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Naomi R. Lamoreaux
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Introduction

Banks in early-nineteenth-century New England were very different from the banks we know today, and perhaps the best way to begin this study is to explain how. Currently the region's financial sector is dominated by a handful of very large institutions, headquartered in major cities, whose influence extends throughout the area as a result of branch offices and mergers. The largest early-nineteenth-century banks were also located in cities, but because branch banking was not allowed, their operations were confined mainly to their local communities. Each bank was an independent, separately incorporated entity that raised its own funds and retained full control over its own lending decisions. There were a great many of them, too – more than three hundred by the mid 1830s and more than five hundred on the eve of the Civil War. By that time most small towns in the region had several banks each, and cities like Boston and Providence had as many as forty apiece.[1]

Despite their large numbers, early banks – unlike modern institutions – rarely provided financial services to ordinary households. Their customers consisted almost entirely of local businessmen whose borrowings took a very different form from what is common today. Typically, early-nineteenth-century businessmen brought notes (IOUs) to their banks to have them "discounted." Banks would advance borrowers an amount equal to the face value of their notes less an interest charge, and borrowers were then liable for the full value of the notes at maturity. Discounts were usually granted for only short periods of time (often for as

1. J. Van Fenstermaker, *The Development of American Commercial Banking, 1782–1837* (Kent, Ohio: Bureau of Economic and Business Research, Kent State University, 1965), 186–247; Richard Eugene Sylla, *The American Capital Market, 1846–1914: A Study of the Effects of Public Policy on Economic Development* (New York: Arno, 1975), 249–52; Massachusetts, Secretary of the Commonwealth, *Abstracts of the Returns from the Banks* (1860), 78–9; Rhode Island, State Auditor, *Annual Statement Exhibiting the Condition of the Banks* (1860), 35.

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little as sixty days), after which the notes might be renewed upon payment of an additional interest charge. Banks typically required all notes to be endorsed (that is, signed by one or more parties who would guarantee payment in the event of default). Sometimes borrowers were permitted to offer collateral security for their notes instead, but this practice was not very common. Personal security was considered safer than collateral security, because the notes were backed by all the resources of the endorser(s) as well as those of the borrower.

Early-nineteenth-century banks discounted two basic kinds of notes: commercial paper and what was known at the time as accommodation paper.[2] Commercial paper consisted of notes generated in the course of actual business transactions. When a manufacturer sold his wares to a merchant, for example, the merchant would often pay for them by giving the manufacturer an IOU, which he pledged to redeem in cash by a certain date (presumably selling the goods in the interim). If the manufacturer needed his money sooner, he could take the note to a bank and have it discounted, adding his endorsement to the merchant's name as security for the loan. Because of the self-liquidating nature of the debt, this type of note was rarely renewed. Typically the bank would collect payment from the merchant when the note matured, and the transaction was thus completed.

Accommodation loans, on the other hand, were entirely unrelated to any specific commercial transaction. They were a means for borrowers to obtain credit for a variety of purposes, including investments in manufacturing plant and equipment. The borrower drew up a note listing himself as payer, obtained one or more endorsers who were willing to guarantee the debt, and brought it to a bank to be discounted. Although the bank would discount the note only for a short period of time, it was often understood that the note would be renewed at maturity – sometimes repeatedly. In this way early banks transformed what was technically a short-term obligation into a long-term debt. The ratio of accommodation to commercial paper varied from one bank to the next, but it was common for the ratio greatly to exceed one.[3]

2. For further discussion of the nature of early banks' loans, see Fritz Redlich, *The Molding of American Banking: Men and Ideas* (New York: Hafner, 1947), pt. 1, 10–12. In the discussion that follows, and throughout the rest of the book, I use male pronouns to refer to merchants, manufacturers, bank officers, and bank directors. Although women frequently owned stock in banks and occasionally borrowed from them, the kinds of transactions I am describing involved men almost exclusively. Men also monopolized bank directorships and staff positions throughout the nineteenth century.
3. There are two ways to measure the amount of accommodation paper in a bank's portfolio. The best way, but unfortunately one that is possible in only

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Early banks obtained the funds they lent to borrowers from very different sources than modern banks. Today, for example, the most important component of a bank's liabilities is deposits, but these were relatively insignificant during the early nineteenth century, making up only about 10 to 20 percent of the total, depending on locality (see Table 3.7). Unlike modern institutions, early banks were allowed to issue currency in the form of banknotes, that is to say, non-interest-bearing IOUs, and these notes constituted the bulk of the circulating media of the period. Notwithstanding their importance for the operation of the economy, however, banknotes also occupied a relatively insignificant position on early banks' balance sheets. Instead, as Table 3.7 indicates, the preponderance of the banks' liabilities consisted of shares of their own capital stock. This pattern contrasts sharply with that of modern banks. Today such securities account typically for only a minuscule part of total liabilities – a few percentage points at most.[4]

Finally, early-nineteenth-century banks had very different management structures from modern ones. Large banks today have extensive managerial hierarchies consisting of professionals who are responsible for their day-to-day operations. Early banks, by contrast, had only a few salaried workers. The largest might employ a cashier (the effective head of operations), several tellers and clerks, and perhaps a bookkeeper. The smallest might employ only a cashier. Regardless of size, the real managers of an

a few cases, is to look at who actually benefited from the discount. If the proceeds went to the note's endorser, the note was most likely commercial paper. On the other hand, if the proceeds went to the principal, the note was most likely accommodation paper. By this measure, 84% of the notes outstanding at the Eagle Bank of Bristol, R.I., in October 1818 were accommodation paper. Discount Book, 1818–24, Eagle Bank, Fleet National Bank Archives.

The other way to estimate the proportion of accommodation paper is to look for loans denominated in round numbers, on the presumption that commercial paper represented actual transactions and therefore was likely to be in odd amounts. The overwhelming majority of notes in the portfolios of banks from this period were denominated in round numbers. For examples, see Discount Book, 1820–34, New England Commercial Bank, Newport, R.I., Mss. 781, Baker Library, Harvard Graduate School of Business Administration; list of Notes, Jan. 1, 1824, Concord (N.H.) Bank, Mss. 1989–011, Box 5, Folder 7, New Hampshire Historical Society; and list of Notes, Dec. 20, 1842, in Directors' and Stockholders' Minute Book, 1815–85, Pawtuxet Bank, Warwick, R.I., Rhode Island Historical Society Manuscript Collections.

4. Some scholars have suggested that early banks' capital stock was largely fictitious, but, as I will argue in Chapter 1, this was true only during the initial years of a bank's existence.

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early-nineteenth-century bank were its directors, one of whom was chosen by the others to act as president. Although the president was sometimes paid a small salary, the directors typically received no remuneration at all for their services. Nevertheless, they were responsible for such important managerial functions as verifying the cashier's accounts, deciding how much money the bank could afford to lend, and, most significantly, deciding who should receive the loans.

As Chapter 1 will demonstrate, an examination of bank records, government investigations, and other sources from the early nineteenth century reveals that directors often funneled the bulk of the funds under their control to themselves, their relatives, or others with personal ties to the board. Though not all directors indulged in this behavior, insider lending was widespread during the early nineteenth century and most conspicuously differentiates early banks from their twentieth-century successors. Modern banks engage in insider lending to some extent, of course, but the practice is neither as pervasive nor as fundamental a part of banking operations as it was then. Indeed, it is my contention that insider lending is the key to understanding New England's early-nineteenth-century banking system; it is the crucial piece of the puzzle that enables us to arrange the banks' other distinctive features in a coherent pattern.

In a developing economy, such as early-nineteenth-century New England's, where capital was scarce and therefore expensive, control of a bank yielded obvious advantages in gaining access to credit. Once it became apparent, as one pamphleteer put it, "that *Bank Directors* had priority of claim in the dispensation of bank favors, . . . then it was that others, less fortunate, conceived the idea that it was a very happy thing to participate in the control of a bank."[5] Shrewd entrepreneurs, eager to use banks as vehicles to accumulate capital for their own ventures, and especially eager for the accommodation loans that banks could extend to their favorites, put enormous pressure on state legislatures to charter additional banks. The politics of the Jacksonian era made it difficult to resist such demands for long, and the region was soon inundated by large numbers of small unit banks – for the most part operated by, and in the interests of, their directors.

There was nothing underhanded or deceptive about the personal use to which bank directors put these institutions. The fact that banks lent so large a proportion of their funds to insiders was common knowledge at the time: legislators investigated the practice; journalists reported on it;

5. Henry Williams (A Citizen of Boston, pseud.), *Remarks on Banks and Banking; and the Skeleton of a Project for a National Bank* (Boston: Torrey & Blair, 1840), 13–14.

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and pamphleteers occasionally debated it. Nevertheless, investors willingly bought up large quantities of bank stock during this period, in large measure because insider lending greatly increased the stock's attractiveness. Investors knew that when they bought stock in a bank they were actually investing in the diversified enterprises of that institution's directors. Investment in bank stock, consequently, was a way in which ordinary savers could participate in the activities of the region's most prominent entrepreneurs – and could do so without exposing themselves to serious risk. Although we call these early-nineteenth-century institutions banks, in actuality they functioned more like investment clubs. As such, moreover, they proved to be extraordinarily effective vehicles for channeling savings into economic development.

This in brief is the argument I develop over the course of the first three chapters of the book. Chapter 1 traces the early history of the banking system, documenting the pervasiveness of insider lending and describing the sequence of financial manipulations that allowed groups of men with only limited resources to found banks and turn them into vehicles for accumulating capital. Chapter 2 takes up the subject of attitudes toward the practice of insider lending during the Jacksonian period. I argue that insider lending provoked general opposition only to the extent that banks were defined as public institutions. As the number of banks multiplied during the 1820s and 1830s, they came increasingly to be viewed as private entities with the prerogative of lending to insiders if they so desired. In the aftermath of the Panic of 1837, when public faith in the soundness of the banking system was at a low ebb, there was a flurry of legislation limiting the proportion of capital that banks could lend to their directors. This legislation did little to curb insider lending, however, and the practice continued to be an important aspect of banking operations when the economy emerged from depression during the late 1840s.

Chapter 3 argues that the failure to regulate insider lending had few or no adverse consequences for the economy as a whole, because other aspects of the banking system minimized the potentially pernicious effects of the practice. Insider lending necessarily resulted in discrimination in the credit markets, but the tremendous expansion in the number of banks that occurred during these years largely offset this effect. Similarly, though insider lending could in theory undermine a bank's soundness, the low level of leverage that characterized most early banks (that is, the low ratio of notes and deposits to total liabilities) operated to prevent most failures. Stockholders, of course, bore the brunt of any losses that the practice inflicted, but directors had powerful incentives to keep the level of risk low. Anxious to maintain the unsullied character of their reputations (which were essential for business success during this period) and also to

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preserve the health of their golden goose, directors carefully monitored each other's borrowing to prevent the kinds of excesses that might damage them all. Reassured by this vigilance and by the high and steady earnings that bank stock typically yielded during these years, investors poured large sums of money into banks, in the process fueling the region's economic growth and development.

The last three chapters of the book analyze the processes that transformed this early-nineteenth-century banking system into something more like the one we are familiar with today. As the century progressed and the region's credit markets continued to evolve, banks came to function less like investment clubs and more like strictly commercial institutions. Economic development was itself a source of change: as the economy expanded and additional banks and other financial institutions were founded, New England was transformed from a capital-scarce region into a capital-rich one. Once credit became more abundant, control of a bank became less necessary for access to loans, and as a result insider lending gradually began to decline. Not that it completely disappeared – some insiders were still monopolizing the bulk of their banks' loans as late as the 1890s – but, in general, the practice was becoming less common.

Chapter 4 documents this shift as well as the downward trend in earnings that afflicted the region's banks beginning in the mid 1870s. Although the drop in earnings was largely a result of an overpopulation of banks in the region, it operated to stimulate further changes in lending behavior. As bankers tried desperately to reduce their losses from bad loans, they developed new standards for evaluating the creditworthiness of borrowers. These standards, in turn, fostered an ethic of professionalism that ran counter to the values that had originally sustained insider lending. At the same time, declining earnings also encouraged bankers to take more aggressive measures to solicit deposits, causing leverage ratios to rise sharply.

As Chapter 5 argues, this rise in deposits increased banks' interdependence and vulnerability to runs, and hence made insider lending appear more dangerous than it had looked earlier in the century. The root of the problem was that depositors had no way of obtaining reliable information concerning the contents of banks' loan portfolios. If one bank collapsed as a result of excessive borrowing by insiders, depositors might rush to withdraw their funds from other institutions as well, fearing that all of them were similarly endangered.

Bankers responded to this potential danger by attempting to eliminate the kinds of excesses that could trigger such episodes in the first place. In particular, they sought to prevent opportunistic behavior on the part of directors by promoting new lending standards that could be monitored

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easily by conscientious stockholders and directors. In this endeavor they were vigorously assisted by an energetic group of professionals (career bank employees, trade-journal publicists, and government regulators) interested in advancing their own positions within the banking community. The end result of their combined efforts was a much narrower definition of the proper scope of banking operations – a definition that effectively restricted a bank's business to commercial lending pure and simple. To the extent that banks adopted the new standards, then, they came to play a much more limited role in economic development than had been true of their early-nineteenth-century predecessors.

In the meantime, the earnings of the banking sector continued to decline. As Chapter 6 explains, by the end of the century falling profit rates finally instigated a movement to combine many of the region's small banks into much larger agglomerations of capital. Significant numbers of mergers occurred only in Boston and Rhode Island, but there they had dramatic effects, substantially reducing the number of banks while greatly increasing the average size of the remaining institutions. More important, as the new financial giants gravitated toward hitherto unexplored areas of national finance, they applied the new professional lending standards more rigorously in their everyday banking business. The net result was to make it more difficult for entrepreneurs, especially in new manufacturing industries, to obtain access to credit in the region. Banks' conservative lending practices thus had the effect of exacerbating the economy's dependence on the continued profitability of the industries of the first industrial revolution.

Widespread insider lending was not unique to the early-nineteenth-century New England economy. There is substantial evidence that banks in other parts of the United States engaged in similar types of lending behavior during this period. Bray Hammond has pointed out, for example, that merchants throughout the Northeast "clubb[ed] a capital together" in order to supply each other with discounts. Fritz Redlich has observed that favoritism in lending was widespread throughout the early years of the century and that the Bank of North America had been "all but crippled" during the 1790s because a few powerful borrowers had monopolized its funds. Similarly, the recent history of New York's Citibank, compiled by Harold van B. Cleveland and Thomas F. Huertas, recounts the bank's transformation during the 1840s from "a kind of credit union for its merchant-owners" into a "treasury" for Moses Taylor's far-flung business empire. The South Carolina planter James Henry Hammond remarked frequently in his diary that the business interests of

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Franklin Harper Elmore and other officers and directors of the Bank of the State of South Carolina were supported by loans from the bank, and similar references to insider lending are sprinkled through Larry Schweikart's voluminous scholarly work on southern banking.[6]

Outside the United States the story was much the same. Recent studies of British banking have uncovered close links between local banks and businessmen resembling those in New England. C. W. Munn has shown that Scottish provincial banks during the late eighteenth century were primarily "self-help" associations for merchants in need of credit, and P. L. Cottrell has discovered that industrialists made similar use of local banks in mid-nineteenth-century England. It hardly seems necessary to refer the reader to the voluminous literature documenting the interrelationships between banks and industrialists in Germany and elsewhere on the European continent. Nor to the equivalent literature on developing countries, with its frequent references to the "group" form of enterprise – that is, to kinship-based networks whose diversified business ventures were and are supported and controlled with the help of captive banks.[7]

6. Bray Hammond, "Long and Short Term Credit in Early American Banking," *Quarterly Journal of Economics*, 49 (November 1935), 79–103; Redlich, *The Molding of American Banking*, 11; Harold van B. Cleveland and Thomas F. Huertas, *Citibank: 1812–1970* (Cambridge: Harvard University Press, 1985), 5–31; Carol Bleser, ed., *Secret and Sacred: The Diaries of James Henry Hammond, a Southern Slaveholder* (New York: Oxford University Press, 1988), 162, 163–4, 220; Larry Schweikart, *Banking in the American South from the Age of Jackson to Reconstruction* (Baton Rouge: Louisiana State University Press, 1987), 190–224, and "Entrepreneurial Aspects of Antebellum Banking," in *American Business History: Case Studies*, ed. Henry C. Dethloff and C. Joseph Pusateri (Arlington Heights, Ill.: Harlan Davidson, 1987), 122–39.
7. C. W. Munn, "Scottish Provincial Banking Companies: An Assessment," *Business History*, 23 (March 1981), 19–41; P. L. Cottrell, *Industrial Finance, 1830–1914: The Finance and Organization of English Manufacturing Industry* (London: Methuen, 1980), 210–36; Richard Tilly, *Financial Institutions and Industrialization in the Rhineland, 1815–1870* (Madison: University of Wisconsin Press, 1966); Rondo Cameron, ed., with the collaboration of Olga Crisp, Hugh T. Patrick, and Richard Tilly, *Banking in the Early Stages of Industrialization: A Study in Comparative Economic History* (New York: Oxford University Press, 1967); Holger L. Engberg, *Mixed Banking and Economic Growth in Germany, 1850–1931* (New York: Arno, 1981); Hans Pohl, "Forms and Phases of Industry Finance up to the Second World War," *German Yearbook on Business History* (1984), 75–94; Nathaniel H. Leff, "Entrepreneurship and Economic Development: The Problem Revisited," *Journal of Economic Literature*, 17 (March 1979), 46–64, and "Industrial

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My point in focusing on New England is not to claim that insider lending was uniquely important there but rather that any such phenomenon needs to be understood in the context of the particular social and cultural environment in which it is imbedded. Just as the functions of banks have varied from one time and place to another, so too have the consequences of insider lending. In many developing countries, for example, this type of lending has had pernicious results. Practiced by banks with a substantial degree of monopoly power, it has served to reduce competition and has thus had a constraining effect on economic growth. In still other cases (including certain parts of New England in recent years), large loans to insiders have undermined the soundness of some banks and jeopardized the health of the local financial system.[8]

By contrast, insider lending as practiced in early-nineteenth-century New England seems to have had a much more salutary effect. The purpose of this study is to explore the reasons why, and in the process to develop a general understanding of the conditions under which banks are likely to play a positive role in economic development. It is my contention that whenever banks maintain a strictly arm's-length relationship with their customers they tend to avoid the risks involved in financing entrepreneurial ventures. When entrepreneurs themselves control banks, this reluctance naturally disappears, but insider lending can itself become a potential source of instability in the economy. In New England's case, however, this problem seems to have been minimized by a combination of easy entry into banking and an incentive structure that encouraged insiders to monitor each other's borrowing. Ironically, however, the system's very success in fostering economic development eliminated the conditions that supported it. Insider lending declined, and banks simultaneously retreated from their active role in supporting investment within the region.

New England is a particularly good place to conduct this kind of study,

Organization and Entrepreneurship in the Developing Countries: The Economic Groups," *Economic Development and Cultural Change*, 26 (April 1978), 661–75.

8. For examples, see Stephen H. Haber, "Industrial Concentration and the Capital Markets: A Comparative Study of Brazil, Mexico, and the United States, 1830–1930," *Journal of Economic History*, 51 (September 1991), 559–80; Nathaniel H. Leff, "'Monopoly Capitalism' and Public Policy in Developing Countries," *Kyklos*, 32 (1979), 718–38; Vartan Gregorian, "*Carved in Sand*"*: A Report on the Collapse of the Rhode Island Share and Deposit Indemnity Corporation* (Providence: Brown University, 1991); Stephen Pizzo, Mary Fricker, and Paul Muolo, *Inside Job: The Looting of America's Savings and Loans* (New York: McGraw-Hill, 1989).

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because the combination of rapid industrialization and a well-developed banking system permits us to explore the relationship between the two. Because, moreover, the banking systems of the various regions of the United States differed from one another in other significant respects, there is good reason to confine this study to New England. In the first place, the regulatory environment in which New England banks operated was unlike that of other regions. At a time when states elsewhere, especially in the Mid Atlantic and Old Northwest, were developing general incorporation laws for banking, the New England states continued to charter banks by special legislative act. At a time when many southern and midwestern states were allowing banks to operate branches, New England remained a region of small unit banks. Similarly, at a time when states like New York and Ohio were experimenting with safety funds and coinsurance schemes, New England continued to rely on the Suffolk system, a private system of note redemption enforced by the largest Boston banks, to keep the region's banking system sound. The balance sheets of New England banks also differed in systematic ways from those of banks in other parts of the country. New England banks, for example, raised a larger proportion of their resources from the sale of capital stock than banks elsewhere. The ratio of deposits and currency to capital for New England banks averaged 69 percent in 1860, as opposed to 114 to 149 percent for banks in other regions of the country. Nevertheless, New England banks were able to supply their communities with more bank money (that is, deposits plus banknotes) per capita than were their counterparts elsewhere. They were also more stable than banks in other parts of the United States.[9]

One final point. Because I am interested in the relationship between banks and economic development, I have focused my attention on the industrial parts of the region: the more or less continuous belt of manufacturing that runs from Rhode Island and eastern Massachusetts to southern New Hampshire and southern Maine.

9. Massachusetts and Connecticut passed general incorporation laws for banks in the early 1850s, but very few banks were chartered under them. Hugh T. Rockoff, "Varieties of Banking and Regional Economic Development in the United States, 1840–1860," *Journal of Economic History*, 35 (March 1975), 160–77; Fenstermaker, *The Development of American Commercial Banking*, 13–29, 77–82; Charles W. Calomiris and Larry Schweikart, "Was the South Backward? North–South Differences in Antebellum Banking During Normalcy and Crisis," unpub. paper, 1988; Sylla, *The American Capital Market*, 249–52; Kenneth Ng, "Free Banking Laws and Barriers to Entry in Banking, 1838–1860," *Journal of Economic History*, 48 (December 1988), 877–89.

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