Free and Wildcat Banking

1837–1862: "Free Banking" Era

In this period, only state-chartered banks existed. They could issue bank notes against specie (gold and silver coins) and the states heavily regulated their own reserve requirements, interest rates for loans and deposits, the necessary capital ratio etc. These banks had existed since 1781, in parallel with the Banks of the United States. The Michigan Act (1837) allowed the automatic chartering of banks that would fulfill its requirements without special consent of the state legislature. This legislation made creating unstable banks easier by lowering state supervision in states that adopted it. The real value of a bank bill was often lower than its face value, and the issuing bank's financial strength generally determined the size of the discount. By 1797 there were 24 chartered banks in the U.S.; with the beginning of the Free Banking Era (1837) there were 712.

During the free banking era, the banks were short-lived compared to today's commercial banks, with an average lifespan of five years. About half of the banks failed, and about a third of which went out of business because they could not redeem their notes. (See also "Wildcat banking".)

During the free banking era, some local banks took over the functions of a central bank. In New York, the New York Safety Fund provided deposit insurance for member banks. In Boston, the Suffolk Bank guaranteed that bank notes would trade at near par value, and acted as a private bank note clearinghouse.

Privately issued note, 1863

Wildcat banking

From Wikipedia, the free encyclopedia

Wildcat banking refers to the unusual practices of banks chartered under state law during the periods of non-federally regulated

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state banking between 1816 and 1863 in the United States, also known as the Free Banking Era. This era, commonly described as an example of free banking, was not a period of true free banking, as banks were free of only federal regulation; banking was regulated by the states. The actual regulation of banking during this period varied from state to state.

According to some sources, the term came from a bank in Michigan that issued private paper currency with the image of a wildcat. After the bank failed, poorly backed bank notes became known as wildcat currency, and the banks that issued them as wildcat banks. However, according to others, wildcat meant a rash speculator as early as 1812, and by 1838 had been extended to any risky business venture. A common conception of the wildcat bank in Westerns and like stories was of a bank that left its safe somewhat ajar for depositors to see, in which the banker would display a barrel full of nails, grain or flour with a thin sprinkling of cash on top, thus fooling depositors into thinking it was a successful bank.

The traditional view of wildcat banks describes them as distributing nearly worthless currency backed by questionable security (such as mortgages and bonds). These actions ended when note circulation by state banks was stopped after the passage of the National Bank Act of 1863. Mark Twain, in his autobiography, refers to the use of such currency in 1853, "The firm paid my wages in wildcat money at its face value"

Before the establishment of the Federal Reserve System in 1913, banks extended loans by issuing notes. An individual may take his promissory notes or bills of exchange to the bank for discount. Banks would issue their own bank notes to the borrowers. Bank notes were usually backed by specie or government bonds. The holder of the bank note had a claim on the bank's assets. The overwhelming determinate of value on a bank's notes would be the quality of that bank's assets. Many of the states regulations required for the banks to back their notes with state bonds. Banks in states that had safe bonds would thrive whereas banks in states that had risky bonds would suffer. Of course other factors could influence the value of a bank note, the major secondary cause would be the likelihood of fraud, either from the bank or from forgery

Many varieties of money different banks traded at different discounts to their face value. Lists were published to help bankers and others to identify and appraise the bills (and forgeries). One of the major causes of discounting occurred due to the real cost of transferring the notes to the original bank