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ANDREW J. ECONOMOPOULOS

## Illinois Free Banking Experience

### 1. INTRODUCTION

RECENT STUDIES BY ROLNICK AND WEBER (1983, 1984) have presented evidence challenging the conventional view of the Free Banking Era (1837–1863). The conventional view depicts a period of financial chaos in which lenient regulations gave rise to a plethora of banks, bank notes and counterfeit bank notes, unscrupulous “wildcat” bankers, and large noteholder losses. Rolnick and Weber do not deny that these problems occurred during the period; however, both assert that the conventional view misrepresents the overall performance of the banking market. Furthermore, they propose that the problems of the period are better explained by a sharp decline in asset prices than by the lack of regulation.

The Rolnick and Weber contention, however, has not been tested utilizing all the available evidence. In their studies, they examined only four of the ten active free banking states.<sup>1</sup> One of the largest states, Illinois, was not examined by Rolnick and Weber. Illinois was second only to New York in the number of free banks it had in operation and has been considered by economic historians to have had a poor free banking experience. Therefore, an examination of the Illi-

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<sup>1</sup>According to Rockoff (1975), nineteen states enacted free banking legislation. Nine of the states showed little free banking activity.

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nois experience would be relevant to the free banking controversy. Such an examination would confront both the accuracy of the conventional view as well as the findings presented by Rolnick and Weber.

In the following section of this paper, a general overview of the free banking law is presented. This overview provides insight into the operations of a free bank and provides the framework for the hypothesis proposed by current researchers. In the third section, the controversy over the conventional view is presented; specifically, the wildcat banking hypothesis and the falling asset hypothesis purported by Rolnick and Weber are summarized. In the fourth section, the Illinois experience is examined. Both hypotheses are examined in light of the Illinois evidence. The fifth section presents the concluding remarks.

## 2. HISTORICAL OVERVIEW

Prior to the free banking era, entry was generally regulated by state legislatures. In order to establish a bank, hopeful bankers petitioned the legislature for a bank charter. The charter granted special privileges to the banker. One such privilege permitted the bank to print and issue bank notes. Bank notes were small-denominated promissory notes that banks exchanged for loans or specie (gold or silver coin) and circulated as money. Note circulation was restricted to a fixed proportion of the bank's equity, generally between two to three times the bank's equity. Charter banks were also required to redeem their bank notes into specie on demand. If a charter bank failed to do so, the bank was legally declared bankrupt and dissolution proceedings commenced. When a bank was declared bankrupt, the charter limited the liability of the stockholders to their investment in the bank.

The charter system eventually gave way to the free banking system. In most free banking states, any individual or group of individuals could "freely" establish a bank without the consent of the legislature. The interested parties were to submit a certificate of operation with the state banking authority. Once minimum capital requirements were met, the free bank could commence operations.<sup>2</sup> Unlike charter banks, free banks could not print bank notes; however, they could obtain bank notes from the state banking authorities by depositing state or federal bonds with the state.

The state authorities were required to issue bank notes equal to a specified percentage of the bond's "legal" price. In most free banking states, the law defined the legal price of a bond to be the bond's market value. Some states, however, defined the bond's legal price to be either the bond's par value or its six-month average market price. The free bank generally received 100 percent of the bond's legal price, although some states did restrict note issue to less than 100 percent.

Free banking states also enacted provisions instructing the state banking au-

<sup>2</sup>Minimum capital requirements among the free banking states ranged from \$25,000 to \$100,000.

thority to maintain the bond reserve requirement. Whenever the bond reserve fell below the required backing of outstanding bank notes, authorities were required to call in bank notes or ask for additional security to meet the statutory requirements. Failure to comply with this standard resulted in forfeiture of banking privileges.

Unlike charter banks, free banks had no limit on the amount of bank notes they could receive from the state and issue to the public.<sup>3</sup> However, like the charter bank, the free bank could forfeit its banking privileges by refusing a noteholder's request for specie. The stockholders of the free bank were not as fortunate as charter stockholders; they had no limited liability privilege. Free bank stockholders were personally liable for the debts of the bank up to the amount of their investment.

### 3. NEW EVIDENCE ON FREE BANKING

Although the free banking laws contained numerous safeguards that protected the noteholder's claim, the traditional accounts of the period suggest that the laws were inadequate. These historical accounts relate frequent bank panics and bank failures, unscrupulous free bankers, and large noteholder losses. Economic historians have generally contended that the liberal entry provisions allowed unscrupulous bankers to establish banks in remote areas (Hammond 1957, Knox 1903). According to Bray Hammond, these so-called "wildcat bankers" purchased

bonds with their own circulating notes and disappeared in order to avoid having to redeem the notes. They had to be hunted for in the woods . . . their cash reserves were sometimes kegs of nails and broken glass with a layer of coin on top (1957, p. 601).

From such bankers, noteholders suffered heavy losses. Hammond cites Hugh McCulloch, then president of the State Bank of Indiana, who estimated noteholder losses from wildcat banking in Indiana and Illinois to be in the millions (1957, p. 620).

The historical evidence of wildcat banking in Illinois is strengthened by Andreas, who cites the Chicago newspaper *The Democrat*:

No man is safe sleeping over night with one dollar of Illinois currency in his pocket . . . There is great danger of a mob in our city. The day laborers will never be content to work for "wildcat" which is not worth thirty-three and one-third cents on the dollar. . . . (1975, p. 619).

Thus, it would appear that wildcat banking was present in Illinois.<sup>4</sup>

<sup>3</sup>A free banker could leverage his investment by purchasing additional bonds with his bank notes and deposit these bonds for more bank notes. Since in most states there were no limits to note issue, the free banking system had unlimited monetary expansionary potential. In practice, the free banks generally limited note issue, but the reason is still unknown. Lawrence White's (1984) general equilibrium model suggests there may be some limits to money expansion under a free banking system.

<sup>4</sup>The article refers to wildcat money as depreciated currency. The question to be answered by this

The paradox of numerous safeguards and large noteholder losses has spurred new research by Rockoff (1974, 1975), Rolnick, and Weber. Hugh Rockoff was the first to reexamine the period and to develop a theory on wildcat banking. Rockoff found that those states issuing notes based on the bond's par value experienced wildcat banking. He identified a wildcat banking state by five criteria: (1) the short life span of the free banks—generally less than one year; (2) the large number of entrants; (3) the low liquidity ratios; (4) the numerous bank failures; and (5) the large noteholder losses.<sup>5</sup> He also found that subsequent changes in the law from par value to market value for bond pricing improved these factors.

Rockoff theorized that under certain circumstances the wildcat bank investor in par valuation states could make a quick capital gain by closing the bank. When the market value of the bond was below the par value of the bond, the banker would receive bank notes in an amount greater than his investment. He could then make a quick capital gain by issuing all the bank notes, presumably through a loan to himself or to a relative. In order for the wildcat banker to receive his capital gain, he needed to convince the public to accept the notes at par value and to maintain the circulation of the bank notes. One way in which the wildcat banker could increase his chances of issuing all the bank notes was to establish the bank in a remote area of the state, thereby reducing the redemption rate of bank notes. When all the notes were circulated, the wildcat banker closed the bank and left town. Thus, the unsuspecting noteholder was left holding bank notes not fully backed and received only the market value of the bond. The wildcat banker, on the other hand, received a capital gain on his investment equal to the difference in the bond's par value and market value. Rockoff believed that this ruse generally took one year to complete at most (1975, p. 8).

Rolnick and Weber also reviewed the period and found evidence that refutes the wildcat banking hypothesis proposed by Rockoff. Although they did not deny that there were frequent bank failures and noteholder losses, they did reject the assertion that fraud was the major factor behind bank failures. They contend that economic disturbances contributed to the bank failures and noteholder losses.

According to Rolnick and Weber, a major drop in asset prices would have been sufficient to generate a run on the banks and possibly force some banks to close. They reasoned that a major drop in asset prices would also have lowered the market value of the bonds backing the bank notes. If the drop had been perceived by noteholders to jeopardize their claim to specie, they would have attempted to redeem their notes at par. Had the bank been insolvent, an addi-

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investigation and left unanswered by the article is whether the depreciation was caused by fraudulent behavior or by economic factors.

<sup>5</sup>Rockoff identifies a second type of wildcat bank that lasted for at least a year. Noteholders of these banks, however, did not sustain losses. Since the crucial issue of wildcat banking is the losses sustained by noteholders, only banks that redeemed their notes below par will be considered.

tional capital outlay by the stockholders would have been required to redeem the notes. In most cases, the stockholders would have refused, thus causing the bank to fail. The bonds would then have been sold by the state at a price below the original purchase price, with the noteholders paid off at some fraction of the face value of the note.

Rolnick and Weber supported their hypothesis with the experiences of four free banking states. From state documents, they found 339 out of 709 banks left the market. Of the 339 banks that left the market only 104 banks were unable to redeem their notes at par. (Rolnick and Weber defined these banks as “failed” banks.) They were able to identify 96 of the 104 “failed” banks as either failing during periods of major declines in asset prices or during periods of rising or steady asset prices. Seventy-six of these banks failed during falling asset prices. Rolnick and Weber also examined these banks to see if fraud was a possible cause of free bank failures and found that only eleven bank failures were solely consistent with the wildcat banking hypothesis. Two of the failed banks were consistent with both the wildcat banking hypothesis and the falling asset hypothesis.

#### 4. ILLINOIS EXPERIENCE

The Illinois free banking experience provides a good test case of the wildcat banking controversy. Although Rolnick and Weber present convincing evidence, their work has been unchallenged. Illinois was labeled by Hammond and Rockoff as a wildcat banking state, but was not included in the Rolnick and Weber analysis. This section addresses the issue of wildcat banking in Illinois.

Illinois’ free banking law, enacted in 1851, contained many of the standard free banking provisions described earlier. The Illinois law set the legal price of bonds equal to the six-month average of the bond’s market value as reported in the New York money market. However, bank notes received on Illinois bonds equaled 80 percent of the legal price, while notes received on all other state bonds equaled 100 percent of the legal value. The maximum amount of notes received per bond was limited to the *market value* at the time of the deposit. Since notes received could not exceed the market value of the bonds, this clause effectively eliminated the chance of receiving capital gains on notes issued and hence, eliminated wildcat banking opportunities.

In February of 1857, the bank commissioners reported that over two-thirds of Illinois bank notes were secured by Missouri bonds. The commissioners became concerned when Missouri officials considered increasing the state’s nineteen-million-dollar debt by several million. They expected a sharp decline in the market value of Missouri bonds if Missouri went through with the new bond issue. The commissioners feared that such a reliance on Missouri bonds as security could be detrimental to the banking system and called upon the legislature to amend the banking laws. The commissioners’ request was heeded by the legislature. In the same month, the legislature amended the law requiring the auditor to issue bank notes on *all* bonds equal to 90 percent of the bond’s legal price (still the

bond's six-month average) with a maximum amount of notes per bond limited to the bond's *par value* rather than market value.

Although the law seemed to increase the margin of security on non-Illinois bonds, it also opened the door to wildcat banking opportunities. Under the amended law, wildcat profit opportunities existed when the notes received (90 percent of the bond's legal value) were less than the bond's par value, but greater than the bond's market value. Such opportunities could only occur when a six-month period of stable bond prices was followed by a major decline in bond prices. Thus, the amended law made wildcat banking possible after February of 1857.

In addition to the changes in the bond security requirements, the amended law contained a provision that tried to increase the "accessibility" of the free bank. The provision restricted the establishment of new free banks to population centers of not less than 200 inhabitants. According to Dowrie, the provision was aimed at eliminating inaccessible banks such as the Bank of Southern Illinois in Bolton where only one family resided (1913, p. 149).

### *The Evidence*

Illinois banks were required to submit quarterly condition reports to the state auditor. Data on the number of bank entrants and exits, circulation, and redemption information were gathered from these reports. Illinois' failure rate and noteholder losses were then calculated. The failure rate was calculated by dividing the number of banks that could be identified as closing below par by the total number of banks.<sup>6</sup> Noteholder losses were estimated by multiplying one minus the redemption rate by the last available circulation figures published in the state auditor's report. These losses represent the upper bound, since notes could have been redeemed at par prior to closing.<sup>7</sup>

According to the state auditor's reports, the free banking system worked reasonably well prior to 1861. In fact, Illinois outperformed three of the four Rolnick and Weber states during this period (see Table 1). Only two banks failed prior to 1861 with noteholders sustaining losses of 8 cents on the dollar. In 1861, however, 93 banks left the market. All but four failed with aggregate losses estimated at \$3.45 million—more than the combined total of the four Rolnick and Weber states. Noteholders sustained losses of 33 cents on the dollar.

### *Wildcat Banking Hypothesis*

The extensive losses and numerous bank failures suggest that wildcat banking may have been present in Illinois. Rockoff confirmed the existence of wildcat

<sup>6</sup>The Rolnick and Weber methodology of calculating failure rates and noteholder losses was employed.

<sup>7</sup>The redemption information on one bank was not available. An estimated redemption rate was calculated by dividing the market value of the bonds by the circulation figure as reported by the auditor. This information on the failed bank was given in the Auditor's Report of 1862.

States (Free banking years)	Free banks (1)	Free banks with redemption information (2)	Free banks exits (% of Col 1) (3)	Free bank failures (% of Col 2) (4)	Total losses of all free banks <sup>a</sup> (5)	Average loss per bank (6)	Average loss per dollar (7)
R & W	449	445	160 (36)	34 (8)	\$ 653,958.32	17,555.84 <sup>b</sup>	.2618 <sup>b</sup>
S A M	140	140	79 (56)	37 (26)	\$ 503,151.42	13,598.69	.2444
P L E	104	77	89 (86)	24 (31)	\$ 798,828.01	9,174.23 <sup>b</sup>	.1087 <sup>b</sup>
S T A	16	16	11 (69)	9 (56)	\$ 165,210.85	18,356.76	.7050
T E S	709	678	339 (48)	104 (15)	\$2,121,148.60	20,405.27	
Illinois (1851-1863)	141	140	117 (83)	91 (65)	\$3,508,116.50	38,550.73	.3229
(1851-1860)			24	2	\$ 49,428.00	24,714.00	.0763
(1861-1863)			93	89	\$3,458,688.00	39,303.00	.3264

<sup>a</sup> Total losses include estimate loss for free banks in which no redemption information was available.

<sup>b</sup> Rolnick and Weber separated the New York and Indiana data into two periods. Average losses for New York and Indiana represent the weighted average of the two periods.

<sup>c</sup> All of Wisconsin free banks failed in 1861.



banks in Illinois by examining the evidence and finding relatively low liquidity ratios and a high entry rate prior to 1861. However, while such information might denote wildcat banking practices, it could also represent a well-functioning market during an economic upturn.<sup>8</sup> Confirmation of the wildcat banking hypothesis can be better determined by examining the three characteristics which have traditionally characterized wildcat banks: (1) the short life span of failed banks, (2) the location of free banks in remote areas, and (3) the entry of failed free banks occurring during periods of wildcat banking profit opportunities.<sup>9</sup>

A fourth characteristic which has not been examined or suggested in the literature, but relevant to the issue, is the purchase of bonds by established banks. Free bankers who entered during periods nonconducive to capital gains on note issue could have also taken advantage of the sudden decline in bond prices. These banks can be identified by a large shift in their bond portfolio toward those bonds that would yield wildcat profits.

The data used to confirm the existence of wildcat banking came from several sources: the state auditor's bond journal, the weekly bond price information from *Banker's Magazine* and *Hunt's Merchant Magazine*, and the population censuses of 1850 and 1860. The dates of bond purchase were taken from the auditor's bond journal where every bond deposit and withdrawal between 1854 and 1864 was recorded and dated.

From this information the lifespan of a failed free bank was determined by subtracting the estimated date of exit from the first date of bond deposit with the auditor. The first date of bond deposit was considered to be the estimated entry date. The estimated date of exit was determined by subtracting six months from the date of the sale of the bonds in New York, unless the date of exit was noted. A six-month lag between the date of exit and the sale of bonds was based on the statutory requirements imposed on the state auditor and the transaction delays concerning the bond sale in New York City.<sup>10</sup> The results, presented in Table 2, show the lifespan of Illinois failed free banks ranging from three and one-half months to eight and one-half years. Twenty-four (26 percent) of the banks operated for less than one year, 19 (21 percent) operated one to two years, 16 (18 percent) operated two to three years, and 32 (35 percent) operated for more than three years. Though a considerable portion of the banks were in operation for

<sup>8</sup>The reason for the high entry rate during this period is uncertain. Dowrie suggests that the bank expansion was due to the strong agricultural markets (p. 155). Wisconsin, a free banking state, also recorded a high entry rate for the same period indicating that the high entry may have been due to a regional trend and not specifically due to the Illinois law change in 1857.

<sup>9</sup>Although the amended law of 1857 attempted to eliminate the problem of inaccessibility, Knox states that the law was not enforced (Knox, p. 725).

<sup>10</sup>The law required the auditor to place notice of failure and sale of bonds of free banks in the local newspapers. The advertisement was to run for at least 20 days before the auditor could sell the bonds. The auditor's records also indicate that the auditor waited for a sufficient number of banks to fail before he brought the bonds to New York for sale. It is likely that the six-month lag is an overestimate and thus an understatement of the life span.

less than two years, a majority operated for more than two years—a length of operation uncharacteristic of wildcat banks.

In addition to the length of operation, wildcat banks were characterized by an entry date that occurred when the amount of notes received per bond exceeded the market price (or when the bank note-market price ratio was greater than one). The Tennessee bond price series was used to calculate the bank note-market price ratio between February 1857 and December 1863, the period in which wildcat banking opportunities could occur. Tennessee bonds were selected for two reasons. First, southern bonds made up a large portion of the free bank's portfolio in 1861 when the majority of the banks failed, with Tennessee bonds accounting for over 30 percent of southern bonds.<sup>11</sup> Second, Tennessee bond price movements were representative of southern bond price movements in general.

Figure 1 shows that there were three periods in which the bank note-market price ratio of Tennessee bonds was greater than one: September 1857 to October 1857; November 1860; and April 1861 to July 1861.<sup>12</sup> In the first two periods the wildcat banker could have initially received at most 7 percent more notes than his original investment. Since the free banker could purchase additional bonds with

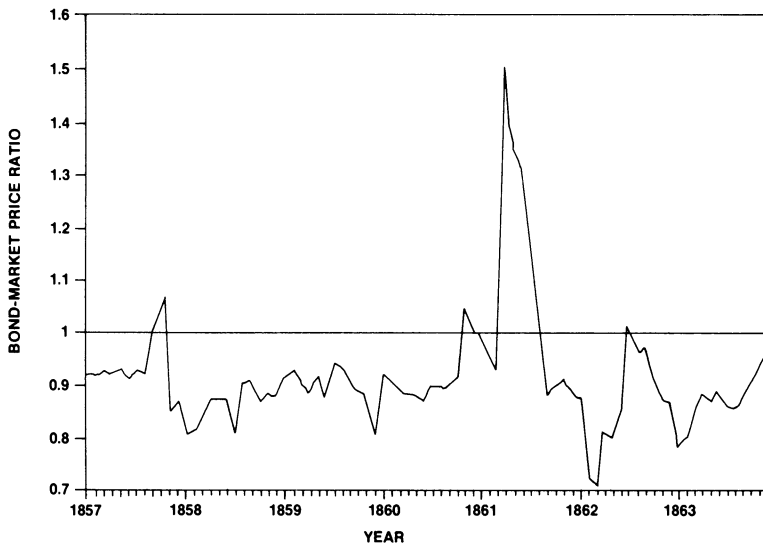


FIG. 1. Bank Notes Received as a Percentage of the Bond Market Value for Tennessee Bonds, January 1857–December 1863.

<sup>11</sup>Southern bonds accounted for 68 percent of the bond portfolio of free banks. Tennessee, Missouri, and Virginia bonds accounted for 80 percent of the southern bonds.

<sup>12</sup>The wildcat profit periods for Missouri and Virginia bonds were also calculated and employed in the analysis. The periods for wildcat profits on Missouri and Virginia bonds varied slightly. Missouri's bank note-market price ratio was greater than one between August and September 1857, for the month of November 1860, and between April and July 1861. Virginia's periods were October and November 1860 and between March and June 1861.

TABLE 2  
ILLINOIS FAILED FREE BANKS

Bank Name	Location	Pop. as of 1860	Date of first bond deposit	Year closed	Years of operation	Redemption rate	Bonds held as of December 1, 1860
Agriculture Bank	Marion	NA <sup>b</sup>	4/14/56	1861	5.03	0.635	MO, LA, IL, TN, NC
Alisana Bank <sup>d</sup>	Sullivan	528	10/10/60	1861	0.39	0.553	TN, VA
American Bank	Vienna	783	8/01/60	1861	0.73	0.795	TN, IL
American Exchange Bank	Raleigh	1092 <sup>c</sup>	10/20/56	1861	4.37	0.510	MO, VA, TN, LA
Bank of Albion	Albion	365 <sup>c</sup>	11/04/58	1861	2.58	0.680	TN, MN, NC, GA
Bank of Aledo	Aledo	563	6/04/60	1861	0.89	0.670	TN, VA, NC, US, IL
Bank of America	Mt. Carmel	1393	11/15/60	1861	0.31	0.930	IL
Bank of Aurora	West Aurora	6011	6/02/56	1861	4.75	0.530	MO, LA
Bank of Benton	Benton	380	10/11/60	1861	0.39	0.580	TN, VA
Bank of Brooklyn	Brooklyn	NL <sup>a</sup>	11/19/59	1861	1.43	0.785	MO, MN, TN, NC
Bank of Carmi	Carmi	479	8/26/58	1861	2.52	0.545	MO, VA, NC, TN
Bank of Chester	Chester	1228	11/26/56	1861	4.27	0.545	MO, NC
Bank of Commerce	Vienna	783	11/30/59	1861	1.40	0.735	TN, IL
Bank of Commonwealth	Robinson	316	6/18/56	1861	4.71	0.530	MO
Bank of Elgin	Elgin	2797	2/07/53	1861	8.07	0.660	MO, GA
Bank of Federal Union	Rock Island	5130	9/15/58	1861	2.60	0.630	TN, MO, OH, IL
Bank of Geneseo	Geneseo	1794	6/04/58	1861	2.89	0.685	TN, MO, NC, MI
Bank of Indemity	Gallatia	NL	5/02/59	1861	2.08	0.950	IL, MN, US
Bank of Jackson County	Carbondale	N/A	9/22/59	1861	1.69	0.790	IL, KY, MI, TN
Bank of Metropolis	New Market	109	2/15/59	1861	2.19	0.640	TN, NC, LA, NY
Bank of Naperville	Naperville	2599	3/22/54	1861	6.95	0.640	TN, VA, MO, NC
Bank of Pike County	Griggsville	2357	10/07/56	1861	4.41	0.630	MO, VA, LA, NC, KY
Bank of Quincy	Quincy	13718	6/11/56	1861	4.73	0.600	MO, IL
Bank of Raleigh	Raleigh	1902 <sup>c</sup>	8/23/56	1861	4.53	0.570	TN, MO, KY, OH
Bank of Southern Illinois	Bolton	NL	10/06/55	1861	5.56	0.560	TN, MO, VA, LA, IL
Bank of the Republic	McLeansboro	446	10/13/56	1861	4.53	0.550	TN, VA, NC, OH, IL
Belvidere Bank	Belvidere	1114	12/15/52	1861	8.22	0.525	MO, VA
Bond County Bank	Greenville	1000	11/10/60	1861	0.31	0.730	GA, TN, KY, MI, IL
Bulls Head Bank	St. Marie	937	12/29/58	1861	2.32	0.700	TN, OH, IL, NC
Canal Bank	Thebes	NL	5/21/60	1861	0.78	0.585	TN, LA, GA
Central Bank	Peoria	7087	10/05/52	1861	8.66	0.750	MO, IL, NC
Citizen's Bank	Mt. Carmel	1393	8/05/57	1861	3.58	0.550	MO, IL, VA, TN
Columbian Bank	Elizabethtown	1460	6/23/59	1861	1.84	0.730	IL, NC, TN, OH
Commerce Bank of NW	New Haven	200	7/14/60	1861	0.64	0.545	TN, LA
Commerce Bank	Palestine	1354	9/01/60	1861	0.50	0.560	TN
Continental Bank	Greenville	1525	1/24/59	1861	2.11	0.580	LA, KY, NC, VA, TN
Corn Exchange Bank	Fairfield	520	11/09/55	1861	5.32	0.600	TN, MO, VA, LA, IL
Corn Planter's Bank	Marshall	1883	9/26/60	1861	0.54	0.540	TN, VA, NC
Douglas Bank	Metropolis	1098	10/12/60	1861	0.39	0.550	TN, VA
Eagle Bank of Illinois	Thebes	NL	8/27/60	1861	0.66	0.700	TN, US
Farmers and Traders Bank	Charlestown	2218	11/20/53	1861	7.29	0.500	MO, VA, IL
Farmers' Bank	New Canton	NL	6/01/60	1861	0.75	0.645	TN, MO
Farmers' Bank of Illinois	Metropolis	1098	1/07/60	1861	1.15	0.610	TN, NC, MO
Franklin Bank	Greenville	687	6/23/60	1861	0.84	0.635	TN, US, IL

<b>Frontier Bank</b>	Benton	380	<b>8/05/57</b>	1861	3.58	0.530	TN, VA, NC
Fulton Bank	Vermont	1962	12/09/59	1861	1.38	0.800	OH, MI, IL, TN
Garden State Bank	Hutsonville	468	12/22/38	1861	2.20	0.655	MO, VA, NC, LA, TN
Grand Prairie Bank	Urbana	1727	4/22/36	1861	4.87	0.530	MO, VA, LA
Grayville Bank	Grayville	794	4/03/55	1861	5.92	0.540	MO, MN
<b>Hamden Bank</b>	Highland Bank	446	6/27/60	1861	<b>0.68</b>	0.580	TN, VA, NC
<b>Humboldt Bank</b>	Pittsfield	2137	9/06/58	1861	2.51	0.850	MI
<b>Humboldt Central Bank</b>	Naperville	2599	7/26/60	1861	<b>0.60</b>	0.560	TN, VA, IL
Illinois River Bank	Newton	NL	12/03/58	1861	2.39	0.820	NC, MI
Illinois State Security Bank	Hardin	425	2/25/60	1861	1.27	0.920	US, LA, TN
Illinois State Security Bank	New Haven	200	6/04/59	1861	1.89	0.730	IL, GA, MI
Illinois State Security Bank	New Haven	200	4/12/59	1862	2.29	0.655	TN, IL
<b>International Bank</b>	Raleigh	1092 <sup>s</sup>	<b>9/08/57</b>	1862	4.73	0.870	NC, IA, IL, MI
<b>Jersey County Bank</b>	Jerseyville	2610	5/21/60	1861	<b>0.78</b>	0.585	TN, VA, NC
Kankakee Bank	Kankakee	2984	11/10/59	1861	1.46	0.720	NC, TN
<b>Kaskaskia Bank</b>	Sullivan	690	9/26/60	1861	<b>0.43</b>	0.620	TN, LA, US
Lafayette Bank	Bloomington	7075	10/07/56	1861	4.41	0.570	MO, LA
<b>Lake Michigan Bank</b>	Lafayette	NL	12/14/58	1861	2.36	0.700	TN, OH, IL
Lancaster Bank	Harrisburg	1302	10/10/59	1861	1.40	0.550	TN, IL
Marshall County Bank	Lacon	1944	5/01/60	1861	1.08	0.860	GA, NC, IL
Merchant and Drivers Bank	Joliet	7104	5/16/53	1861	7.80	0.610	MO, LA, NC, SC, IL
Merchants' Bank	Carmi	479	10/12/58	1861	2.64	0.815	VA, TN, MI, IL, LA
Ms. River Bank	Oxford	839	11/12/56	1861	4.45	0.530	TN, MO, VA, LA, NC
Morgan County Bank	Jacksonville	5528	5/02/56	1861	4.84	0.520	MO, TN, LA, NC
Narragansett Bank	Vienna	783	12/16/59	1861	1.36	0.490	TN, VA, MN
National Bank	Equality	359	3/07/55	1861	5.97	0.600	MO, VA, GA
<b>New Market Bank</b>	New Market	<b>109</b>	5/12/59	1861	1.81	0.620	TN
Ohio River Bank	Golconda	404	9/17/59	1861	1.61	0.815	VA, US, OH, TN, IL
<b>Olympic Bank</b>	Metropolis	1098	9/11/60	1861	<b>0.62</b>	0.710	IL, TN
Patrotic Bank	Hutsonville	1061	7/12/59	1861	1.89	0.860	IL, TN
People's Bank	Carmi	479	3/02/55	1857	2.34	0.940	TN, MO, VA, LA
Pittsfield Bank	Pittsfield	2137	4/13/59	1861	2.14	0.815	IL
<b>Plowman's Bank</b>	Taylorville	2039	<b>10/18/60</b>	1861	<b>0.37</b>	0.535	TN, VA
Prairie State Bank	Washington	488	12/05/55	1861	5.39	0.590	TN, MO, LA
Railroad Bank	Decatur	3839	5/25/54	1861	6.78	0.550	TN, VA, NC
Reed's Bank	Galesburg	4953	3/06/57	1861	3.99	0.650	MO
Rock Island Bank	Rock Island	5103	9/15/52	1861	8.47	0.500	MO
<b>Shawans Bank</b>	Elizabethtown	1460	4/12/60	1861	<b>0.89</b>	0.635	TN, LA, NC, VA, GA
Southern Bank of Illinois	Grayville	794	11/19/55	1861	5.29	0.560	MO, LA
State Bank of Illinois	Shawneetown	1115	4/26/54	1862	7.48	0.870	MO, VA, LA, NC, SC
State Stock Bank	St. Johns	N/A	3/15/60	1861	1.11	0.720	TN, KY, LA, IL, MI
Stock Security Bank	Danville	632	7/30/52	1857	4.81	0.883	TN, MO, VA, LA, CA
<b>Toulon Bank</b>	Toulon	1784	10/01/60	1861	<b>0.56</b>	0.670	TN, NC, KY, IL, VA
<b>Union County Bank</b>	Jonesboro	842	7/20/60	1861	<b>0.62</b>	0.610	TN, NC, VA
Warren County Bank	Monmouth	2506	9/28/59	1861	1.58	0.700	MO
<b>Western Bank of Illinois</b>	Savanna	825	10/17/60	1861	<b>0.99</b>	0.620	TN, US
Wheat Growers Bank	Anna	769	10/25/59	1861	1.50	0.700	TN, VA, MI

a Not listed on census

b Not available

c Population taken from the 1850 U.S. census

d Boldface type indicates that the bank was identified as having a characteristic consistent with wildcat banking

his notes, the banker could have leveraged his investment, thereby increasing the capital gain on his investment. In the third period the degree of leverage, and thus wildcat profit opportunities, was the highest. Wildcat bankers could have initially received 45 percent more notes than their investment if they had decided to enter in April 1861.

A comparison of the wildcat profit opportunities with the first bond deposit date (entry date) of the banks reveals that only seven banks (8 percent of all failed banks) entered in periods conducive to high profit levels. It is interesting to note that two of the banks entered in 1857 while five of the banks entered in the second period, 1860. The journal records show none of the failed Illinois banks entering during the period of highest wildcat profit opportunities. This evidence suggests that the capital gains motive was not a major factor in the entry decision of the seven banks.

Although the evidence showed few entrants taking advantage of opportunities, existing banks may have taken advantage of the price discrepancies between the legal price of bonds. An existing bank is said to have wildcat characteristics if the bank deposited southern bonds or swapped southern for northern bonds with the auditor during the wildcat periods. The examination of the auditor's bond journal showed six banks (7 percent of all failed banks) taking advantage of the price discrepancies between the legal price and the market price of southern bonds (see Table 3). The additional purchases represented ranged from 1.67 percent to 53.2 percent of the bond portfolio of the failed banks.

The last characteristic to be examined is the "inaccessibility" of the free bank. The U.S. Censuses of 1850 and 1860 provided county and town population figures. If the location of the bank was not listed in the censuses, it was assumed to lack a sufficient population to warrant a census. Three counties in which free banks were located did not report town population figures. The evidence indicates that ten banks violated the 200-minimum-inhabitant restriction enacted by the legislature. Seventeen banks were located in population areas of between 200 and 499 inhabitants while sixteen banks were located in population areas of between 500 and 999. Surprisingly, a majority of the banks (46) were in highly populated areas of more than 1,000 inhabitants. If the 200-minimum-population restriction set by the legislature is any indication of "accessibility," it would seem

TABLE 3

## ILLINOIS FAILED BANKS PURCHASING BONDS DURING WILDCAT PROFIT PERIODS

Bank	Dates	Type: Amount	Bond holdings as of October 1860
Bank of Naperville	4/05/61	MO \$ 4,000	\$ 65,000
Farmers Bank	5/25/61	NC \$ 1,000	\$ 60,000
Fulton Bank	11/01/60	TN \$28,000	\$ 58,000
Garden State Bank	10/30/60	TN \$30,000	\$145,000
	11/10/60	TN \$15,000	
Kashaskia Bank	10/30/60	TN \$ 3,000	\$ 65,000
New Market Bank	11/13/60	TN \$31,000	\$ 82,000

that the traditional accounts of numerous inaccessible banks have been exaggerated.<sup>13</sup>

In summary, the data show that 52 Illinois banks were identified as having no wildcat characteristics while 37 banks were identified as having at least one wildcat characteristic.<sup>14</sup> Only one of the 37 free banks (Farmer's Bank, New Canton) was identified as having all three characteristics consistent with wildcat banking. Eight banks were identified as having two of the major characteristics while 28 banks were identified as having only one of the three major characteristics (see Table 4). This suggests that the conventional view of wildcat banking in Illinois is not supported by the evidence, and the claim that noteholder losses were primarily due to wildcat banking is questionable.

### *Falling Asset Hypothesis*

The alternative hypothesis proposed by Rolnick and Weber that falling asset prices caused free bank failures provides a better explanation for bank failures than the wildcat banking hypothesis. However, the Illinois evidence raises new questions concerning the agent causing the bank failures. Recall that Rolnick and Weber claimed that the sharp decline in asset prices would prompt noteholders to demand specie from bankers; unwilling bankers would allow their notes to be protested and be declared bankrupt by the auditor. The evidence indicates that some of the failures may not have been caused by the noteholder's protest of banknotes, but by the banking commissioner's demand for additional capital from the stockholders.

The Tennessee bond series was used to approximate the general movement in asset prices held by free banks. Three periods of major declines occurred between

TABLE 4  
WILDCAT CHARACTERISTIC MATRIX OF BANKS HAVING AT MOST TWO CHARACTERISTICS

	Characteristics			Total
	Less than one year	Capital gains motive	Inaccessible location	
Less than one year	16			16
Capital gains motive	5	6		11
Inaccessible location	2	1	6	9
Total	23	7	6	36

<sup>13</sup>It should be noted that nine banks operated in Chicago between 1853 and 1863, none of which failed. Eight of the nine Chicago banks exited before 1860. Whether this lack of failures was due to the accessibility of the banks or some other characteristics unique to the city is not known and open to further research.

<sup>14</sup>Since the focus of the paper is to examine the accuracy of the conventional view of wildcat banking, the strict conventional definition was used; i.e., having a life span of less than one year, locating in inaccessible areas as defined by the legislature, and purchasing bonds during wildcat profit periods.

1851 and 1863: March 1854 to December 1854; June 1857 to October 1857; and June 1860 to June 1861 (see Figure 2). Tennessee bond prices declined 13 percent and 24 percent in the first and second periods. In the last period bond prices declined 55 percent.

The first two failures in Illinois, the People's Bank and the Stock Security Bank, occurred during the price decline of 1857. The cause of the failures can be traced to the fall in bond prices and to the bank commissioner's demand of additional capital. In the Bank Commissioner's Report of 1858 the commissioner states,

finding that the securities of a portion of the banks had become insufficient, by reason of diminution of value, as security for the redemption of their circulation on the 8th day of May, 1857, made requisition upon such banks to be within 40 days, additional securities, or return enough of their circulation to make the securities filed with the treasurer sufficient for the redemption of the residue outstanding . . . This requisition was responded to by all the delinquent banks, within the time required, except the Stock Security (which had been tested during the pendency of the call) and the Peoples Bank (1859, p. 194).

The remaining 89 banks exited during the third price decline. On November 19th, 1860, the bank commissioners called upon twenty-two banks for additional bonds because the bonds securing bank notes depreciated to such a degree that bank notes were no longer secured. The banks were required to pay one-fourth of the call by February 20, 1861 and the balance of the amount by March 20, 1861 (1863, p. 216). Dowrie reports that "the holders of the notes made vigorous objection to the commissioners actions . . ." (Dowrie, p. 157). Apparently, the commissioners delayed liquidation of the protested called banks fearing the sale of

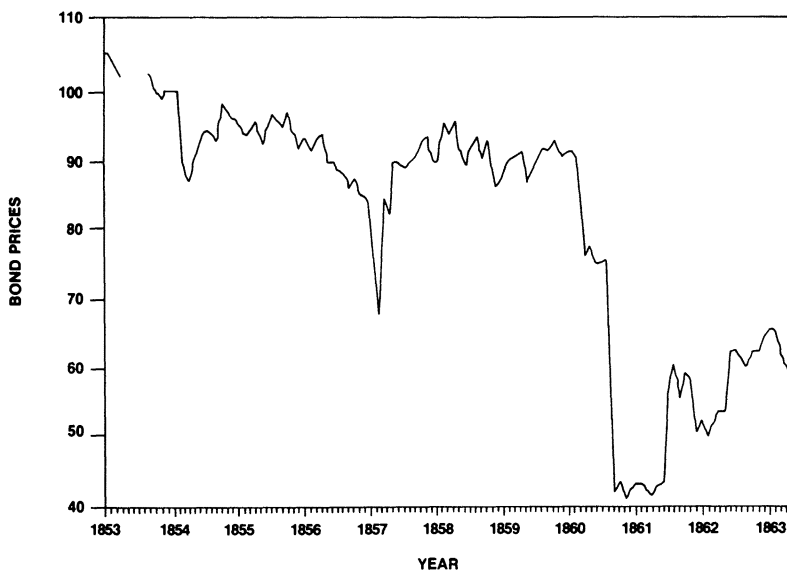


FIG. 2. Tennessee Bond Prices.

the bonds would further depress bond prices and would not be in the best interest of the noteholders. The commissioners, however, allowed noteholders to exchange their bank notes for bonds. Several agencies were established for the conversion of notes into bonds and then into specie.

The decline of bond prices continued into 1861 necessitating a call on all but seventeen banks for additional securities. The auditor delayed liquidation of bonds of defaulting banks “so long as any considerable amount of notes were held by parties that preferred to take securities” (1863, p. 110).

Thus, the evidence indicates that the fall in bond prices was a major factor in the free bank failures of Illinois, but it is uncertain whether the call from the state or the protest of the noteholders ultimately led to the bank’s default. However, the auditor’s willingness to exchange bonds for notes suggests that the deciding factor rested with the noteholder.

## 5. SUMMARY

The reexamination of the Illinois experience has provided several insights into the free banking controversy. First, the evidence clearly indicates that the traditional accounts of wildcat banking in Illinois are unsubstantiated: only ten failed banks had two or more characteristics consistent with wildcat banking. Free bank failures were not generally linked to fraudulent behavior, but to falling asset prices. Second, the evidence lends strong support to the hypothesis proposed by Rolnick and Weber: all of the free banks failed during periods of major bond price declines. However, the severity of noteholder losses during the free banking era was greater than was suggested by Rolnick and Weber. Estimated losses in Illinois exceeded the total losses of the Rolnick and Weber four-state sample.

Two questions that need further research can be raised from this study. First, did the provision requiring a long-term financial asset as security for a short-term liability increase the interest rate risk exposure of the free bank? Although interest rate risk can be partially offset by the purchase of a short-term asset (such as specie), the large noteholder losses suggest that this was not the case in Illinois. The failure of the free bank managers to adjust their portfolios may explain Rockoff’s observation that low liquidity ratios were associated with free bank failures and noteholder losses. Future research on the portfolios of the individual free banks could explain why some free banks failed while others remained solvent and why noteholder losses vary considerably among the states.

Second, did the call upon free banks for additional capital during times of financial stress exacerbate the financial problems of the free bank and therefore contribute to the decision to close rather than to weather the turmoil? An investigation into the financial structure of the free bank could provide insight into the decision-making process of the free banker and help determine the state’s role in inducing free bank failures.

*Data for this paper are available from the JMCB editorial office.*



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