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The Political Economy of Banking Regulation, 1864–1933

EUGENE NELSON WHITE

The laws and regulations that shaped the structure of the banking industry from the Civil War to the Great Depression were strongly influenced by the banking community. In this period legal constraints on banks were weakened by competition between state and federal regulators trying to increase membership in their banking systems. The elimination of regulation was not completed, however, because the politically most powerful group in the industry, the unit banks, had an interest in preserving some regulations.

NATIONAL money and capital markets gradually emerged in the United States from the integration of regional markets and the circumvention of regulatory constraints imposed on financial intermediaries.[1] Regulation of the banking industry created a number of impediments to the formation of these markets. Although economic historians have examined the effects of this regulation, they have not given much attention to the economic and political forces that shaped its evolution. Changes in banking regulation were the product of protracted political struggles among different interest groups seeking to influence the structure of the industry. In this paper, the evolution of banking regulation from the Civil War to the Great Depression is analyzed by examining the actions of the three interested parties: the banks, the public, and the government regulators. These were not homogeneous groups but were categorized by divergent economic interests. Influence thus depended on the political coalitions that arose. The most effective political coalition that emerged was formed by the smaller unit banks. The durability of some banking laws and changes in others in this period are largely explained by the considerable influence wielded by these banks.

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[1] Studies of the development of American money and capital markets include: Lance Davis, "The Investment Market, 1870–1914: The Evolution of a National Market," this JOURNAL, 25 (Sept. 1965), 355–99; Richard E. Sylla, *The American Capital Market, 1846–1914* (New York, 1975); John A. James, *Money and Capital Markets in Postbellum America* (Princeton, 1978); Richard H. Keehn, "Market Power and Bank Lending: Some Evidence from Wisconsin, 1870–1900," this JOURNAL, 40 (March 1980), 45–52.

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THE DUAL BANKING SYSTEM

The point of departure from which opposing interests vied with one another to influence regulation was the establishment of the National Banking System. Created by the National Banking Act of 1864, this system disrupted the existing balance of forces shaping the regulatory environment and restructured the banking industry. The Office of Comptroller of the Currency was established and given authority to charter national banks that were permitted to issue banknotes backed by government bonds. Most banks were induced to join the new system when Congress levied a 10 percent tax on all non-national banknotes. The National Banking Act also regulated the size and activity of national banks by imposing minimum capital and reserve requirements, restricting real estate loans, and prohibiting branching.[2]

These barriers to entry and constraints on banking activity prevented the supply of banking services from keeping pace with the demand as the country grew and expanded westward. The lack of adequate banking facilities was particularly acute in agricultural areas where communities were not large enough to support a minimum size national bank. The unfulfilled demand for more banking services stimulated the public to press for currency and banking reform. Although most agrarian agitation focused on the issue of silver monetization, business emphasized the lack of banking facilities in addition to monetary reform. At the 1897 Indianapolis Monetary Convention, dominated by Midwestern businessmen, it was resolved that the lack of adequate banking facilities should be met by "a diminution of the minimum capital required for banks in places of small population and authority for the establishment of branch banks."[3]

This demand for more bank offices was answered by the states, which began to pass "free banking" laws in the late 1880s and 1890s. These laws permitted new banks to incorporate under general legal provisions instead of requiring them to obtain special charters from the state legislatures. This change made entry into the banking industry much easier.[4] To ensure the attractiveness of the reorganized state systems, the state legislatures required banks to conform to regulations less restrictive than those imposed on national banks. Thus, the Comptroller of the Currency's 1895 survey of state legislation found that all but two states' minimum capital requirements were lower, few imposed any restrictions on their banks' real estate loans, and only sixteen states had reserve requirements.[5] Given this incentive structure, it is not surpris-

[2] For a more detailed description of state and federal banking regulations, see Eugene Nelson White, *The Regulation and Reform of American Banking, 1900–1929* (Princeton, forthcoming), Chap. 1.

[3] Quoted in Sylla, *The American Capital Market*, p. 71.

[4] James, *Money and Capital Markets*, pp. 233–34.

[5] *Annual Report of the Comptroller of the Currency* (Washington, D.C., 1895).

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ing that national banks grew very slowly from 3,484 in 1890 to 3,731 in 1900, while state-chartered banks increased from 2,534 to 4,405.[6] The federal government had sought to monopolize the regulation of banking, but the short supply of banking services drew the states back into the business of chartering banks, breathing life into the dual banking system.

REGULATORY COMPETITION

Confronted by vigorous competition from state banking authorities chartering new banks and trust companies and faced with strong public pressure, federal officials moved to improve the attractiveness of national bank charters. The Comptrollers of the Currency in the early 1890s were favorably disposed towards legislation that would permit some form of branching to increase banking facilities in rural areas. In 1895, Secretary of the Treasury John Carlisle and President Cleveland both recommended that national banks be allowed to branch.[7] When the unit banks in small towns and rural areas realized that their profitable position and perhaps even their independence was threatened by branching that would allow the larger city banks to reach out into their territory, they rallied to oppose these proposals. Their cause was taken up by Charles Dawes who became Comptroller in 1898. He helped to kill a bill in Congress that would have allowed some branching; in its place, he promoted lower capital requirements to increase the number of rural bank offices.[8] Congress accepted this proposal, and the Gold Standard Act of 1900 allowed national banks with a capital of $25,000 to be established in towns of fewer than 3,000 inhabitants.

The state banking authorities quickly recognized the effect this federal law might have on applications for state charters. By the time of the next survey of state banking laws in 1909, all but one state (Massachusetts) that had minimum capital requirements above the new federal level had reduced their requirements to maintain their advantage.[9] State banking authorities were not anxious to see the number or proportion of institutions under their control decline, the public wanted more bank offices, and the country unit bankers did not want to see the introduction of intrastate branching. This political alignment of interests virtually ensured that reductions in capital requirements would be the predominant legislative response to the insufficient supply of banking services. The result of lower state and federal minimum capital require-

[6] Data on the national banks came from the *Annual Report of the Comptroller of the Currency* (Washington, D.C., various years). The series on state banks was obtained from George Barnett, *State Banks and Trust Companies* (Washington, D.C., 1910).

[7] *Annual Report of the Comptroller of the Currency* (Washington, D.C., 1896), pp. 103–04.

[8] Gerald C. Fisher, *American Banking Structure* (New York, 1968), pp. 27–28.

[9] Samuel A. Welldon, *Digest of State Banking Statutes* (Washington, D.C., 1909).

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ments and buoyant economic conditions before the First World War was a rapid growth of small banks. The number of national banks rose to 7,518 in 1914 while the number of state banks climbed to 14,512. The anti-branching lobby was further strengthened by these new and often very small financial institutions.

The changes in banking regulation rendered by the Federal Reserve Act of 1913 did not attempt to alter the structure of the banking system; the aim instead was to make membership in the new Federal Reserve System sufficiently attractive to draw in state banks. Reserve requirements were cut, restrictions on real estate loans were reduced, and members could obtain loans from the discount window. The states proved to be obdurate competitors. Many legislatures refused initially to pass legislation enabling state banks to become members of the Federal Reserve, and by 1915 fifteen states had reacted to the reduction of member reserve requirements by lowering their requirements. The Federal Reserve Board criticized the states, but it did not rely on moral suasion alone. In 1921, it secured a further reduction of member reserve requirements. The states reacted to this change; by 1928, 12 states had again reduced their reserve requirements.[10]

The economic theory of regulation provides a general framework for analyzing these regulatory changes. This theory posits that regulation is a good for which there is an active market. Favorable regulation will be supplied to the individuals or groups that have valued it most by voting and lobbying the government.[11] Direct evidence of bankers' influence on legislatures is difficult to find. It does appear, however, that when bankers argued strongly for or against a piece of legislation they could sway the legislature. In New Jersey, the state bankers association had a legislative committee that drew up bills to be presented to the state assembly, and the association tried to organize its members so that they would present a united front at hearings on banking legislation in Trenton. Most legislation proposed by the association was passed with few alterations.[12] The California Bankers Association also had a legislative committee that conferred regularly with the superintendent of banks before each session to discuss possible changes in the Banking Act. The superintendent usually heeded their counsel; the legislature, in turn, was inclined to accept the advice of the superintendent.[13]

The economic theory of regulation typically views regulation as being supplied by a monopoly producer and being demanded by a competing

[10] *Federal Reserve Bulletin* (Washington, D.C., November 1928), pp. 778–805.

[11] George Stigler, "The Theory of Economic Regulation," *Bell Journal of Economics,* 2 (Spring 1971), 3–21; Sam Peltzman, "Toward a More General Theory of Regulation," *Journal of Law and Economics,* 19 (August 1976), 221–40.

[12] Edwin W. Kemmerer, "New Jersey Banking, 1902–1927," *Journal of Industry and Finance* (May 1928), 28–30.

[13] Shirley D. Southworth, *Branch Banking in the United States* (New York, 1928), pp. 36–37.

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public. One of the key characteristics of the American banking system, however, has been the absence of such a monopoly regulator. The federal and state governments have instead competed with one another to regulate banks. It has been argued that rivalry between regulators will lead to a dilution and finally an elimination of regulatory constraints.[14] This hypothesis is clearly supported by the gradual weakening in capital and reserve requirements and portfolio restrictions—which most banks favored. But what needs to be explained is why the restrictions on branch banking remained virtually unchanged. The branching issue divided the banking community. The unit bankers, particularly those in small towns and rural areas, were opposed to any changes in the branching laws. They had an important stake in maintaining the existing banking structure and feared that the city banks would penetrate their markets. The unit bankers when threatened were able to exert considerable political pressure. The reform legislation that came out of the Congress clearly reflected the interests of the unit bankers, who formed the largest block in the banking community. There was no new provison for branching, and the decentralized character of the Federal Reserve System was aimed at preventing the "monopolistic interest" from gaining control.

THE BRANCHING ISSUE

At times the regulatory competition led to serious consideration of increased branch banking. The federal authorities wanted to permit branching by national banks to increase the number of bank offices, meet the public's demand for banking services, enlarge existing national banks, and prevent national banks from switching to state charters to obtain limited branching privileges. Support for increased branching also was found in some parts of the banking community. Led by A. P. Giannini of the Bank of America, the larger banks that lobbied hard for more branching believed that it would enhance their position in the industry, increase the efficiency of money markets, and strengthen the banking system. Loopholes for branching by national banks appeared in the National Bank Consolidation Act of 1918 and some of the rulings of the Comptroller of the Currency, but the opportunities for national bank branching nonetheless remained limited.[15]

In the few states in which the law allowed state banks to open additional offices, branching grew rapidly. Nationwide, branch offices as a percentage of all bank offices rose from 5.7 percent in 1920 to 15.7

[14] Jack Hirschleifer, "Comment," *Journal of Law and Economics,* 14 (August 1976), 241–44; and Richard B. McKenzie and Hugh H. Macaulay, "A Bureaucratic Theory of Regulation," *Public Choice,* 35 (1980), 297–313.

[15] Ross M. Robertson, *The Comptroller and Bank Supervision: A Historical Appraisal* (Washington, D.C., 1968), pp. 101–05.

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percent in 1930, and the share of branching banks, loans and investments in total loans and investments increased from 18.6 percent to 45.5 percent.[16] These rapid changes prompted the unit bankers to take defensive action by seeking state anti-branching legislation. In 1909, 26 states had no statutory prohibition of branch banking, but when branches began to appear the unit bankers were able to obtain anti-branching laws from state legislatures in all but seven of these states.[17]

In most southern and western states where unit banking was well established, the state bankers associations became the vehicles for the opposition to branching. In Kansas, Illinois, Iowa, Minnesota, Nebraska, and South Dakota, the state bankers associations attacked branching and the bills they sent to their state legislatures to prohibit branching were accepted. In other states such as California where branch banking was already very strong, the unit bankers formed their own separate associations. The California League of Independent Bankers tried to arouse the public to what it perceived as the dangers of branching by playing on their fears of monopoly control. The association's organ, *The Independent Banker*, argued that "the public is more interested in the democratic decentralization of credit control than it is in the progressively concentrative and autocratic control of credit."[18] This populist theme was echoed by the local press. The *San Bernadino Sun* warned that the country customer would become only a numbered account, "a slave, lashed to the chariot of metropolitan control."[19] Although this campaign failed to make any headway in California, it was very successful in areas where branching was unknown or unfamiliar. In a 1924 Illinois referendum the public rejected by a two-to-one vote a law to permit branching, and thereby protected themselves and their local unit banks from the moguls of the big city.[20]

In Congress the unit bankers were able to thwart most efforts of federal officials and the larger banks to obtain legislation allowing full-service branching by national banks. When in 1927 the McFadden Act finally conceded some branching privileges, it was limited to resolving the problem of the inequality between member banks.

Branch banking did expand in the twenties, but only in a few states. No coalition to fight for branching appeared. Compared to the large number of country bankers, there were relatively few bankers in favor of branching, and they were divided among themselves. The largest banks supported nationwide branching while regionally strong banks

[16] Board of Governors of the Federal Reserve System, *Banking and Monetary Statistics, 1914–1941* (Washington, D.C., 1943), p. 297.

[17] Frederick A. Bradford, *The Legal Status of Branch Banking in the United States* (New York, 1940).

[18] Quoted in Southworth, *Branch Banking*, pp. 70–71.

[19] *Ibid.*, pp. 71–72.

[20] *Ibid.*, p. 17.

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favored trade-area or statewide branching. Although business and the public bore the costs of a less-than-optimal banking structure, these costs were diffuse. This diffusion of costs impeded the formation of a pro-branching lobby. On the other hand the unit country bankers were keenly aware that they would bear the costs of increased branching. Their perceived common interest made the unit bankers a cohesive group capable of erecting legal barriers to further expansion of branching banks.

THE GREAT DEPRESSION AND BANKING REGULATION

The massive bank failures of the 1930s initially sapped the strength of the unit bankers' lobby by thinning their ranks and discrediting their policies. Several states that previously had forbidden branching altered their laws to enable surviving banks to acquire defunct banks' offices. The Federal Reserve and some influential members of Congress thought that it was an appropriate time to establish a uniform system of banking regulation and to allow freer branching. The first drafts of reform bills would have allowed statewide or trade-area branching; the unit bankers, however, regrouped to fight the federal regulators and the pro-branching bankers in Congressional hearings and behind the scenes. In this struggle, the unit bankers received some support from state regulators who were loath to see the federal authorities assume more control over the chartering and regulation of banks. The unit bankers were successful in their efforts and blocked the more radical changes; the Banking Act of 1933 conceded to Federal Reserve member banks only the same branching privileges as those allowed by state law.[21] The unit bankers, however, were able to achieve this success only because deposit insurance presented a quick, apparently viable alternative that would safeguard the banking system. The small town bankers always had looked favorably upon deposit insurance as a means to protect them from failure, and a few states had experimented with deposit guarantee funds after the panic of 1907.[22] Federal deposit insurance previously had failed to make any headway in Congress because of the intransigent opposition of the city bankers who lobbied vigorously against it, fearing they would end up subsidizing the smaller banks and paying for their mistakes. This impasse was broken after the banking panics when the public was moved to whole-hearted support of deposit insurance. *Vox populi* and the unit bankers formed a formidable political coalition that led Congress to create the Federal Deposit Insurance Corporation, an

[21] Helen M. Burns, *The American Banking Community and New Deal Banking Reforms, 1933–1935* (Westport, Connecticut, 1974), chapters 3 and 4.
[22] Eugene N. White, "State-Sponsored Insurance of Bank Deposits in the United States, 1907–1929," this JOURNAL, 41 (September 1981).

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innovation that weakened the previous sense of urgency to modify federal statutes regulating branching.

CONCLUSION

During the Civil War when Congress chose to rely on economic incentives rather than coercion to draw banks into its regulatory system, it unintentionally set the stage for the emergence of competitive state regulators. Although the federal government faced only one regulator in each state, it could not obtain a monopolistic settlement because the number of state banking authorities and legislatures made nationwide cooperation difficult if not impossible.

The competitive reduction of regulations benefited many banks, but the greatest advantage accrued to the unit bankers whose influence was strengthened by the increase in new unit banks. The unit bankers' actions were largely defensive, but what they lacked in terms of leadership or a program they made up in brute political clout. This was not a result of their relative economic importance in the industry. By any conventional measure of banking power their importance was declining at the time they were able to secure many state anti-branching statutes. Their influence may be attributed to their presence in most rural and many urban areas, a presence that gave them a broad political base from which to influence Congress and the state legislatures. Many Americans were intensely suspicious of large banks and thus tended to support local independent banks because they feared the spread of branching into their communities. The unit bankers also found influential allies among state banking authorities who distrusted the aggrandizing tendencies of the federal regulators. The state regulators had an obvious stake in preserving the dual banking system, as did the smaller banks which preferred the looser constraints of the states' banking laws and recognized that these were a product of regulatory rivalry. The elimination of state charters would have left them facing a single federal regulatory agency much more difficult to influence.

From their advantageous political position, the dominant coalition of unit bankers was able to withstand the depression and rapid changes in the banking industry that favored the growth of large branching banks. Rivalry between the state and federal regulators weakened most banking regulations and helped to facilitate the integration of money and capital markets. But the substantial legal impediments to branch banking remained largely unchanged at the behest of the unit bankers. They had the most to lose by drastic changes in regulation and they worked strenuously to influence banking laws. Owing to these efforts the unit bankers largely succeeded in maintaining those regulations they regarded as necessary for their survival.

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