciate their contributions as well as the core function that community banks serve in thousands of communities across the United States.

I hope you'll indulge me as I briefly preface my remarks this morning with some personal history. Yesterday marked a milestone for me: 35 years of service with the Federal Reserve. When I came to work for the Kansas City Fed as a bank examiner in 1982, I was also a first-time homeowner. I was delighted to have a job that would help me pay my bills, especially my mortgage. At that time, I thought I'd made a steal to have assumed an existing mortgage at the low rate of 12 percent.

Working at the Fed, I soon came to appreciate that it was a particularly challenging year for the banking industry. Our region was hard hit by the trifecta of downturns in commercial real estate, energy and agriculture. That year, the failure of a small bank in Oklahoma triggered the failure and eventual government bailout of one of the largest banks in the U.S. Meanwhile, hundreds of banks failed in the Tenth District. This was the environment in which I was trained to be a bank supervisor.

This also was the year that a former New York Fed president, E. Gerald Corrigan, wrote an essay titled "Are Banks Special?"<sup>262</sup> It proved to be a foundational piece that has been occasionally revisited by others in the 35 years since. Today, I would like to return to the theme of Mr. Corrigan's essay by looking at the role of banks while asking a slightly different question, "Do traditional banks still matter to the U.S. economy?" A spoiler alert: My answer is a definitive "yes." I'll use the remainder of my time today outlining why this is so, and why I believe this key component of the U.S. economy may be at risk.

Before going further, I should note that my comments today are my views only and not those of the Federal Reserve System or its Board of Governors.

*262. E. Gerald Corrigan served as president of the Federal Reserve Bank of Minneapolis from 1980 to 1984 and president of the Federal Reserve Bank of New York from 1985 to 1993.*

## *The Banking Landscape in 1982*

In an interview some years later, Mr. Corrigan recalled the reason he wrote the 1982 essay. Simply put, the competitive position of traditional banks was rapidly eroding, and policymakers were contemplating the implications.

In the early 1980s, the combination of high interest rates and deposit rate ceilings made it difficult for banks to compete with alternatives that were not subject to the same restrictions, including savings and loan NOW accounts and money market mutual funds. By the time interest rate ceilings were eliminated on most deposits, money market funds were well established.

In credit markets, the seeds of greater capital market competition for bank loans were also planted in the early 1980s. The development of government and agency mortgage-backed securities were followed by private label mortgage and other asset-backed securities. Another major innovation was funding new credits with high-yield bonds, which previously had been used only to refinance companies whose debt had been downgraded below investment grade.

Given the dramatic nature of these changes, questions arose about whether the role of banks had been diminished. Would these new nonbank entrants supplant their role? Did it matter? With reflection on these questions, Mr. Corrigan concluded that banks were different and unique in three ways:

- Only banks offered transaction deposits payable on demand at par and readily transferable;
- Banks served as the primary and ultimate source of liquidity for all other classes and sizes of institutions, both financial and nonfinancial;
- Banks served as the transmission mechanism for monetary policy which, combined with operating the payments mechanism, facilitates efficient markets and orderly end of day settlement – a particularly important role in periods of financial stress.

At that time, these special characteristics of banks had three important implications for the structure of our financial system and its regulation:

- No other type of financial company had its funding protected by the public safety net of federal deposit insurance and the Federal Reserve discount window.
- Banks were regulated and supervised because of this safety net and their key role in the economy. At that time, the separation of commercial banking from investment banking and commerce was an important part of the prudential regulatory structure.

- Only banks had direct access to the Federal Reserve's payments rails.

From 1982 to 1999, the financial system continued to evolve, aided by regulatory interpretation and court decisions. And the banking industry began to experience rapid consolidation. Much of the consolidation reflected mergers of smaller banks as intrastate and interstate restrictions were relaxed. However, the most significant effect for the banking system was an increase in the market share of the largest banks, driven by their efforts to create nationwide operations and enhance global competitiveness. During this period, the market share of the ten largest banking companies increased from 28 percent to 51 percent of total banking assets.

The scale of these firms made it profitable to operate securities dealing and underwriting subsidiaries under the Glass-Steagall Act's Section 20 authority. This was the first major crack in the wall between commercial and investment banking. In 1999, Glass-Steagall gave way to the Gramm-Leach-Bliley Act (GLBA), which invited bank holding companies to adopt investment banking activities with important safety net advantages.

With the addition of these nonbanking activities, the ten largest banking organizations saw their market share rise further to 55 percent in 2007. Meanwhile, the composition of their assets changed dramatically. The average portfolio share of nonbanking assets rose from only 13 percent in 1997 to 25 percent in 2007.

This summer marks the tenth anniversary of the financial crisis. That event brought to light what had previously only been conceptually understood: the largest banking organizations were highly interconnected and indeed too big to fail (TBTF). The safety net designed to cover only commercial banking activities was stretched well beyond the insured depository subsidiaries to their parent companies and nonbanking subsidiaries. However, only commercial banks truly retained the unique characteristics that Mr. Corrigan argued made them special.

As a practical matter, the largest banks were the only firms that could acquire other large and troubled investment banks, commercial banks, and savings associations. The remaining large independent investment banks became bank holding companies. As a result, the 10 largest banking organizations now account for 67 percent of industry assets, while the average nonbanking-asset share of their portfolios has climbed to 29 percent.

As I look through the lens of the past 35 years, the financial system landscape has certainly changed. There are three features that I find particularly striking over this period.

- Banking system assets as a share of financial system assets have fallen from 37 to

19 percent.

- The number of banks has significantly declined from more than 18,000 to around 5,000, largely reflected in fewer community banks with less than \$100 million of assets.
- Community banks' market share fell from 45 percent in 1982 to just 13 percent today.

What has emerged within the banking system are two very different kinds of commercial banking firms: a small number of very large banking organizations with significant non-banking activities and sufficient scale to pose systemic risk to the economy, and thousands of traditional banks generally referred to as community banks.

### *Do Traditional Banks Matter to the U.S. Economy in 2017?*

Despite such monumental shifts in the financial system landscape, one could reach the same conclusion today as Mr. Corrigan did in 1982. Namely, that the banking system retains a unique role in our economy. Banks are still the only type of financial firm that can provide liquidity whenever needed, ensure payments are readily transferable, and aid the implementation of monetary policy.

Yet, the differences between the largest banks and community banks are significant and those differences pose important challenges for setting effective regulatory policy. This leads me to ask a slightly different question than Mr. Corrigan asked: Are traditional banks, or community banks, still important to the U.S. economy in 2017?

I answered this question affirmatively at the beginning of my remarks. Indeed, traditional banks are essential to thousands of communities across the country. In contrast to the largest banks, community banks still rely primarily on relationship lending, with a focus on funding local loans with core deposits. Their heterogeneous customer base and credit decisions include not only quantitative but qualitative aspects including judgments about the repayment ability of their Main Street customers. These bankers serve on the boards of local schools, hospitals and other civic organizations, providing a key source of leadership in the community.

They serve their communities and are part of their communities.

But do they matter to the U.S. economy as a whole? Can online banking and scale satisfy the credit needs on Main Streets and in rural areas? I am reminded that although we often refer to "the U.S. economy" in aggregate, as though it were a single monolithic entity, there are in fact thousands of micro-economies that taken together make up the \$19

trillion U.S. economy. In these micro-economies, community banks are a critical source of financing for small businesses, including startups. While community banks account for just 13 percent of industry assets, they are responsible for some 40 percent of bank lending to small businesses. In turn, small businesses with less than 500 employees account for about 50 percent of U.S. private employment.<sup>263</sup> Moreover, recent research shows that small startups with 20 to 499 employees play a large role in net job creation that continues for up to five years after their formation.<sup>264</sup>

This evidence indicates community banks are still extremely important to our economy, although, their competitive position is under stress. Market forces of technology and innovation are everywhere and community banks will need to be responsive to customer demand for new services and methods of banking. But these are not the forces that particularly concern me. The risk I see stems from a misaligned regulatory environment that poses a threat in my view to the diversity of the U.S. banking system and healthy competition that has long served the country well.

### *Policy Implications*

Today, the nation stands at a crossroads of policy choices. As policymakers consider regulatory reform, the special role of banks in our economy and particularly the role of community banks, must factor into their decisions.

We witnessed the tremendous cost of a financial crisis. The regulatory response that followed was well intended and even justified in its aims to end TBTF and protect consumers.

However, while the aim was specific to the largest banks, the regulatory net has ensnared thousands of community banks. Regulators have applied supervisory approaches and protections that often fail to take into account the incentives and risk profile associated with relationship lending models of community banks.

For example, international capital standards, which formed the basis to reduce leverage in the biggest banks, layer on unnecessary reporting requirements and complexity for banks that already held high levels of capital. Appraisal standards aimed to ensure independent valuations support new loans create challenges for thousands of smaller banks that are portfolio lenders.

These small institutions, often located in more rural markets, struggle to find knowledgeable appraisers with sufficient comparable property sales to comply with the rules, and in some cases, conclude that qualified borrowers' credit needs can't be met.

263. "United States Small Business Profile, 2016," U.S. Small Business Administration, Office of Advocacy.

264. See Robert Jay Dilger, "Small Business Administration and Job Creation," Congressional Research Service, February 8, 2017.

Finally, rules aimed at protecting consumers and other customers from unfair and deceptive practices are important. However, long-term relationship lending also aligns the incentives that protect community bank customers. Unfortunately, the compliance burden for community banks introduces costly processes along with fear and confusion as they struggle to apply narrow legal interpretations and opaque statistical models to the fair credit needs of their borrowers.

Ultimately, communities suffer when access to credit is unnecessarily limited, and so does the larger economy. Rules that aim to address the business models and incentives of the largest banks may unintentionally put the diversity of the banking system at risk, and the lack of new bank charters over the past decade suggests the barriers to entry may be high.

## *Conclusion*

The regulatory remedy for today's banking system will not be easily prescribed. But it will need to recognize that the institutions we collectively refer to as "commercial banks" have drifted apart over the past 35 years. At one end of the spectrum are banks that engage in global financing with systemic implications for failure and impact to the broader economy. At the other end are banks that engage in traditional lending and deposit-taking, whose impact on small business and small communities translates to real economic outcomes.

Today, the federal safety net supports both models and it is sagging, stretched by ever larger and more complex firms with significant nonbanking activities. Banking regulation must do its best to offset the very real exposures for taxpayers and the risk to economic and financial stability. Nurturing incentives that reward success and punish failure are key. Aligning regulation that effectively addresses risk at both ends of this spectrum will require that regulators either close the gap between their differences or embrace the two models and attempt to apply very different supervisory frameworks and approaches.

Market forces will continue to reshape the industry as they have for the past 35 years and longer. And community bankers are no strangers to those market forces or a challenging operating environment. But the banking industry has evolved in very different ways and rules that inhibit market forces without offsetting gain warrant scrutiny.

As a highly concentrated banking system takes hold in the U.S., the issue of today's banking landscape poses a slightly different but important question about the ability of regulation to differentiate its aim. It will matter to thousands of communities served by you in the years ahead, and by extension to the U.S. economy.

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“

While other countries may accept a banking system composed of only a few large banks, Americans at the time of our nation's founding and in the years that followed very clearly recognized the value of having banks firmly planted within their *communities* that were serving their needs. The resulting system, including institutions of various sizes and chartered by both state and federal authorities, I believe, has been very much to our national benefit. Importantly, this *decentralized structure* has allowed for the experiments, and sometimes the failures, that are necessary in creating the efficient, dynamic financial system that was the foundation for creating in the United States the



world's most vibrant economy. This is successful capitalism. Before we allow this structure to fade we may be well served to understand and more fully appreciate its roots. ”

*Esther L. George*  
*President and Chief Executive Officer*  
*Federal Reserve Bank of Kansas City*