

What Happened to the Dual Banking System

-Historical Meaning of Interstate Banking and
Branching Reform in the United States (1) -

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I. Introduction

On September 29, 1994, President Clinton signed into law the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994¹. The act eliminated most restrictions on interstate bank acquisitions and made interstate branching possible in the U.S. for the first time in seventy years. Under the new law, states could "opt-out," that is, prohibit interstate branching within their boundaries by June 1 1997,

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¹ Pub. L. No.103-328, 108 Stat. 2338 (12 USC); H.R. Conf. Rep. No. 651, 103d Cong., 2d Sess.

but would then forfeit the right for the state's banks to branch into other states. Similarly, states could "opt-in" to allow interstate mergers and acquisitions immediately after September 29, 1995.

The provisions governing the operation of interstate branches can be thought of as intervention of the federal government over state sovereignty, although pre-1997 branching restrictions did not altogether prevent geographic diversification in all states. In other words, the establishment of the Riegle-Neal Act would have a significant effect on the dual banking system, which has been one of the most prominent features of the U.S. banking system.

Historically, the differences between state and national banks have lessened through out the years, and the authorities over them have not been in conflict to the degree they once saw. Also, federal control over state banks has gradually strengthened, particularly since the FDIC was established. These examples show that state power over state banking systems has been weakening,² which has also weakened an important component of the dual banking system.

This event is revolutionary because provisions of the 1994 Riegle-Neal Act are direct orders to state legislatures. Until then, federal control over state banking systems was exercised indirectly by ruling member state banks from the Federal Reserve System and the Federal Deposit Insurance Corporation.

II. Background and Previous Research

Most literatures on the U.S. financial system's evolution toward establishing a central bank has mentioned the United States' dual banking system, but not focused on it.³ Among these authors White (1983) and Robertson (1995)⁴ concentrate on the system.⁵ Because this paper will examine how the dual banking system developed and how historical branching deregulation has affected it, White's

(1994) (*the Conference Report*).

² Federal Reserve Chairman Alan Greenspan remarked that the Office of the Comptroller of the Currency (OCC) is threatening the viability of the state bank charter and attacking the dual banking system with the opening-subsiary rule of the OCC and with impact of nationwide interstate branching. *American Banker*, May 5, 1997.

³ Brown (1968), Federal Reserve Committee on Branch, Chain, and Group Banking (1933), Scott (1979), and Thompson (1962) focused on the dual banking system.

⁴ Robertson (1995) sketches the history of commercial bank regulation in the United State with special attention to the history and functions of the Office of the Comptroller of the Currency. He examines the first half-century of federal bank regulation, addressing bank chartering and entry, bank supervision in a dual system, and multi-office and multiunit banking up to the Great Depression.

⁵ Takagi (1979 and 1982) are exceptional articles written in Japanese from where his study concentrates on the dual banking system and where it develops to the arguments over the unification of bank supervisory authorities in early 1980s.

study holds considerable relevance in this context.

In *The Regulation and Reform of the American Banking System, 1900-1929*, E. N White analyzed the dual banking system from the early part of the National Banking Era to 1929. He argues that the American banking systems' weakness against banking panics is derived from the dual system of chartering and supervising banks, which comprises thousands of independent, small unit banks. These banks preferred to remain within the state banking systems because they were attracted by lower capital and reserve requirements, fewer portfolio restrictions, and weaker supervision. Correspondent banks and clearinghouses helped their survival by offering clearing services and by meeting the temporary need for liquidity. Therefore these banks could remain within state systems without joining the Federal Reserve System. When many state banks failed after the banking panic of 1907, the state banking authority began making attempts to improve its vulnerable system, but did not see results.⁶

White concludes that key factor –branch banking– could have increased Federal Reserve membership, instead diminished the role of the correspondent banks, and improved banks' strength against failures. Free branch banking would have reduced the number of banks and facilitated their mutual help in times of crises. White maintained that free intrastate and interstate branching could very well solve the Federal Reserve's membership problem and that the key to strengthening the banking system would be found in deregulating the banking industry, rather than creating new government agencies and regulations.⁷

Though the creation of the Federal Reserve, and especially, Federal Deposit Insurance, affected the state bank authorities, the dual system of chartering, regulation and supervision is still strongly alive today. At the close of 1999, there were 6,215 state chartered commercial banks, representing approximately 72% of the nation's 8,580 commercial banks, though total assets the state banks held were about 43% of all US commercial banks.⁸ Moreover, state banks are still enjoying such activities as securities brokering, municipal revenue bond underwriting, real estate brokering, real estate developing, participating in real estate equity and insurance brokering in many states,⁹ which most national banks are not permitted to do.

The paper follows the development of a dual banking system, focusing on competition between state and federal banking authorities, especially those in the field of branching deregulation and its

⁶ White (1983), pp. 10-11, 42-54, 80-82, and 223-227.

⁷ Ibid., pp. 226-227.

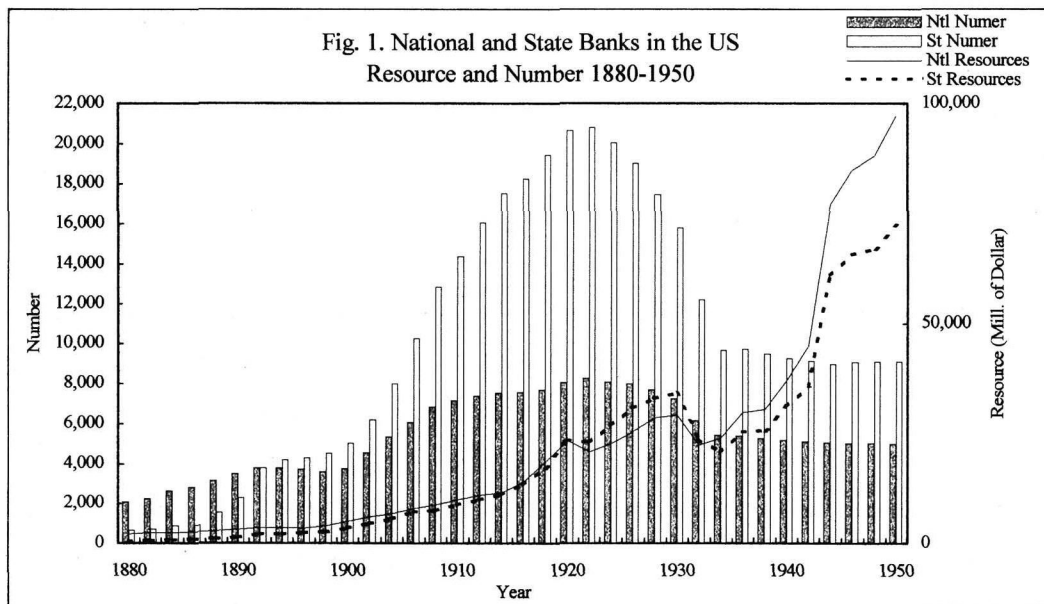
⁸ Source: Office of the Comptroller of the Currency, *Quarterly Journal*, Volume 19, Number 1, March 2000, pp. 6 & 12. FDIC, *Historical Statistics on Banking*, <http://www2.fdic.gov/hsob/index.asp>.

⁹ CSBS, *Permissible activities (beyond power of national banks)*, <http://www.csbs.org/info/permissible.html>

historical changes in characteristics.

III. The Dual Banking System: Historical Development and pre-WWII Changes in Characteristics

Figure 1 shows the trends of the number and resources that national and state banks had from 1880 to 1950. The competitive advantages of one system over the other can be traced by changes in the number and resources of banks chartered, and by transfers from one part to the other. The total number of national and state banks grew from 2,726 in 1880 to a high of 29,417 in 1921, then decreased to 12,045 in 1930, and down to 15,080 by 1934. After the banking panic of 1933, the total number of banks rose to 15,106 in 1936, but thereafter, these numbers saw a downward trend.



Source: Years 1880 to 1890 inclusive: *Annual Report of the Comptroller of the Currency*, 1931, pp. 3 & 5.
Years 1892 to 1950 inclusive: *Annual Report of the Comptroller of the Currency*, for the years cited.

In 1880, there were 2,726 national banks in the U.S., accounting for 72 percent of the total national and state banks. The number of state banks overtook that of national banks between 1890 and 1892, and their predominance in number remained unchanged, although in the 1920s, the number of state banks decreased dramatically, as a result of the tremendous number bank failures.

In this chapter, we will study the reasons that caused changes in the competitive advantages of one system over the other, and the historical relevance of the dual banking system before World War II.

CREATION OF NATIONAL BANKS

Competition between the systems

In 1781, the Continental Congress formed the Bank of North America. In 1782 the state of Pennsylvania chartered this bank, which placed it in a state of duplicated charters, which, in turn, spawned banking conflicts between national and state governments.

The conflict actually began its long history in 1791, when Congress chartered the First Bank of the United States,^D but this conflict did not have the same characteristics as the conflict that arose after both the national and state banking laws were established.

For our purposes, the dual banking system began on February 25, 1863, with Congress passing the “An act to provide a National Currency, secured by a Pledge of United State Stocks, and to provide for the Circulation and Redemption thereof.” The act authorized the establishment of national banking associations as a means through which the national currency secured by the government obligations would be circulated and redeemed. The act was extensively rewritten and strengthened in the National Bank Act of 1864.^{II} The revision’s principal purpose was to provide a market for government bonds issued during the Civil War and to establish a uniform national currency based on national banks.

Charters for national banks were to be available under the free banking system, provided that minimum capital and other organizational requirements were satisfied. The free bank acts were incorporation laws of allowing anyone meeting certain standards and requirements to secure a bank charter. The laws passed first in Connecticut, Michigan, and New York in 1837 and 1838, with many other states later establishing similar acts. Until then, the chartering of banks by states needed to pass a special legislative act for each chartering application.^B

The National Currency and National Bank Acts brought the federal government into active supervision of commercial banks for the first time in American banking history. The Office of the Comptroller of the Currency was established by the acts, and given responsibility for chartering, supervising, and examining all national banks.^B

As shown in Figure 2, in the first year, 66 banks took the national charter. To join the new system, they needed to abandon their state charters, hold reserves against their notes and deposits, and accept tighter supervision and more restrictive lending and investment powers under the National Bank Act.

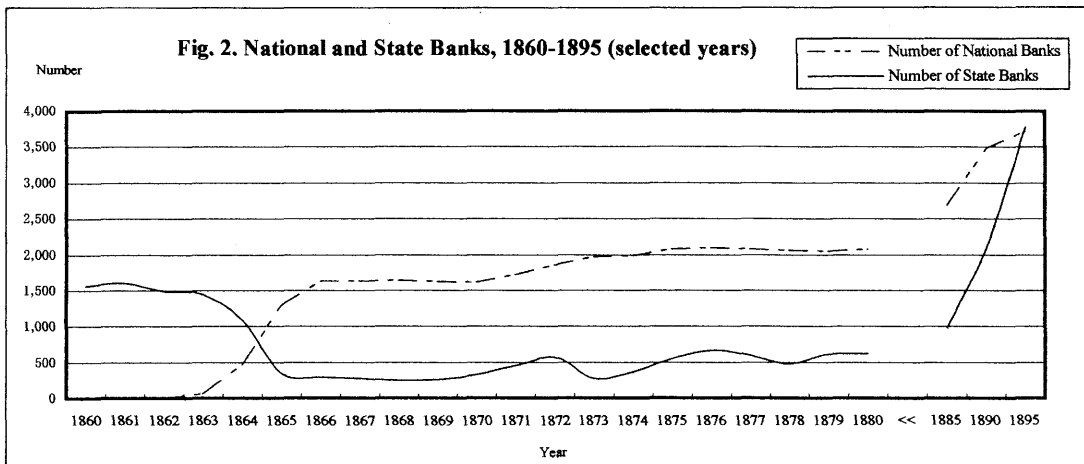
^D Fischer (1968), pp. 9 & 11-14.

^{II} Cagen (1963), pp.16-19.

^B Walton & Rockoff (1990), pp.253-254.

^B Robertson (1995), pp. 57-62.

To give banks more incentive to join the national bank system and to foster the development of a national currency, in 1865 Congress imposed a prohibitive 10 percent tax on state bank notes, which was to begin July 1, 1866. Because the ability to issue notes was one of the most important bank powers at that time, most state banks took out national charters to avoid the earnings disadvantage of state notes. As a result, the number of state banks decreased from 1,089 in 1864 to 349 in 1865, and then to 247 by 1868. Figure 2 shows this dramatic decline.



Source: U.S. Office of the Comptroller of the Currency, *Annual Report*, various years.

State bank chartering, however, re-surfed after 1868, except for a sharp drop in the panic year of 1873, consequent to the development of deposit banking and commercial credit. Checkable deposits increased rapidly in the 1870s, compared to bank notes, because checks became widely accepted and proved to be more convenient and safer to use for many transactions. State banks found it possible to operate profitably without the note-issue privilege, forcing profits of national banks to decline. By 1874, the total deposits in state banks surpassed the total notes of national banks: this was eventually a two-to-one ratio by the latter half of 1880s.⁴ As a result of this, national bank notes became a less

⁴ U.S. Department of Commerce (1947), pp. 25, 262, 263 & 274.

⁵ Huntington and Mawhinney (1910), p. 333.

⁶ Helderan (1931), p. 150, Kane (1923), p. 321.

⁷ Herrick (1915), p.32.

⁸ U.S. Department of Commerce (1947), pp. 1024-1031.

⁹ U.S. Office of the Comptroller of the Currency (1896), pp. 203-04.

²⁰ Robertson(1995), appendix.

²¹ Barnett (1910), pp. 11, 613 & 614.

²² U.S. Board of Governors of the Federal Reserve System (1941), pp. 134-138.

²³ The Clayton Act declared it to be illegal for a director or officer of a national bank with resources of over \$5 million to be a director or officer in another bank wherever situated, and similarly declared it to be illegal for a director or officer of another bank in the same city. FRB, *Digest of Ruling*, 1914-1927. Pratt, A. S. & Sons (1917), pp. 353-359.

significant factor in banking.

When selecting a charter, banks would choose on the basis of their relative advantage, as determined by the regulations that each system provided. The only competitive advantage that national banks seemed to have was that National Bank Act provisions were more familiar to those who invested in newly developed sections of the country as nonresident investors. With these investments, outside capital was needed to establish banks. Because interstate communications were slow, it was difficult for out-of-state investors to learn about other state's banking laws.

State charters had several advantages. First, lower amounts of capital were required in most state jurisdictions and under nearly all circumstances. In the Western and Southern states, \$10,000 minimum capital requirements were common, though, some states had no capital minimums. A national bank's minimum capital stock had to be \$50,000 in towns with a population under 6,000, and \$100,000 in cities with a population greater than 50,000.⁶

Second, reserve requirements against deposits were lower under most state banking laws than under the National Bank Act. Besides this, national banks had to observe substantially stricter rules regarding the amount of cash they held in reserve.

Third, national banks operated under much stricter lending and investment policies in general than did their state-chartered competitors. The National Bank Act of 1864 prohibited loans on real estate, which constituted a major portion of competing banks' business in agricultural areas, such as the West and South, where land was the principal asset. In many states, state banks and trust companies were permitted to exercise investing stocks, but national banks were barred from such activities.⁶

Fourth, standards of bank supervision and examination for national banks were much higher than for state banks. Actually, a large number of states made no provisions for bank supervision, by as late as 1863.

In addition, one of the most serious competitive problems faced by national banks was the rapid development of trust companies. Trust companies could conduct all activities that an ordinary bank might, except issuing notes, besides performing various trust and securities business. These broad powers attracted many customers.⁷

By 1895, the number of state banks surpassed the number of national banks; there were 3,774 state banks that year-end, and 3,715 national banks,⁸ though the national bank resources were nearly twice as much as those of state banks.

Changes in the National Banking System

To address the vigorous competition from state banking authorities chartering new banks and trust companies, Congress attempted to improve the attractiveness of national bank charters. The Comptroller of the Currency recommended that Congress loosen federal regulations on national banks,⁹ although he had formerly thought that the national system should be strengthened through

tighter supervision and control. After this, the first significant amendment to the National Bank Act made thereafter was designed to aid the national system by adding to the number of banks. The Currency Act of 1900 lowered the minimum capital requirement for banks in towns of fewer than 3,000 people, to \$25,000.²⁰ This resulted in the establishment of a considerable number of national banks with less capital than \$50,000.²¹ After the amendment, the number of national banks increased by 91 percent, from 3,731 in 1900, to 7,138 in 1910. Besides this, in the 1910s (shown in Figure 1), state banks more than doubled their number over national banks and nearly equaled them in resources.

In 1906, the national bank limitation of 10 percent of capital on loans to one borrower was increased to 10 percent of capital and surplus, with an absolute limitation of 30 percent of capital.

With real estate loans and fiduciary and securities business, national banks sought to counter competition from state banks, not only through legislation, but also through indirect methods. By implementing interlocking directorates and common stockholders and trustee arrangements, national banks, particularly in the larger American cities, tied themselves in with state banks, trust companies, and security and real estate corporations. While such affiliations did not bring all operations together under one charter, national banks could refer customers they could not accommodate to a state-chartered affiliate. In this manner stockholders in these institutions reaped the specialized advantages that each type of institution could offer.²² Therefore, to some extent, inequities in power between national and state banks were diminished indirectly, which kept national banks in the system, although the passage of the Clayton Act in 1914 hampered the development of this approach by national banks.²³ We will argue more on group banking in Chapter V.

Increased competition between state and federal bank regulators in this period led to leniency with national banking regulations to attract more banks to the national system. This made the system vulnerable to severe recession or depression, rather than more stable.

ESTABLISHMENT OF THE FEDERAL RESERVE SYSTEM

More relaxing in control over national banks

The establishment of the Federal Reserve System in 1913²⁴ was a new challenge from the federal banking reformers who tried to strengthen and unify control over commercial banking in the United States. After the Federal Reserve Bank Act was finally passed, however, it was found that membership in the system was voluntary for state banks.²⁵ Despite that national banks were forced to be members

²⁰ The national banking system had demonstrated two weaknesses by 1900. One was an inelastic currency supply and the other was an occasional inability to provide sufficient credit to move crops to market in autumn. They caused a severe monetary panic in 1907 and Congress moved toward permanent bank reform at last. The Federal Reserve Act became law only after considerable debate about the future of the country's banks. At long last, the system was composed of twelve Federal Reserve Banks and to be headed by a Federal Reserve Board composed of seven members. (See more: Treiber (1964), pp. 97-99.)

²¹ Section 9 of the Federal Reserve Act.

by the law, they were free to leave the System by converting to state charters. So to that extent, membership in the System was voluntary for all banks²⁶. In some ways, the System was just run on top of the National banking system, thus adding another supervisory authority to the banking structure.²⁷

During the course of the hectic struggle to establish the Federal Reserve System, the government decided to give state banks the privilege of full membership, while forcing national banks' membership. National banks took this opportunity to wring concessions in the form of additional privileges threatening to make large withdrawals from the System.²⁸

With the passage of the Federal Reserve Act, national banks were given the power to receive time deposits subject to a reserve of only 5 percent, as compared with 12, 15 or 18 percent (depending on the bank's location) required on all deposits under the National Bank Act. They were also given limited power to make farm real estate loans and given the power to exercise, with the permission of the Federal Reserve Board, fiduciary powers as executor, trustee, administrator, and registrars of stock.²⁹

State bank membership

State banks could be authorized to become members of the System upon certain conditions: state member banks needed comply with national bank requirements for capital, reserves and loans to one borrower, and they needed submit to examination and reports as required by the Comptroller. State member banks, however, still had broader banking and investing powers, more extensive fiduciary powers, and in many states, they had the privilege of branching. In most states, state member banks had further advantages of lower capital requirements, less stringent supervision, and the power to extend a larger volume of loans to one borrower.³⁰ The number of state banks joining the Federal Reserve System was small indeed,³¹ except for what proved to be a temporary membership movement during WWI. While many of these conditions were distasteful to state banks, the stipulations were later

²⁶ *The Commercial and Financial Chronicle* reported on January 24 in 1914: there was some fear that the National City Bank, the largest national bank in the country, would give up its charter rather than join and many of the still hesitant banks decided to do like wise when it finally agreed to enter. (Tippetts (1929), p. 50.)

²⁷ White (1983), p. 126. Tippetts (1929), p. 31.

²⁸ Tippetts (1929), p. 21.

²⁹ White (1983), pp. 97-99 & 141-143. Tippetts (1929), pp. 32-33 & 375-379.

³⁰ Tippetts (1929), p. 48.

³¹ Tippetts (1929) explained the reasons why the majority of the state institutions postponed entry into the federal reserve system and raised two major objections: first, distrust of the administration of the federal reserve system; second, no needed facilities offered by the federal reserve system or no advantage in joining (pp. 98-102).

modified, in some cases substantially; so significant numbers of state banks did not join the System until after 1933³² (See Table 2).

The power of national banks broadened again

Powers of national banks were broadened by a number of amendments to the Federal Reserve Act and National Bank Act over the ten years after the acts were passed. In 1916, national banks' power to make real estate loans was increased, and the Comptroller was authorized to allow national banks in towns with not more than 5,000 people to act as insurance agents and as brokers or agents in making real estate loans³³. Not as a result of these new powers, but out of patriotism during the WWI, the number of newly joined state member banks increased by 218 in 1917 and 683 by 1918, which made the total membership 930 in 1918.³⁴

Banks	Number	Capital and Surplus	Resources
<u>All in the United States</u>	30,325	5,600	50,150
National	8,244	2,358	20,700
State member banks	1,648	1,142	11,025
<u>All member banks</u>	9,892	3,500	31,725
Eligible non-members	9,678	1,209	8,985
Non-eligible non-members	10,755	891	9,440

Source: Tippetts, Charles S. (1929). *State Banks and the Federal Reserve System*. D. Van Nostrand Company: New York.p. 144.

In 1918, the fiduciary powers that national banks exercised were extended to include any kind of fiduciary business,³⁵ provided that state banks were permitted to do so under state law. Restrictions on loans to one borrower were liberalized in 1918 and 1919 and the fiduciary powers of national banks were effectively broadened again in 1922,³⁶ when they were given 99-year charters in place of their former 20-year charters, which deterred banks from acquiring trust business.

³² Ibid., pp.177-196 & 249-256.

³³ Ibid., pp. 254-256.

³⁴ *Annual Report of the Federal Reserve Board, 1925*, p.176.

³⁵ Willis & Chapman (1934) showed the total number of national banks holding permits to exercise fiduciary powers increased from 356 in 1914 to 1,074 in 1919, and to 1,696 in 1923 (P.216).

³⁶ Ibid.

Reasons for not joining

As the numbers in the Table 1 indicate, only 51 percent (9,892 banks) of all eligible banks that joined the Federal Reserve System were members in 1922. Though eligible for membership, 32 percent of banks in the United State had failed to join the System. Those described as eligible non-members held 22 percent of the nation's banking capital and surplus and 18 percent of the nation's banking resources. If these banks had joined the System, less than 20 percent of the nation's capital and surplus and banking resources would have remained outside the Federal Reserve System or 35 percent (10,755 banks) of all banks in the U.S. According to Reinhardt (1943), the eligible non-member banks' reasons for not joining were:

- Non-payment of interest on deposit reserves,
- Extra work from red tape, reports, examinations,
- Loss on exchange charges,
- Restrictions on loans,
- Improbability of dividends on Federal Reserve banks stock,
- And Clayton Act prohibition on directorates.³⁷

Besides the reasons above, the laws of some states continued to prevent state banks from becoming members of the System even though their numbers were decreasing.³⁸

The McFadden Act of 1927

During the mid-1920s bank closures numbered in the hundreds; in the peak year of 1926, 975 banks closed. This happened at a time when the competitive focus was on the power to establish branches. On the national level, branch banking had been illegal until passage of the McFadden Act in 1927,³⁹ which permitted national and state member banks to establish branches in their cities or towns if sanctioned by state law. Within 30 months of the passage of the McFadden Act, the number of branches operated by national banks more than doubled.⁴⁰ As shown in the Table 3, between 1920 and 1930 the growth rate for state chartered branches was 103.3 percent and that of national chartered branches was 1554.0 percent.

³⁷ Reinhardt (1943), p. 29 was based on a research conducted by the FRS which had been published in Federal Reserve Bulletin, Vol. 3, NO. 5, May 1, 1917, pp. 355-372. Tippetts(1929) also discussed in page 55.

³⁸ Reinhardt (1943), p. 54.

³⁹ P. L. 639, 69th Cong., 1st Sess., Ch. 191, 44 Stat. 1224.

⁴⁰ Wysocki (1963), p.317.

Table 2. Number of Banks and Branches in the US Selected Years 1900-1945

Year	Class of Bank	Number of Banks	Number of		Percent Change in Number of Branches in ten years	Number of Banking Offices
			Operating Branches	Number of Branches		
1900	Total	12,427	87	119		12,546
	National	3,731	5	5		3,736
	State	8,696	82	114		8,810
1910	Total	24,514	292	548	360.5	25,062
	National	7,238	9	12	140.0	7,150
	State	17,376	283	536	370.2	17,912
1920	Total	30,291	530	1,281	133.8	31,572
	National	8,024	21	63	425.0	8,087
	State	22,267	509	1,218	127.2	23,485
1930	Total	23,679	750	3,518	174.6	27,197
	National	7,247	166	1,042	1,554.0	8,269
	State	16,432	584	2,476	103.3	18,908
1935	Total	15,246	830	3,202	-9.0 * ¹	18,448
	National	5,386	182	1,327	27.4 * ¹	6,713
	State	9,860	648	1,875	-24.3 * ¹	11,735
1940	Total	14,399	974	3,593	2.3	17,992
	National	5,144	201	1,542	37.7	6,686
	State	9,255	773	2,051	-22.7	11,306
1945	Total	14,183	1,138	3,954	10.0 * ²	18,137
	National	5,017	311	1,814	17.6 * ²	6,831
	State	9,166	827	2,140	4.3 * ²	11,306

*1: in five years from 1930, *2: in five years from 1940.

Source: 1900 to 1930, U.S. Board of Governors of the Federal Reserve System (1941), p.428; 1935 to 1945, FDIC, *Annual Report*, 1975.

However, the numerical rise in branch banks somewhat overstates real branch expansion due to the fact that during this period there was also a sharp dropping-off in the total number of banks. Many banking offices that appear to be *de novo* branches actually are representative of conversions of independent banks following purchase or merger.⁴ We will argue more on branch banking later in Chapter V.

The McFadden Act of 1927, which was a part of the National Bank Act, affected the ability of

⁴ *Federal Reserve Bulletin*, Dec. 1929, p. 762.

nationally chartered banks to branch either intrastate or interstate. On an intrastate basis, it gave state legislatures the power to govern within their state's borders the branching activities of all banks, both national and state chartered banks. Additionally, after amendment by the Banking Act of 1935, it prohibited national banks from branching across state lines. When the Federal Reserve Board extended this prohibition to state chartered banks, virtually all banks were limited to having a physical presence in only one state.

In addition to granting the power to branch, the McFadden Act made other concessions to national banks, giving them indeterminate charters, materially broadening their power to make real estate loans, and again relaxing the limitations on loans to one borrower. The practice of underwriting and merchandising securities, which had developed in a number of national banks, was officially recognized by the imposition of some reasonable limitations.⁴² The federal authority's challenge of state banks was still not successful enough at this stage. By 1930, the trend in national bank powers for three decades had been one of almost continuous and broadening and relaxation.

Improvements in the federal supervision of national banks

National bank supervision, however, had taken, to some extent, an opposite tack. After the passage of the Federal Reserve Act, federal supervision improved markedly and through the next two decades, state supervision also improved. The act changed the ineffective method of paying, by providing national bank examiners with fixed salaries and compensation system for their expenses, rather than compensating them on the basis of the number of banks visited, as the National Bank Act had specified. The act also provided that the power to appoint examiners vested in the Comptroller should be subject to approval from the Secretary of the Treasury.⁴³ Of potentially great significance, however, was a supervisory power, assumed without benefit of specific legislation by Comptroller Murray, who served from 1908 to 1933. Each of his predecessors in office had taken the view that he had no discretion in issuing a national bank charter once it appeared that the applicants had organized the bank for a legitimate purpose under the following constraints: the requisite capital was subscribed and paid, the necessary papers were executed, and other specific provisions of law relating to organization were complied with. Murray, on the contrary, assumed power to determine the need and demand for proposed banks and to exercise discretion in accordingly issuing or withholding his

⁴² Ibid.

⁴³ Robertson (1995), pp.107-113.

certificate of authority.⁴

Table 3. Number of Commercial Banks in the United State by membership, 1900-1945

Year	National banks	State Banks			Total Banks
		Federal Reserve member banks	Nonmember banks	Total	
1900	3,731			8,696	12,427
1905	5,664			12,488	18,152
1910	7,138			17,376	24,514
1915	7,597	17	19,776	19,793	27,390
1920	8,024	1,374	20,893	22,267	30,291
1925	8,066	1,472	18,904	20,376	28,442
1930	7,247	1,068	15,364	16,432	23,679
1931	6,800	982	13,872	14,854	21,654
1932	6,145	835	11,754	12,589	18,734
1933	4,897	709	8,601	9,310	14,207
1934	5,417	958	8,973	9,931	15,348
1935	5,425	985	9,078	10,063	15,488
1936	5,368	1,032	8,929	9,961	15,329

Source: U.S. Department of Commerce (1860). *Historical Statistics of the United States: Colonial Times to 1957*. GPO: Washington D.C.

Aside from this power, which also came to be increasingly exercised by state bank supervisors in the following years, the national bank supervisory authorities, just as their state bank counterparts, were not endowed with adequate powers for a number of years.⁵ In addition, they were unable to make full and effective use of the powers they did possess. While the existence of the dual banking system was not entirely responsible for this situation, the fact that banks could avoid the supervision of one system by leaving it and entering the other was significant.⁶

FROM THE GREAT DEPRESSION TO THE NEW DEAL

Chartering banks

⁴ Kane (1923), pp. 393-394.

⁶ Fischer (1968), pp. 188-197.

Between 1912 and 1929, 5,411 banks failed in the United States. From 1930 to 1933, 8,812 banks failed. As shown in Table 3, by the end of 1933 the total number of banks in the United States decreased to less than half of the number in 1920. Statistical analyses showed that a large percentage of failed banks, both national and states, had capital of \$25,000 or less and were doing business in towns with less than 2,500 people, and 85 percent of the failed banks had total assets of less than \$1 million.⁴⁷ Before 1930, larger banks did not fail in significant numbers. One reason for the failure of the banking structure cited in nearly every study on the subject was the small minimum capital required to organize both state and national banks and the lax chartering policies of the supervisory authorities.⁴⁸ For example, Willis and Chapman (1934) concluded thus:

A large percentage of all banks that failed from 1921 to 1931, inclusive, had capital of \$25,000 or less. There was a noticeable increase in the number of larger banks that failed during 1930 and 1931. This would seem to indicate that the larger banks were able to stand up longer under a period of depression than the smaller banks, since the bank failure epidemic had been in process for several years prior to the beginning of the depression in 1929.⁴⁹

Further, the Economic Policy Commission (1935) also concluded that

“The following study gives an impressive revelation of how great a part mistaken public policies in the chartering of banks in the United States played in creating the unsound banking structure which finally collapsed with the Bank Holiday in 1933.”⁵⁰

Some responses to the studies in this period were found in provisions of the Banking Act of 1933. The Act eliminated the \$25,000 minimum capital provision that had been added to the National Bank Act in 1900, and raised it to \$50,000 for banks in towns with not more than 6,000 people.⁵¹ Then, with the Banking Act of 1935, further attempts to strengthen the capital structure of new national banks was made by adding a requirement that surplus, equal to 20 percent of capital, be paid in before a new bank may begin operations.⁵² Before WWII, however, Congress did not specifically require that 100 percent

⁴⁶ Westerfield (1939), pp. 927-931.

⁴⁷ Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin*, March 1933, Vol. 19, No. 3, p. 144.

⁴⁸ See, for example, White (1984), Economic Policy Commission (1935), Westerfield (1939), Wicker (1998), and Willis & Chapman (1934).

⁴⁹ Willis & Chapman (1934), p. 315.

⁵⁰ Economic Policy Commission (1935), p. 5.

⁵¹ Revised Statutes, Sec. 5138, 12 USC Sec. 51.

⁵² *Ibid.*

of the capital be paid in by a new national bank before going into business.⁵³

To strengthen the capital structure of national banks, additional statutory requirements were added in the form of prohibiting the payment of dividends, except those resulting from net profits,⁵⁴ and requiring that surplus be carried until surplus equals 100 percent of capital before dividends are paid, totaling at least one-tenth of the net profits.⁵⁵ Additionally, a national bank may not increase its capital by the issuance of a stock dividend unless the remaining surplus will be equal to at least 20 percent of the capital.⁵⁶

Memberships of the Federal Reserve and FDIC

Section 12B of the Federal Reserve Act as amended created the Federal Deposit Insurance Corporation and defined its organization, duties and functions. It provided for two separate plans of deposit insurance: a temporary plan which was to be initiated on January 1, 1934, and a permanent plan which was to become effective on July 1, 1934. All Federal Reserve member banks licensed by the Secretary of the Treasury under terms of an Executive Order of the President, issued March 10, 1933, were required by law to become members of the temporary fund. Other banks were authorized to join the fund upon certification of their solvency by the respective state supervisory agencies and after examination by, and with the approval of, the Federal Deposit Corporation. The Temporary Federal Deposit Insurance Fund opened with 13,201 banks insured. Of these, 12,987 were commercial banks and 214 were mutual savings banks. These represented 90 percent of all commercial banks and 36 percent of all mutual savings banks.

The original permanent plan was superseded by a new permanent plan in the Banking Act of 1935. The Federal Deposit Insurance (FDIC) Act provides that the Comptroller must certify to the FDIC that consideration has been given to the following factors, which the Corporation must consider when insuring a bank: the financial history and condition of the bank, the adequacy of its capital structure, its future earnings prospects, the general character of its management, if the bank will fill the needs of the bank's surrounding community, and whether or not the bank's corporate powers are inline with the purposes of the Federal Deposit Insurance Act.⁵⁷ No specific standards for capital structure or for other factors are prescribed, though.

⁵³ Act of Sept. 8, 1959, Pub. L. 86-230, Sections 2, 4 (73 Stat. 457), 12 USC. Sections 26, 53.

⁵⁴ Revised Statutes, Sec. 5204, 12 USC Sec. 56.

⁵⁵ Revised Statutes, Sec. 5199, 12 USC Sec.60.

⁵⁶ Revised Statutes, Sec. 5142, 12 USC Sec.57.

⁵⁷ 12 USC, Sections 1814(b), 1816.

The FDIC, before admitting a state bank to insured status, must likewise give consideration to the factors previously mentioned, unless the bank elects to join the Federal Reserve System. Then the System must certify to the FDIC that it has considered these factors in admitting the bank to membership,⁸ and that the bank becomes an insured bank at the time it becomes a Federal Reserve member.

For a state bank to be admitted to membership in the Federal Reserve System, it must have capital and surplus which, in the judgment of the Board of Governors, are adequate in relation to the character. Also going under consideration, are the conditions of the bank in question's assets and its existing and prospective deposit liabilities and other corporate responsibilities are also scrutinized. If the bank does not have the capital and surplus required for the establishment of a national bank in the same place, it must be, or have been, approved for deposit insurance by the FDIC.⁹ As previously indicated, the Board must also give consideration to the FDIC factors in situations when a bank applying for membership is non-insured.

Thus, after the Federal Deposit Insurance Corporation established, the federal control over state banks dramatically strengthened. Moreover with the Act, the federal authority justified to exercise its influence upon state bank authorities and to use them as its agents.

CONCLUSION FOR THIS CHAPTER

The dual banking system changed in its characteristic through the years before WWII. During National Banking Era, several attempts made by federal government to unify the bank chartering and supervising system eventually failed. To address the vigorous competition from state banking authorities, Congress attempted to improve the attractiveness of national bank charters through relaxing national banking regulations. This made the national banking system vulnerable to severe depression and did not attract many state banks.

After the panic of 1907, a new attempt to unify control over commercial banking established the Federal Reserve System in 1913. During the 1910s and 1920s, to encourage state banks to join the System and to press national banks to remain in the System, the federal government made further progress in relaxing the banking regulation of its members. In this period, the federal government, however, intervened the state banking system by controlling state member banks for the first time in

⁸ 12 USC, Sections 1814(b), 1815.

⁹ 12 USC, Sec. 329.

American banking history.

The establishment of the Federal Deposit Insurance strengthened the federal control over state banks dramatically. As previously mentioned, with the Act, the federal authority justified to exercise its influence upon state bank authorities and to use them as its agents.

State sovereignty over state banks had been gradually weakened by the national banking reforms before WWII. The differences between state banks and national banks grew less in banking regulation. Though federal government's attempts to unify chartering and supervising banking systems did not succeed, the federal control over the state systems became stronger after the Great Depression.

(TO BE CONTINUED)

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