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THE AMERICAN APPROACH TO BANKING: DIVERSITY OF SYSTEMS AND SUPERVISION

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THE AMERICAN APPROACH TO BANKING: DIVERSITY OF SYSTEMS AND SUPERVISION

The American nation today has a quality, and a quantity, of banking unmatched at any other time, or by any other nation. One of the great strengths of the economy is our banking system. It has helped develop an economy which gives more people more services than are available to any other people.

Perhaps the key to this system is the diversity of approach which permeates the whole banking structure. That diversity extends not only to the number of banks but to the types of banks and other financial institutions, and to the supervisory structure itself.

To comprehend just how strong this system is, we must ask ourselves just what the objectives of the banking system are, how well the system meets these objectives, and how the system differs in organization and in results, from those developed in other nations. But before we examine these, I think it proper we review the development of the system and the basic philosophy which motivates it. The present system is the result of many years of painful evolution, some serious setbacks, and, frankly, a piecemeal approach to solving problems confronting the nation.

It seems incredible to foreign observers that our makeshift banking structure works as well as it does. It seems to have been thrown together in bits and pieces. But once the nation decided the basic approaches to be used, and the basic goals to be sought, all further evolution maintained these essential standards. The result has been the development of a system which works, however complex and disorganized it may seem to be to outsiders. Today we shall examine two basic points: How the system has developed and how the system serves the nation.

The nation's earliest approaches to banking were spotty and disorganized. Indeed, in the earliest days of the colonies, even the circulation of currency was difficult. English, French, and Spanish coins circulated, together with some home-minted issues, especially in New England areas.

The earliest attempts at bank organization came in Massachusetts, at the time perhaps the foremost colony in trade -- and trade activities always have leaned heavily on banking support. In 1681 the Massachusetts Bank was founded as a land bank, issuing currency with land as security and backing. Five years later the Bay state Colony officially chartered the bank. As the years passed other land banks gradually emerged, and were somewhat successful in providing a currency which was generally acceptable.

In most of these instances, the credit of the Crown, as represented by the Colonial Governors, stood behind the banks. However, in 1740 the first truly private bank, which issued notes backed by goods, rather than land, was established. Again Massachusetts had the honor; the institution was the Land and Manufactures Bank in Boston. In that same year a Silver Bank was established in Boston, with its notes backed by specie.

We will never know how successful these various approaches might have been. Some years earlier, as a result of the disasterous failure of the schemes of John Law in England, Parliament enacted the Joint Stock Companies Act, and in 1741 Parliament extended this Act to this continent, abruptly closing every private bank of any kind within the Colonies.

The result was a complete stripping of the American colonies of home-owned financial institutions. By the time the Revolutionary War began, the insurgent colonies had neither credit organizations nor a sound currency on which to operate. This was the truly desperate situation which French aid did so much to alleviate. Additionally, steps were taken by the colonists themselves, through formation of The Bank of Pennsylvania in Philadelphia in 1780, which issued notes and used them to assist Washington financially. This "bank," formed by Robert Morris, one of the nation's first truly great financiers, never functioned as a bank in the sense we know it today. Rather it acted as an agent for Washington and his army.

The second great financier of the young nation, Alexander Hamilton, then urged the formation of a national bank, patterned upon the European models then in existence. After lengthy correspondence with Morris, the Continental Congress was approached, a charter issued, and the Bank of North America opened in Philadelphia. The year was 1781; the American continent had its first conventional bank.

It has been suggested that Hamilton believed solely in the existence of a national bank, yet his actions show that, even from his earliest days, he supported to a degree the concept of locally oriented institutions. In 1784 he helped found the Bank of New York, the oldest bank in the United States still operating under its original charter and title, and he gave that bank a charter so carefully drawn, so suitable to local operations, that it became a model to hundreds of local banks formed in the next century.

He also assisted in the organization of the Director and stockholders of The Bank of the Manhattan Co., a water works with incidental banking powers (better known as The Bank of the Manhattan Company), organized in 1799 and now a part of the Chase Manhattan Bank.

Earlier, he led the fight for the First Bank of the United States, the first effort for a "central" bank in this country. Hamilton insisted at that time that the existing banks should not be merged into this national bank but continue operations as local institutions.

The Bank of the United States, when organized, had branches in leading cities throughout the country. That bank ran into political difficulties during its life span, and when its charter expired, in 1811, the Congress did not see fit to make an extension. During its operations, there were other charters granted by states for local institutions, and by 1805 there were 75.

Actually, the First Bank of the United States functioned in some respects as does today's central bank, the Federal Reserve System. It granted credits to state institutions, acted as a channel for currency circulation, and acted as a model for all other banks. It thus became a forerunner of our present supervisory structure.

After the close of the bank in 1811, for five years the banking scene became fragmented and disorganized, largely because of a lack of our supervisory concept. Many banks were sound and operated to the benefit of their communities, but there was no great banking tradition, or body of experience. As a result, many of these banks failed. Bank notes, issued by these institutions and serving as the main currency of the public, were suspect in all too many instances. A note issued by a New York bank might be accepted at par in New York, but at only 50 percent out on the Western Frontier.

There even emerged some curious newspapers, starting around this time and continuing for some sixty or seventy years. These tried to list every bank, outline the safeness of the institution and its currency, and list as many as possible of the numerous forgeries which circulated.

In 1816 attempts were finally successful for formation of the second Bank of the United States primarily because the state banking structure had been unable to finance the War of 1812 and the country had faced a serious specie shortage. This second bank also functioned largely as a central bank. It issued notes, sought to control the amount of currency outstanding and to keep it in pace with economic needs. It also helped maintain state banking standards.

This last was accomplished through an interesting device. The Bank of the United States accepted state bank notes as payment to itself, but never paid out in such notes. It paid only in specie, and its own notes, and, as it collected notes from state banks, presented them for payment in specie.

The effect on state banks was to make them maintain sound operations, so that these demands by the Bank of the United States for specie could be met. The net result was a reasonably healthy system.

Nevertheless, the idea of a central bank dominating the nation's financial structure was politically repugnant to many, and the persistent efforts which had brought down the first Bank of the United States were continued against the second.

The Western, rural, agricultural areas of the nation were suspicious of central government and doubly suspicious of the Eastern mercantile class. Even in those days many feared and distrusted the image of "Wall Street."

Had the leadership of the Bank understood this deeply seated fear, had they attempted to allay it, they might have been able to achieve continued existence, even if modified. But no such attempts were made; Andrew Jackson, then President and a representative of the Western philosophy, was impelled by a deep distrust of the Bank and its president, Nicholas Biddle. He vetoed a bill passed by Congress, and the bank was forced to wind up its affairs and liquidate in 1836.

Some thirty years were to elapse before a new national effort was made to create a truly national currency, and almost eighty years before a new central bank was to be established. These were an odd eighty years, full of bank failures and panics, although there were spasmodic efforts to establish order.

However, on balance, it is perhaps well that this period did happen, because it permitted a development of a system which probably never could have emerged under a central bank. It must be understood that the fight over the second Bank of the United States was basic, relating to the direction of the nation's financial structure.

That struggle was over the question of whether the nation would have a centralized, unified financial structure, or a diverse, diffused system, locally owned, and locally controlled.

There probably was no way to establish the two systems side-by-side; perhaps such an act would always be impossible. Furthermore, the more rigid, more unified, more powerful central system, if started on a parity, would probably have tended to drive out the local institutions.

The concept of local control and local service probably was one which could not stand against a fully operative central system. In no other nation has this diverse concept ever emerged. It did in this nation, but only because the actions of 1836 gave the diverse, state-oriented system, a time to grow without threat of massive central opposition, competition, or regulations.

By the time this nation was able to return to the concept of a central banking system the development of locally owned and controlled financial institutions, and the diffusion of financial control throughout the United States, was so well entrenched and so universally accepted that it could not be changed, but only shaped and strengthened.

After the second Bank of the United States suspended operations the nation entered into a period known as the "free banking" era. There were, of course, some startling excesses during this period. There were some money panics, bank failures, wildcat banking, the issuance of worthless notes, and other examples of bad banking. One bank note reporter carried a rather interesting item which gives some of the flavor of the period:

"A new wildcat bank, called the Bank of Florence, chartered by the Legislature of Nebraska, has made its appearance. It is owned by money speculators and is located at some inaccessible place, where it would be as difficult to get specie for its notes, as if they were redeemable at Jerusalem or Mecca. Beware of the trash."

Nevertheless there were developments; the first rudiments of state bank supervision began to emerge in some states, notably in the Midwest. Some of these states organized a state bank, and all private institutions seeking charters were chartered not as banks, but as branches of the state bank. These branches were subject to state supervision and examination, and to certain state controls over capital and note issuance. Some of these systems worked quite well, and were only ended during the Civil War. Additionally, some of the states started deposit insurance funds, and in one or two instances ran them successfully for years.

During the early 1800's two other types of financial instititions had their genesis. These were the mutual savings bank system and the system of savings and loan associations. While now both systems operate substantially in the same manner, originally their concept of operations differed materially.

The mutual savings bank system, which traces its beginnings back to Edinburgh, Scotland, came to the United States in 1818. They were formed originally by groups of public spirited citizens, who placed some of their own capital into the institutions, as mutual units designed to accept modest savings from the poorer classes of people.

These institutions were seen as service units for poorer people who did not need ways to save funds. Their names, even today, reflect their original purpose - a purpose which continues: Emigrant Industrial Savings, Dime Savings, Seaman's Bank for Savings, Five Cent Savings.

In those days mortgage investments made up only a small part of the mutual savings bank portfolio, which was invested in common stocks of a high grade, high grade bonds and other securities.

The saving and loan industry in the United States started out in Philadelphia in 1836 as a mechanism whereby people could pool their funds for the purpose of financing home construction. The very first "building and loan association," as they were known then and as some are still known, was a group of individuals who pooled savings, and, when a sufficient amount had accumulated to construct one house, drew lots to see who could be permitted to borrow the funds for a home. The plan was to continue this process until all original owners of the association had constructed homes. Gradually the concept of savers financing their own homes was revised to the current concept, whereby savings from any share holder of an association could be used for mortgage investment.

The Civil War forced upon this nation a new national position regarding its currency, credit, and banking system. At the beginning of the War there was no acceptable national currency or workable method to provide the necessary credit mechanisms.

As a result it was determined that a national currency should be created, and, after much debate, it was decided to create such a currency through the banking system, with its primary goal the winning of a war. If the currency was to have validity the system would need controls. Therefore, it was decided to form a system of nationally chartered and supervised banks, which alone would be empowered to issue national bank notes, after satisfaction of certain careful standards.

The emphasis of this measure was not to thrust the government into bank supervision, but rather into currency control. This is shown by the popular designation of the act as the National Currency Act. Furthermore, the Act was carefully tailored to preserve the essential elements of local ownership, control, and service.

President Lincoln signed the Act on February 25, 1863. It contained four key provisions: Creation of the Office of the Comptroller of the Currency, within the Treasury Department, as supervisor of the national bank system; issuance of national bank notes secured by bonds; stipulated reserves to be maintained by national banks for both notes issues and deposits, and individual stockholder liability, a second form of reserve.

Some people, notably the New York Clearing House Association, opposed the measure because it was designed to preserve local ownership and control. They foresaw danger in the possibility of the entry into banking by people all over the country, inexperienced and with little control by the central money centers -- such as New York. But again the predilection
national prediction for diversity was upheld.

Numerous revisions to the Act were pushed through in the first year, resulting in the National Bank Act of 1864, which limited the powers of these banks. Among them were the restriction to a single office -- a provision not eliminated until 1927 -- and the removal of national banks from the real estate lending field. The following year, in March, the Congress took an additional step, designed to eliminate state bank currency issues and assure, for the first time, a national currency based on Federal law. This legislation was in the form of a tax on state bank issues. This law did more than was anticipated. It nearly drove state chartered banks out of business.

In 1865 there were over 1,000 State chartered banks, compared to 638 national banks. By 1867, less than two years after the tax on state bank notes was passed, there were only about 300 state chartered banks compared with 1,648 national banks.

However, increased reliance upon deposit banking as a source of lendable funds, together with the development of other new banking tools, came to the rescue of the state banking system, and by 1890 there were about 2,800 state banks, compared with 3,383 national banks. By 1893 the number of state chartered banks exceeded the number of national banks. This situation prevails today.

There is a lesson to be learned from this incident. The American people were then, and are now, in the process of evolving a highly successful and highly serviceable banking system. But because of its diversity, any revision of the structure must be done with care and foresight, if it is not to upset this balance between national policies and the philosophy of local service and local ownership.

Further refinements of the national banking laws, including the McFadden Act of 1927, continued to emphasize the concept of local control. The McFadden Act for the first time permitted national banks to branch, on the same basis as states permitted their state chartered banks to branch -- and this is still the law.

During the late 1800's another development of importance showed up. While there had been some small use of the correspondent banking before, it was during this period that correspondent banking became a major activity.

In those days New York was pre-eminently the correspondent bank city, although today most of the nation's large cities and some smaller ones have many banks which act in such a capacity.

This system provides a flexibility to banking. In those days it was one of the few means at hand for distributing pools of funds into areas where they were needed, although it was not an efficient method of handling this monetary task. Perhaps the most serious problem resulted when a correspondent bank experienced difficulty. This could cause the funds of many small banks to be frozen, spreading a wave of financial problems across the country.

The Panic of 1907 shows this problem clearly. A major stockbrokerage firm failed, and certain connections between the firm and a major New York City bank were cited. The bank apparently was in fairly good shape, but a run developed.

Under conditions then prevailing, there was no central bank and no other source of funds to which the bank could turn, except to other banks, and these were fearful of runs on themselves. The bank failed, not because it had troubles with its loan portfolio, but because it ran out of specie and bank notes, and had no other liquidity source available.

In failing, the bank had frozen the correspondent accounts of many small banks all over the country. With a substantial part of their liquidity lost to them, many of these sound banks failed.

Several other institutions in New York were threatened when runs developed, and the only thing which finally stopped the disaster was the action of some leading bankers, impelled by J. P. Morgan, to raise $50 million in cash to guarantee the payout of deposits. Mr. Morgan subscribed $25 million himself, and browbeat other leading bankers to subscribe the other half. (Browbeat is the right word, in this case. He called the leading bankers into his home, had the doors locked, and refused to let them go home until the fund was subscribed. The bankers were locked up for several hours before the final pledges were made and Morgan would let them leave.)

A Congressional probe followed, and after several years of effort, in 1913 the Congress established the Federal Reserve System, for the first time giving the nation a central monetary authority.

Over the years the Federal Reserve's discount window has done much to smooth the flow of credit throughout the nation, while the Federal Reserve's activities have also provided a surer mechanism for maintaining a circulating medium which could finance the nation's economic development.

But while the Federal Reserve helped in these problems it was no match for the great world-wide Depression which started in 1929.

We do not have time to analyze the reasons for the Depression. That is of itself a long, and still highly controversial, subject. But out of that experience came the latest step in the development of our unique banking system. That was the formation of the Federal Deposit Insurance Corporation.

In 1884 the first attempt was made to enact Federal legislation establishing a form of deposit guarantees. For the next 48 years 149 such measures were introduced, some calling for insurance of national banks only, some of Federal Reserve member banks, some of all banks. The structure and administration of these various proposals were widely divergent. But the basic principles of protection to the depositor, was embodied in every measure.

In 1933 H. B. Steagall, of Alabama, introduced the 150th such proposal in the House. Carter Glass of Virginia introduced a companion measure in the Senate. After a vigorous debate the measure was passed as a part of the National Banking Act of 1933. The Corporation was established on a temporary basis, with a temporary fund, insuring deposits up to $2,500 per depositor. The next year the temporary fund was extended one year and the limit raised to $5,000 and in 1935 the temporary fund was made permanent.

The laws relating to FDIC were further codified in a separate act in 1950, and the insurance limit raised to $10,000, where it now stands.

The Congress gave to the Corporation the responsibility for Federal examination of state chartered banks which are insured, but which are not members of the Federal Reserve System.

Very early, the Corporation was charged with the task of liquidating closed national banks, and over the years most states have also asked the Corporation to liquidate banks where necessary.

Since 1935 there have been no major changes leading toward restructuring of the system. There have been improvements both with respect to the laws relating to banks and to the laws relating to the supervisory agencies. There have been administrative actions designed to improve the banking structure. But the system as a whole operates under the framework, and the basic philosophy, established in 1933-35.

Two opposing pressures helped shape our system. The first impelled towards a controlled, centralized system responsive to the dictates of national authority and central money markets. The second pressure, almost unique to this country, pushed for diverse and localized control over money and credit.

The nation has been fortunate. It was able to develop the local approach with sufficient force so that when it was necessary to impose some of the controls and restraints of the national approach it could be done without losing the strengths of local emphasis. We have succeeded in a blend of these two seemingly opposite philosophies.

From these have come a banking system which has developed the obvious strengths of the American economy. The nation has a high standard of living. The American citizen has available to him a greater variety, and a more accessible variety, of banking services than any other nation's citizens.

It is no accident that the American people enjoy a more personalized, and a more complete, banking service. The era of "free banking", although it may have failed to serve the average citizen in its time, and although it may have led at that time to many problems, sowed the seeds for today's banking developments.

In Canada, to the north of us, financial resources are dominated by the Ottowa-Toronto-Montreal axis. While New York City is the largest single money market in the world, its position of financial power within the United States is proportionately far less than that of Montreal in Canada.

For every New York there is a San Francisco; for every Boston a Seattle; for every Philadelphia a Los Angeles; for every Atlanta a Salt Lake City. There are other outstanding regional money centers scattered throughout the United States, in every region. Additionally within each region there are smaller centers of influence, and every county has its own town or village which has its bank, its locally controlled financial center, its own resources.

The wealth of all these areas flows not to one center, but to dozens of local ones. Controls for allocating resources have provided in this nation a system under which no region need go hungry for funds because they are drained to a major center. True, there are flows of capital -- but the money power is fragmented to the benefit of every region in the country.

Herein lies the ultimate strength of the blending of the ideas of such men as Alexander Hamilton and Andrew Jackson. They were, after all, both right. Hamilton was himself a supporter of the local institution, but he realized the importance of some national policy, to unify control. Jackson also was right, because Jackson instinctively knew the importance of maintaining a system where no part of the country could dominate financial resources.

There are no regions in this nation which are totally without resources. Some are naturally richer than others, but all have resources, and all control most resources locally.

Ours is a broadly based, diffuse system, and it has a great hunger for competent personnel. The thousands of banks, the many supervisors, state and national, the other financial units, and the financial intermediaries, must have a constant and large flow of trained potential managers entering their ranks.

Yet financial managers should understand more than the day by day administration of such financial institutions. They should appreciate also the powers of this diverse system. They should understand the philosophy which has gone into its difficult but successful evolution. Only then will they be equipped to serve the public, and the system, to the fullest extent.

Understanding the system, serving as part of it, can be one of the most exciting, most rewarding careers available.