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First U.S. Bank Regulations May Look Strikingly Familiar

By Marc Levinson - Feb 25, 2013

One hundred fifty years ago, the U.S. was two years into a brutal Civil War. The financial cost left the federal government under enormous stress, leading to a result no one had imagined: the first modern system of bank regulation.

Before Congress passed An Act to Provide a National Currency on Feb. 25, 1863, government oversight of banking had been quite crude. The Second Bank of the United States, chartered by Congress in 1816 and 20 percent owned by the federal government, functioned in some ways like a central bank. At the time, there was no national currency, and most banks issued notes that were accepted as money.

In principle, those notes were redeemable for specie -- gold or silver coin -- but a merchant who accepted a banknote from a customer had no way to know whether the issuing bank would make good on its promise to pay. Many notes found their way to the Second Bank of the United States, which returned them quickly to the issuers with a demand for specie. The threat that such tactics could put a bank out of business encouraged bankers to manage conservatively.

After one of the most famous political battles in American history, Congress, at the behest of President Andrew Jackson, let the Second Bank's charter expire in 1836. All responsibility for banking passed to the states. Many states made it easy to start a bank, imposing few requirements and exercising little supervision. Having banks in every town issuing notes seemed an effective way to stimulate local economies, and if a large number of them failed, well, that was a price many governors and legislatures were willing to pay in return for economic growth.

Greenbacks Proliferate

Faced with nearly endless needs for cash during the Civil War, Congress decided it was time for a national currency, but it lacked the gold and silver to support one. In 1862, it authorized a government-issued paper currency with no promise to redeem the bills for specie. Those bills, popularly known as "greenbacks," were declared to be legal tender for most purposes. But the greenbacks circulated alongside notes issued by private banks. Most people thought the private banknotes were sounder, and were reluctant to take greenbacks except at a discount.

The purpose of the Act to Provide a National Currency was to replace this jumble of bills of uncertain value with a single national currency. The law created a Currency Bureau in the Treasury Department, headed by a comptroller of the currency. The comptroller's job was to charter national banks that would issue U.S. currency. To do that, he needed to ensure the national banks were sound.

The law's language may seem archaic, but its approach to regulation was surprisingly modern. It set what we would now call capital requirements: The organizers of a national bank had to put up $50,000, or $100,000 in a city with a population of more than 10,000. It set reserve requirements: Each national bank had to deposit bonds with the Treasury equal to at least one-third of its capital. There were liquidity requirements: A national bank was required to keep on hand "lawful money" equal to at least 25 percent of outstanding banknotes and deposits. And there were disclosure requirements, too: At the start of every quarter, each national bank had to give the comptroller a "true statement of its condition" with data on loans, overdrafts, insider lending, real-estate ownership and other matters.

New Rules

The law also imposed some novel rules on how bankers did their business. It set limits on how much a national bank could lend to any individual or company. It prohibited banks from dipping into their capital to pay dividends to shareholders. It required bankers to recognize loans on which interest was six months past due as a bad debt, the first regulatory intervention into bank accounting. To make sure things were on the up and up, the comptroller was to appoint an examiner to visit each national bank and "make a full and detailed report" of its condition. If a national bank failed to make good on its notes, the comptroller had the power to close it and pay off its creditors.

All this may sound familiar. Many of the regulatory concepts put in place in 1863 are still with us today. But in one important way, the nation's earliest bank regulations were stricter than today's. Congress made national bank shareholders doubly liable -- if a national bank became unable to repay depositors or other creditors, its shareholders could be forced to ante up the par value of their shares, in addition to the amount they had already invested. Double liability proved a recipe for keeping banks sound. It was discontinued in the 1930s, but the comptroller's examiners are still paying visits to national banks today.

(Marc Levinson's books include "The Great A&P and the Struggle for Small Business in America." The opinions expressed are his own.)

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