Banking Before The Fed

by Steve Brown

It is the 100th birthday of the Federal Reserve and the story of how the US got its central bank is pretty interesting. Just before Christmas in 1913, Congress created the Federal Reserve. There were a number of attempts to create a universal currency and banking system prior to 1913, but no consensus was achieved until chaos had reigned for some time.

The US first printed paper money in 1775 and continued through 1791 in order to finance the American Revolution. Those notes, called "continentals" were issued in such quantity as the war progressed that they became worthless--it was not a great start. In 1791, Treasury Secretary Alexander Hamilton urged Congress to form the First Bank of the United States in Philadelphia, marking the first attempt at a central bank in the US. The bank had a 20Y charter which Congress failed to renew by one vote in 1811, as agrarian constituents were uncomfortable with the idea of a large bank-controlled institution. The year 1816 then brought about the Second Bank of the United States, but in 1828 Andrew Jackson was elected president, and as a central bank foe he vowed to kill it. In 1836, the Second Bank's charter was also not renewed.

From 1836 through the Civil War, state chartered and "free banks" issued their own paper which could be redeemed in gold or specie (coins). Subsequently, a series of financial crises rolled through the country beginning with the Panic of 1837. After the dissolution of the Second Bank, state banks relaxed lending standards and did not maintain safe reserve ratios. In addition, the closing of the central bank caused the transfer of specie away from the main commercial centers on the east coast. With fewer monetary reserves in their vaults, banks had to scale back loans and in the end stopped repaying notes at full value. Many individual states defaulted on their bonds and for a time the US had to withdraw from international markets.

During this time when banks failed there was no FDIC to guarantee deposits, so depositors rushed to other banks to withdraw their funds, causing further bank collapses--the result was a recession that lasted for some 7Ys. The Panic of 1837 was only the beginning, and the US suffered numerous banking implosions in the run-up to the Civil War and afterwards. Given this history it is somewhat remarkable that deposit insurance did not come about until 1933.

While free banks were issuing their own currency, there was not enough other currency circulating to carry out business. Minted coins were the legal tender and their value was based on the amount of metal in the coin regardless of where it was minted. Many foreign coins were used, especially those from Mexico. During the Civil War, the National Banking Act of 1863 established a stable US currency by providing circulating notes backed by US government securities. The act also required taxation on state bank notes but not national bank notes, thereby creating a uniform currency. Free bank notes continued to flourish from the period after the Civil War through 1907, but their value was only worth the reputation of the issuing institution and the result was numerous bank runs and financial panics.

There was a growing consensus that the US banking system needed serious attention and in 1907, the US was the last major country without a central bank....Chapter II tomorrow.

BANK NEWS

Earnings

Bank of America reported full year net income of $11.4B, up 173% from 2012. Other metrics on a year over year (YOY) basis: ROA 0.53% (+179%); ROE 7.13% (+174%); efficiency ratio 77.1% (-10%); revenue (+4%); loans (+2%); NIM 2.47% (+5%); allowance to loans 2.78% (+42%); loans to small business customers $13.3B (+6%); active online customers 30.0mm (+1%); active mobile customers 14.4mm (+20%); ATMs 16,259 (-1%); branches 5,151 (-6%) and FTE employees 242,117 (-9%).

Crackdown Possible

The CFPB is reportedly looking at how financial product and service providers advertise to consumers. As part of the review, the CFPB said it found direct marketing happened most often through internet display and search (44%), direct mail (22%), direct response TV advertising (16%), direct response print ads (8%) and social networking (4%). Banks should review how they advertise through these and other channels to ensure they don't get sidewise with regulators given this focus.

Data Usage Warning

Bankers should note a story in the Wall Street Journal that indicates regulators are concerned lenders may be using social media sites to help determine borrower identity and creditworthiness. Regulators are monitoring things here, so bankers should prepare for more scrutiny around underwriting processes that include such data, with a focus on unfair credit denials, consumer privacy issues or higher interest rates based on social-media presence.

Small Biz

Intuit reports hiring at small businesses with less than 20 employees ticked higher in the final 2 months of the year. Overall, these businesses are up 2.8% from the recession low point to now vs. a 7.0% increase for private payrolls.

Costs Rising

The US Postal Service will raise the cost of 1st class letter stamps from 46 cents to 49 cents effective Jan 26. Meanwhile, bulk mail rates are rising 6% and first class packages are rising 5%.

Tapering Path

The FOMC minutes show members seem comfortable with a gradual tapering path that would reduce asset purchases at a $10B pace per meeting (would end in the second half of 2014).