Office of the Comptroller of the Currency

MOMENTS IN HISTORY

ECONOMIC INSIGHTS FROM THE HISTORY OF THE FEDERAL BANKING SYSTEM

# The Evolution of Bank Chartering

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This overview of the history of the evolution of the political philosophy governing the chartering of banks is organized as a sequence of questions and answers. It traces changes from the early history of bank chartering to the establishment of the federal banking system, and its subsequent evolution.

*1. What was Alexander Hamilton's plan for a bank chartering system for the new republic? How did it evolve? Was this an unusual idea, or similar to the plans that created the Wisselbank in Amsterdam in 1609 and the Bank of England in1694?*

Hamilton's vision was for the federal government to charter a single national bank, with branches throughout the country, to help place government debt, to lend to the government as well as to private borrowers, and to assist in collecting taxes. He won the Constitutional battle over whether the federal government had the power to charter a bank and chartered the Bank of the United States (BUS) in1791 for a 20-year period. The BUS was owned partly by the government and partly by private stockholders. Hamilton earlier had chartered the Bank of New York in1784. He opposed the creation of other chartered banks in New York and advised other states against creating multiple chartered banks. That preference can be understood from a developmental perspective as a means of endowing chartered banks with some monopoly power, which added to their economic value, thus enabling them to lend more than they otherwise could on the basis of the existing scarce financial capital that could serve as paid in equity capital.

The Wisselbank was a monopoly, but it was quite different from the BUS. The Wisselbank was organized as a clearing house for bills of exchange used to fund international trade. It made almost no loans for the first century and a half of its existence. The Bank of England was the true predecessor of the BUS. It was chartered as an equity-for-debt swap of sovereign debt, which also helped to consolidate other sovereign debts into a single, more liquid sovereign bond. Its main function from 1694 to 1815 (when France was defeated) was to fund the war against France. It was the only chartered bank in England and Wales between 1694 and 1825. In 1825, in the wake of a banking crisis that caused many private banking partnerships to fail, banks other than the Bank of England were permitted to be chartered, and this chartering policy was expanded after 1833.

While the monopoly privileges of favored banks helped "capitalize" them by adding intangible equity value to their paid-in capital, it also gave them substantial control (in partnership with the government) over their respective financial systems. This reflected the view that chartered banks were partners with sovereigns, as part of the international competition among states. But to some observers, the power of banks in partnership with government was not welcome. Thomas Jefferson's supporters, who had opposed the original chartering of the BUS, were in power in 1811 and chose not to renew the BUS charter when in expired in that year. But they soon regretted the absence of a bank to facilitate the funding of the War of 1812 (when the government suffered extreme difficulty funding its troops in the field). In 1816, President Madison's Administration supported the creation of the Second Bank of the U.S., again with a 20-year charter.

*2. What did Massachusetts do to change corporate chartering policy in 1829? In what sense was this the beginning of the movement to oppose corrupt legislative action?*

Massachusetts' general incorporation law was a departure from special incorporation laws, which were a primary activity of legislatures, and which doled out special privileges to the politically powerful in each state. In the view of Massachusetts' reformers, the special charters granted by legislatures to a privileged few "corrupted the economy" by undermining competition and giving special economic privileges and "corrupted the political process" by encouraging special interests to lobby or pay for legislative favors. General incorporation laws, in contrast, gave the same rights to anyone who could qualify to form a corporation, which ended the favoritism. This meant that the corporate organizational form was open to everyone, and this was helpful in organizing business enterprises of all kinds, especially banks.

*3. What did Michigan (in 1837) and New York (in 1838) do to adapt the Massachusetts reforms to bank chartering policy? In what respects was the structure of banks chartered by this policy similar to subsequent national banks?*

In the wake of the Panic of 1837, which produced many bank failures, the favoritism of special bank chartering, and more generally, special legislative chartering of corporations, was criticized as having contributed to the scarcity of credit and the weakness of the banking system. Michigan and New York (and later many other states) passed "free banking" laws. This new type of law provided that anyone could charter a bank for any location and required bank notes to be backed by government bonds. Those two key aspects were copied by the federal banking system in 1863.

*4. What three things did Indiana do in 1851, which had not been done (all together) by any state prior to that date? How did Indiana's bond default contribute to its Constitutional changes in 1851?*

Indiana was the first state to combine three reforms: general incorporation law, prohibition of special corporate chartering, and prohibition of private legislative acts of all kinds. The state's bond default (one of several that had occurred in the 1840s) showed that huge public spending, and state bankruptcy, could result from corrupt partnerships between the state and specially chartered corporate entities. This drove the reform movement in Indiana and elsewhere (a process that had begun as early as 1829 in Massachusetts, but which accelerated after the Panic of 1837).

*5. What was Andrew Jackson's policy toward the Second Bank of the U.S.? In what two aspects is the federal banking system a Jacksonian solution to creating a national policy regarding bank chartering?*

Jackson opposed the rechartering of the Second Bank of the U.S. (which was set to expire in 1836), and he vetoed the bill to recharter it in 1832. He did not oppose any federal chartering of banks, but he opposed the Second Bank for two reasons: First, it gave a special privilege to one bank that he regarded as not working in the public interest (he had specific criticisms of the practices of the Second Bank, which he saw as indicative of its abuse of its power). Second, Jackson also opposed all small denomination paper currency issues by banks, which traded at a discount that increased with the distance from the location of the issuing bank. Jackson believed that such pricing of notes created opportunities for the "common man" to be taken advantage of. He wanted to see a banking system that would abolish those currency issues. Many Jacksonians, such as Charles Duncombe in 1841, argued for a national note circulation backed by U.S. government debt as a solution to the discounting of state bank notes. Salmon Chase, President Lincoln's Treasury Secretary, who pushed for the creation of the federal banking system since he was appointed in 1861, was an adherent to Jacksonian monetary views.

Because the federal banking system created a "free banking" system rather than one based on special legislative charters, and because it backed national bank notes with 111 percent U.S. government bonds deposited at the Treasury, additional greenback reserves, and the redundant full faith and credit of the U.S. government, national bank notes did not trade at discounts.

*6. What are some activities that were not permitted for national banks to do in 1864, but that were permitted later? What drove the changes in what was permissible within the national bank charter?*

National banks as originally chartered could not lend any funds against real estate. They could not issue any credit guarantees, including bankers' acceptances or bills of exchange. They could not branch (according to a questionable interpretation of the National Bank Act by the first Comptroller of the Currency). They also were not permitted to engage in trust activities or securities underwriting.

The Federal Reserve Act of 1913 was a response to the Panic of 1907. The Panic had led many observers to criticize the banking system's structure and propose changes to that structure. The Federal Reserve Act brought changes to the chartering rules governing national banks, and those rules changed further in the next two decades. The Federal Reserve Act removed the prohibition on real estate lending by national banks in agricultural areas. This was a political compromise by Federal Reserve System (Fed) advocates who succeeded in attracting support for the act from agricultural interests. Other limits on real estate lending were relaxed subsequently in 1916 and 1927. The prohibition on national banks' issuing acceptances also was removed in the Federal Reserve Act, as part of a philosophy that saw "two-name" acceptances as a desirable way to finance trade within the country. There were additional further changes to encourage acceptances in 1916 and 1935. In 1927, national banks were allowed to branch, but only in states that permitted state banks to branch.

Securities markets grew dramatically during the early 20th century, and this also produced major changes in banks' strategies and powers. The rise of securities markets created new opportunities for trust banks to act as custodians and asset managers. Before national banks were permitted to perform trust activities (in 1913), they used affiliates to do trust business. Securities underwriting was also provided through affiliates (until underwriting affiliates were prohibited in 1933). Such affiliates were allowed again after 1987.

There was a general pattern of competition encouraging national banks into a new line of business, which sometimes occurred through a questionable loophole. Over time, as a banking practice became recognized as legitimate, it often was codified in revised charter rules, rendering the loophole unnecessary. Economic historian Eugene White, in his 1986 study of securities affiliates of banks, writes:

"In its first effort to define commercial banking, Congress sought to restrict national banks to a narrow range of financial activities. According to the National Banking Act of 1864, a national bank's prescribed role was to invest its funds in short-term, self-liquidating loans to finance goods in the process of production or exchange. But, whatever Congress' original intention was, national banks could not conduct such a limited business and survive in the tough competition of the American financial markets. The national banks did have one important loophole in the law: they were permitted to perform such "incidental" activities as were necessary to their operations (Peach, 1941, pp. 7–19). In practice, this was generally interpreted by the courts to mean that they could take up almost any financial activity that was not specifically prohibited to them by law … however, this loophole had its limitations. At the turn of the century, trust companies presented a grave challenge to national banks because of their ability to combine commercial banking with fiduciary powers not granted to national banks. When the growth of trust companies threatened to usurp their place, commercial banks discovered the legal device of the affiliate. This allowed them to set up affiliated trust companies and indirectly supply trust services to their customers. The use of affiliates allowed a bank to get into almost any type of financial intermediation. At a Congressional hearing in 1932, Federal Reserve Board Governor Eugene Meyer presented a list (U.S. Senate, 1932, p. 392) of all known national bank affiliates. Security, realty, bank building, and safe deposit affiliates led a list totaling 770."

White's (1986) detailed historical study analyzes whether prohibiting underwriting affiliates in 1933 was warranted on economic grounds. He finds that it was not. Underwriting income was a source of diversification that made bank failure less likely. Other subsequent studies (written in the 1980s and 1990s) have shown that bank-underwritten bonds from the 1920s and early 1930s performed better during the Great Depression for any given ex ante rating category than bonds that were not underwritten by banks. These studies helped support the case for effective repeal of Glass–Steagall Act prohibitions on commercial banks engaging in underwriting.

That process of repeal occurred in several steps. Initially, courts found some limited experimentation with underwriting to be consistent with the Glass–Steagall Act so long as it remained limited, and so long as the underwriting occurred outside the bank itself. Over time, regulators relaxed the boundaries placed on underwriting. Limits on the types of securities and amounts underwritten by affiliates were repealed in 1999 as part of the Gramm–Leach–Bliley Act.

*7. Looking back on the historical evolution of banking powers within the national bank charter, how much chartering policy change can be ascribed to wars and other crises (Dutch wars, the Second Hundred Years' War, the Panic of 1825, the Panic of 1837, The Great Depression, The American Civil War, the creation of the national banks, the Panic of 1907, etc.)?*

Wars or banking crises were often important in precipitating changes in the policies regarding the chartering of banks, especially to further the reach of the sovereign, to fund the sovereign, or to expand access to credit in the wake of a severe crisis. In the U.S., chartering was deeply reformed after the Panic of 1837 to permit greater bank chartering, as it had been in Britain after the Panic of 1825. The American Civil War created a massive funding need of the Union government. This need gave Chase the opportunity to push through a bank chartering plan (for the federal banking system) that he had favored on Jacksonian grounds before the war. The Panic of 1907 produced the National Monetary Commission, which gave rise to the Federal Reserve System and to major changes in the chartering powers of national banks. Typically, the ideas for charters, or chartering reform, existed long before those events, but wars and other crises acted as catalysts to make change happen.

Under the federal banking system, changes in rules governing national bank powers mainly were driven by the desire to allow national banks to respond to technological changes or competition from state-chartered banks.

Overall, the bank chartering philosophy of the federal banking system from inception can be described as reflecting a philosophy of equal access (unfettered after 1880), a recognition that payments systems benefit from uniformity of the unit of account and stability of the medium of exchange value, and a desire to remain competitive with other chartered banks or non-chartered financial institutions. Responses to competition took a variety of forms in addition to changes in banks' powers, including regulatory changes that reduced minimum capital requirements for national banks in 1900.

New fintech chartering, including the potential chartering of stable value crypto coin issuers, is just the latest chapter in this history. The redefinition of the national bank charter to take account of new technologies, and new charter competition from states chartering new types of fintech banks, is encouraging the expansion of the national bank chartering policy in a manner highly consistent with the history of the evolution of the charter.

It is worth noting that, despite all the chartering innovation in the U.S., many of the adaptations that permitted new bank powers, or relaxed anti-competitive limits on banks, happened slowly. A failure to adapt policies quickly produced large "shadow banking" systems in the U.S. For example, the establishment of the Fed was supposed to include all banks, but most state banks chose not to join. They were able to access the Fed discount window indirectly, at least partially, and saw Fed regulations as too onerous. In the mid-20th century, finance companies, money market funds, and other nonbank "shadow" intermediaries grew dramatically as the banking system experienced disintermediation reflecting Regulation Q, high reserve requirements, and other limits on chartered banks.

Major changes in U.S. bank regulatory policy have occurred infrequently (1935, 1980, 1999, 2010). The long delays in regulatory reform sometimes have been a major source of shadow bank growth. In contrast, Canadian banks' charters lapse every five years, which leads to a complete rethink of banking powers every five years. Canada has kept up much better with technological changes or the need to change unproductive regulations, and it has never seen its chartered system challenged significantly by shadow banks.

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