The Banker's Thumb: The Institutional and Evolutionary History of Bank Supervision in the U.S., from the Civil War to Global Financial Crisis

Banker's Thumb Introduction

Among O. Henry's lesser known works is *Friends in San Rosario*, the story of a tiny bank in San Rosario, Texas that is facing the fearsome and exacting examination of one J.F.C. Nettlewick, a bank examiner sent by the federal Comptroller of the Currency. Written in 1909, the story proceeds in the usual O. Henrician fashion, with the impending collapse of the entire bank because of a misunderstanding that is resolved through chance and device by a wily protagonist. It's no *Gift of the Magi*, but even at his worst O. Henry could tell a charming tale.

What we learn in this mostly forgotten gem, though, is how bankers in Texas regarded the arrival of their Yankee examiner. O. Henry, né William Sydney Porter, knew of which he wrote. Porter was himself a former banker (and embezzler, for that matter), who knew his way around banks and bank examination. He wrote with authority, then, of that certain "something so icy and swift, so impersonal and uncompromising about [Nettlewick] that his very presence seemed an accusation. He looked to be a man who would never make nor overlook an error."

Fast forward 100 years and bank examiners enjoy a very different reputation. To the extent that they were involved in the 2008 crisis at all, it was as facilitators of bank overexpansion and risk taking. Rather than providing the "icy and swift" oversight of bankers, they became "captured" by the very enthusiasms that led banks over the cliff. To quote one banker's colorful and profane view of the rules these examiners enforced, "[w]hatever rule those fucking idiots come up with on Monday, I'll have found a thousand ways around it by Friday."[1]

Whether and to what extent this kind of reception represents a transformation of the position of the bank supervisor—and the institutions of bank supervision more generally—is the

[1] As quoted in Andrew Palmer, *Smart Money: How High Stakes Financial Innovation is Reshaping Our World—for the Better*, Basic Books: New York City, 2015.

story we hope to tell in this history. Beginning in the immediate postbellum period when federal bank supervision is born under the National Bank Acts of 1863 and 1864, we will use primary archival sources to tell the institutional history of bank examination through the eyes of bank examiners at the Comptroller of the Currency (located within the U.S. Treasury), the Federal Reserve System, and the Federal Deposit Insurance Corporation. It is a personal story of individuals who make their careers trying to force bankers—among the most powerful and hated of political constituencies—to change their behavior. It is a personal story of bankers seeking freedom from governmental oversight even as they seek scapegoats for decisions gone awry. It is a story of financial crises and political infighting. And it is a story of the growth and development of the U.S. state: before there were food inspectors or antitrust prosecutors or environmental protection scientists or civil rights investigators, there were bank examiners. We will tell their story.

The Banker's Thumb will examine the history of a set of institutions—collectively, bank supervision—but it will also showcase a new way for scholars to approach institutional history. In this book we intend to pivot institutional history away from a so-called "Big Bang" theory of institutional genesis. In that theory, scholars look at founding moments and the founders present there to understand what they were about when they "created" the institution, which then continued on single straight trajectory thereafter. Constitutional history is an obvious example of this phenomenon, as scholars replay the moves of the "founding generation," defining, through their thoughts and intentions, institutions from free speech to affirmative action, gay marriage to gun control. Banking history often falls into a similar pattern. Yet, seeing how the National Banking Acts were put together tells us very little about how bank supervision worked in practice or changed over time. A different approach to institutional history is necessary.

Instead of institutional origins, we're interested in institutional evolution. If we can mix science metaphors, rather than a single Big Bang that should motivate our historical narratives, we should instead look at institutions as changing according to a kind of "punctuated equilibrium" where changes occur rapidly and in short bursts. We are not, however, idealistic Darwinists. Evolution is a messy, imperfect process. Following evolutionary biologist Stephen Jay Gould—to whose 1980 essay, "The Panda's Thumb," this book's title alludes—we reject the idea that institutional evolution is simply a teleological march toward greater and greater perfection. Instead, like Gould, we find that the "Odd arrangements and funny solutions are the proof of evolution—paths that a sensible God would never tread but that a natural process, constrained by history, follows perforce."

The history of bank supervision in the United States, though not a "natural process," is certainly a story about clumsy design, wrought by a political economy that made use of the materials at hand to layer, institutionally, responses to problems of the recent past. The system, as we will show, was always changing. Sometimes the change occurred rapidly, usually in response to violent, disruptive events. We see strong punctuations: The Civil War led to the creation of the Comptroller of the Currency (1865); the Panic of 1907, the Federal Reserve (1913); and the Great Depression, the Federal Deposit Insurance Corporation (1933). Still, disruptive evolutionary changes are only part of the story. Even in equilibrium institutions quietly evolve. New challenges present themselves but are not quickly resolved. Important reconfigurations occur beyond the perception of most observers. The supervisory mutations occur, but rarely with a clear design objective in place. How and why these shifts happened, how and why institutions change suddenly and slowly, are questions *The Banker's Thumb* will answer.

Institutional change may build slowly through history, but when change finally does occur, it can be extraordinary. The global financial crisis of 2007-2009 reflected exactly this kind of long-simmering pressure on bank supervision, culminating in the Dodd-Frank Act of 2010. A major argument in our book will be that while bank supervision saw remarkable, even lamentable institutional stability over 150 years, Dodd-Frank has meant we are currently living at the beginning of a radically new banking supervisory era. To understand the dominant themes of banking politics and practice today—themes that are squarely about bank supervision—we must have a better sense of that historical transformation. Our book will provide that account.

Our shift away from the Big Bang version of institutional history is part of a broader historiographic movement already afoot. It is a new institutional history, one that we hope will take its place alongside the bedrock subdisciplines of history, whether economic history, social history, political history, or cultural history. The new institutional history builds primarily on theories of what institutions are and how they change developed in institutional economics and organizational history, while also engaging the historical study of institutions across social-science disciplines. *The Banker's Thumb* will be an example of this new methodological approach, but only one example. Conti-Brown is also writing a comprehensive history of the Federal Reserve and Vanatta a history of credit cards along similar methodological lines. In this way, *The Banker's Thumb* will be a part of a disruptive moment all its own in the retelling of institutional history.

Themes in *The Banker's Thumb*

As we tell the story of bank supervision over the course of 150 years, we anticipate at least five interrelated themes: (1) institutional stability for bank supervisors, in that the structure of bank supervision looks mostly the same; (2) financial instability, or the idea that financial markets dramatically remake themselves in successive generations; (3) regulatory competition through the ever ratcheting expansion of bank supervisors' bailiwicks; (4) policy disarray about what, exactly, is the point of bank supervision at all; and (5) institutional change as a roughly evolutionary process, bound by the past and shifting between relative equilibrium and punctuated change.

First, institutional stability. One of the important discoveries that we have made is that the Examiner's Report, the form used by bank examiners working for the Comptroller of the Currency, remained little changed in form or function—from 1866 until 1953. In other words, the very list of outputs that bank examiners were supposed to produce about a bank didn't fundamentally change during the rise and fall of the international gold standard, the rise of the Federal Reserve as a new way of organizing the national financial system, the rise of the United States as a global financial center, a world war, the Great Depression, another world war, and the establishment of a new global financial order in the International Monetary Fund and World Bank. Not a bad run, Examiner's Report, not bad at all.

But institutional stability is more than the repeated use of the forms and procedures. From the very beginning, bank examiners were outgunned in terms of resources, time, and above all, information. What economists call "informational asymmetries"—or the lopsided access to information that can disrupt two-sided transactions, including in governmental regulation—is nowhere more evident than in bank supervision. These asymmetries did not appear unexpectedly with the advent of complex collateralized debt obligations or off-balance sheet special purpose vehicles. They were there in the days of Nettlewick. Examiners have always been at a decisive disadvantage to their banker charges. A remarkable feature of the history of bank supervision is that the institutions have changed so little, even, and perhaps especially, their weaknesses.

The institution of examination has also been reliably place-based: Bank examination happens in bank offices, introducing a persistent geographic impediment to examiners' work. In the nineteenth century, simple distance was the obvious challenge, as bank examiners navigated the nation's rudimentary transportation system. Examiners rushed through examinations to catch the last train out of town. They followed predictable routes, giving banks ample warning. In the twentieth century transportation improved, but different geographies intruded. The nation's borders were not banking's borders, and as American banks opened offices abroad, examiners lost oversight capabilities of these operations.

While bank supervision and bank supervisors remained static, the global financial system was anything but immobile. This brings us to our second theme, financial instability. Central to our story are the successive waves of globalized financial change that reshaped American financial institutions over the past 150 years, and ways US financial firms, in turn, transformed the size, scope, and very nature of their businesses. The basic intermediation function of banking remained—banks were always, to greater and lesser extents, in the business of extending credit on long maturities against their own short-term liabilities to depositors. But the nature of this business constantly changed. Banks entered into other lines of businesses, including complex securitization schemes, multi-trillion dollar derivatives markets, and international sovereign finance (an ancient form of banking that was not always constant on the U.S. scene). Other bank businesses were not so straightforwardly financial, as banks sought stable counterweights to the vagaries of finance. The forerunner of Bank of America once owned and operated a salmon cannery. Where would that go on the Comptroller's Bank Examiner's Report?

Our third theme is regulatory competition. It is no secret that congressional responses to social and economic problems have increased the influence of bureaucracy on American life. In banking, this has meant two interrelated features: the growth of the number of banking supervisors and the growth of supervisory responsibilities. When our story begins in 1864, there was exactly one federal banking regulator. By the time we finish, and depending on how you count, there are eight. These banking supervisors don't occupy exclusive spaces. A single entity could receive supervisory examinations from seven of the eight (credit unions are the exception). Competition among these entities tell us a story of politics in the twentieth century, including how interest groups exercise their voices and influence through a political process increasingly aimed at the administrative state, rather than congress. Bank supervisors serve many competing constituencies. The result has been a banking supervisory scenario that resembles the pit at a death metal concert. Sometimes the crowd moves together, but often elbows get thrown and things get quickly out of hand.

Fourth, the rise of banking bureaucracies coincided with the rise of banking supervisory functions. Supervisors are interested in questions as diverse as securities disclosures, consumer financial protection, extensions of credit to excluded communities, systemic risk regulation, the establishment of vehicles for monetary policy, and much else. These interests do not spring out of casual curiosity—congress has compelled them through successive additions to bank supervisors' responsibilities. To what end, then, supervision? In one sense it might be said that supervisors should be able to walk and chew gum at the same time. After all, the same examination methods that ensure loan-to-value ratios are followed can determine whether credit profiles are compiled appropriately and don't discriminate. The real question becomes when regulatory policies are in direct tension with each other. Can a bank become healthier—that is, more financially secure—by exploiting behavioral weaknesses in consumer loan applications? The short answer is yes. What if the same examiners are in charge of enforcing both standards? These kinds of policy tensions have, at various points in history, created an air of incoherence to the ways we regulate and supervise financial institutions.

And finally, we drive home the titular theme of the *The Banker's Thumb*, the idea that we must look past the "design" aspect of institutional history. As with Gould's panda, whose elongated wrist bone passably approximates an opposable thumb, banking supervision as an institution wasn't designed to accomplish specific tasks. It wasn't really designed at all. It evolved over time, fitfully and sometimes frenetically. And unlike the panda's thumb, banking supervision through much of its history hasn't been at an equilibrium, but has caromed in one direction or another in search of its utility. *The Banker's Thumb* is, in this way, a disruptive institutional history in two senses of the word. The history of banking supervision in the United States evolves in a chronically disrupted way. And our book seeks to disrupt a more organizationally focused view of institutional history.

The Banker's Thumb: A Chapter Outline

Chapter 1: *The Civil War, the Gilded Age, and the Birth of Federal Bank Supervision*

Chapter 2: *Banking on the Fed*

Chapter 3: *The Great Depression: A Failure of Supervision?*

Chapter 4: *Supervision through Deposit Insurance: The Rise of the FDIC*

Chapter 5: *War, Peace, and the American Century: Bank Supervision and Geopolitical Conflict, 1940 – 1960*

Chapter 6: *Consumer Finance and Supervision as Social Policy*

Chapter 7: *Mobsters, Terrorists, and Drug Dealers: Bank Secrecy and Anti-Money Laundering*

Chapter 8: *The Savings & Loan Crisis: Supervision, Corruption, and the Political Economy of post-Watergate Washington*

Chapter 9: *The Long Road to De-Supervision*

Chapter 10: *The Subprime Crisis*

Chapter 11: *The Dodd-Frank Revolution in Bank Supervision*

Chapter 1: Federal Bank Supervision in the Nineteenth Century: A Preliminary Institutional History

Introduction: The Silver Sled

Perched on the edge of American civilization, Michigan in the 1830s was a resource-rich territory in need of capital. The state had the misfortune of joining the federal Union just as the era of federal banking union was in its death throes, making the possibility of depending on capital from outsiders a much more difficult enterprise. In response, in 1837--its first year of statehood--lawmakers enacted the nation's first "free banking" law, creating a streamlined process for investors who wished to charter a bank. Soon, Michigan's woods and hollows were teeming with financial life, some of it wholesome, much of it nocturnal and predatory. Erstwhile bankers flooded the state with notes and then retreated into the wild, hoping that no one would come knocking, seeking to turn those paper promises back into the gold and silver they nominally represented. It was in this financial frontier that these banking institutions earned the fitting nickname "wildcats."

State legislators had anticipated the incentive to try to roll banking customers with inferior banking products. The state law that allowed these banks to flourish also called for them to be examined by state officers, whose job it was to make sure that the paper notes they issued was backed by solid coin. One winter, as the state examiners trekked from one bank to another, each more remote than the last, they noticed something odd. On every leg of their winding journey, a fresh set of heavy sled tracks was always ahead them. This was no mere passenger rig, but something carrying sizeable cargo. To their dismay, they learned from a tip that the sled's tacks and theirs were not coincidental: that early sled hauled a cache of silver, successively filling the vaults of the banks they were coming to inspect before they could inspect them. The bankers, with knowledge of the examiners' likely path—there weren't many options in mid-19th century Michigan—had created a mobile specie reserve. When inspected, each bank looked sound even though none were. "Gold and silver flew about the country with the celerity of magic," the state banking commissioner reported, "its sound was heard in the depths of the forest; yet, like the wind, one knew not whence it came or whither it was going." Michigan's experiment with free banking was, perhaps not coincidentally, rather short-lived.[2]

In the stories that unfold in this (and the following) chapters, the bank examiners we document were often chasing silver sleds, literal and figurative. Before Congress created the national banking system in the 1860s, and with it the beginnings of our modern federal supervisory structure, many of the institutional tools that would fill the bank supervisor's toolkit had already been tried and found wanting. The bankers' thumb was a flawed appendage from the start. In this chapter, we briefly explore the history of American banking and the early efforts to supervise banks that accompanied it. We then look at how antebellum supervisory tools were incorporated into the National Bank Acts during the Civil War, and how the new Bureau of the Currency made the best of these tools as its clerks and examiners exerted new federal control over the financial system. Political values have strongly influenced the nation's financial structure, not just in the canopy of high-level debates between Alexander Hamilton and Thomas Jefferson, Nicholas Biddle and Andrew Jackson. These debates about what money could be and who got to decide so go down to the roots, where state actors tried to influence, cajole, and otherwise induce private actors to manage their businesses in line with rules and political feelings. We tell that story too.

I. Antebellum Banking

From the beginning of the American experiment, the young nation's politicians understood the twin questions of the nature of the nation's currency and the structure of its

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[2] Bray Hammond, *Banks and Politics in America from the Revolution to the Civil War* (Princeton, N.J.: Princeton University Press, 1957), 601.

banking system as closely intertwined, not only as a matter of economics but perhaps more importantly as a matter of politics. In an era when national governments increasingly defined silver and gold as the only acceptable forms of money, the American colonies were chronically short of specie, having no substantial mines or deposits of their own. One solution to the new nation's severely constrained money supply was government-issued paper currency, which the Continental Congress employed during the Revolution and several states used afterward. Another was note-issue banking, where private or public institutions made loans by issuing paper notes, which were not currency themselves, but were redeemable in specie. As long as the promise of redemption was credible, these private notes circulated as money. At the national level, antebellum banking politics were a constant tug between Alexander Hamiltonian's vision of a centralized financial system and Thomas Jefferson and his successors' antagonism toward concentrated financial power. Under the Articles of Confederation, each state maintained its own system of money, leading to national commercial confusion. To rein in the chaos, the framers of the 1787 Constitution specifically barred the states from issuing paper currency and implicitly discouraged the federal government from doing the same. As one delegate to the convention stated plainly, the Constitution was meant "to shut and bar the door against paper money."[3]

But what the federal government might not do directly, Alexander Hamilton hoped it would do indirectly. In his Second Report on the Public Credit, Hamilton proposed a "national bank," eventually called the Bank of the United States, modeled on the Bank of England. Hamilton's bank would serve as the fiscal agent of the treasury; pay interest on the public debt; receive subscriptions for new issues of government securities; pay government salaries; facilitate foreign exchange; moderate the outflow of specie; and provide foreign specie to the mint. In other words, it would dominate nearly every aspect of the new nation's financial life.[4]

[3] Hammond, *Banks and Politics*, 89-93; Mary M. Schweitzer, "State-Issued Currency and the Ratification of the U.S. Constitution," *The Journal of Economic History* 49, no. 2 (June 1, 1989): 311–22.
[4] Hammond, *Banks and Politics* 114, 129-137.

Congress accepted the proposal almost exactly as Hamilton made it, passing legislation to grant the Bank's charter in 1791. Here is where the controversy began. Whatever utility the Bank offered in its provision of financial services to the public and private sector, its very existence contravened Jeffersonian political ideology. Jefferson, then Hamilton's fellow cabinet secretary in the first Washington Administration, fought for a presidential veto that never came. Hamilton won the battle for that first bank.

The battle, but not the war. Where Jefferson acquiesced to other forms of concentrated power once he assumed the presidency—he approved, after all, the Louisiana Purchase, despite constitutional ambiguity as to his authority to do so—he steadfastly rejected the Bank of the United States as the "most deadly hostile existing against the principles and form of our Constitution." Congress, in the hands of Jefferson's party and under the presidential administration of his protégé James Madison, allowed the bank's charter to expire in 1811. With the War of 1812 on the horizon, Congress's timing could not have been worse. Widespread bank suspensions during the conflict complicated government efforts to finance the war effort. In its wake, Congress, led by John C. Calhoun, chartered the Second Bank of the United States in 1816, a more robust version of the original, with wide congressional support. Even Madison agreed that the Jeffersonians had lost that debate.[5]

The drama over the first Bank of the United States is well known. It's the subject of a record-setting Broadway musical, after all. What is less well understood is the supervisory relationship between the Banks of the United States and the smaller financial institutions spread throughout the country. Both banks of the United States exercised wide, though indirect, supervisory authority over the national banking market. As the federal government experimented with the 19th century version of "central banking," the states took the lead in chartering note-

[5] As quoted in Thomas K. McCraw, The Founders and Finance: How Hamilton, Gallatin, and Other Immigrants Forged a New Economy (Cambridge, Mass: Belknap Press of Harvard University Press, 2012), 290; Hammond, *Banks and Politics*, 208, 228-235, 244.

issuing banks that collectively furnished a national money supply. Despite Jefferson's fears, the centralization of power in the federal Bank didn't mean there was no role for the state banks.

Seeking to lubricate the wheels of commerce and drive local economic development, states chartered banks at a rapid clip, a move anticipated (even desired) by Hamilton's design. In 1791, there were only 3 banks in operation in the United States; by 1820 there were more than 300. Many of these early banks were partly or wholly owned by state governments. The consequence was not only the decentralization of banking services, even during the Bank of the United States era, but also the proliferation of different versions of national currency. With so many banks issuing so many notes, the currencies of the United States were a confetti: there was no standardization in this era. Hence the need, and the reality, of federal bank supervision. The Banks of the United States, through their market power, could ensure that these notes were sound by refusing to accept notes from banks not measuring to the standards set by this inherently supervisory institution.

After a decade and a half of successful operation, Andrew Jackson, again antagonistic to its centralized financial power, vetoed the Second Bank's re-charter in 1832; "His Accidency" John Tyler vetoed another attempt at a national banking system in 1841, prompting the mass resignation of all but one of his cabinet secretaries. The Bank was popular, but not popular enough to overcome Jacksonian hostility. But that same Jacksonian ideological attack on concentrated financial power at the national level also challenged it within the states, with important implications for the way our supervisory institutions would develop. "In the long run," banking historian Bray Hammond demonstrates, "the role of government bec[a]m[e] supervisory rather than proprietary." Supervision continued, just not at the federal level. For the rest of the antebellum period, the federal government took a hands-off approach, levying taxes in ports where it could collect specie, and leaving banking and supervisory innovation to the states.[6]

[6] Hammond, *Banks and Politics*, 145, 164-166, 171, 323; Ross M. Robertson, *The Comptroller and Bank Supervision: A Historical Appraisal* (Washington, D.C.: Office of the Comptroller of the Currency, 1995), 19.

A. Antebellum State Supervision

Antebellum supervision relied on a fluid system of legislative, administrative, and judicial oversight, which evolved differently in each state, but was everywhere guided by states' efforts to simultaneously unleash the economic and developmental energies of their populations while maintaining system liquidity and soundness.[7] The supervisory toolkit we will examine through the rest of the book developed sporadically in the antebellum years, relying on enduring practices like bank chartering, examination, and receivership (or liquidation, as the practice would come to be known), and strategies that fell away, like note-redemption. With limited state capacity, private actors also developed their own institutions to undertake supervisory tasks. The results were uneven and mixed.

Before the rise of free banking in the 1830s, the primary state supervisory tool was the corporate charter. In one sense, charters are primarily regulatory, not supervisory: they established each institution's corporate rights and privileges, granting a corporate group benefits such as monopoly rights, perpetual legal existence, and the ability to raise capital by issuing stock, a controversial proposition for banks. In the antebellum period, states offered such privileges to harness the material interests of private actors and direct them toward the public good. State legislatures granted charters to entrepreneurs who promised to build bridges, dig canals, level turnpikes, manage banks, and otherwise undertake developmental work states were not willing or able to do themselves. Charters functioned on a kind of regulatory vector: once established, they sent the chartered banks into the world to follow the legal architecture that gave them life as they understood that architecture.

But the starting point of that vector was also supervisory. State legislatures, which granted corporate charters through individual acts of legislation, used this moment to ascertain the intentions and standing of would-be corporate managers, a process that was often not just

[7] James Willard Hurst, *A Legal History of Money in the United States, 1774-1970* (Lincoln: University of Nebraska Press, 1973).

political, but even nakedly partisan. Securing a banking charter required political connections and political cunning. To cite but one famous example, Aaron Burr hid banking powers in the charter for the Manhattan Water Company, creating a rival Jeffersonian institution to federalist banks controlled by Alexander Hamilton in New York.[8]

Banks like the Manhattan Company issued notes, which acted like money as long as note-holders were secure in the promise that the notes could be converted into more secure stuff, namely, gold and silver coin. With the safety of local currency systems at stake, states and private actors stepped in to ensure this promise was enforceable. Following a particularly flamboyant fiasco where a Rhode Island banker printed millions in spurious notes with no intention to redeem them, states began to enact laws and specify in new charters that banks must redeem notes on demand under penalty of liquidation. Although state officers were empowered to act on these clauses, they were more often administered by bank counterparties, first the Banks of the United States, then by the Suffolk system, a consortium of New England banks. Suits for redemption, though, were difficult to win and usually not worth the effort. Meanwhile, state officials—legislators, executives and judges—often relieved banks of the responsibility to redeem their notes in times of stress, believing it was better to have an uncertain currency than no currency at all. Eventually, many states required bankers to pledge bonds with the supervisory authorities equal to their note issue, providing a sound foundation (and, conveniently, a market for state bonds).[9]

The debates about note redemption represent one of the few institutional crossroads for banking supervision in its history. One the one hand, the strategies of litigation and legislation are prominently on display. But bank supervision is a different model. Supervision is the in-person friction between agents of the state and private market actors, an examination process that is proactive, not reactive, and not about assertions of private rights by one set of private actors (banking depositors) against another (bank proprietors). These two sets of strategies began in

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[8] Brian Phillips Murphy, *Building the Empire State: Political Economy in the Early Republic*, American Business, Politics, and Society (Philadelphia: University of Pennsylvania Press, 2015), 76.
[9] Hammond, *Banks and Politics*, 595, 691; Hurst, *A Legal History of Money*, 158.

parallel in this early phase. Indeed, note redemption was a negative tool activated by external pressure, but states also experimented with positive supervisory institutions designed to actively shape banking practices. Many early charters required banks to submit periodic statements of condition to state governors or legislatures, especially in cases where the states held stock in the bank. If an institution's finances looked amiss or there were questions about its solvency, public officials were empowered to make a thorough examination of the institution's records. Here we mark the beginning of a pure supervisory regime, much more so than the market-based supervisory mechanisms pursued by the Banks of the United States.

Examination itself is much older than the antebellum period, and is derived from visatorial powers, an element of ecclesiastical law tied to the power of bishops to visit, and essentially audit, local parishes and if necessary, remove a priest, clean up the finances, and ensure the proper administration of the mass. Since corporations were created by the states governments, and the states were often stockholders, states evolved this power for their own purposes.[10]

How and when supervision began displacing litigation is difficult to say, but at least one critical juncture occurred in New York, where, in his only notable act as governor—he was Governor for only three months—Martin Van Buren instituted the Safety Fund, a rudimentary insurance scheme to protect the banking system by insuring individual banks in 1829. Van Buren's motives were, then as ever, politically ambitious: He and the legislature hoped that by strengthening New York banks, they would undermine Philadelphia, home to the Second Bank of the United States, as a financial hub.

Whatever the motivation, The Safety Fund Act created more than a banking competitor; it was a supervisory innovator. The Act created a board of three commissioners to inspect each New York bank once every four months: a process for regular, proactive supervision that was independent of any scandal or complaint. The innovation appeared to be short-lived, facing

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[10] Hammond, *Banks and Politics*, 187; Robertson, *The Comptroller and Bank Supervision*, 24-25. The practice was not without controversy: As banks became privately held, bankers in some states refused examination.

legislative abolition in 1843, "despairing that such officers could curb improper banking practices, but without effort to improve their capacity to do so." But the seed had been planted, and New York became a model for banking and bank supervision adopted widely by other states and, eventually, the federal government.[11]

II. Civil War and the New National Banking System

Such was the state of the banking supervisory system on the eve of the Civil War. There was little federal participation in that system, and intense state innovation that focused mostly on the mechanism of bank charters. The archipelago of 1,601 state chartered banks that floated in 1860 was not equipped to endure four years of sustained armed conflict. To meet the massive costs of waging war across a continent, the Northern States needed to quickly develop a robust and centralized financial system. What it created instead was a clumsy hybrid. Although the Civil War is often portrayed as a conflict pitting the centralized Union against the states' rights Confederacy, American political traditions of decentralized power remained firmly in place in the Northern States throughout the conflict. The National Banking Acts, which gave birth to a system of privately-owned, nationally chartered banks, were Congress's attempt to preserve these traditions, retaining in the words of their Senate sponsor, John Sherman, the "combination between the interests of private individuals and the government" that had typified the antebellum financial regime.[12]

When Abraham Lincoln assumed the presidency in March 1861, South Carolina troops were already laying siege to Fort Sumter, while the federal treasury lay virtually empty. Meanwhile, the federal government, still cowering under Andrew Jackson's long shadow, could only deal in hard currency, not bank credit. To finance the coming conflict, Treasury Secretary Salmon P. Chase developed a simple plan: The federal government would sell bonds for gold. The plan's simplicity, though, was marred by its lack of sophistication. The nation's bullion largely sat

[11] Hammond, *Banks and Politics*, 556-563, 593; Hurst, *A Legal History of Money, 157.*
[12] Robertson, *The Comptroller and Bank Supervision*, 16; Hammond, *Banks and Politics*, 727.

in vaults of its state-chartered banks, providing the solid foundation undergirding the national money supply, a combination of note-issue and checkable deposits. Chase's plan would and did remove this foundation, and in short order New York's banks suspended specie payments. By December, the federal finances were in worse shape than when the war began.[13]

As he struggled to fund the war effort, Chase undertook an ambitious side-errand: Reclaiming the federal government's constitutional power over the currency from the states and their banks. A constitutional lawyer and former governor of Ohio, Chase had little financial experience. Building on ideas submitted to him by financiers, Chase proposed a new national bank-note currency, issued by private, federally-chartered banks and secured by federal bonds. Chase imagined this system would generate ready money for the government: Bankers would buy the government's bonds in specie, while bankers' own notes would be backed by government promises, not gold reserves.[14] Remaking the financial system was hardly expedient, however. In the crisis of December 1861, with the nation floundering to pay its soldiers, sailors, and suppliers, Congress took the lead, authorizing Chase to directly issue national legal tender notes—greenbacks—which were as functional as they were unpopular.[15]

Chase though, did not give up on his national currency plan, which he advanced again in December 1862, this time with success.[16] The national banking system Chase envisioned and Congress enacted in February 1863 guaranteed private control of the financial system in line with the nation's long-standing political institutions, adopting a decentralized system of private banks that enabled the federal leviathan to avoid the politically fraught centralized power of a third Bank of the United States. The first National Banking Act was instead a free banking measure, which

[13] Hammond, *Banks and Politics*, 730; Bray Hammond, *Sovereignty and an Empty Purse: Banks and Politics in the Civil War* (Princeton, N.J.: Princeton University Press, 1970), 60-62, 168-169. See also, John Sherman, *John Sherman's recollections of forty years in the House, Senate and Cabinet: An Autobiography* (Chicago: Werner, 1895), 269-300; Sherman notes that the greenback and national banking questions were so entwined that they had to be discussed together. He never discusses examiners. His faith is in the system itself, especially of note redemption.
[14] Setting aside the fact that the most reputable banks are operating on checkable deposits and fractional gold reserves.
[15] Hammond, *Banks and Politics*, 718-725. Unpopular with bankers. Congress and the general population love them.
[16] Hammond, *Sovereignty*, 290. (well, The National Bank Act "was a superfluous triumph of nationalist emotion, of Chase's pertinancy, and of John Sherman's spokesmanship (339-340).")

provided a streamlined administrative process for chartering national banks. It required bankers to deposit with the Treasury federal bonds equal to their note circulation, and to retain fractional reserves against their deposits. Initially few associations and even fewer prominent state banks secured or converted to national charters. Congress substantially reformed the law, building on recommendations of its administrator, the new Comptroller of the Currency Hugh McCulloch, both by enacting a revised National Banking statute in June 1864, and by levying a crippling tax on state bank notes in March 1865. (It is a nice bit of irony that federal banking officer Hugh McCulloch, champion of the use of federal taxing power on state bank notes, would share the name of federal banking officer James McCulloch, who sued Maryland over its use of state taxing power over federal bank notes. This was a coincidence, not the fulfillment of a generational grudge.)

Chase did not grasp that by the 1860s, note-issue was largely incidental to sound banking; national banks were not eager to issue notes and state banks could live on not issuing them. Many of the system's subsequent flaws, which ultimately complicated the work of its new supervisors, were tied to Chase and Congress's relentless focus on creating national bank notes that would act as currency and ignoring deposit which served as money.[17]

A. *The New Regime of Federal Bank Supervision*

The national banking system vested power in the hands of private economic actors, but bound them in a new web of federal oversight, administered by the Currency Bureau and its head, the Comptroller of the Currency. The nation's new bank-supervisory regime, at least as constructed by Congress, was likewise largely private, borrowing extensively from state

[17] Hammond, *Banks and Politics*, 727-734; Robertson, *The Comptroller and Bank Supervision*, 41, 47-48; Hammond suggests this point, but does not follow the story forward.

experience in its reliance on chartering and note redemption to manage market entry and use market surveillance by bank counterparties to ensure regulatory compliance.[18]

McCulloch, first Comptroller and later Secretary of the Treasury, decisively shaped the early practices of federal bank supervision by making the Currency Bureau an effective, autonomous institution.[19] McCulloch came to the Comptroller's office after a long career in banking. He had joined the Fort Wayne branch of the State Bank of Indiana as a cashier in 1835, and eventually was appointed president of that institution's successor by the Indiana legislature in 1857. In that capacity, McCulloch came to Washington in 1862 to lobby against Chase's proposed national banking system. McCulloch feared a new Bank of the United States, "a mammoth corporation with power to increase and diminish its discounts and circulation, at the will of its managers, thus enabling a board of directors to control the business and politics of the country." But he became a convert to Chase's plan to "furnish the people of the United States a national bank note circulation without the agency of a national bank," and accepted the Treasury Secretary's unexpected offer to head the new Currency Bureau.[20]

McCulloch's commitment to decentralized, Jeffersonian political institutions made him a credible leader for the new federal bureau. In his first year on the job, McCulloch convinced Congress to systematically revise the original 1863 Banking Act, to make the hastily drawn-up law more "methodical in its arrangement, clear in language, and comprehensive and consistent in its provisions." Congress and Chase, focused as they were on funding the government and nationalizing the currency, had not been especially interested in innovative supervisory practices or expanding the federal government beyond its already swollen size. McCulloch, for his part, focused his revisions primarily on bank regulations and left largely unchanged the Currency

[18] Eugene White, "Lessons from the History of Bank Examination and Supervision in the Unites States, 1863-2008," in Alfredo Gigliobiano and Gianni Toniolo, *Financial Market Regulation in the Wake of Financial Crises: The Historical Experience* (Banca d'Italia Eurosistema, November 2009), 18-22.
[19] Daniel P Carpenter, *The Forging of Bureaucratic Autonomy: Reputations, Networks, and Policy Innovation in Executive Agencies, 1862-1928* (Princeton, N.J.: Princeton University Press, 2001).
[20] Hugh McCulloch, quoted in Thomas P. Kane, *The Romance and Tragedy of Banking; Problems and Incidents of Governmental Supervision of National Banks*, 2d ed (New York: The Bankers Publishing Co, 1923), 24.

Bureau's supervisory powers, reflecting his commitment to the supervisory regime of chartering and private surveillance.[21]

The National Bank Acts largely entrusted the new national banking system to the self-interest of bank stockholders and market surveillance by bank counterparties, mediated by a new system of mandated reporting administered by the Comptroller. The National Bank Acts imposed double liability on stockholders, meaning that in the case of bank capital impairment or outright failure, their personal resources could be called on to meet the liabilities of the bank, creating strong incentives for bank principals to carefully monitor their agent bank officers.

But there was much that was inherently supervisory, too. To enable counterparties and examiners alike to enforce sound bank behavior, the National Bank Acts mandated that national banks submit detailed quarterly statements of condition, which were then published in Washington DC and bank's hometown paper. As with antebellum efforts, what gave the oversight regime its teeth was the ultimate threat of receivership and liquidation, in the case of insolvent or otherwise impaired institutions, and criminal prosecution in the case of fraudulently operated ones. In revising the National Bank Act, McCulloch suggested strengthening these incentives, specifically by making bank insolvency *prima facie* evidence of fraud on the part of bank directors, a change that would have given private enforcement even more weight.[22]

On top of these slow shifts toward supervision came the most important innovation, the new office of federal bank examiner, a position given little concrete shape in the law. Congress had provided for examination regimes in the past, particularly for steamships boilers and imported medicines.[23] But despite advances in administrative institution-building, when Congress created federal bank examiners, it reverted to the *ancien* supervisory *régime*. The new

[21] US, Office of the Comptroller of the Currency, Annual Report of the Comptroller of the Currency, 1863, 49.
[22] Robertson, *The Comptroller and Bank Supervision*, 79-81; Annual Report of the Comptroller of the Currency, 1863, 51. The fraud section is also in line with steamboat inspection: the 1838 act makes a boiler explosion, etc., prima facia evidence of negligence on the part of captain, etc.
[23] The Steam inspection regime of 1838 looked much like the bank examination regime of 1864, but in the meantime, the steam examination regime had made major advances that were not incorporated into bank examination. Jerry L. Mashaw, *Creating the Administrative Constitution: The Lost One Hundred Years of American Administrative Law* (Yale University Press, 2012), 187-208.; Act of July 7, 1838, ch. 191, 5 Stat. 304.

federal bank examination force was temporary, appointed “as often as shall be deemed necessary and proper” by the Comptroller. Their pay was meager, equal to the bounties paid steamboat inspectors. The structure of the act does not suggest that Congress intended the bank examiners to be a vital administrative force. Instead, the section authorizing the Comptroller to appoint examiners sits between provisions holding directors liable for violations of the law, and provisions describing penalties for embezzlement. Congress seems to have imagined bank inspectors largely as a force of deputized fraud detectors.

From these meager beginnings, and with little legislative authority behind them, McCulloch and his successors at the Comptroller built something much bigger. As Union armies slowly ground down the Confederate war machine and continued during the forestalled political and social transformation of the South during Reconstruction, the role of the bank examiner grew increasingly secure and central to the exercise of federal power over private local action. When militant white Southerners defeated that effort through a rein of racial terror, the nation’s focus shifted toward a renewed mania for territorial expansion and massive push toward industrialization in what we now call the Gilded Age. Over these decades bank examiners became increasingly powerful representatives of a newly powerful federal government. They were likewise enmeshed in that government’s political scandals, like corruption and the spoils system, and most often representatives within it of hard money politics. “It should be,” McCulloch advised, “the object of all honorable bankers to expedite, as far as practicable, rather than to postpone a return to specie payments,” a view that placed the Comptroller and the Currency Bureau at the dead center of the politics of the next half century.

By the end of the first decade of its existence, the Comptroller of the Currency and the office of the federal examiner had enough of an institutional foothold to persist. The form such persistence would take, however, was an open question.

III. Federal Bank Supervision in Action

McCulloch and future comptrollers made the examination force a public, but not publicized, counterweight to the privately-enforced publicity regime, working to overcome the vagueness of the banking acts, the opposition of bankers, and antipathy toward expanded federal power in Congress to make bank examination a robust element of federal bank supervision. Over the ensuing decades, while the publicity regime remained largely static and chartering became more automatic, Comptrollers pushed examination to the fore. This relied on a corps of dedicated examiners and administrative staff. It also required chartering banks, so there would be a national banking system to supervise.

A. Currency Bureau, Open for Business

McCulloch firmly believed that most bank managers, acting in the interests of their shareholders, would operate their institutions soundly, with robust internal oversight and no need for a federal supervisory regime at all. But he also did not depend on self-interest alone to act on the business practices and consciences of every banker. Even as he urged bank officers to consider their duty to the nation, since "the reputation of the system," McCulloch argued in an 1863 circular, "depends upon the manner in which his particular institution is conducted,"[24] he also kept his federal supervisory powder dry. McCulloch's experience in Indiana convinced him that bank officers often did not take their oversight responsibilities seriously. Internal bank audits were often "rather more formal than actual." By contrast, McCulloch, as the state bank's president, vested with full supervisory authority and charged by the legislature with serving the public interest, was far more exacting. "So searching and thorough were" his examinations, "that fraud or mismanagement could hardly have escaped detection."[25]

[24] McCulloch in Kane, *Romance and Tragedy*, 30-31. What Kane leaves out is McCulloch's exhortation that the national banks help return the nation to sound coin as soon as possible (United States, Office of the Comptroller of the Currency, *Instructions and Suggestions of the Comptroller of the Currency in Regard to the Organization and Management of National Banks* [hereafter: *Instructions*], 1864, 35).
[25] Hugh McCulloch, *Men and Measures of Half a Century* (New York: Charles Scribner's Sons, 1889), 113-114. Hard to miss the consonance with O. Henry's "so icy and swift."

The art of examination needed competent artists, and the new force of federal bank examiners who would perform McCulloch's thorough and searching examinations was a mixed lot. By 1867, the Currency Bureau employed only 15 examiners, concentrated in the commercial centers of New York, Pennsylvania, and Massachusetts. Four years later, 18 examiners reached somewhat further afield, but many covered multistate districts, including one assigned to the "Southern States." None yet covered the West Coast. Most of the new examiners had either been lawyers or state banker officers, and in the early days many continued in these lines of work even as they fulfilled their examiners' duties. Nearly all had wives and children.

But they weren't an entirely homogeneous lot. Butler Ward, who oversaw national banks in New York, had worked as a bookkeeper in Illinois before enlisting in the Union Army. Wounded at the Battle of Stones River in Tennessee, he signed on as an examiner while in his early 30s. Michigan's Sullivan M. Cutcheon attended Dartmouth, was briefly a school superintendent in Springfield, Illinois (where local lore has him playing handball with Lincoln), and after passing the bar was elected to the Michigan legislature at age 26. Two years later, in 1863, he was elected Speaker. If the new examiners shared anything in common, it was likely deeply-held commercial ambition, in line with the get-ahead ethos of the time.[26]

R. W. Derrickson, who served as an examiner from September 1867 to January 1869 (and perhaps longer, though we only have records covering that period), provides a fascinating window into the day-to-day practices of bank supervision at its beginning. Derrickson was in his late 20s and based out of Meadville, Pennsylvania, then a small university town 20 miles east of the Ohio border and 40 miles south of Lake Erie. His examiners' book, one of the few that survive, narrates the story of his work, which in the fall and winter of 1868 and 1869 took him north to Lake Erie, then more than 170 miles south past Pittsburg to Uniontown, and finally more than 200 west to

[26] We're building a database of federal bank examiners, using the Official Register of the United States, Congressional documents, and archival sources to compile their names, biographical information, and years of service. For the prevalence of ambition and disappointment, see: Scott A. Sandage, *Born Losers: A History of Failure in America* (Harvard University Press, 2006).

east, from towns like New Castle and Greenville to Lebanon, past the state capital in Harrisburg. He likely covered most of this distance by rail. Like most of his colleagues, after leaving the federal service, Derrickson became a banker, serving as the cashier of the Meadville National Bank until at least 1880, before ultimately retiring west to Washington State.[27]

Aiding the examiners in the field were a growing army of clerks based in Washington, D.C., who provided the bureau with a swelling reservoir of administrative capacity, and, in many cases, a pool for future examiners. At the top of the bureau, the administrative staff was a source of early continuity. McCulloch's principal successors, Hiland R. Hulburd (1867-1872) and John Jay Knox (1872-1884) each served as Deputy Comptroller before ascending to the top job. After Knox, appointees to the head of the Bureau were usually outsiders, but by then a robust bureaucratic machinery was in place and had its own momentum. The staff was largely divided on gender lines, between male clerks and female copyists, but over time some women moved into decision-making positions. Although the staff would eventually develop into a professional bureaucratic force, the early high turnover also reflects the fact that, during the Civil War and the years soon after, the federal government was a ladder for ambitious young men, eager to advance. Well publicized backbiting and infighting showed that in the Currency Bureau, there was money to be made.[28]

Staffing the bureau was necessary, but McCulloch and his successors were equally eager to extend bank charters to ensure the national circulation began circulating. They would not, however, hand out charters indiscriminately. McCulloch focused sharp attention on the chartering process, rendering it equal parts regulatory and supervisory (as had occurred during the free banking era). To guide aspiring national bankers, he developed instructions for obtaining

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[27] R.W. Derrickson, Bank Examiner's Book, University of Pittsburg, Manuscript Collections. Census records.
[28] Illustrated in the many congressional investigations, including: US Congress, House of Representatives, *Failures of National Banks: Testimony taken by the Committee on Banking and Currency Relative to National Banks* [hereafter: *Failures of National Banks*], 42 Cong., 2 Sess., 26 March 1872, Mis. Doc. No. 153, p. 21; US Congress, House of Representatives, *Merchant's National Bank of Washington* [hereafter: *Merchant's National Bank of Washington*], 42 Cong., 3 Sess., 29 Jan. 1873 (Original Testimony 16 May 1866), Mis. Doc. No. 106; *Message from the President of the United States Transmitting A Letter from the Secretary of the Treasury, in Response to Senate Resolution of December 6, 1881, Concerning Instructions and Reports of Certain Examiners of National Banks, &c* [hereafter: *Response to Senate Resolution of December 6, 1881*], 47 Cong., 1 Sess., Ex. Doc. No. 31.

a charter. In one sense, the rules he laid down rather straightforwardly followed the law: At least five individuals could form an association, so long as they raised the requisite capital. But McCulloch and his staff also relied on informal procedures, particularly aimed at determining would-be bankers' reputations and aspirations for their bank. McCulloch required organizers to submit letters of reference "from gentlemen of well-known character and reputation." He and his successors also asked examiners to determine the "banking experience and business qualifications" of bank officers. Although later comptrollers would institute mechanically enforcing the rules, McCulloch adopted norms based on reputation, aimed at preventing "men without capital, and adventurous speculators" from obtaining control of national banks.[29]

The charter did not make the bank, or at least not all by itself. Once an association had secured permission to commence a banking business, McCulloch was also concerned that they obtain the material trappings of a proper bank. This meant a "suitable and safe banking-house or room," with "a good vault or safe, (which ought to be both burglar and fire proof) and the necessary books and papers." The examiners would keep a keen eye on the furnishings, "in regard to all of which the Comptroller will require full and satisfactory information." Supervision extended to the very paper bank clerks were writing on.[30]

B. Establishing the Supervisory Routine

In the early decades of the national banking system, as examination resources remained thin, the bureau's staff worked to create procedures that would maximize supervisory efficiency. The quarterly reporting system provided supervisors with useful information, but reports also had severe limitations. "The bank might have a very large deficiency in reserve, and large amounts of over-drafts, or a great amount in suspended paper," a clerk at the Currency Bureau complained.

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[29] *Instructions*; Robertson, *The Comptroller and Bank Supervision*, 59-61; S.T. Howard to S.M. Cutcheon, May 17, 1865 and F. Clarke to Andrew B. Mygatt, June 22, 1865, reproduced in *Response to Senate Resolution of December 6, 1881,* pp. 12-13; Annual Report of the Comptroller of the Currency, 1863, 58.
[30] Derrickson does not tell us much about this process; in his reports, the sections reserved for "Records," "Other Books," "Office," and "Safe," were uniformly covered by cursory notations like "Very Satisfactory," "All Right," or "Same as last year."

"These things would not be shown by the report; they would appear only by an examination of the books of the bank."[31]

The first question was the threshold supervisory one: which banks should be examined, when. Congress provided for examinations "as often as shall be deemed necessary and proper," and under McCullough, "the theory is that examinations are to be made once per year." With few examiners, however, theory did not match practice. For examiners with fixed geographic districts, the Comptroller simply sent them a list of banks and authorized them to "proceed to examine at your pleasure." Examiners also kept their ears to the ground, listening for sounds of trouble. "Sitting in the reading room of [his] hotel," one examiner was drawn to "some gentlemen were conversing in so loud a voice that I could not avoid hearing them." The substance of their conversation was a "thoroughly rotten" Memphis bank. The examiner conveyed the conversation to the Comptroller and within a week was on his way to Tennessee. [32]

Once the examiner arrived at a bank, he usually began by asking the officers to draw up a statement of the bank's assets and liabilities. "When such a statement is furnished me," federal examiner John Bull explained, "I commence to examine the assets to verify the statement." The task started with redoing the bank's self-reported math. "If the statement shows that the bank has $200,000 in greenbacks," Bull continued, "I go to work and count the greenbacks to ascertain whether it has that amount. If it appears the bank has 7-30's," 30-year bonds paying 7-percent interest, "I count the 7-30's." Counting was the easiest part of the examiner's work, and the least likely place to uncover serious fraud or financial impairment. Bank assets also usually included deposits with far-off institutions, and examiners wrote or telegrammed to see if funds claimed were present in fact. Examiners also inquired closely about the status and security of loans, a

[31] US Congress, House of Representatives, *Failures of National Banks: Testimony taken by the Committee on Banking and Currency Relative to National* Banks, 42 Cong., 2 Sess., Mis. Doc. No. 153, testimony of Henry H. Smith, Feb. 20 1872, 22.
[32] *Merchant's National Bank of Washington* (Testimony of John Bull), p. 10, 19; F. Clarke to Andrew B. Mygatt, June 22, 1865, reproduced in *Response to Senate Resolution of December 6, 1881,* p. 12; *Failures of National Banks* (Testimony of John Bull), 36.

process that when done well required ready knowledge of market conditions, stock and bond prices, and the reputations of local businessmen. Without such knowledge, the examiner's best proxy was looking at how many loans were past-due and for how long.[33]

The reports examiners bundled together and mailed back to Washington were usually short and relatively straightforward, though they grew more complicated over time. The first page was a report of condition nearly identical in form to the call reports banks made to the Comptroller. On the second page, the examiner provided descriptions of the bank's books and records; its officers, directors and shareholders; and the office and condition of the safe. They also reported recent dividend payments and provided basic information about the kinds and amounts of the loans carried by the bank. The standard form also had a specific section for the most common violation, loans exceeding the legal limit of 10 percent of a bank's capital, which Derrickson reported for nearly 25 percent of the banks he examined.[34] Finally, the examiner could use the "general remarks" section to report other concerns or violations of law. In his insider's history of the Currency Bureau, Thomas P. Kane estimated that by the turn of the century, nearly 60 percent of reports contain some violation.[35]

When examiners found and reported violations of the letter or the spirit of the banking laws, as they very often did, responsibility then shifted to the army of clerks who received the reports in Washington, DC. In their conversations with bank management, examiners provided immediate and candid assessments of bankers' successes and failures, but their final reports were confidential, and bankers had to wait on official word from the Comptroller to find out how they weathered the exam. Clerks read and evaluated the reports and then wrote offending banks, under the signature of the Comptroller, detailing violations and requiring prompt correction.[36] The

[33] *Merchant's National Bank of Washington* (Testimony of John Bull), 16; *Failures of National Banks* (Testimony of John Bull), 5; a description is also in given "Broken Banks and Lax Directors," *Century Illustrated Magazine (1881-1906)*, March 1882.
[34] 11 of 48.
[35] Kane, *Romance and Tragedy*, 302 [check].
[36] *Failures of National Banks*, 18, 29

bank's officers were compelled to respond, explaining what they would do to comply. Such centralized administration enabled the comptroller to establish uniform policies and administer them nationally, even as they relied on individual bank examiners in the field. Centralized control and recordkeeping also created a paper trail for when the bank did fail, enabling the Comptroller to provide the District Attorney ample evidence of negligence or fraud. Examiners saw the salutary results first hand. Derrickson was apt to write "doing a safer business than last year," after finding fault with an institution. The paper machinery also went into motion, when the banks' periodic reports showed deficiencies in capital or reserves, likewise allowing the Comptroller to repair minor problems before they became major ones.[37]

Looming over the administrative process was the threat of liquidation and criminal prosecution. The National Bank Acts authorized the Comptroller to appoint a receiver if a bank could not redeem its notes, or to bring suit to forfeit the charter if a bank's officers violated any provisions of the act. In the first decades, most liquidations were voluntary, undertaken in partnership with the Comptroller when a bank got into trouble and the officers sought an orderly resolution. But when a bank was run by adventurous speculators, the Comptroller often needed to act swiftly and secretly, taking possession of the institution before the officers could cover up their misdeeds. "If Mr. Hulberd had designed to put the bank in the hands of a receiver," a former clerk recalled, "he would not have notified them."[38]

Importantly, the substance of the Comptroller's largely out-of-sight regime of examination was nowhere in the National Banking Acts, which relied on public disclosure and market surveillance to keep banks in line The nascent supervisory regime that the Comptroller's office did create was largely from the imagination of McCulloch and his successors. They were coaxing a different system into being, one that relied less on private market discipline and the tools of

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[37] *Failures of National Banks* (Testimony of Henry H. Smith), 18-19, 29; Kane, *Romance and Tragedy*, 366;
[38] *Failures of National Banks* (Testimony of Henry H. Smith), 21.

private litigation and more on public-private partnership to enhance public trust before problems occurred, not after.

C. *Establishing the Republican Supervisory Regime*[39]

The first generation of federal supervisors worked, then, to promote a set of banking practices that we call "republican banking": Loans of small amounts, profitably made, and widely distributed and assiduously recorded. While we see in this philosophy elements of modern loan diversification, supervisors' concerns were more directly focused on ensuring the independence of bank officers from influence by dominant clients and underwriting the legitimacy of the new system by making credit widely available. Bankers who profitably purchased and held government bonds may have served their shareholders, but did not meet the wider public obligation to serve their communities implicit in a banking charter. As such, they were not worthy of the privileges they received. Republican banking matched the Republican Party's commitments to free labor and individual proprietorship, while also harkening back to the republican political ideology of Jefferson, which abhorred centralized financial power.[40]

To promote republican banking, McCulloch drafted a set of instructions and suggestions to bankers explaining his views of sound, republican banking policy, which in turn strongly guided how examiners judged successful banking. For inexperienced examiners like Derrickson, the influence of McCulloch's dicta was clear as they worked to instill the ideals of republican banking in the institutions they oversaw in the early years of the federal system. Some banks, like the First National Bank of Indiana, Pennsylvania, a farming community and county seat 50 miles east of Pittsburg, perfectly encapsulated the republican vision. The bank was "doing a safe + very profitable business," Derrickson reported, with "money loaned in very small amts throughout this county." Safety and profitability were reinforcing characteristics of successful banks, which not

[39] The concept of republican banking mirrors Bensel's party state. Richard Franklin Bensel, *Yankee Leviathan: The Origins of Central State Authority in America, 1859-1877* (New York: Cambridge University Press, 1990).
[40] See McCullough in *Bankers Magazine*, quoted Kane 24, and his circular to banks (Kane, *Romance and Tragedy*, 29-31).

only kept the bank in business but also promoted public confidence. "There are few items that will have a better look upon the balance sheet," McCulloch explained, "and secure for it the confidence of the people, than a large surplus fund." Moreover, wide loan distribution not only helped to insure safety, but it also underwrote local political legitimacy, since the institution was serving its community, fulfilling the public obligation that came with the privileges conveyed in a corporate charter.[41]

Many banks, though, did not live up to these standards or practiced banking on principles outside the "spirt and intent of the law," as McCulloch and his examiners defined it.[42] Working through the banks in Erie, Pennsylvania in November 1868, Derrickson examined a mix of successful and unsuccessful firms. While the Keystone National Bank of Erie was "doing a safe and profitable business," Derrickson found that the First National of Erie, "does a small business," and "is of no public benefit." While the bank had $150,000 in capital, it had only lent out $64,399, almost half of which was to the officers of the bank. By contrast, the Keystone bank, with $250,000 in capital, had $315,622 in loans outstanding, only 20 percent of which were in the hands of bank officers. Derrickson elaborated on his dissatisfaction more fully in a lengthy critique of the First National Bank of Girard, which he examined later that month. "This bank," Derrickson wrote, "does but very little if any business outside of the six stockholders who own the bank. The president informed me that they would not take the risk of loaning out their circulation when they could purchase U.S. Bonds with it."[43]

The idea that bank supervision was meant to be an arm of the government to promote purely governmental interests doesn't capture the examination process propounded by McCulloch and practiced by Derrickson. What safer, more patriotic investment was there than U.S. bonds? But Derrickson was not pleased. "I would deem it very advisable if legislation could

[41] H. McCulloch to Charles Callender, Sept. 15, 1864, in *Response to Senate Resolution of December 6, 1881,* 9-10; Derrickson, Examiners Book, 104; McCulloch in Kane, *Romance and Tragedy*, 31.
[42] *Response to Senate Resolution of December 6, 1881,* Ex. Doc. No. 31, pp. 12-13.
[43] Derrickson, Examiners Book, p. 46.

be had to take the priveledge [sic] granted away from these gentlemen, and give it where it could be used as was intended by the framers of the Act." National banking's explicitly public purpose meant that insider lending could not long be tolerated.[44]

If a burgeoning business ideology of appropriate banking practices was arising among examiners, the enforcement tools for promoting it weren't as robust. Despite his dissatisfaction with Girard's practices, Derrickson had few tools available to enforce the spirit of the law. From 1867 to 1876, the two banks Derrickson praised maintained loan-to-capital ratios of around 1.5 percent. The First National Bank of Erie improved its performance, coming into line with this ratio by 1876. But the directors of First National Bank of Girard remained stubbornly committed to returning safe profits to themselves without lending in the wider community. Despite a change in management in 1872, their bank never lent more than 65 percent of its capital in this period. The National Bank Acts vested the money supply in private hands. By using their circulation to buy U.S. Bonds, the directors of the First National Bank of Girard were starving their local community. But this was not grounds for revoking the banks' charter, so aside from harassing them, there wasn't much more Derrickson and the Comptroller's office could do.

IV. Institutional Evolution of Federal Supervision

The evolution of examination from a tool of fraud policing to a subtler device for nudging bankers toward what the Comptroller and its examiners regarded as legitimate banking practices was hardly a smooth process, as Derrickson's failure at Girard suggests. Examiners like Derrickson faced a variety of challenges, some rooted in their ambiguous mission, others in the inadequacy of their supervisory tools. Over the second half of the nineteenth century, Comptrollers worked to clarify what national supervision was and to overcome the institutional limitations imposed by law, custom, and force of habit. They did so, however, against a backdrop

[44] On this point, see testimony of James Buffinton, an agent of the treasury department charged with examining designated depositories in the 1866 congressional investigation of failed banks. He lists several banks, whose only customer is the government and are "a disgrace upon the whole national banking system (*Merchant's National Bank of Washington* [Testimony of James Buffinton, 129])."

of dramatic national change. The moment of republican banking was brief. On the one hand, the reintegration of the Southern states into the Union, and the reestablishment of Democratic Party rule through violent means, meant that the Republican Party lost its monopoly on the state. At the same time, institutional challenges within the Currency Bureau threatened the experiment. Comptrollers worked to reorient their mission and the thrust of supervision to make the process more effective and sustainable.

A. *Geography, Information, and the Element of Surprise*

The Comptroller's most persistent challenge was a running conspiracy between geographic impediments and information asymmetries: The Currency Bureau's clerks depended on reports bankers compiled themselves; examiners did their work in the bankers' domain, in his community, in his very office. As the supervisory regime took shape, Comptrollers, clerks, and examiners all wrestled with how to overcome the fact that they would never know as much as bankers and would never examine banks as frequently or as thoroughly as they would like. At best, they could only hope for the element of surprise.

The statutory regime of publicity and private surveillance that constituted the National Banking system relied on bankers to report their conditions to the Currency Bureau, and its primary weakness was that bankers knew exactly when their reports were due. Congress had fixed the dates for bankers' quarterly reports on the first Mondays of January, April, July, and October. Knowing the dates well in advance, bankers put clean bindings on their rotten books. "It is certainly a point to be gained to know that the banks can make a good showing at least once every quarter," Comptroller Hulburd quipped, "but it would be more satisfactory to know that they do so at all times." And bankers were not the only ones to take advantage of the fixed statutory dates. Knowing that bankers would be trying to bring up their reserves in time with the statutory requirements, speculators drove up the price of gold in New York City bullion markets in advance of each reporting day.[45]

Following the urging of Comptroller Hulburd, in 1869 Congress converted from fixed quarterly reports to less-predictable call reports, where Comptrollers announced the call for reports and banks had to respond immediately, with penalties for tardiness. The element of surprise, then, was an early supervisory victory and key to pushing forward the institutional basis of supervision as something other than pure publicity. The change in reporting dates didn't eliminate the examiners' informational disadvantages, but it did mitigate them.

Whatever leftover informational challenges at the home office, however, paled in comparison to those examiners faced in the field. Examiners were paid for each bank they examined, and earning a decent living meant moving things along quickly: the incentives for thoroughness were clear on a compensation schedule as it then existed. If his journal is to be believed, Derrickson inspected the First National Banks of Indiana and Johnstown, both small towns in west-central Pennsylvania, in a single day in December 1868. Following prevailing rail lines, the towns are an hour drive apart now, and it seems unlikely Derrickson could have made the trip so expeditiously. He had to be quick inside the banks. And Derrickson hardly ever slowed down. After spending Christmas in Hollidaysburg, where he inspected the town's bank on December 28, Derrickson moved on to Clearfield, where he cleared the town's two banks on successive days. By the 31st he was in Curwensville, examining the bank there. One day off on New Year's Day, then Bellefonte, 50 miles to Huntingdon, 36 miles to Lewistown, and 57 miles to Harrisburg; all on successive days. Comptroller Hulburd may well have had Derrickson in mind when he advised Congress that "the labors of examiners are very severe, involving work by day

[45] Annual Report of the Comptroller of the Currency, 1868, XX. Kane emphasizes each comptroller's annual reports, which we think he sees as the root of administrative legitimacy and expertise. In this light, the conversion to call reports demonstrates early development of competency and the acknowledgement of that competency by Congress.

and travel by night; while the rigid and careful scrutiny required to investigate fully the condition and accounts of the banks is wearying and exhausting."[46]

The compensation structure meant speed, potentially undermining the practice of supervisory quality. Geography also didn't help. For Derrickson, this meant that when he arrived in Erie, Pennsylvania, on the shores of the lake by the same name, and once he inspected the first of the four banks in town, the other three had ample warning he was there and would be knocking on their doors soon. So did the bankers in neighboring Girard and North Coast. Once Derrickson left, these bankers likewise knew he wouldn't be back their way for some time. In cities with more than a handful of banks, examiners might preserve the element of surprise by inspecting only a few banks at a time, as Derrickson did when he visited Pittsburg in late November 1868, leaving the remainder for when they passed back through or for the other examiner working their territory. Ultimately, though, incentives and geography pulled examiners toward efficiency that undercut the element of supervisory surprise.[47]

The constraints imposed by time and space were matched by more existential problems of unreliable informants and observer effects. Examiners who traveled the length and breadth of a state, who swooped in for a few-hours examination, could never know enough about the communities they visited to judge which farmer or local merchant's notes were good and which were not. "He is a stranger," the *Century Magazine* observed in March 1882, who "can know little, except by hearsay, of the character and habits of the bank's officers, or of the security of its loans." The magazine's observations came after the spectacular failure of the Mechanics' National Bank of Newark, New Jersey in November the previous year. There, two successive examiners had found the cashier, Oscar L. Baldwin, a "good officer" and "a competent and efficient officer" before

[46] Annual Report of the Comptroller of the Currency, 1869, X-XI.
[47] Charles W. Calomiris and Mark A. Carlson, "National Bank Examinations and Operations in the Early 1890s" (Board of Governors of the Federal Reserve System (U.S.), Finance and Economics Discussion Series: 2014-19, 2014), http://www.federalreserve.gov/pubs/feds/2014/201419/201419pap.pdf. p. 2.

it came to light that Baldwin had competently and efficiently ransacked $2.5 million from the bank.[48]

Further, observing a bank changed it. Banks were and are financial flows in motion, propelled forward by public confidence that was always at risk of ebbing away. The course of the bank shifted in the presence of the examiner. Bankers called in overdrafts and took other immediate steps to correct minor flaws, course corrections that rippled out into their communities. Like an unsound levy, ordinary examinations could provide false assurance to bank stockholders and depositors. Although Edward Shelly, the examiner of the Mechanics' National Bank, sought to assure Comptroller Knox that he had done his work "carefully" and "faithfully discharged my duties to the good people of Newark," Shelly's feeling of guilt was not equivalent to an expansive legal duty. The stockholders learned this when they tried to hold the Comptroller responsible for publishing the bank's false reports. Likewise, the presence of an unexpected examiner could cast doubt on an institution's stability. As he examined the "thoroughly rotten" National Bank of Tennessee in Memphis, examiner John Bull was confronted by "several persons" who "represented that they had special deposits in the bank," and who wanted to know if their deposits were present. "As a matter of course I could not inform them," Bull explained. The depositors had reason to worry; their deposits were gone.[49]

B. Who Pays?

The wearying and exhausting travel examiners endured was not helped by the meager and poorly-structured compensation authorized by Congress, another problem the Comptrollers recognized early but struggled to resolve. When Congress enacted the National Bank Acts, it followed an established system of compensating government employees based, "immediately and objectively, on the delivery of services and the achievement of outputs." Under the law, bank

[48] "Broken Banks and Lax Directors.," *Century Illustrated Magazine (1881-1906)*, March 1882; *Response to Senate Resolution of December 6, 1881*.
[49] Edward H. Shelly to John Jay Knox, Nov. 5, in *Response to Senate Resolution of December 6, 1881,* 34; "Broken Banks and Lax Directors."

examiners were paid through a system of per diems, $5 for each work day plus $2 per 25 miles traveled, charged directly to the bank examined. Almost immediately, however, Hugh McCulloch recognized that such rates were insufficient to recruit and retain competent employees. "I found I was getting so short," John Bull explained of his own decision to leave the examination force, and "I did not care to be a bank examiner."[50]

To overcome the flaws in the fee system, McCulloch devised and implemented a compensation plan in which larger banks were charged more, to account for the time and effort necessary to thoroughly vet them. McCulloch's new plan, however, was, on its face, beyond the scope of the law. Bankers noticed. Reacting to what seemed to him like a cursory examination followed shortly by a $25 bill, an irate banker from central Massachusetts balked, asserting that the comptroller "has *no* authority to charge to such an extent." Hiland Hulburd, as Deputy Comptroller, agreed with the banker that "the amount is not assessed according to a technical construction of the law," but ventured to explain that it "is intended to pay such a salary as will enable the Department to employ a competent man to make these examinations." As Hulburd, later as Comptroller, wrote to Congress hoping to make the office's illegal expedient legal, "The compensation allowed by law is totally insufficient to pay the right kind of men to undertake this duty." Congress amended the law in 1875, expanding the pay scale based on the capital of the bank (neglecting deposits), while allowing the Comptroller to fix the salaries for key examiners in reserve cities.[51]

The fee system's flaws, however, ran deeper than adequate pay and beyond the incentives for speed over thoroughness mentioned above. More profoundly, the fee system complicated and confused bankers' relationships with their supervisors. Were bankers paying a fee for services

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[50] Nicholas R. Parrillo, *Against the Profit Motive: The Salary Revolution in American Government, 1780-1940* (Yale University Press, 2013), 1; *Failures of National Banks*, 5.
[51] *Correspondence between The Comptroller of the Currency and First National Bank of Marlboro', Massachusetts, Relating to Charges for Examinations* (Boston: Geo. C. Rand & Avery, 1867), p. 6; Annual Report of the Comptroller of the Currency, 1869, X. Until the Federal Reserve Act of 1913, subsequent comptrollers fought in vain to convert all examiners to salaried employees.

rendered? Or were they submitting to a bounty, which induced examiners to exercise coercive state power over them? Was their relationship with examiners friendly or adversarial? Lurking behind these questions were nagging concerns about corruption; that favorable treatment could be bought and paid for. Rumors swirled. Examiners were getting rich at the expense of the national banks. Clerks ushered through bank charters for organizers who could pay. The compensation structure sent mixed and dangerous signals.

Many bankers believed that one way or their other, examiners existed to serve their interests. "There are two sides to these examinations," our irate Massachusetts officer adroitly observed: "Not only is the Government to protect stockholders by a rigid examination of banks and bank-officers, as if they might all be rogues; but … bank-officers themselves will demand…that the examinations shall result in positive proof to their employers that they are worthy of their trust, and that the banks are sound and well managed."[52]

The idea that bank examiners served the banks examined wasn't a posthoc rationalization of a new system that bankers did not prefer. These views largely matched the legal construction of the bank examiner found in the National Bank Acts. Here, the examiner was a fraud detector, an image that found wide currency in the banking press through the mid-1870s. Examiners were fraud-stoppers who would sniff out thieving cashiers and sticky-fingered tellers. "Under our National banking system," *Bankers' Magazine* cheered, "the wrong-doers will not go long undetected."[53]

But by the early 1880s, after a wave of national bank failures, punctuated forcefully by Baldwin's pilfering of the Mechanics National Bank in Newark, observers began to recycle the objections to examination raised by the New York legislature in the 1840s: When bankers were honest, examiners weren't needed; when bankers were dishonest, examiners where hopelessly out of their depth. The failures even inspired poetry:

[52] *Marlboro*, 10-11.
[53] "Our Banking System and Its Dangers.," *The Bankers' Magazine and Statistical Register* 10, no. 10 (April 1876): 753.

> The Bank Examiner! Didn't he come?
> Well—he wasn't exactly deaf and dumb;
> Nor was he one of the fungus kind
> With a wooden head and eyes so blind.
> He seemed to be sharp and bright and quick,
> But he wasn't up to my little trick.
> With all his sharpness he couldn't see
> How the bank was mismanaged by me—
> For I kept things looking neat and fair
> The business seemed to be done on the square.
> He looked at the books and counted the cash,
> And said, in a way that now seems rash,
> That the Bank's condition was healthy and sound
> As any Bank he ever had found
> And with such directors and such a cashier
> There would never be anything to fear.[54]

From the perspective of less poetic bankers, if examiners could not root out embezzlers, why should they submit to the labor and annoyance, much less the expense, of an examination? A month after the Mechanics National Bank went under, the Senate demanded answers, compelling Comptroller Knox to redefine what bankers were paying for, even as he and his successors argued in vain to convert all examiners to salaried employees.[55]

C. *From Fraud Fighters to Management Consultants*

Under intense public scrutiny, Comptroller Knox began to articulate a revised vision of federal bank examiners' behind-the-scenes work, so that they might become known publicly as what he was shaping them into in practice: management consultants with subpoena power. Responding to the wave of dramatic failures, Knox pushed examination away from the image of courageous fraud detection, acknowledging in his statements to Congress that examiners like Edward Shelly were unlikely to catch long cons like Oscar Baldwin. "A rogue or dishonest man who acquires the confidence of his associates to such an extent that he can appropriate the funds

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[54] "Song of the Fugitive Bank Cashier.," *Life*, November 13, 1884.
[55] *Response to Senate Resolution of December 6, 1881.*

of the bank to his own uses," Knox wrote Congress in 1884, "can have but little trouble in deceiving an examiner and of hiding his peculations from him." Even with the element of surprise, the geographic obstacles were just too great, and the examiner would always be merely an interloper into a fraudster's machine. In this effort to shift public expectations, Knox was joined by a sympathetic banking press, which extolled shareholders and bank officers to vigilance. It was up to principals to monitor their agents. The best examiners could do was try to nudge and steer.[56]

The Comptroller's shift in posture filtered through to his instructions to examiners, which crept toward an increasing sense that supervision should protect and strengthen the banking *system*, not just serve the needs of individual banks. Examiners should monitor and correct bank management practices, Knox argued, focusing on areas like lending limits and reserves where bank management decisions could compromise bank safety. This meant transitioning from a strictly adversarial posture, as if all bank officers might all be rogues, and instead adopting honey, even in the face of clear legal transgressions. "All violations of law developed in the course of examinations should be pointed out in a courteous manner to the managing officers," Knox instructed. With courtesy, too, Knox encouraged examiners to coach up bank officers. "Any improvements in books and the method of keeping accounts which would add to the safety and efficiency of the conduct of the business," Knox continued, "should be suggested in such a way as will best secure their adoption." That "violations of law" would not prompt enforcement, litigation, or prosecution tells us already that by the 1880s, supervision as an institutional practice had come into its own.[57]

The consulting posture shows up clearly in the examination journals of A. Barton Hepburn, a New York state banking superintendent, federal bank examiner, and eventually

[56] Annual Report of the Comptroller of the Currency, 1881; "Bank Examinations and Bank Directors," *The Bankers' Magazine and Statistical Register* 36, no. 6 (December 1881): 414; "Bank Examinations.," *The Bankers' Magazine and Statistical Register* 36, no. 7 (January 1882): 542; "Bank Examinations," *The Independent*, January 12, 1882; "Broken Banks and Lax Directors;" "Bank Examinations and Bank Directors.," *The Bankers' Magazine and Statistical Register* 39, no. 4 (October 1884): 241; "Bank Examinations.," *The Bankers' Magazine and Statistical Register* 39, no. 7 (January 1885): 483; "Bank Examinations Once More.," *The Bankers' Magazine and Statistical Register* 39, no. 9 (March 1885): 651.
[57] "Instructions to National Bank Examiners," in *Response to Senate Resolution of December 6, 1881,* 4.

Comptroller who worked in New York in the late 1880s and early 1890s (he was Comptroller from 1892-1893). In areas like accounting, Hepburn looked for and promoted models of best practice. The "system and method" of the Importers and Traders' National Bank, for instance, was "looked upon as a model by the other banks." By contrast, the National Park Bank's "system of bookkeeping is antiquated & not up with the times," requiring "more work on the part of the clerical force than is necessary, and," as far as Hepburn was concerned, "it certainly involves more work on the part of an examiner to ascertain its condition."[58]

Hepburn also focused on personnel, corporate culture, and managerial strategy, combining close knowledge of market conditions with a sense of how the industry was evolving before his eyes. In his reports, Hepburn was apt to comment on bank personnel, especially when a managerial change seemed to improve the prospects of a bank. The Nassau National Bank in Brooklyn, had, in Hepburn's view, "made a good move in changing presidents," and the new man was "an energetic and efficient businessman with good knowledge of banking." Hepburn also enjoyed a front row seat to changes in banking practice. The First National Bank, "is unlike any other in the city. It is strong and well managed. But does an investment business rather than an old fashioned bank business. It makes money very fast." Hepburn, embodying the forward-driving spirit of his age, was focused on helping his banks move forward. He was disappointed when culture, personnel, and strategy all conspired toward stagnation. This East River National Bank, Hepburn observed, "is managed by very old men is very old fashioned and very conservative."[59]

Although in professional circles Knox's vision largely prevailed, popular legitimacy of bank supervisors remained tied to their success stopping fraud and keeping depositors safe. Such legitimacy was threatened, however, by the growing perception that examiners were captured by

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[58] A. Barton Hepburn, Bank Examiners Book, vol. 1, Report for Importers and Traders National Bank, No. 1231, 31 Oct. 1889, Columbia University Rare Book and Manuscript Library (8920).
[59] Hepburn, Bank Examiners Book, vol. 1, Report for National Bank of the Republic, No. 1000, 29 Oct. 1889 ("The bank has a new vice-president, whose influence upon the bank management will I think be beneficial [8908]);" Hepburn, Bank Examiners Book, vol. 3, Report for Nassau National Bank of Brooklyn, no. 658, 4 Aug. 1890 ("This bank is very strong and has made a good move in changing presidents [9220].)"; vol. 4, Report for First National Bank, No. 29, 6 Dec. 1890 (9343); vol. 1, Report for East River National Bank, No. 1105, 12 Aug. 1890 (9245).

banker interests.[60] The hew and cry of "where was the examiner" followed major embezzling scandals, and the failure to unearth frauds was compounded by the fact that the comptroller's office had a fast-revolving door into the banking industry. Extensive industry knowledge matched with meager pay meant that the Comptroller's office became a finishing school for would-be bankers, including and especially the Comptrollers themselves. For instance, the Chase National Bank in New York City, named for Treasury Secretary Salmon Chase who created the National Banking System, was headed by three successive former Comptrollers during the late 19th and early 20th centuries. Moreover, like other branches of the nascent administrative state, by the turn of the century the Comptroller's office was a deposit account for the spoils system. Even after civil service reform, national bank examiners are exempt from the Civil Service Rules. [61]

D. Closing Down and Selling Off

Both the publicity regime of market pressure and the surveillance regime of federal enforcement relied on the ultimate threat of receivership and liquidation. As in the antebellum era, shuttering a bank was a very blunt tool, and Comptrollers, bankers, and the wider public all shared an interest in keeping it high on the shelf. And as with the Comptroller's other tools, this one was poorly fashioned. In addition to the public outcry and market turmoil that accompanied a bank closing, taking down a national bank was at once a complex and circumscribed legal process. Here we'll focus on three key steps: appointing a receiver, taking possession, and disposing of assets.

To wind down a national bank, the Comptroller's first move was to appoint a receiver, but his authority to do so was initially very limited. Under the National Banking Acts, he could only do so if a bank chronically failed to meet its required reserve or if, following from Congress's obsession with the new bank-note currency, a bank failed to redeem its circulating notes. But note

[60] Well, in 1908, Comp. Murray asks bankers what Comp. can do to improve examinations, they ask that examiners spend more time trying to root out defalcations (Robertson, *The Comptroller and Bank Supervision,* 75).
[61] Theodore Roosevelt, Amendment to the Civil Service Rules, Feb. 3, 1909 (No. 1018).

redemption was on its face an impossible legal hurdle. On the one hand, an insolvent bank could still have enough cash to repay its notes on demand. More pointedly, national banks' notes were fully secured by bonds held by the Treasury. Still, failure to redeem was an unambiguously valid legal reason to take over a bank and appoint a receiver, and when possible, the Comptroller used this power in agreement with the failed bank, presenting a dollar of the bank's circulation, and being formally, if artfully refused, initiating an orderly receivership. Fraud provided another route, but first fraud had to be proven in court, a process that promised a messy end to a bank long before the Comptroller got involved. "If there is any authority by which the comptroller can summarily put a receiver in charge of any bank which has a defalication [embezzlement], or a robbery, or a loss of one sort or another…that authority is not in the act which gives him his official existence," the *Financier* observed in 1873. Like the other aspects of supervision, comptrollers worked to increase their powers. Unlike in other efforts, here they were successful, with Congress expanding receivership provisions in 1869 and 1875.[62]

Although liquidation relied on a receiver, in practice, bank examiners often first took possession of a failed bank, a process that mirrored the challenges examiners faced in their usual work. Speed and surprise where of the utmost importance, both to preserve whatever assets the bank had left and to preserve the Comptroller's authority in the face of other remedies creditors might pursue (not to mention the reputational damage the Comptroller and the entire federal banking supervisory apparatus might suffer in the face of ham-handed responses). When contemporaries described the Comptroller putting a bank in the hands of a receiver, they meant it literally. The receiver physically took possession of the assets and records of the bank, often locking them up in the bank's own safe. Examiners were often in the best position to get to the bank quickly, but they also had the skills and knowledge to bring order to the chaos that accompanied a busted bank. They determined whether the bank was salvageable. But, again, they

[62] Kane, *Romance and Tragedy*, 60; Annual Report of the Comptroller of the Currency, 1869, V; "The Power of the Comptroller Over National Banks," *Financier (1872-1875); New York* 4, no. 40 (October 4, 1873): 182–183.

had to get there fast. A dispute among the directors of a small Connecticut bank led one faction to request a state court appoint a receiver. When the Comptroller read the press dispatch, he called the local examiner. After traveling all night, the examiner arrived and immediately took over the bank the following morning. There he met the state-appointed receiver, who, though he had arrived the previous evening, had slept too late. An examiner had been on the losing side of a similar race in Oklahoma the previous year.[63]

Once they took over a failing bank, the Comptroller then had to try and salvage the assets, which often contained past-due loans, worthless bonds, and unwieldy collateral. Managing the winddown, receivers and Comptrollers engaged in a fundamental debate (similar, as we shall see, to the one that would occupy the FDIC in later decades): was it the receiver's duty to dispose of the assets quickly, accepting that immediate market conditions might yield poor returns, or to invest his time, effort, and possibly even money to turn doubtful assets into paying ones for the benefit of the creditors and shareholders? Theodore M. Davis, the receiver for the Ocean National Bank, faced this dilemma. The bank had $500,000+ secured by Canal Company bonds. Without additional funding, the Canal would never get built and the bonds would be worthless. Davis took extraordinary measures to secure financing and salvage the canal company. After thorough investigation, the House Banking Committee praised his initiative. The story wasn't over. A decade later, the same committee completely reversed course and condemned his action, though, to be fair, by that point Davis was president of the Canal Company rather than in the government's employ. Likewise, the Comptroller was also criticized for failing to promptly prosecute bank officers, instead preferring to keep them out of jail, where they would have a better chance of making good the claims against them. The idea that supervision would displace litigation and prosecution was not, then or ever, an uncontroversial proposition.[64]

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[63] Kane, *Romance and Tragedy*, 156, 177-180.
[64] US Congress, House, *Ocean National Bank: Testimony Relating to the Ocean National Bank of New York Taken by the Committee on Banking and Currency*," 46 Cong., 2 Sess., Feb 12, 1880, Mis. Doc. No. 26; Kane, *Romance and Tragedy*, 103.

E. The Reemergence of State Chartering

Because the National Banking Acts had been a currency and financing measure, and because its authors understood banking as primarily about note issue, their efforts to snuff out state-chartered banking systems had likewise relied on snuffing out their note issuing privileges. The federal tax on state bank notes had succeeded up to a point: By 1870, there were more national banks than there had been state banks at the start of the Civil War, while less than a fifth as many state banks remained in operation (Chart 1). But state banks were poised to make a sweeping come back. The transition from note-issue to deposit banking, combined with the lower capital requirements, wider investment privileges, and, anecdotally, less rigorous supervision, all combined to make state charters appealing. In turn, the resurgence of state chartering threatened the newly system-conscious Comptrollers, because much of the system was beyond their influence.

The reemergence of state chartering coincided with, and likely influenced, the decline of chartering as a serious supervisory tool. Under McCulloch and the early Comptrollers chartering procedures had relied on both the formal legal rules established by the National Bank Acts and close extralegal inquiry into the reputations and likely prospects of banks. To protect the new system against fraud, McCulloch was keen to explain that he was "requiring the most satisfactory references or credentials in regard to the standing and responsibility of the persons proposing to organize national banks," despite the fact the provision for such requirements were nowhere in the law. With the rise of state chartering competition and the wider acceptance that private individuals should be able to freely claim corporate privileges, Comptrollers applied the law blandly. "The Comptroller has no discretionary power," Knox explained in the 1881 annual report, "but must necessarily sanction the organization, or reorganization, of such associations as shall have conformed in all respects to the legal requirements." In the face of regulatory competition with state charters, federal chartering ceased to be a meaningful method of accomplishing the tasks of bank supervision, a trend that would endure through the Panic of 1907. Instead, Comptrollers, recognizing the state competition, urged congress to reduce the existing chartering requirements. The Gold Standard Act (1900) accomplished this goal. The number of national banks doubled in a decade; state banks expanded faster still.[65]

Year	State Banks	National Banks
1870	325	1,612
1880	650	2,076
1890	1,791	3,239
1900	5,007	3,731
1910	14,348	7,138

Source: Ross M. Robertson, *The Comptroller and Bank Supervision: A Historical Appraisal* (Washington, D.C.: Office of the Comptroller of the Currency, 1995), 67.

Conclusion:

Salmon Chase, Hugh McCulloch, and congressional sponsors designed the National Banking System largely to serve an agrarian and only incompletely industrializing economy, one devastated by war and faction. Many of these same forces meant that the idea of a consolidated banking system was a political non-starter. But banks, like the economy they served, were not static. As the needs of the financial system changed, banks changed too, adopting affiliates that were outside the supervisory regime but could still inflict significant harm on that regime. Large urban banks were the levers financiers pulled as they dramatically remade the US economy. Supervisors did their best to keep abreast of these changes as they refined their systems of public reporting and surveillance and private fraud detection and management coaching.

The system of flexible examination and administrative follow-up carefully cultivated by a generation of Comptrollers, examiners, and clerical staff, however, could easily and quickly be disrupted by one antagonistic or "eccentric" Comptroller. That Comptroller was Lawrence O. Murray, appointed by Theodore Roosevelt in the wake of the panic of 1907.[66] Murray's

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[65] Annual Report of the Comptroller of the Currency, 1864, 49; Annual Report of the Comptroller of the Currency, 1881, 11; Robertson, *The Comptroller and Bank Supervision,* 61-71.

[66] Kane described Murry this way: "Mr. Murray was the most peculiar character who ever occupied the office of Comptroller of the Currency. His moods and tenses were so changeable and inconsistent that the subordinate officers and employees of the Bureau who came into daily contact with him were at first inclined to believe that his mental eccentricities were due to the condition of his health. But later they were obliged to abandon this charitable diagnosis,

administration whipsawed between policies. First, he summoned examiners, at their own expense, to Washington, and dressed them down for not doing their work thoroughly enough. "Frankly," he informed them, "their work was bad in the main—too hurried; too superficial; that their estimates of the assets of the banks were practically worthless; and that unless their methods improved many of them would have to be dismissed." From then on, he required truly searching examinations, and expected examiners to resolve violations on the spot, rather than working through the established administrative procedures. Yet, as soon as the new, exacting standards began to attain results, Murray swung hard in the opposite direction. He commanded the administrative staff to cut down on bank correspondence, to keep from "annoying" bankers. Thomas P. Kane, who had spent much of his working life in the Currency Bureau, was disgusted by Murray's "utter disregard for law and precedent." A generation of institution-building could quickly be ground into dust.[67]

Despite outrage within and without, Murray survived his term, but President Taft appointed a thoroughly conventional man to replace him. But the landscape was about to change with the Federal Reserve Act.

because of the fact that as his health improved his peculiarities became more pronounced (301-302)." The COC, in its historical material, claims that Murry represented Roosevelt's desire to shake up established institutional practices and hierarchies (https://www.occ.gov/about/what-we-do/history/150th-comptroller-murray.htm).

[67] National Monetary Commission, *Suggested Changes in the Administrative Features of the National Banking Laws*, (Washington, D.C., 1910) pp. 268, 281; Kane, *Romance and Tragedy*, 302.