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Why Supervise Banks? The Foundations of the American Monetary Settlement

Lev Menand
Columbia Law School, lmenand@law.columbia.edu

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*Lev Menand**

Administrative agencies are generally designed to operate at arm's length, making rules and adjudicating cases. But the banking agencies are different: they are designed to supervise. They work cooperatively with banks and their remedial powers are so extensive they rarely use them. Oversight proceeds through informal, confidential dialogue.

Today, supervision is under threat: banks oppose it, the banking agencies restrict it, and scholars misconstrue it. Recently, the critique has turned legal. Supervision's skeptics draw on a uniform, flattened view of administrative law to argue that supervision is inconsistent with norms of due process and transparency. These arguments erode the intellectual and political foundations of supervision. They also obscure its distinguished past and deny its continued necessity.

This Article rescues supervision and recovers its historical pedigree. It argues that our current understanding of supervision is both historically and conceptually blinkered. Understanding supervision requires understanding the theory of banking motivating it and revealing the broader institutional order that depends on it. This Article terms that order the "American Monetary Settlement" ("AMS"). The AMS is designed to solve an extremely difficult governance problem—creating an elastic money supply. It uses specially chartered banks to create money and supervisors to act as outsourcers, overseeing the managers who operate banks.

Supervision is now under increasing pressure due to fundamental changes in the political economy of finance. Beginning in the 1950s, the

* Academic Fellow and Lecturer in Law, Columbia Law School. Thanks to Ash Ahmed, John Crawford, Christine Desan, Jeff Gordon, David Grewal, Michael Heller, Daniel Herz-Roiphe, Bob Hockett, Kate Judge, Robert Katzmann, Jeremy Kessler, Jeremy Kress, Jed Lewinsohn, Da Lin, Yair Listokin, Jon Macey, Jane Manners, Jamie McAndrews, Gillian Metzger, Robert Miller, Saule Omarova, Robert Post, Jed Purdy, Sarah Bloom Raskin, Morgan Ricks, Reuel Schiller, Dan Schwarz, Ganesh Sitaraman, Joe Sommer, Dan Tarullo, Rory Van Loo, Art Wilmarth, David Zaring, Josh Zoffer, and workshop participants at Columbia, U.C. Hastings, and George Mason for many helpful comments and suggestions. Thanks also to support from the Gray Center for the Study of the Administrative State and to the exceptional editors of the *Vanderbilt Law Review*.

government started to allow nonbanks to expand the money supply, devaluing the banking franchise. Then, the government weakened the link between supervision and money creation by permitting banks to engage in unrelated business activities. This transformation undermined the normative foundations of supervisory governance, fueling today's desupervisory movement. Desupervision, in turn, cedes public power to private actors and risks endemic economic instability.

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INTRODUCTION

Administrative agencies are usually designed to operate at arm's length, enforcing broad statutory principles through formal legal proceedings and making generally applicable rules following public notice and comment. In practice, many agencies also operate informally, relying on guidance—nonbinding, rule-like statements of general applicability—to accomplish their statutory goals.[1] But the federal banking agencies—the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System ("Fed"), and the Federal Deposit Insurance Corporation ("FDIC")—are different. They were *designed* to operate informally; they "supervise."[2]

Supervision is a form of governance distinct from rulemaking, adjudication, and guidance. It proceeds through iterative, ongoing, firm-specific engagement.[3] In the case of banks, supervision is the product of statutory provisions granting the OCC, Fed, and FDIC capacious approval powers,[4] monitoring rights,[5] and remedial

1. *See, e.g.*, Nicholas R. Parrillo, *Federal Agency Guidance and the Power to Bind: An Empirical Study of Agencies and Industries*, 36 YALE J. ON REGUL. 165 (2019) (examining the role of guidance); *see also* Rory Van Loo, *Regulatory Monitors: Policing Firms in the Compliance Era*, 119 COLUM. L. REV. 369, 384–86 (2019) (examining how agencies exercise discretion in deciding when and how to enforce the law); Christopher J. Walker, *Administrative Law Without Courts*, 65 UCLA L. REV. 1620 (2018) (examining seven categories of administrative activity largely insulted from judicial review); Todd D. Rakoff, *The Choice Between Formal and Informal Modes of Administrative Regulation*, 52 ADMIN. L. REV. 159 (2000) (examining the use of guidance and assessing its causes and effects).

2. *See Guidance, Supervisory Expectations, and the Rule of Law: How Do the Banking Agencies Regulate and Supervise Institutions?: Hearing Before the S. Comm. on Banking, Hous. & Urb. Affs.*, 116th Cong. 6 (2019) [hereinafter *Guidance, Supervisory Expectations, and the Rule of Law*] (statement of Margaret E. Tahyar, Partner, Davis Polk & Wardwell LLP) ("Many sectors of the economy today are regulated, but only the banking sector is also supervised."); Indep. Bankers Ass'n of Am. v. Heimann, 613 F.2d 1164, 1168 n.13 (D.C. Cir. 1979) (explaining that banks are subject to the "most intensive supervision" of any industry). This Article focuses on national banks supervised by the OCC, bank holding companies and state "member" banks supervised by the Fed, and state "nonmember" banks supervised by the FDIC. It refers to them collectively as "banks." The analysis could be extended to federal savings and loan associations, which are a special type of bank also supervised by the OCC. *See* 12 U.S.C. § 5412. This Article does not treat the Consumer Financial Protection Bureau ("CFPB") as a banking agency. Congress created the CFPB in 2010 to eliminate predatory practices at bank and nonbank lenders. *See* Adam J. Levitin, *The Consumer Financial Protection Bureau: An Introduction*, 32 REV. BANKING & FIN. L. 321 (2013).

3. *See infra* notes 29, 56.

4. The agencies decide if banks can commence business, *see* 12 U.S.C. §§ 26-27 (national banks), *id.* § 1815 (insured state nonmember banks), *id.* § 321 (state member banks); alter their capital structures, *see id.* §§ 51a, 51b, 57, 59 (national banks); or expand their activities, *see id.* §§ 21, 24 (national banks), *id.* § 1844 (bank holding companies), *id.* § 1831a (insured state banks). They can also veto mergers and acquisitions, *id.* § 215 (national banks), *id.* §§ 1842, 1850 (bank holding companies), and place banks into receivership outside of the bankruptcy process (without notice or a hearing), *id.* § 191 (national banks), *id.* § 1821 (insured banks).

5. The agencies can review books and records, administer oaths, take testimony, subpoena witnesses, and shield the examination process from public disclosure. *See id.* § 481 (national

authorities.[6] For example, the agencies can discipline banks not only when bankers break express legal rules, but whenever, "*in the opinion of* [the agencies]," bankers are engaging in, have engaged in, or the agencies reasonably believe are about to engage in "unsafe or unsound practice[s]."[7] Rather than specify what sort of practices are "unsafe" or "unsound," Congress authorized the agencies to "define and eliminate" them.[8] And the courts have held that the "discretionary authority" of the agencies to do this "is to be liberally construed."[9]

But unlike the National Labor Relations Board,[10] Federal Trade Commission,[11] or other government bodies that apply similar standards ex post to specific circumstances, the banking agencies—by design—almost never end up in court.[12] Instead, they sort things out privately, sharing their safety and soundness concerns through routine communications and confidential letters known as "matters requiring attention" ("MRAs").[13] For large banks, this dialogue is continuous, with agency examiners working, day in and day out, at offices and desks

banks); *id.* § 483 (member banks); *id.* § 1844(c) (bank holding companies); *id.* § 1820(b) (insured banks); *id.* § 1818(n); *infra* note 96 (citing regulations deeming supervisory work product government property).

6. The agencies can direct banks to claw back bonuses, halt dividends, and divest assets. 12 U.S.C. § 1818(b). They can also levy fines and trigger criminal penalties. *Id.* § 1818(i) (civil money penalties for insured banks); *id.* § 1818(j) (criminal sanctions for insured banks); *id.* § 93(b) (civil money penalties for national banks). And they can terminate deposit insurance coverage, *id.* § 1818(a); revoke charters, *id.* § 93(a); deny access to government loans, *id.* § 347b(b)(4); and remove bank executives from office, *id.* § 1818(e).

7. *Id.* § 1818(b) (emphasis added); *see also id.* § 1831p-1 (enabling rulemaking). In the case of cash advances, even this finding is not required; the Fed can cut banks off for no reason at all. *Id.* § 347b(b)(4); *see also supra* note 6.

8. Indep. Bankers Ass'n of Am. v. Heimann, 613 F.2d 1164, 1169 (D.C. Cir. 1979). Congress expects courts to defer to the agencies whenever a bank "has been harmed or the interests of the depositors have been prejudiced without requiring the agencies to quantify the harm or prejudice." H.R. REP. NO. 101-222, at 439 (1989) (Conf. Rep.) (for the Financial Institutions Reform, Recovery, and Enforcement Act); *see also* MCorp Fin., Inc. v. Bd. of Governors Fed. Rsrv. Sys., 900 F.2d 852, 862 (5th Cir. 1990) ("[T]he phrase 'unsafe or unsound banking practice' is widely used in the regulatory statutes and in case law, and one of the purposes of the banking acts is clearly to commit the progressive definition and eradication of such practices to the expertise of the appropriate regulatory agencies." (quoting Groos Nat'l Bank v. Comptroller of Currency, 573 F.2d 889, 897 (5th Cir. 1978))).

9. *Indep. Bankers Ass'n*, 613 F.2d at 1168–69. *See also* Bank of Am. Nat'l Tr. & Sav. Ass'n v. Douglas, 105 F.2d 100, 104 (D.C. Cir. 1939) (describing the comptroller's power over national banks as "plenary").

10. National Labor Relations Act § 10, 29 U.S.C. § 160 (empowering the National Labor Relations Board to combat "unfair labor practices").

11. Federal Trade Commission Act § 5, 15 U.S.C. § 45 (empowering the Federal Trade Commission to combat "unfair methods of competition").

12. *See In re* Subpoena Served Upon the Comptroller of the Currency, 967 F.2d 630, 634 (D.C. Cir. 1992) ("It is the very rare dispute, however, that culminates in any formal action . . . .").

13. Thomas Eisenbach, Andrew Haughwout, Beverly Hirtle, Anna Kovner, David Lucca & Matthew Plosser, *Supervising Large Complex Financial Institutions: What Do Supervisors Do?*, 23 FED. RSRV. BANK N.Y. ECON. POL'Y REV. 57, 72–73 (2017).

inside the bank.[14] In the words of the Court of Appeals for the District of Columbia Circuit, the supervisory relationship is "extensive and informal":

> It is extensive in that bank examiners concern themselves with all manner of a bank's affairs . . . . [And it] is informal in the sense that *it calls for adjustment, not adjudication*. In the process of comment and response, the bank may agree to change some aspect of its operation or accounting . . . [but it] is the very rare dispute . . . that culminates in any formal action . . . .[15]

Even the internal appeals mechanism is barely used.[16]

This mode of governance—continuous and confidential comment and response geared toward "safety and soundness"—is now under pressure. Beginning in the late 1990s and early 2000s, the banking agencies unilaterally disarmed, rolling back their oversight of bank business practices and adopting permissive bright-line rules focused on shareholder equity levels.[17] Agency leaders argued that shareholders would be better stewards of safety and soundness and that government officials and agency staff were not capable of understanding the risks banks were taking.[18]

The result was the worst financial crisis since the Great Depression. Amid the fallout, legislators were indignant. Where were the supervisors?[19] The agencies reversed course. President Obama appointed new officials, including Dan Tarullo at the Federal Reserve. Governor Tarullo and his colleagues revived traditional oversight and developed an innovative stress testing program for supervising large financial conglomerates. This program allowed the Fed to control risk taking, dividend payments, and share buybacks. In the years that followed, banks strengthened their capital structures, reduced their leverage, and altered their business models.

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14. *See id.* (describing prudential supervision by the Federal Reserve); *In re* Subpoena Served Upon the Comptroller of the Currency, 967 F.2d at 633–34.

15. *In re* Subpoena Served Upon the Comptroller of the Currency, 967 F.2d at 633–34 (emphasis added).

16. Julie Andersen Hill, *When Bank Examiners Get It Wrong: Financial Institution Appeals of Material Supervisory Determinations*, 92 WASH. U. L. REV. 1101, 1105 (2015) (showing that the appeals rate is "astonishingly low").

17. *See* Lev Menand, *Too Big To Supervise: The Rise of Financial Conglomerates and the Decline of Discretionary Oversight in Banking*, 103 CORNELL L. REV. 1527, 1541–74 (2018).

18. *See id.* at 1551–74.

19. *Modernizing Bank Supervision and Regulation, Part II: Hearing Before the S. Comm. on Banking, Hous. & Urb. Affs.*, 111th Cong. 17 (2009) (Sen. Richard Shelby) ("Where were they? That is the question. . . . [Y]ou would have to give them an 'F' . . . on their ability to regulate the banks.").

But now a second "desupervisory" wave is cresting.[20] This time the critique of supervision is not that the market knows best; instead, it sounds in legal tones. Banks and their advocates argue that supervision is opaque and inconsistent with administrative law norms.[21] Troublingly, agency officials agree, citing due process and transparency to justify shifting the core of bank oversight (once again) to notice-and-comment rulemaking.[22] Thus, in the name of administrative law regularity, the Fed has largely eliminated its stress tests as a disciplining device.[23] The Fed has also announced it will put significant supervisory guidance out for comment, remove "bright lines"

20. WILLIAM K. BLACK, THE BEST WAY TO ROB A BANK IS TO OWN ONE: HOW CORPORATE EXECUTIVES AND POLITICIANS LOOTED THE S&L INDUSTRY 32 (Univ. of Tex. rev. ed. 2013) (coining the term "desupervision").

21. *See, e.g.*, *Examination of the Federal Financial Regulatory System and Opportunities for Reform*: *Hearing Before the Subcomm. on Fin. Insts. & Consumer Credit of the H. Comm. on Fin. Servs.*, 115th Cong. 44–65 (2017) (statement of Gregory Baer, President, The Clearing House Association) (criticizing stress testing, supervisory ratings, and supervisory engagement with bank boards); Margaret E. Tahyar, *Are Bank Regulators Special?*, CLEARING HOUSE, https://www.theclearinghouse.org/banking-perspectives/2018/2018-q1-banking-perspectives/articles/are-bank-regulators-special (last visited Oct. 13, 2020) [https://perma.cc/62RA-SDUF] (arguing that the "lack of transparency and tensions with the APA in the" stress tests are "just one example of many where guidance is used as a substitute for notice-and-comment rulemaking"); Letter from Gregory Baer, President, The Clearing House Ass'n, to Anne Misback, Sec'y, Bd. of Governors of the Fed. Rsrv. Sys. (Jan. 22, 2018) (supporting efforts to improve transparency of the Fed's stress testing); *see also* COMM. ON CAP. MKTS. REGUL., THE ADMINISTRATIVE PROCEDURE ACT AND THE FEDERAL RESERVE STRESS TESTS: ENHANCING TRANSPARENCY 1 (2016), https://www.capmktsreg.org/wp-content/uploads/2019/05/The-Administrative-Procedure-Act-and-Federal-Reserve-Stress-Tests-Enhancing-Transparency.pdf [https://perma.cc/A8DT-DH7H] (arguing that the Fed has not complied with the Administrative Procedure Act ("APA") in adopting stress tests); Hal Scott, *Stress Tests: Restore Compliance with the APA*, CLEARING HOUSE, https://www.theclearinghouse.org/banking-perspectives/2017/2017-q3-banking-perspectives/articles/stress-tests-apa-compliance (last visited Oct. 13, 2020) [https://perma.cc/LD9D-L3TC] ("Supervisory practices at the Federal Reserve must be reformed to restore compliance with the Administrative Procedure Act, especially for stress tests.").

22. *See, e.g.*, Randal Quarles, Vice Chair for Supervision, Fed. Rsrv. Bd. of Governors, Remarks at the Law and Macroeconomics Conference at Georgetown University Law Center: The Global Evolution of Macroprudential Regulation 12 (Sept. 27, 2019) (arguing that supervisory rollbacks are needed to "afford[ ] greater due process to the affected participants" and that the initial stress tests "dispensed with due process considerations"); Randal Quarles, Vice Chair for Supervision, Fed. Rsrv. Bd. of Governors, Remarks at the American Bar Association Banking Law Committee Meeting: Spontaneity and Order: Transparency, Accountability, and Fairness in Bank Supervision 12–14 (Jan. 17, 2020) [hereinafter Quarles, Spontaneity and Order] (making recommendations to increase regulatory fairness and transparency); *see also* U.S. DEP'T OF THE TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES: BANKS AND CREDIT UNIONS 53 (2017) (recommending that "the Federal Reserve subject its stress-testing and capital planning review frameworks to public notice and comment").

23. The Fed has released information about its proprietary models, making the tests like bright-line rules: exercises banks can game. The Fed has also reduced testing frequency and limited the consequences for poor performance. *See* Daniel K. Tarullo, *Are We Seeing the Demise of Stress Testing?*, BROOKINGS (June 25, 2020), https://www.brookings.edu/blog/up-front/2020/06/25/stress-testing/ [https://perma.cc/7M58-SSVB] ("The stress testing regime that is emerging appears little more than a compliance exercise.").

and "mandatory language," and cut back on MRAs.[24] These efforts have culminated in a joint agency rulemaking stating that supervisory guidance and engagement does not create "binding legal obligations for the public" and prohibiting agency officials from "criticiz[ing]" banks for failing to comply with it.[25] Further easing is almost certainly taking place behind closed doors.[26]

While scholars and practitioners have challenged some of these changes[27] and attacked administrative law monism on analytic grounds,[28] they have not returned to the legal, historical, and conceptual bases of supervision. Key questions about the scope of federal law, why it was designed to allow the agencies to proceed informally, and why banks may not be entitled to the same level of transparency and due process as other businesses have gone unasked. It is forgotten that the Supreme Court and leading administrative law theorists once understood bank supervision to be a distinct mode of necessary, effective, and legitimate governance.[29] Today, supervision is

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24. Quarles, Spontaneity and Order, *supra* note 22, at 15. Similar retrenchment is in evidence at the Financial Stability Oversight Council, which announced it would avoid imposing Fed supervision on nonbank financial institutions and would instead prioritize rulemaking. Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 84 Fed. Reg. 9028, 9029 (Mar. 13, 2019) (to be codified at 12 C.F.R pt. 1310).

25. Role of Supervisory Guidance, 85 Fed. Reg. 70,512, 70,514–15 (proposed Nov. 5, 2020) (to be codified at 12 C.F.R. pt. 4, 262, 303, 791, 1074).

26. *See, e.g.*, Lalita Clozel, *Banks Get Kinder, Gentler Treatment Under Trump*, WALL ST. J. (Dec. 12, 2018, 1:11 PM ET), https://www.wsj.com/articles/banks-get-kinder-gentler-treatment-under-trump-11544638267 [https://perma.cc/M3Q3-364R] (quoting the Fed's Quarles as saying that changing supervision "will be the least visible thing I do and it will be the most consequential thing I do"); Patrick Rucker, *Trump Financial Regulator Quietly Shelved Discrimination Probes into Bank of America and Other Lenders*, PROPUBLICA (July 13, 2020, 5:00 AM EDT), https://www.propublica.org/article/trump-financial-regulator-quietly-shelved-discrimination-probes-into-bank-of-america-and-other-lenders [https://perma.cc/9GBN-Z83C] (reporting that the OCC halted investigations into whether Bank of America arbitrarily denied mortgage loans to minority homebuyers).

27. *See, e.g.*, Daniel K. Tarullo, Remarks at the Americans for Financial Reform Conference on "Big Bank Regulation Under the Trump Administration": Taking the Stress Out of Stress Testing 9–10 (May 21, 2019) (arguing against watering down stress tests).

28. *See, e.g.*, Jeffrey N. Gordon, *The Empty Call for Benefit-Cost Analysis in Financial Regulation*, 43 J. LEGAL STUD. S351, S352–53 (2014) (explaining why cost-benefit analysis is ill-suited to constructive regulatory schemes like banking law); John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882, 885–89 (2015) (explaining why cost-benefit analysis is not desirable for many forms of financial regulation).

29. *See* United States v. Phila. Nat'l Bank, 374 U.S. 321, 330 (1963) (describing "[f]ederal supervision of banking" as " 'one of the most successful (systems of economic regulation), *if not the most successful*' " to which "we may owe, in part, the virtual disappearance of bank failures . . . ." (emphasis added) (quoting 1 KENNETH CULP DAVIS, ADMINISTRATIVE LAW TREATISE § 4.04, at 247 (1958))); KENNETH CULP DAVIS, ADMINISTRATIVE LAW § 44, at 157 (1951) ("The critical process in the federal control of banking is the supervising power, not adjudication or rule making. The supervising power is not and probably cannot be surrounded by formal procedural safeguards . . . ."); LEONARD D. WHITE, THE JACKSONIANS: A STUDY IN ADMINISTRATIVE HISTORY,

missing from administrative law casebooks,[30] and when the banking agencies *are* considered, their unusual informal methods are undertheorized or ignored.[31]

This Article rescues supervision, recovering its past, explaining its rationale, and defending its use. It argues that our current approach to supervision is both historically and conceptually blinkered. Understanding supervision requires understanding the theory of banking that motivated it and the broader institutional order of which it is a part. This Article terms that order the "American Monetary Settlement" ("AMS"). The AMS is a comprehensive solution to an extremely difficult governance problem—creating an "elastic" money supply (i.e., one that expands over time to support a growing economy).[32] The legislators who established the OCC, the Fed, and the FDIC believed that the power to expand the money supply was too great to leave in the hands of elected bodies and that doing so would lead to corruption, stagnation, and a debased currency. But they were also afraid to allow the power to concentrate in the hands of a few unelected executives. So, they steered a middle course by diffusing the power and constraining it as much as possible. They set up a system of chartered banks whereby anyone willing and able to comply with certain terms and conditions could apply for a charter to create money.

This system has four pillars: (1) delegation—privately owned banks, not the government, create the bulk of the money supply; (2) separation—banks cannot engage in commerce (i.e., use their monetary powers to compete in ordinary business activity); (3) open access—every community is allowed its own banks, with charters available to the general public on a nonpartisan basis; and (4) supervision—special

1829-1861, at 475 (1954) (describing "regular inspection in detail" of bank operations by official agents "with power to act" as "the only effective means of controlling" banks).

30. Today's leading casebooks, for example, do not consider banking at all even though the OCC predated the Interstate Commerce Commission by more than two decades and supervision served as a precedent for many aspects of the modern administrative state. *See, e.g.*, PETER L. STRAUSS, TODD D. RAKOFF, GILLIAN E. METZGER, DAVID J. BARRON & ANNE JOSEPH O'CONNELL, GELLHORN & BYSE'S ADMINISTRATIVE LAW: CASES AND COMMENTS (12th ed. 2017); STEPHEN G. BREYER, RICHARD B. STEWART, CASS R. SUNSTEIN, ADRIAN VERMEULE & MICHAEL HERZ, ADMINISTRATIVE LAW AND REGULATORY POLICY: PROBLEMS, TEXT, AND CASES (8th ed. 2017); JERRY L. MASHAW, RICHARD A. MERRILL, PETER M SHANE, M. ELIZABETH MAGILL, MARIANO-FLORENTINO CUÉLLAR & NICHOLAS R. PARRILLO, ADMINISTRATIVE LAW: THE AMERICAN PUBLIC LAW SYSTEM: CASES AND MATERIALS (8th ed. 2014).

31. *See infra* Section I.A (discussing the secondary literature's treatment and description of the banking agencies).

32. *Cf.* Davidson v. Lanier, 71 U.S. 447, 454 (1866) (Chase, C.J.) ("To keep [the currency] sound, and to guard it as far as possible from fluctuation, are among . . . the most difficult problems of government.").

government officials are empowered to stamp out "unsound"[33] banking and ensure that banks fulfill their public purpose.[34] Supervisors are not regulators in the classical sense. They are outsourcers. And banks are not like other private businesses. They are a form of premodern independent agency: they use private shareholders and managers to avoid monetary overissue and politicized asset allocation by the government.[35] Supervisors, in other words, do not restrict private liberty; they enhance it by keeping these "agencies" in check.

This Article proceeds in three parts. Part I.A surveys our current revisionist understanding of the banking agencies. It catalogues six scholarly accounts, each of which accepts the premise of the administrative law critique: that banks are just a type of private business entitled to the same sort of procedural protections as any other business. I call this the "licensing model." While these accounts capture important aspects of contemporary practice, they do not grapple with the unusually broad scope of federal banking agency powers or the statutory text that gives the agencies a specific, substantive mandate—to eliminate unsafe and unsound banking. Nor can they explain the fact that supervision predates many of the other institutional mechanisms the government has established to bolster the AMS including the Federal Deposit Insurance Fund (the "Fund") and the Federal Reserve's Discount Window.[36] Indeed, they obscure the special character of banking that underlies them.

Part I.B advances a theory of bank supervision grounded in banks' monetary function. It shows that banks are not just for-profit lenders. They are also a kind of mint, issuing notes and deposits designed to circulate as a medium of exchange and serve as a store of value.[37] Privately owned mints exercise what was once referred to as "delegated" authority.[38] On this view, the banking agencies do not "intervene" in private market activity; they are franchisors, designed to

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33. Soundness is a technical term that reflects the animating purpose of banking law—to create "bank money" that is equivalent to a "base" of government-issued cash or coin. The term was first adopted by New York and Ohio in the 1840s and added to federal law in 1933. *See infra* notes 185–189.

34. The degree of delegation, separation, open access, and supervision has varied since these elements were first combined 180 years ago. And the progression has not always been linear. *See infra* note 48; Parts II, III.

35. *Cf.* Cass R. Sunstein & Lawrence Lessig, *The President and the Administration*, 94 COLUM. L. REV. 1, 30 (1994) (describing the Second Bank of the United States as "the first truly independent agency in the republic's history").

36. *See infra* Part II.

37. United States v. Phila. Nat'l Bank, 374 U.S. 321, 326 (1963) ("[B]anks do not merely deal in[,] but are actually a source of, money . . . .").

38. *See infra* notes 135, 255.

charter banks and ensure that the notes and deposits they issue meet government standards. I call this the "outsourcing model."[39]

Part II shows why the outsourcing model better comports with the statutory text, legislative history, and a century and a half of agency practice at the state and federal level. Drawing on legislative archives, newspaper accounts, presidential papers, and early administrative law scholarship, Part II reveals a longstanding, durable commitment to robust discretionary oversight of banking.

First, it recovers and explicates the AMS. The AMS emerged at the state level in the 1830s following the collapse of an earlier monetary order imported from Britain. That order was characterized by the First and Second Banks of the United States—two federally chartered corporations that engendered passionate and sustained opposition. The AMS was a compromise—a way to keep the government from having to expand the money supply directly without creating overmighty citizens (like the executives who ran the First and Second Banks). It delegated monetary powers to thousands of administratively chartered banks. And to further limit the power of bankers and to manage them, it pioneered supervision—informal, technocratic, and discretionary government oversight. During the Civil War, Congress federalized the AMS, establishing the OCC to charter and oversee a system of "national banks." Legislators expected these banks to operate collectively, as a sort of "Third Bank of the United States."

In 1913, in response to a half century of monetary breakdowns, Congress strengthened the AMS by creating the Federal Reserve. Congress hoped that the Fed would coordinate national banks, extend federal oversight to state banks, and avert panics. But the Fed failed to tame state banks, and after the system collapsed in 1933, Congress again faced calls to nationalize money creation. And again, legislators chose a middle path—restoring and strengthening the key planks of the original settlement, especially supervision. They created the FDIC to explicitly backstop bank money for the first time and to subject state banks to federal regulation. And they bolstered informal discretionary oversight by authorizing the Fed to remove bank executives who failed to heed supervisory directives. The result? Individual lending decisions by banks are a matter of "private ordering," but the banking agencies are empowered to control overall risk levels and fire bankers for unsafe or unsound practices.

39. Banking, on this view, is a type of "government by contract," Jody Freeman & Martha Minnow, *Introduction: Reframing the Outsourcing Debates*, *in* GOVERNMENT BY CONTRACT 1 (Jody Freeman & Martha Minow eds., 2009), in which the contract is a corporate charter, *see* WILLIAM M. FLETCHER, 2 CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 769 (1917) ("It is well settled that the charter of a corporation is a contract between the state and the corporation.").

This hybrid system, widely lauded, was left untouched by the procedural revolution of the mid-twentieth century. In the 1940s, when policymakers sought to check excesses in the administrative state, the banking agencies, despite their "plenary" authority,[40] were given a pass.[41] The Administrative Procedure Act of 1946 ("APA"), which was the product of these reform efforts, sidestepped supervision by focusing on formal actions. And, in 1966, Congress made it *easier* for the agencies to check banks while avoiding formal proceedings by further expanding their remedial authorities.[42] For example, Congress authorized the agencies to suspend bankers without judicial process and to order bankers to cease and desist from engaging in practices the agencies judged, in their "opinion," to be "unsafe or unsound."[43]

Congress's commitment to supervision did not stop there. In the 1970s and '80s, as financial globalization transformed the economy and a new wave of reformers again reworked the administrative state, Congress doubled down on iterative, informal bank oversight, reinforcing supervisory governance in 1978, 1983, and 1989. Even in 2001, when Congress removed structural barriers separating banking from other financial activities, it strengthened supervision, adding new approval authorities tied to discretionary agency judgments about the quality of bank management.[44]

Contemporary critics are thus, in one key respect, correct: federal law locates vast power in the hands of the OCC, the Fed, and the FDIC. But it is a category error to view their exercise of this power as a form of administrative lawmaking restricting private liberty. Instead, it is more like government regulating itself[45]—which, in the case of banks, includes the private actors that the government has recruited to expand the money supply. This outsourcing rationale was embraced not just by nineteenth-century Treasury secretaries like Alexander Hamilton, Albert Gallatin, and Salmon P. Chase. Twentieth-

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40. Bank of Am. Nat'l Tr. & Sav. Ass'n v. Douglas, 105 F.2d 100, 104 (D.C. Cir. 1939).

41. *See infra* notes 280–291 and accompanying text.

42. *See infra* Section II.C.2.b.

43. *See infra* Part II. The administrative law critique of bank supervision, by contrast, is premised on a view of the relationship between the banking agencies and banks that categorizes the former as public and the latter as private. *Cf.* Rakoff, *supra* note 1, at 160 ("[A]dministrators are government functionaries, not businessmen. They are supposed to set and enforce the rules of the game, but not to cross the line that separates the public from the private as if they were playing the game themselves."). As discussed herein, bank regulation resists this dichotomy because of banks' public monetary function. *See infra* Part II.

44. *See infra* Section II.C.2.

45. As James Landis put it, when the government acts in a "proprietary" capacity, its actions are "comparable to rules prescribed by any official in a private industry." JAMES M. LANDIS, THE ADMINISTRATIVE PROCESS 21–22 (1938) (describing the Civil Service Commission, Tennessee Valley Authority, and Reconstruction Finance Corporation).

century policymakers like Franklin D. Roosevelt also saw banks as "*agencies*" of the government, "supervise[d] [by the government] to see to it that they conform to certain high standards."[46] Industry complaints about procedural protections, from this perspective, are an attempt to upset the terms of the agreement that permits bankers to wield monetary powers in the first place.[47] And the decision by government officials to turn to "market discipline" in the late 1990s, and to rulemaking today, conflicts with the basic logic of the AMS—one that recognizes the public power bankers wield.

Part III attempts to explain why, in the absence of any changes to the statutory bases of agency authority, the banking agencies have diluted supervisory methods twice in the past two decades. It rejects as incomplete explanations focused on capture. It suggests instead that the problem is structural, and it shows how changes in the theory and practice of banking law tracked deeper transformations in the political economy of finance.

Durable supervisory governance depends on more than just broad agency powers—it requires an alignment between banks and the banking agencies. This alignment faltered with the rise of "shadow banking," monetary expansion by firms without a banking charter (or corresponding oversight) and "universal banking," the entrance of banks into other business lines. Universal banking put supervisors in the position of overseeing complex businesses that the government has no special role in administering, leading to calls for the agencies to leave monitoring to market participants. At the same time, shadow banking left the agencies unable to oversee, for lack of jurisdiction, keys aspects of monetary expansion, the very function they were designed to discipline. These changes also damaged the norms that sustain the supervisor-banker relationship. Individual banks were once critical infrastructure. But today, many banks are redundant as conglomerates operate nationwide. Additionally, the largest banks, with vast legal, lobbying, and consulting resources at their disposal, are more capable of resisting supervisory direction and less vulnerable to punishment.

As long as these structural shifts persist, we can expect industry pressure and conflict between the government and large banks to continue to threaten supervisory governance. Unfortunately, with one pillar of the AMS—separations—eroded, supervision has only grown in

46. *See* Franklin D. Roosevelt, President, U.S., Remarks to the American Bankers Association 2–3 (Oct. 24, 1934) (emphasis added) (draft available from the Franklin D. Roosevelt Presidential Library, File No. 745).

47. These complaints are an example of "transparency's ideological drift": the use of transparency arguments to undermine the government's ability to check private power. David E. Pozen, *Transparency's Ideological Drift*, 128 YALE L.J. 100, 102–03 (2018).

importance. The most recent fortification of our financial system—stress tests—reflects that. Stress tests sustain what remains of the AMS. Shortsighted efforts to neuter them and to rely even more on bright line rules risk renewed instability, future bailouts, and an even more radical realignment.[48]

This Article makes several contributions. It unpacks the theoretical and historical foundations of bank supervision, a distinctive form of administrative governance. It describes the AMS and reveals how supervision was designed and strengthened in order to make the AMS politically and economically durable. It puts banking law theory and history into dialogue with administrative law.[49] It categorizes bank supervision as a type of administrative law in which the government acts as an outsourcer rather than as a regulator of private activity.[50]

48. Although the statutory bases of supervision have been strengthened time and again, all four pillars have faced pressures before. Separations were eroded in the 1910s and 1920s, and the government modified delegation and open access in the 1860s, 1910s, 1930s, and 1980s. Some configurations of the AMS delegate more control over monetary expansion to private hands, others are more weighted toward government officials. *See infra* Part II.

49. In doing so, it pursues administrative law pluralism, which is a worldview that used to be common, but has faded in recent decades. *See, e.g.*, James M. Landis, *Crucial Issues in Administrative Law – The Walter-Logan Bill*, 53 HARV. L. REV. 1077, 1080 (1940):

> Just as the architect follows different conceptions when creating a railroad station and building a hanger, the administrative agencies we have created have had both their organization and procedure shaped largely by the tasks with which they were confronted. It would be silly, for example, to build the same structure for a bank as for a railroad station; equally absurd is it to insist that the details of organization and operation of the Federal Communications Commission and the Federal Reserve Board shall be alike;

LEONARD D. WHITE, INTRODUCTION TO THE STUDY OF PUBLIC ADMINISTRATION (4th ed. 1955) (describing various administrative forms and structures from executive departments and independent regulatory commissions to government corporations); Richard B. Stewart, *The Reformation of American Administrative Law*, 88 HARV. L. REV. 1667, 1670 n.5 (1975) (emphasizing the importance of differences in agency forms and structures). For an example of contemporary pluralism that is also applicable to bank supervision, see Charles Sabel, Gary Herrigel & Peer Hull Kristensen, *Regulation Under Uncertainty: The Coevolution of Industry and Regulation*, REGUL. & GOVERNANCE, June 2017, at 2 (examining recursive systems of cooperative governance designed "to formulate and update detailed plans for risk identification and mitigation that no central rulemaker could possibly hope to approximate").

50. It thus deepens efforts to explain the relationship between financial regulation and administrative law (in the case of the banking agencies). *See* Note, *Cashing Out a Special Relationship: Trends Toward Reconciliation Between Financial Regulation and Administrative Law*, 130 HARV. L. REV. 1183, 1185–87 (2017) (examining differences between financial regulation and other forms of regulation); Gillian E. Metzger, *Through the Looking Glass to a Shared Reflection: The Evolving Relationship Between Administrative Law and Financial Regulation*, 78 L. & CONTEMP. PROBS. 129, 144 (2015) (arguing that financial regulation is geared toward enabling private market activity rather than constraining it); Thomas W. Merrill, *A Comment on Metzger and Zaring: The Quicksilver Problem*, 78 L. & CONTEMP. PROBS. 189, 199 (2015) (arguing that financial activities are too malleable to restrain through ex ante rulemaking). In doing so, it builds on recent efforts to recover the role that banks play in the economy. *See infra* notes 125–127. And it addresses a longstanding gap in the administrative law literature; even mid-century scholarship failed to fully account for the distinctiveness of the banking agencies. *See infra* note 122.

And it shows why recent challenges to supervision are misplaced and how efforts by the agencies to "normalize" their methods are inconsistent with nearly two centuries of practice.

I. TWO APPROACHES TO BANKING LAW

Banking law is theoretically adrift. Most contemporary scholarship accepts a mistaken view of what banks are and what they do. I call this view the licensing model. The licensing model casts banks as garden variety financial intermediaries. A better framework recognizes that banks are "special": they create money as well as invest it. On this view, the banking agencies are outsourcers.

This Part reconstructs the theory of bank regulation immanent in much of the literature and outlines the outsourcing model. The outsourcing model recognizes banks' role in our monetary framework, the AMS, and grounds the historical recovery that follows.

A. The Licensing Model

This Section examines six ways scholars and practitioners describe the banking agencies and their method of oversight. Each implicitly or explicitly embraces a licensing model, treating banks as privately owned financial intermediaries that borrow from people who have too much money (savers) and lend to people who don't have enough (borrowers).[51] The licensing model emphasizes the virtues of private ordering, downplays the distinctiveness of bank liabilities, and frames the role of the banking agencies as correcting market failures. It focuses on the fact that banks, unlike other lenders, are (and should be) subject to extensive oversight because they are particularly prone to runs.[52] These runs are caused by information asymmetries (e.g., bank creditors do not effectively monitor bank managers)[53] and coordination problems

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51. *See, e.g.*, RICHARD CARNELL, JONATHAN R. MACEY & GEOFFREY P. MILLER, THE LAW OF FINANCIAL INSTITUTIONS 64–65 (5th ed. 2013) (defining banks as financial intermediaries); FREDERIC S. MISHKIN, THE ECONOMICS OF MONEY, BANKING & FINANCIAL MARKETS 7–8 (7th ed. 2010) (same and defining financial intermediaries as "institutions that borrow funds from people who have saved and in turn make loans to others"); Merton H. Miller, *Do the M&M Propositions Apply to Banks?*, 19 J. BANKING & FIN. 483, 484–86 (1995) (treating banks as financial intermediaries). *See also* Robert C. Hockett & Saule T. Omarova, *The Finance Franchise*, 102 CORNELL L. REV. 1143, 1144–46 (2017) (critiquing the paradigm); Morgan Ricks, *Money as Infrastructure*, 2018 COLUM. BUS. L. REV. 757, 758–64 (2018) (same).

52. *See* Douglas Diamond & Philip Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401, 401 (1983) (arguing that banks are susceptible to damaging runs).

53. Depositors are bad monitors. *See* Jonathan R. Macey & Geoffrey P. Miller, *Deposit Insurance, the Implicit Regulatory Contract, and the Mismatch in the Term Structure of Banks' Assets and Liabilities*, 12 YALE J. ON REGUL. 1, 10–12 (1995); Jonathan R. Macey & Maureen O'Hara, *The Corporate Governance of Banks*, 9 FED. RSRV. BANK N.Y. ECON. POL'Y REV. 91, 98

(e.g., bank creditors are numerous and diffuse),[54] which government interventions such as capital regulation and deposit insurance correct by reducing the likelihood of creditor losses and aligning the incentives of shareholders and creditors. On the licensing view, the banking agencies aid in these efforts (and address resulting moral hazard) by enforcing regulatory rules, facilitating market discipline, preventing regulatory arbitrage, limiting the government's financial exposure to banks, bolstering creditor confidence, and combatting systemic risk. In other words, bank supervisors act as "rule enforcers," "discipline facilitators," "gap fillers," "agents" of the Federal Reserve Banks and the Federal Deposit Insurance Fund, "confidence legitimators," and "macroprudential stewards."[55]

1. Supervisors as Rule Enforcers

Perhaps the most popular account of the banking agencies goes like this: Bank balance sheets are complex and opaque, and the regulatory rulebook is long and technical. A special group of experts is required to promulgate these bright-line strictures and ensure that bankers comply with them, so Congress created the banking agencies and endowed them with "monitoring" powers.[56] Former Fed Governor Fredric Mishkin takes this view: "The government establishes

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(2003). *See generally* Jonathan R. Macey & Elizabeth H. Garrett, *Market Discipline by Depositors: A Summary of the Theoretical and Empirical Arguments*, 5 YALE J. ON REGUL. 215 (1988) (examining arguments regarding depositor discipline).

54. *See* Diamond & Dybvig, *supra* note 52, at 401.

55. This list is not exhaustive. Kris Mitchener and Matthew Jaremski suggest that one of the roles of the banking agencies is to protect vested interests by blocking new entrants. Kris James Mitchener & Matthew Jaremski, *The Evolution of Bank Supervisory Institutions: Evidence from American States*, 75 J. ECON. HIST. 819, 822–24 (2015). The agencies also sometimes act as "agricultural extension agents," diffusing big city wisdom to small-town bankers, and as "consultants," conducting horizontal reviews and spreading best practices while guarding trade secrets. *See, e.g.*, FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT 307 (2011) (explaining that supervisors before the crisis "acted something like consultants, working with banks to assess the adequacy of their systems"); WILLIAM H. KNIFFIN, JR., THE PRACTICAL WORK OF A BANK 349 (1915) ("The examiner going from bank to bank acquires a fund of information that he can use to advantage . . . and can advise the officers in many things to their profit."). There is also evidence that in the nineteenth and early twentieth centuries the banking agencies facilitated correspondent banking by allowing money center banks to deal in the notes of distant rural outfits. I have been unable, however, to find any sources asserting that these functions are the *purpose* of supervisory law. *Cf.* Joseph H. Sommer, *Why Bail-In? And How!*, 20 FED. RSRV. BANK N.Y. ECON. POL'Y REV. 207, 215 (2014) (suggesting that supervisors may be agents of a bank's creditors or top management, auditors, or employees of an "agricultural extension service" for banking).

56. *See* Rory Van Loo, *Regulatory Monitors: Policing Firms in the Compliance Era*, 119 COLUM. L. REV. 369, 384–86 (2019) (subsuming bank supervision within ordinary administrative practice by highlighting its similarities to "regulatory monitoring"). Supervision, as described herein, involves more than just this sort of monitoring. Many agencies monitor, *see id.* at 409–10, including the CFPB, *see* Levitin, *supra* note 2, at 355–57, but monitoring alone does not create the sort of cooperative governance that characterizes banking.

regulations to reduce [bank] risk taking and then supervisors monitor banks to see that they are complying with these regulations and not taking on excessive risk."[57] Roberta Romano similarly describes supervisors as "adjutants" to the regulatory apparatus "directed at assessing the adequacy of a bank's capital" under the Basel Accord.[58] And former Fed Chair Ben Bernanke had this "rule enforcers" model in mind when he explained in 2006 that agency actions are tied "to a bank's leverage and risk-based capital ratios."[59]

Other commentators adopt the supervisor-as-rule-enforcer model in part, distinguishing it from the stress-testing approach taken by supervisors more recently. For example, Peter Conti-Brown writes:

> Before the 2008 financial crisis . . . the line between "bank regulation" and "bank supervision" was relatively easy to summarize. "Regulation" was the rulemaking that administrative agencies issued pursuant to some statutory authority. "Supervision" was the micro-application of regulation to individual firms, a kind of check-the-box exercise that ensured that the supervisors saw in the banks what the regulators wanted them to see. In other words, the regulators made the rules, and the supervisors made sure the rules were followed.[60]

"Rule enforcer" accounts also sometimes highlight the role that monitoring plays in shaping regulatory rules: because agencies interact

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57. Frederic S. Mishkin, *Prudential Supervision: Why Is It Important and What Are the Issues?*, *in* PRUDENTIAL SUPERVISION: WHAT WORKS AND WHAT DOESN'T 1, 8 (Frederic S. Mishkin ed., 2001); *see also* Heidi Richards, *Influence and Incentives in Financial Institution Supervision*, *in* FINANCIAL SUPERVISION IN THE 21ST CENTURY 73, 81 (A. Joanne Kellermann, Jakob de Haan & Femke de Vries eds., 2013) (explaining that it "is commonly asserted that supervisors mainly enforce 'compliance' with prudential requirements" and that the "prominence of [the] compliance [view] is evident throughout many pronouncements by the Basel Committee on Banking Supervision and similar authorities").

58. Roberta Romano, *For Diversity in the International Regulation of Financial Institutions: Critiquing and Recalibrating the Basel Architecture*, 31 YALE J. ON REGUL. 1, 10 (2014).

59. Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Rsrv. Sys., Remarks at the Annual Convention of the American Bankers Association (Oct. 16, 2006) (speech entitled "Bank Regulation and Supervision: Balancing Benefits and Costs").

60. Peter Conti-Brown, *Stress Tests and the End of Bank Supervision*, OXFORD BUS. L. BLOG (May 8, 2016), https://www.law.ox.ac.uk/business-law-blog/blog/2016/05/stress-tests-and-end-bank-supervision [https://perma.cc/Z67Y-ZZW8]. *See also* PETER CONTI-BROWN, THE POWER AND INDEPENDENCE OF THE FEDERAL RESERVE 164 (2016) (describing supervision as examination followed by enforcement). Armour et al. give a similar account in their encyclopedic treatment of financial institutions law, noting that "until the mid-1990s, prudential supervision . . . consisted primarily of periodic examinations to determine whether banks had complied with applicable regulatory requirements." JOHN ARMOUR, DAN AWREY, PAUL DAVIES, LUCA ENRIQUES, JEFFREY N. GORDON, COLIN MAYER & JENNIFER PAYNE, PRINCIPLES OF FINANCIAL REGULATION 580 (2016) (describing this "traditional" approach as emphasizing "technical compliance with prescriptive rules"); *see also* A. Joanne Kellermann & Robert H.J. Mosch, *Good Supervision and Its Limits in the Post-Lehman Era*, *in* FINANCIAL SUPERVISION IN THE 21ST CENTURY, *supra* note 57, at 1, 5 (explaining that, traditionally, supervisors "concentrated on checking whether [banks were] meeting the statutory requirements in terms of solvency, liquidity, and controlled business operations"); MICHAEL BARR, HOWELL JACKSON & MARGARET E. TAHYAR, FINANCIAL REGULATION: LAW AND POLICY 831–36, 841–49 (2016).

closely with bank employees, they can glean information that will allow them to refine their strictures over time.[61]

2. Supervisors as Discipline Facilitators

But the banking agencies cannot be only rule enforcers, at least as a matter of statutory design. Title 12 of the U.S. Code specifically differentiates between violations of law and unsafe and unsound practices, empowering the banking agencies to take corrective actions in both cases.[62] The Code also repeatedly distinguishes between supervision and enforcement, treating the former as a distinct regulatory process.[63]

Two other approaches better account for the discretionary and informal practice of bank oversight by accepting the rule enforcers model as a baseline and refining it. One of these approaches dominated official accounts of supervision in the run-up to the 2008 crisis. This framework imagines supervisors as facilitators of market discipline. Discretionary oversight is necessary, this view holds, because banks are opaque and agency problems between bank shareholders and bank managers threaten to undermine financial stability. As Robert Clark put it, "a financial intermediary's assets consist of intangible claims," which—absent special regulation—"would be easy for the management of an intermediary to sell . . . and replace . . . with new claims that in the aggregate constitute a portfolio with a radically different level of risk."[64]

The opacity of bank risk-taking is problematic because, in the words of former Fed Governor Lawrence Meyer, "markets cannot operate well without transparency."[65] The "prerequisite for market discipline" of banks, according to Meyer, "is more rapid dissemination of information [to the market, and the] provision to market participants of critical and timely information about risk exposures by the [banks] themselves."[66] The government must "intervene" to ensure that this

61. *See* Eisenbach et al., *supra* note 13, at 21–28.

62. *See, e.g.*, 12 U.S.C. § 1818(b). Many policymakers likely subscribe to the "rule enforcers" view for normative reasons. I call these individuals "rule absolutists." Menand, *supra* note 17, at 1584. They oppose discretionary government action on principle because they think it jeopardizes first-order liberty interests.

63. *See, e.g.*, 12 U.S.C. § 1831bb(e); *id.* § 4806(f)(1) (describing various "supervisory determinations"). Dan Tarullo catalogues many further examples in forthcoming work.

64. Robert Charles Clark, *The Soundness of Financial Intermediaries*, 86 YALE L.J. 1, 14–15 (1976) ("[F]inancial intermediaries can shift their aggregate risk levels more readily than other corporations.").

65. Laurence H. Meyer, *Supervising Large Complex Banking Organizations: Adapting to Change*, *in* PRUDENTIAL SUPERVISION: WHAT WORKS AND WHAT DOESN'T, *supra* note 57, at 97, 100.

66. *Id.*

information reaches market participants because "[p]ublic disclosure is not going to be easy for bankers [as] it may well bring new pressures that [managers] may not like in the short run."[67]

On this view, the banking agencies are empowered to "independently test and compare systems and models to best practices" and "review[ ] [bank] disclosures to confirm that . . . [a] bank's actual disclosures are consistent with its own policy."[68] Safety and soundness authority and informal, iterative engagement allow the agencies to both enforce regulatory rules *and* strengthen "private regulation."[69] The Fed, under the leadership of Alan Greenspan, made this sort of market-oriented oversight official policy in the late 1990s and dubbed it "risk-focused supervision" ("RFS").[70]

Many subsequent commentators depict RFS as a salutary advance from what they assume preceded it: a pure rule-enforcement model. Others suggest that facilitating market discipline has always been the purpose of supervisory law.[71] According to the latter group, the point of the Fed's postcrisis stress tests is (or should be) to enhance transparency so that the market can identify weaknesses and force banks to correct them.[72] As will become clear, such approaches leave

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67. *Id.* at 102.

68. *Id.* at 99, 102.

69. *Id.* Meyer's model rests on Greenspan's diktat that, since the "self-interest of market participants generates private market regulation," the "real question" for government "is not whether a market should be regulated," but "whether government intervention strengthens or weakens private regulation." Alan Greenspan, Chairman, Bd. of Governors of the Fed. Rsrv. Sys., Remarks at the Financial Markets Conference of the Federal Reserve Bank of Atlanta: Government Regulation and Derivatives Contracts (Feb. 21, 1997).

70. *See* BD. OF GOVERNORS OF THE FED. RSRV. SYS., THE FEDERAL RESERVE SYSTEM: PURPOSES & FUNCTIONS 63 (9th ed. 2005) ("The goal of the risk-focused supervision process is to identify the greatest risks to a banking organization and assess the ability of the organization's management to identify, measure, monitor, and control these risks."); *see also* Eisenbach et al., *supra* note 13, at 9 (identifying the advent of RFS in the 1990s). RFS was designed to complement capital regulations promulgated in the late 1980s and 1990s. Greenspan and Meyer designed these regulations to address, in Greenspan's words, the "needs for larger shock absorbers and for increased private incentives to monitor and control [bank] risk." Alan Greenspan, *Innovation and Regulation of Banks in the 1990s*, 74 FED. RSRV. BULL. 783, 784 (1988).

71. For example, Mitchener and Jaremski argue that supervision lessens "asymmetric information . . . by providing [an] independent collaboration of accounting information and by checking for management fraud." Mitchener & Jaremski, *supra* note 55, at 835. On their account, supervision evolved to "promote product and price competition and to enforce legal restrictions on bank activity." *Id.* Eugene White argues that facilitating market discipline was the original purpose of federal supervision and bemoans the shift toward government policing post-1913. *See* Eugene N. White, *Lessons from the History of Bank Examination and Supervision in the United States, 1863-2008*, *in* FINANCIAL MARKET REGULATION IN THE WAKE OF FINANCIAL CRISES 15, 18, 38–39 (Alfredo Gigliobianco & Gianni Toniolo eds., 2009) (arguing that, until 1913, "supervision [was] primarily aimed at reinforcing market discipline").

72. *See, e.g.*, Li Lian Ong & Ceyla Pazarbasioglu, *Credibility and Stress Testing*, 2 INT'L J. FIN. STUD. 15, 17 (2014) ("The stress tests should usefully inform markets about the risks

parts of the law unexplained, including its emphasis on supervisory secrecy and its panoply of remedial sanctions. Moreover, these approaches are historically ungrounded—inconsistent with not only the legislative history of Title 12, but also with agency practice prior to Greenspan's tenure.[73]

3. Supervisors as Gap-Fillers

A third model of supervision conceives of safety and soundness as a "gap-filling principle"[74] and supervision as "the regulatory gap-filler."[75] "Congress left it to the agencies," Heidi Mandanis Schooner explains, "to decide what practices are unsafe or unsound," because safety and soundness law is designed "to close the gaps in the regulatory framework."[76] As banking is highly complex, "neither Congress nor the federal banking agencies could (or should) attempt to regulate specifically each and every bank activity."[77] It would be "prohibitively costly" to write all these rules and, given how fast things change, not likely to work.[78]

On this view, supervision complements rule writing, which is backward-looking, because supervision allows the banking agencies to make law ex post at the point of application. For example, it allows the agencies to deem a specific bank investment "unsafe and unsound" even if the investment complies with the rules. Many observers who argue Congress created the agencies to enforce bright-line rules contend that, in recent years, supervisors have become more focused on using their authority to close holes in the regulatory framework.[79]

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associated with the banks . . . ."); Giovanni Petrella & Andrea Resti, *Supervisors as Information Producers: Do Stress Tests Reduce Bank Opaqueness?*, 37 J. BANKING & FIN. 5406 (2013).

73. *See, e.g.*, Gerald Dunne, *The Legal Basis of Bank Supervision*, *in* BANK SUPERVISION 6, 8–9 (1963) (explaining that the "widespread consequences of misconduct or bad judgment" at a bank "are such as to require governmental rather than market sanction").

74. Heidi Mandanis Schooner, *Fiduciary Duties' Demanding Cousin: Bank Director Liability for Unsafe or Unsound Banking Practices*, 63 GEO. WASH. L. REV. 175, 188 (1995).

75. *Id.* at 187.

76. *Id.*

77. *Id.*

78. *Id.* at 187–88; *see also* PAUL TUCKER, UNELECTED POWER: THE QUEST FOR LEGITIMACY IN CENTRAL BANKING AND THE REGULATORY STATE 469 (2018) ("[F]inance is a shape shifter. Regulatory arbitrage is endemic, and the rule writers can end up chasing their tails.").

79. *See, e.g.*, ARMOUR ET AL., *supra* note 60, at 582:

> [Supervision, with its emphasis on] discretion and judgment . . . is a reflection of both the resource constraints faced by regulators and the reality that it is simply unrealistic to expect them to write—or, crucially, to update on a timely basis—a prudential rulebook capable of prescribing the most desirable course of action in every potential future state of the world in which market participants may find themselves;

Although I have not seen it in any of the literature,[80] one could imagine a law and economics explanation for supervision that proceeds along these lines: The problem with banking is that banks cannot devise verifiable debt covenants (ones for which a breach can be proven in a courtroom). A small nonverifiable change in volatility, easily adopted in finance, can change the risk profile of a high-leverage business like a bank dramatically. As private bank creditors cannot be expected to provide extra-corporate governance, the solution is a form of contingent governance—government supervision—with the power to intervene even in the absence of verifiable events.

The "gap-filler" model might also be flipped on its head. To address rule incompleteness, the government could be said to intentionally *overregulate* banks, using the banking agencies to selectively waive requirements after the fact. In other words, supervision might reflect the need for what Jason Scott Johnston calls, in the retail products context, "tailored forgiveness"—the ability to reward those who behave non-opportunistically.[81] I am not aware of anyone who has made this argument for supervision in banking,[82] but there is support for it in practice.[83]

4. Supervisors as Agents of the Fund and Reserve Banks

All three of the abovementioned theories treat bright-line rules as the foundation of banking law and treat the agencies as enforcing those rules in one way or another. But they miss that many of the rules, including modern capital requirements, grew out of supervisory guidance issued in the 1980s.[84] That guidance was designed to clarify official expectations during a period of declining bank profitability so that banks would not be surprised by cease and desist orders.[85] Indeed,

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A. Joanne Kellermann & Robert H.J. Mosch, *Good Supervision and Its Limits in the Post-Lehman Era*, *in* FINANCIAL SUPERVISION IN THE 21ST CENTURY, *supra* note 57, at 1, 5 (arguing that supervision must shift to "tackle the possible root causes of later problems before they even translate into deteriorating solvency and liquidity ratios").

80. *But see infra* notes 99–100 (articulating a related theory).

81. Jason Scott Johnston, *The Return of Bargain: An Economic Theory of How Standard-Form Contracts Enable Cooperative Negotiation Between Businesses and Consumers*, 104 MICH. L. REV. 857, 879 (2006).

82. Kenneth Abraham argues that the need to engage in "tailored forgiveness" might be one reason why governments choose not to act as insurers. Kenneth Abraham, *Four Conceptions of Insurance*, 161 U. PA. L. REV. 653, 687 (2013).

83. Indeed, "regulatory forbearance" in the 1980s raised so many concerns that Congress actually restricted the power of the banking agencies to ignore certain rule violations. *See* 12 U.S.C. § 1831*o* (requiring banking agencies to take "prompt corrective action").

84. *See* Menand, *supra* note 17, at 1551–52.

85. *See id.* at 1561–62.

it was only subsequent policy changes that led scholars to see supervision as a gap-filler instead of rules as a fail-safe.

A fourth theory stands out from these approaches by emphasizing the government's role in banking. This theory attributes informal, discretionary oversight to the fact that (1) the FDIC insures most bank liabilities, making the FDIC, in effect, every bank's primary creditor and (2) the Federal Reserve Banks extend discount window loans and intraday credits to banks to facilitate payments, accepting transfers of bank deposits as money. Supervisors, on this view, are agents of the Fund and of the Reserve Banks—government bodies in privity with the banks. Supervisors' broad powers minimize the government's financial exposure to banks and protect the government's contractual rights; private market actors with similarly large contingent claims, the thinking goes, would demand similar authority.

Richard Carnell, Jonathan Macey, and Geoffrey Miller advance this view in their textbook.[86] And officials sometimes speak about supervision in this manner.[87] Statutory support for this interpretation can be found in section 21 of the Federal Reserve Act, which provides that "examinations shall be so conducted as to inform the Federal reserve bank of the condition of its member banks and of the lines of credit which are being extended by them."[88] But, as discussed shortly, this view overlooks the purpose of the Fed's lending programs and the Insurance Fund, and it does not grapple with the establishment of the OCC during the Civil War or the subsequent development of supervisory law in the 1960s, '70s, and '80s.[89]

5. Supervisors as Confidence Legitimators

A fifth theory emphasizes the role of supervisors in promoting market confidence. According to this view, the banking agencies have

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86. CARNELL ET AL., *supra* note 51, at 440 ("[D]eposit insurance . . . gave supervision a new rationale: protecting the insurance funds. Now the bank supervisor acts, in a sense, as agent for the fund."); *see also* TUCKER, *supra* note 78, at 448, 459 (advancing a similar view).

87. Narayana Kocherlakota, Speech at the Allied Executives Business & Economic Outlook Symposium: The Economy and Why the Federal Reserve Needs to Supervise Banks (Mar. 2, 2010) (arguing that supervision is necessary because if the "Federal Reserve makes a bad loan . . . through the discount window, that loss appears on its balance sheet").

88. Federal Reserve Act of 1913, Pub. L. No. 63-43, § 21, 38 Stat. 251, 272 (codified as amended in scattered sections of 12 U.S.C.); *see also* The Federal Reserve Act, December 23, 1913, *reprinted in* 4 DOCUMENTARY HISTORY OF BANKING AND CURRENCY IN THE UNITED STATES 2436, 2465–66 (Herman E. Krooss & Paul A. Samuelson eds., 1969).

89. Nor can it account for the Federal Home Loan Banks, which provide liquidity to banks to support housing finance and take much greater risk in their dealings with banks despite having no supervisory powers. *See* Kathryn Judge, *Three Discount Windows*, 89 CORNELL L. REV. 795, 821–27 (2014).

extensive powers so that they can credibly provide a governmental stamp of approval to prevent skittish depositors and other bank creditors from withdrawing their deposits during periods of economic uncertainty. Carnell, Macey, and Miller describe a version of this theory in their textbook,[90] without fully subscribing to it,[91] and a similar logic suffuses some recent assessments of the Fed's postcrisis stress testing regime.[92] Anne Khademian, in a monograph focused on supervisory autonomy and accountability, also adopts this framework.[93]

Although there are superficial similarities between the "confidence legitimator" and "market discipline" views (both, for example, are oriented toward private markets), the two in fact sit in tension. After all, if *confidence* is the goal of supervision, problems at banks are best worked out in private, between agency officials and bank executives. Secrecy is a virtue because it helps obscure weaknesses that might undermine trust in banks. By contrast, if *market discipline* is the goal, secrecy is a sin because it prevents market actors from policing bad practices. The government should advertise information about bank weaknesses so that bankers are incentivized to address them.

Current law is more consistent with the confidence-legitimator view as it shields material information about banks from the market through the common law bank examiners' privilege,[94] statutory provisions exempting supervisors from the Freedom of Information Act,[95] and regulations requiring banks and supervisors to treat

90. CARNELL ET AL., *supra* note 51, at 440 (explaining that before deposit insurance, "supervision played a crucial role in preventing runs" and that, in that regard, "[p]erception mattered as much as reality" because "if the public believed that banks were strictly supervised, it would be less likely to lose confidence in a bank at the first ugly rumor of problems"). Mitchener and Jaremski also argue supervision might be necessary because depositors are "[u]nable to discern if bank managers [take] on too much risk or [are] committing fraud," so, absent a government stamp of approval, "would be reluctant to put money in the bank." Mitchener & Jaremski, *supra* note 55, at 835.

91. *See* CARNELL ET AL., *supra* note 51, at 440.

92. *See* Ong & Pazarbasioglu, *supra* note 72, at 16 (emphasizing the importance of stress tests as a way to build credibility). Supervisory stress tests are necessary, on this view, not to enable the agencies to identify weak banks and force them to take corrective actions, but to signal to the market that the banks are trustworthy counterparties. *Id.*

93. ANNE M. KHADEMIAN, CHECKING ON BANKS: AUTONOMY AND ACCOUNTABILITY IN THREE FEDERAL AGENCIES 29 (1996) ("Banking is a business of risk that depends on depositor and investor confidence. The examination profession must facilitate that confidence by restricting risks that threaten safety . . . .").

94. *See, e.g.*, Martinez v. Rocky Mountain Bank, 540 F. App'x 846, 854 (10th Cir. 2013) (recognizing the bank examination privilege); Eric B. Epstein, *Why the Bank Examination Privilege Doesn't Work as Intended*, 35 YALE J. ON REGUL. BULL. 17, 18 n.4 (2017) ("[T]he bank examination privilege is recognized in every federal circuit.").

95. *See* 5 U.S.C. § 552(b)(8) (exempting information "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions"); *see also* Pub. Invs. Arb. Bar Ass'n v. SEC, 930 F. Supp. 2d 55, 64 (D.D.C. 2013), *aff'd*, 771 F.3d 1 (D.C. Cir. 2014) ("[T]he primary reason

supervisory work product as government property.[96] The bread and butter of modern supervisory oversight—the MRA—is never released to the public nor are annual agency assessments of bank health, including the composite scores that agencies calculate and which determine whether banks can distribute capital to their shareholders.[97]

6. Supervisors as Macroprudential Stewards

In the wake of the 2008 financial crisis, a sixth way of conceptualizing the banking agencies emerged, one that highlights system-level fragilities, moral hazard, and the government's tendency to recapitalize banks when they get in trouble. This view treats markets and rules as perhaps sufficient to ensure microprudential soundness—the solvency of individual banks. But it holds that the state also has a special interest in *macroprudential* stability, an interest that requires and justifies discretionary government oversight of banks and other financial institutions that pose "systemic" risks.[98]

As Mathias Dewatripont, Jean-Charles Rochet, and Jean Tirole explain:

> The only way of breaking the vicious circle of recurrent banking crises, fed by phases of speculative mania, is to give the agencies in charge of banking supervision the power to

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for adoption of exemption 8 was to ensure the security of financial institutions. Specifically, there was [a] concern that [the] disclosure of . . . reports containing frank evaluations of . . . banks might undermine public confidence and cause unwarranted runs on banks." (citation omitted) (quoting Consumers Union of U.S., Inc. v. Heimann, 589 F.2d 531, 534 (1978))); S. REP. NO. 89-813, at 9 (1965) ("Exemption No. 8 is directed specifically to insuring the security of our financial institutions by making available only to the Government agencies . . . examination, operating, or condition reports . . . .").

96. *See* 12 C.F.R. § 4.32(b) (2020) (defining "[n]on-public OCC information" to include materials related to examinations and supervisory activities); *id.* § 261.2(c)(1)(iii) (defining "[c]onfidential supervisory information" for the Fed to include documents prepared in connection with supervisory activities); *id.* § 309.5(g)(8) (defining "[e]xempt information" for the FDIC to include examination materials).

97. Perhaps unsurprisingly, those who think that supervisors should facilitate market discipline are eager to remove these restrictions. *See, e.g.*, *Guidance, Supervisory Expectations, and the Rule of Law*, *supra* note 2, at 3 (arguing that the scope of restricted supervisory information should "be narrowed to the core minimum necessary"); *see also* Alfred Dennis Mathewson, *From Confidential Supervision to Market Discipline: The Role of Disclosure in the Regulation of Commercial Banks*, 11 J. CORP. L. 139, 176 (1986) (arguing that "public disclosure" of bank regulatory information "must be systematic and continuous").

98. *See generally* Robert Hockett, *The Macroprudential Turn: From Institutional 'Safety and Soundness' to Systemic 'Financial Stability' in Financial Supervision*, 9 VA. L. & BUS. REV. 201, 204 (2015) (explaining that a focus on "financial stability" is a hallmark of macroprudential policy). The idea that supervisors have a system-wide mandate has pre-crisis roots. *See* TUCKER, *supra* note 78, at 446; George Blunden, Deputy Governor, Bank of Eng., Supervision and Central Banking (April 8, 1987), *in* BANK ENG. Q. BULL., Aug. 1987, at 380–85 ("It is part of the [supervisor's] job to take [a] wider, systemic view and sometimes to curb practices which even prudent banks might, if left to themselves, regard as safe.").

> take charge of troubled banks *before* they really endanger the funds of their small depositors and/or the stability of the financial system.[99]

In other words, "shareholders must be open to expropriation, and managers must be dismissed *before*" banks default.[100]

The Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law in 2010, reflects this approach. For example, it creates the Financial Stability Oversight Council to extend Fed supervision to nonbank financial companies that pose systemic risks,[101] and it sets up a bank-like, government-imposed resolution process for nonbank financial institutions whose failure might jeopardize financial stability.[102] The Fed's annual stress tests can also be justified on these grounds, as they are explicitly geared toward protecting the economy from an undercapitalized banking system.

B. The Outsourcing Model

Although the abovementioned theories accurately describe many aspects of supervisory practice, none are wholly consistent with the design of the banking agencies. Even the agent model, which highlights the government's special role, casts the government as just another market actor in the banking system.[103] The actual relationship between the state and the banking system is closer to the reverse: banks are government instrumentalities with private managers acting in a *public* capacity. This becomes clear if one recognizes that banks are more than just lenders with unusually volatile funding. Banks create money as well as invest it. Once money creation in addition to investment is recognized, the banking system is better conceived of as an outsourcing scheme: (1) banks expand the money supply (2) on

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99. MATHIAS DEWATRIPONT, JEAN-CHARLES ROCHET & JEAN TIROLE, BALANCING THE BANKS: GLOBAL LESSONS FROM THE FINANCIAL CRISIS 74 (Keith Tribe trans., 2010). This argument resembles, in part, Leonard White's view that legislatures created bank commissions because the right to sue an insolvent bank is an empty protection. WHITE, *supra* note 49, at 464 ("Preventive, not punitive, measures were required, and these could be taken only by the executive branch, through administrative agencies armed with inquisitorial and other powers."). *See also* TUCKER, *supra* note 78, at 68 (explaining that after a banking collapse, "the losers are never going to be able to recover their costs from the 'financial polluters' because the banks and other intermediaries are bust," and accordingly, "[s]tability warrants state intervention to reduce the probability of crises and to limit how bad they are").

100. DEWATRIPONT ET AL., *supra* note 99, at 74.

101. 12 U.S.C. § 5323.

102. *Id.* § 5383.

103. *See supra* Section I.A.4.

behalf of the government and (3) the banking agencies act as franchisors by chartering banks and supervising their work.

1. Banks as Monetary Institutions

Banks do not simply lend; when they lend, they create money.[104] Indeed, government-chartered banks create most of the money in the economy (and, as we will see, this is by design). Although the Treasury Department prints—and the Federal Reserve System issues—the cash in your wallet,[105] households and businesses use little cash as a means of payment or store of value. Instead, they rely primarily on promises to pay cash issued by banks—exchanging them as if they were cash. This "bank money" (also known as "inside money") can take many forms.[106] In the eighteenth and nineteenth centuries, the most common form of it was physical paper called "bank notes"; today, it is bank account balances called "deposits," "checkbook money," or "account money."[107] Deposits are a "credit" on the books of a bank that serve as a store of value and a means of payment.[108] Banks create deposits by

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104. N. GREGORY MANKIW, PRINCIPLES OF MACROECONOMICS 347 (5th ed. 2009) ("*[B]anks create money*."); *see also* MERVYN KING, THE END OF ALCHEMY 104 (2016). This understanding was once shared across disciplines. *See, e.g.*, BRAY HAMMOND, BANKS AND POLITICS IN AMERICA: FROM THE REVOLUTION TO THE CIVIL WAR 39 (1957) ("[I]t is the function of banks to create money . . . ."). And it is returning to the financial stability literature. *See, e.g.*, GARY GORTON, MISUNDERSTANDING FINANCIAL CRISES 10–11 (2012); MORGAN RICKS, THE MONEY PROBLEM: RETHINKING FINANCIAL REGULATION 101, 162–63 (2016) ("[B]anking is first and foremost a monetary activity."); KATHARINA PISTOR, THE CODE OF CAPITAL: HOW THE LAW CREATES WEALTH AND INEQUALITY 77–107 (2019).

105. *See* 12 U.S.C. §§ 411, 418 (empowering the Fed to issue Federal reserve notes). The Treasury Department also issues coins through the U.S. Mint. *See* 31 U.S.C. § 5131 (providing for the organization of the U.S. Mint); *id.* § 5111 (empowering the Treasury secretary to issue coins).

106. There is no bright line separating money-issuers from non-money-issuers, as very short-term debts serve certain monetary functions. *See* RICKS, *supra* note 104, at 29–62; Robin Greenwood, Samuel Hanson & Jeremy Stein, *The Federal Reserve's Balance Sheet as a Financial Stability Tool*, ECON. POL'Y SYMP. PROC. 335, 347–55 (2016) (calculating the "moneyness" premium); *see also* JOHN M. KEYNES, GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY 166–70 (1936) (explaining that we should draw the line between "money" and "debts" at whatever point is most convenient for handling a particular problem).

107. *See* JAMES WILLARD HURST, A LEGAL HISTORY OF MONEY IN THE UNITED STATES 35, 50 (1971) (discussing the increased use of bank deposits relative to bank notes).

108. PAUL SAMUELSON & WILLIAM D. NORDHAUS, ECONOMICS 228 (13th ed. 1989) (explaining that deposits are money "like any other medium of exchange. Being payable on demand, [deposits] serve[ ] as money in the same sense that 1000 dollar bills do"); *id.* at 227 (explaining further that "today is the age of bank money" and that "[i]f we calculate the total dollar amount of transactions, nine-tenths take place by bank money, the rest by paper money"); MANKIW, *supra* note 104, at 84 (explaining that "[a] second type of asset used for transactions is demand deposits, the funds people hold in their checking accounts," which "are therefore added to [cash] currency when measuring the quantity of money"); Geoffrey P. Miller, *Essential Papers on the Economics of Financial Law* 7 (N.Y.U. L. & Econ. Rsch. Paper Series, Paper No. 16-01, 2016) ("The deposit account is a form of private money created by the bank.").

crediting accounts (using the "bookkeeper's pen"[109]) when they originate loans. In other words, banks lend to account holders by plussing up their balances.[110]

Today, only the Federal Reserve circulates paper notes—and they are no longer redeemable for gold and silver coins.[111] But privately owned (publicly chartered) banks still have a legal monopoly on account money. And given the dominance of this form of money in everyday life, deposits are what counts. Banks can expand the supply of account money, triggering inflation, or contract the supply of account money, triggering deflation, regardless of how much cash the Fed puts into circulation. Indeed, the only way that cash enters circulation is through banks when depositors withdraw it. Although borrowers can normally redeem account money for cash, banks hold little cash on hand, and the total supply of it (around $1.8 trillion) represents a fraction of outstanding deposit balances ($15 trillion).[112]

2. Minting as Governing

One way to conceptualize money creation is as a special province of the state.[113] There are many reasons to adopt this view (although

109. Milton Friedman, *The Euro-Dollar Market: Some First Principles*, 7 FED. RSRV. BANK OF ST. LOUIS 16, 17 (1971).

110. *See, e.g.*, ALBERT GALLATIN, CONSIDERATIONS ON THE CURRENCY AND BANKING SYSTEM OF THE UNITED STATES 31 (1831) ("[B]ank notes and deposits rest precisely on the same basis . . . we cannot therefore but consider the aggregate amount of credits payable on demand, standing on the books of the several banks, as being part of the currency of the United States."); JOSEPH SCHUMPETER, HISTORY OF ECONOMIC ANALYSIS 1081, 1114–16 (1954) (noting "the obvious truth that deposits and banknotes are fundamentally the same thing"). Contra Schumpeter and Gallatin, there *are* differences between deposits and notes. Payments by check, for example, rely primarily on the credit of the payor and the payee's bank, and the payee is in privity with both. By contrast, a payment by note relies entirely on the credit of a third party, often unknown to either the payor or the payee.

111. *See infra* Section II.C; HURST, *supra* note 107, at 180–81.

112. Bd. of Governors of the Fed. Rsrv. Sys., *Deposits, All Commercial Banks*, FRED: FED. RSRV. BANK OF ST. LOUIS, https://fred.stlouisfed.org/series/DPSACBW027SBOG (last visited Dec. 12, 2020) [https://perma.cc/E5EQ-9WQL].

113. There are other ways. *See, e.g.*, GEORGE SELGIN, MONEY: FREE AND UNFREE (2017) (treating governments as interlopers in private monetary arrangements); FREDRICH HAYEK, THE DENATIONALIZATION OF MONEY 12 (1976) (offering "the revolutionary proposal to replace state control of the money supply by competing private issuers in the market"); LUDWIG VON MISES, THE THEORY OF MONEY AND CREDIT 435–57 (1912) (proposing a "return to sound [non-state] money"). On a market theory of money, money is conventional and a state is not needed to create it. *See, e.g.*, JOHN HICKS, THE MARKET THEORY OF MONEY (1989). This view is traceable chiefly to John Locke. *See* JOHN LOCKE, TWO TREATISES OF GOVERNMENT 56–66 (1690); JOHN LOCKE, SOME CONSIDERATIONS ON THE CONSEQUENCES OF LOWERING OF INTEREST AND RAISING THE VALUE OF MONEY (1691); *see also* CHRISTINE DESAN, MAKING MONEY: COINS, CURRENCY, AND THE COMING OF CAPITALISM 330–59 (2014) (discussing the influence of John Locke).

adopting it is not critical for the historical recovery that follows).[114] These reasons include its doctrinal pedigree,[115] its constitutional status,[116] and its theoretical underpinnings.[117] But let me offer two further reasons.[118]

First, whatever one thinks about the power to issue money generally, the power to issue money denominated in the state's unit of account is very much the state's concern. For example, the federal government uses the dollar[119] and issues monetary instruments denominated in dollars. Other entities that issue instruments

114. It suffices to say that this is how most of the legislators who wrote our banking laws and forged the AMS understood banking.

115. Recognition of the sovereign's authority over money is as old as the Anglo-American legal tradition itself. *See* DESAN, *supra* note 113, at 93 ("The Anglo-Saxon rule that 'there shall run one coinage throughout the realm' date[s] to the reign of Athelstan in 930."). The Privy Council sitting as the highest court in England and Ireland decided the canonical case in 1605. *See* The Case of Mixed Money in Ireland, Trin. 2 JAMES I. A.D. 1605, *reprinted in* COBBETT'S COMPLETE COLLECTION OF STATE TRIALS 114–30, 118 (1809) ("[T]he King by his prerogative may make money of what matter and form he pleaseth, and establish the standard of it, so may he change his money in substance and impression, and enhance or debase the value of it, or entirely decry and annul it."); *id.* at 116 (no other person, the Council noted, could make money "without special license or commandment of the king"). The Supreme Court adopted the Privy Council's holding in 1871. Knox v. Lee, 79 U.S. 457, 565–66 (1871) (noting that "the power given to Congress to coin money and regulate the value thereof . . . [was] much discussed in the great case of Mixed Moneys . . . and it was there held to belong to the king's ordinary prerogative over the coinage of money," and that, in the United States, whether the standard of money should be changed is "undoubtedly" a question of "legislative discretion"); *see also* Veazie Bank v. Fenno, 75 U.S. 533, 549 (1869) (upholding a prohibitive tax on state bank notes); Ling Su Fan v. United States, 218 U.S. 302, 310 (1910) ("The power to 'coin money and regulate the value thereof, and of foreign coin,' is a prerogative of sovereignty and a power exclusively vested in the Congress of the United States."); Norman v. Balt. & Ohio R.R. Co., 294 U.S. 240, 304 (1935) ("[T]here attaches to the ownership of gold and silver those limitations which public policy may require by reason of their quality as legal tender and as a medium of exchange." (citing *Ling Su Fan*, 218 U.S. at 310)).

116. U.S. CONST. art. I, § 8, cl. 5 ("Congress shall have [the] Power . . . To coin Money [and] regulate the Value thereof."); *id.* § 10, cl. 1 ("No State shall . . . coin Money; emit Bills of Credit; make any Thing but gold and silver Coin a Tender in Payment of Debts; pass any . . . Law impairing the Obligation of Contracts."); THE FEDERALIST NO. 69, at 361 (Alexander Hamilton) (George W. Carey & James McClellan eds., 2001) ("[The King] is in several respects the arbiter of commerce, and in this capacity can . . . coin money [and] authorize or prohibit the circulation of foreign coin."). In the eighteenth century, the verb "to coin" meant "to make or forge any thing" and it was common to speak of "coining" paper money. *See* Robert G. Natelson, *Paper Money and the Original Understanding of the Coinage Clause*, 31 HARV. J.L. & PUB. POL'Y 1017, 1062–63, 1063 n.282 (2008) (collecting two dozen examples).

117. *See* Robert C. Hockett, *Rousseauvian Money* 14 (Cornell Legal Stud. Rsch. Paper Series, Paper No. 18-48, 2018), https://ssrn.com/abstract=3278408 [https://perma.cc/V3BP-TXHG]. It also seems likely that successful moneys, including money issued by nonstate actors, are the product of state power and its monopoly on the legitimate use of violence. *See* GEORG FRIEDRICH KNAPP, THE STATE THEORY OF MONEY 1 (1905) (arguing that money is a creation of the state); GEOFFREY INGHAM, THE NATURE OF MONEY 74–80 (2004) (similar); *see also* MILTON FRIEDMAN, A PROGRAM FOR MONETARY STABILITY 8 (1960) (arguing that money provision is "an essential governmental function on a par with the provision of a stable legal framework").

118. I develop these points in two works in progress: "Why Private Money Is Bad (and What to Do About It)" and "Administering Money: The Federal Reserve System in Theory and Practice."

119. 31 U.S.C. § 5101.

denominated in dollars (like banks) debase the value of dollars issued by the United States to the extent that the dollars they issue are used to satisfy dollar demand in the economy. For example, prices would be much lower if there were only $1.8 trillion in circulation (i.e., if people did not write bank checks denominated in dollars) because people who wanted to hold their wealth in dollars would have to get their hands on cash issued by the government. Since most governments rely on their money to tax and spend, private activity that changes the value of government-issued money poses a significant risk.[120]

Second, the power to create money in a monetary economy, one in which most goods and services and tangible and intangible assets have prices, is the power to govern the motions of economic life. For example, when a borrower comes to a bank to finance a new venture, the bank is not constrained by the amount of cash that already exists. The bank can empower the borrower to requisition the necessary social resources by creating new money instruments out of thin air. This sort of governing power has long been of central concern to states, which have generally constrained the sorts of projects that can be financed in this way (and constrained the amount of money banks can create) in an effort to direct this power toward certain ends.[121]

3. Supervisors as Outsourcers

If we recognize banks' role as the primary source of monetary elasticity, and the government's explicit and implicit backstopping of the money banks issue, banking law figures as an elaborate outsourcing scheme. Agency authority is broad because banks are franchisees and supervisors are franchisors. Yes, the franchisors enforce rules, fill gaps, legitimate confidence, mitigate moral hazard, and combat macroprudential risks. But the franchisors perform these functions because the government is the proprietor of the system, governing through banks to expand the money supply. And the robust scope of supervisory power—the ability of the banking agencies to enter banks uninvited, direct bank activities, and remove bank officers and directors—follows from the fact that banks are not purely private businesses but premodern independent agencies operated by private actors. This perspective renders legible many aspects of the statutory

120. *See* Lev Menand, *Regulate Virtual Currencies as Currency*, JUST MONEY (Feb. 14, 2020), https://justmoney.org/l-menand-regulate-virtual-currencies-as-currency [https://perma.cc/WW8Y-MZRR] (cataloging harms caused by virtual currencies).

121. Seen in this light, safety and soundness oversight of banks by government officials is an area where the government has long practiced the principles of "law and macroeconomics"—using discretion to loosen (or tighten) restrictions on banks in response to economic conditions. *See* YAIR LISTOKIN, LAW AND MACROECONOMICS: LEGAL REMEDIES TO RECESSIONS (2019).

framework including the Insurance Fund and the Discount Window. These programs are best understood not as special subsidies to business organizations, but as efforts to administer a bank-money system by explicitly backing bank money.

Although most of the legislators who designed our banking system subscribed to this outsourcing model, it is rarely mentioned in the contemporary literature.[122] One exception is a short 1978 article by a lawyer in private practice who noted that banking is "an instrument of government, a means through which governmental policy is executed."[123] Another is Willard Hurst's 1971 legal history of money, which described bank charters as "statutory franchises" that confer "special privileges to issue circulating currency and place[ ] [banks] under legal regulation of their finances unlike any imposed on the general run of business."[124] There is also the important recent work of

122. It is also curiously absent from the mid-twentieth century administrative law literature, despite the fact that this literature recognized supervision's distinctiveness. *See, e.g.*, Davis, *infra* note 293, at 713 ("The banking agencies of the federal government have long maintained systems of secret evidence, secret law, and secret policy."); Kenneth C. Davis, *Administrative Powers of Supervising, Prosecuting, Advising, Declaring, and Informally Adjudicating*, 63 HARV. L. REV. 193, 194 (1949) (defining the "supervising power" and comparing supervision of banks with FCC supervision of radio programs and SEC supervision of registration statements). Instead, scholars during this period justified banking law either by reference to its long history or the difficulty of addressing the consequences of bad banking through formal procedures. *See, e.g.*, DAVIS, *supra* note 29, at 155–57. James Landis, for example, recognized the OCC's unusual power but did not attempt to explain it—noting only that there is no judicial review if the agency decides to publicize reports of bank condition even though the consequences for banks are "truly significant." Landis, *supra* note 49, at 1084. Landis omitted the banking agencies from THE ADMINISTRATIVE PROCESS (1938) and his REPORT ON REGULATORY AGENCIES TO THE PRESIDENT-ELECT (1960). Leonard White observed that early state banking laws served as a basis for railroad, gas, and electricity regulation, *see* Leonard White, *The Origin of Utility Commissions in Massachusetts*, 29 J. POL. ECON. 177, 177, 190 (1921), but adopted a licensing view of bank oversight, *see* WHITE, *supra* note 49, at 464, and ignored the federal banking agencies almost entirely, *see* WHITE, *supra* note 49, at 126. Despite the OCC's pivotal importance in the development of the federal administrative state, White devotes just a sentence to the organization in his chapter on the Treasury Department in THE REPUBLICAN ERA: A STUDY IN ADMINISTRATIVE HISTORY 1869-1901, at 114–15 (1958). Even James Freedman stretched to account for supervisory power in his treatment of informal administrative processes. JAMES FREEDMAN, CRISIS AND LEGITIMACY: THE ADMINISTRATIVE PROCESS AND AMERICAN GOVERNMENT 211–32 (1978) (arguing that the government can act summarily in banking to protect the public against injury, a version of White's theory, *supra* note 49, at 464). *See also* FREEDMAN, *supra*, at 219 ("Appointment of a conservator can effectively protect the interests of depositors and creditors and of the banking institution only if it can be done summarily.").

123. Roy T. Englert, *Bank Supervision in Historical Perspective*, 34 BUS. LAW. 1659, 1662 (1979).

124. HURST, *supra* note 107, at 31. Some scholars acknowledge a monetary motive for bank oversight, while adhering to a licensing model. *See, e.g.*, RICHARD S. GROSSMAN, UNSETTLED ACCOUNT: THE EVOLUTION OF BANKING IN THE INDUSTRIALIZED WORLD SINCE 1800, at 132, 229–45 (2010).

Bob Hockett and Saule Omarova,[125] Christine Desan,[126] and Morgan Ricks,[127] all of whom adopt a "money view" of banking. But none of this work connects bank supervision as a distinct mode of governance to the franchise nature of banking or reveals the role that the outsourcing model played in the genesis of banking law.[128] It is to that task that this Article now turns.

II. BUILDING THE AMERICAN MONETARY SETTLEMENT

For most of American history, legislators, administrators, and judges understood bank supervision to be a distinct, necessary, and legitimate mode of governance. Underlying their understanding was a recognition that banks—because they create the money supply—are more like premodern independent agencies than private businesses. Discretionary oversight of banks by special government officials comprised a constant and critical element of what I call the AMS, an institutional arrangement that has endured for over 150 years.

The AMS was substantially forged at three critical moments: 1838, 1863, and 1933. This Part revisits these moments in order to illuminate the intellectual, legal, and political conditions that made the AMS and supervision possible. Section II.A examines the emergence of the AMS in antebellum state law. In the 1830s and 1840s, New York paired open-access outsourcing with informal, strict oversight by special government officials. Section II.B explains how the New York model went national, as Congress copied it in 1863 and used it to design the OCC and the Fed. Section II.C follows the story from the New Deal to the present day, revealing how Congress created the FDIC and expanded the powers of all three banking agencies decade after decade so that the agencies could adjust bank activities without resorting to formal legal process. Time and again, Congress sustained and

125. Hockett and Omarova explicitly analogize financial firms to franchisees, but they apply the concept to all financial firms as a matter of normative theory. Hockett & Omarova, *supra* note 51. On their view, the entire financial system can be conceptualized in outsourcing terms. *See* Robert C. Hockett & Saule T. Omarova, *"Special," Vestigial, or Visionary? What Bank Regulation Tells Us About the Corporation—and Vice Versa*, 39 SEATTLE U. L. REV. 453, 453–54 (2016).

126. Desan situates banks within a millennium of Anglo-American monetary history, delineating their quasi-statal role, but does not extend the story to modern banking law and administration. *See supra* note 113.

127. Ricks describes banking as a public-private partnership but does not address supervision. RICKS, *supra* note 104, at 162–63, 204–05.

128. The only scholarship I am aware of that attempts this is nearly a century old. *See* ALLAN G. GRUCHY, SUPERVISION AND CONTROL OF VIRGINIA STATE BANKS (1937) (examining state bank oversight and its methods); THOMAS KANE, THE ROMANCE AND TRAGEDY OF BANKING (1921) (recounting the history of the OCC). Classic banking treatises consider supervision but do not theorize it. *See, e.g.*, JOHN T. HOLDSWORTH, MONEY AND BANKING 318–35 (6th ed. 1937) (describing supervision); KNIFFIN, *supra* note 55, at 349–70 (same).

strengthened this mode of governance, aware of its unusual features and unphased by reform efforts designed to formalize other parts of the administrative state.

A. State Origins

The AMS emerged in response to the political and institutional failure of the first American monetary order. This order, which lasted from the Founding to 1836, used parastatal banking corporations to expand the money supply and fuel economic growth. It was based off of a monetary settlement struck in England in the 1690s. That settlement had three main features: (1) delegation—Parliament chartered the Bank of England to issue notes and deposits for use as money,[129] pledging not to expand the money supply directly by devaluing the metal content of its coins;[130] (2) separation—Parliament prohibited the Bank from engaging in commercial activities;[131] and (3) monopoly—Parliament agreed not to charter any other banks and forbade any other company or partnership exceeding six persons from issuing bills, notes, or any other debt instruments maturing in six months or less.[132]

Drawing on these antecedents, Congress chartered the Bank of the United States ("BUS") in 1791 and renewed its charter in 1816. The Founding generation largely agreed that creating a bank to expand the money supply would strengthen the new government and avoid overissue.[133] But like the members of Parliament who built the Bank of

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129. The idea of using a bank to create an elastic money supply dates to the seventeenth century. *See* WILLIAM PETTY, QUANTULUMCUNQUE CONCERNING MONEY (1682), *reprinted in* THE ECONOMIC WRITINGS OF SIR WILLIAM PETTY 446 (Charles Henry Hull ed., 1899) ("What remedy is there if we have too little Money? Answ. We must erect a Bank, which well computed, doth almost double the Effect of our coined Money."). Petty, of course, refers to "a Bank," not "banks."

130. For centuries, devaluations served as the primary means of monetary policy. They were not always popular with financial and mercantile elites. DESAN, *supra* note 113, at 120–21, 169.

131. Bank of England Act (1694) § 26:

> [T]o the Intent that their Majesties Subjects may not be oppressed by the said Corporation by their monopolizing or ingrossing any sort of Goods, Wares, or Merchandizes, . . . the said Corporation . . . shall not at any time . . . Deal or Trade . . . in the buying or selling of any Goods, Wares or Merchandizes whatsoever.

132. A. ANDRÉADÈS, A HISTORY OF THE BANK OF ENGLAND 123 (1909). *See also* CHARLES W. CALOMIRIS & STEPHEN H. HABER, FRAGILE BY DESIGN: THE POLITICAL ORIGINS OF BANKING CRISES & SCARCE CREDIT 90–91 (2014). Calomiris and Haber describe this arrangement as the outcome of "the Game of Bank Bargains," *id.* at 85, "a political process . . . whose stakes are wealth and power," *id.* at 13, in which a country's political bodies and financial elites haggle over "[f]inancial [p]roperty [r]ights," *id.* at 38. Calomiris and Haber adopt the licensing view of banking that this Article rejects.

133. *See* Alexander Hamilton, *The Report of the Secretary of the Treasury, (Alexander Hamilton), on the Subject of a National Bank*, *in* 7 CHARLES BROCKDEN BROWN & ROBERT WALSH, AMERICAN REGISTER, OR GENERAL REPOSITORY OF HISTORY, POLITICS, AND SCIENCE 225, 238 (1810) [hereinafter *Hamilton Report*]:

England,[134] early U.S. officials viewed money creation as a prerogative of government.[135] Chartering the BUS thus meant in some sense delegating state power to private actors and required some public control.[136] In practice, public control derived from the government's status as the Bank's biggest customer and largest shareholder.[137] The Bank's charter was time limited. And the Treasury secretary had formal inspection rights.[138] The Congress also had (and at one point exercised) the power to convene a special committee to investigate the Bank's affairs. In 1816, when Congress rechartered the BUS, it gave the president the power to appoint, by and with the advice and consent of the Senate, five of the Bank's twenty-five directors.[139]

> The stamping of paper is an operation so much easier than the laying of taxes, that a government, in the practice of paper emissions, would rarely fail in any such emergency, to indulge itself too far in the employment of that resource, to avoid as much as possible, one less auspicious to present popularity;

HURST, *supra* note 107, at 154 (discussing "Hamilton's emphasis on trusting the creation of currency to private management, because it would be insulated . . . from the pressures that beat upon public officials").

134. During the colonial period, Massachusetts tried to open a mint, but Parliament viewed American coins as a usurpation of Parliament's sovereign power and forbade them. *See* GLYN DAVIES, A HISTORY OF MONEY 461 (2002); RONNIE J. PHILLIPS, THE CHICAGO PLAN & NEW DEAL BANKING REFORM 9 (1995). As a result, the colonists experimented extensively with paper moneys. But Parliament did not like this either and so it restricted the ability of the colonies to issue paper currency. PHILLIPS, *supra*, at 10.

135. For example, Albert Gallatin, secretary of the Treasury from 1801 to 1814, explained that "[t]he right of issuing paper money as currency, like that of gold and silver coins, belongs exclusively to the nation." STEPHEN W. NICKERSON, LAW OF MONEY 40 (1900). William Crawford, secretary of the Treasury from 1816 to 1825 and a skeptic of private banking, argued that "[c]oinage and the regulation of money have[,] in all nations[,] been considered the highest acts of sovereignty," and therefore money "should not issue upon the credit of any individual or association of individuals." *Id.* Daniel Webster argued that the statal nature of banking was settled at the founding and that it would be a mistake to allow the states to "delegate" the power to create money to dozens of banks. DANIEL WEBSTER, MR. WEBSTER'S SPEECHES IN THE SENATE, UPON THE QUESTION OF RENEWING THE CHARTER OF THE BANK OF THE UNITED STATES 5 (1832) (lamenting that, although "[i]t cannot well be questioned, that it was intended by the Constitution to submit the whole subject of the currency of the country . . . to the control . . . of Congress," including the "exclusive power" to "decide how far any substitute should interfere with it, and what that substitute should be," the states have "taken possession of the power" and "delegated" it to dozens of state banks).

136. As Hamilton put it, an incorporated "bank is not a mere matter of private property, but a political machine of the greatest importance to the state." *Hamilton Report*, *supra* note 133, at 92. *See also id.* at 240 ("Public utility is more truly the object of public banks, than private profit."); Letter from the Secretary of the Treasury, 29 ANNALS OF CONG. 505, 508 (1815):

> The National Bank ought not to be regarded simply as a commercial bank . . . it is not an institution created for the purposes of commerce and profit alone, but much more for the purposes of national policy, as an auxiliary in the exercise of some of the highest powers of the Government.

137. HAMMOND, *supra* note 104, at 144–45, 167; HOWARD BODENHORN, STATE BANKING IN EARLY AMERICA 84 (2003).

138. Act of Feb. 25, 1791, ch. 10, § 7, 1 Stat. 191, 193–195.

139. WHITE, *supra* note 49, at 460–75.

States established analogues like the Bank of New York and the Massachusetts Bank.[140] These banks were also parastatal monopolies, part-owned by the government,[141] and their ability to expand the money supply was regulated (and limited) by the BUS, which could redeem their notes for specie to check overissue.[142]

This regime, championed by the country's first Treasury secretary, Alexander Hamilton, was politically unstable from the start and ultimately collapsed. The first and most significant problem was that the shareholders and managers of the BUS (and its couple dozen state cousins) mostly came from the Federalist Party and formed what appeared to be a new aristocracy. As one critic complained, in chartering a single national bank, Congress "lodged" extraordinary power "in the hands of less than fifty individuals, who [could] make the whole monied capital of the United States bow to them."[143] That these individuals belonged to a minority party during a period of Democratic-Republican ascendancy only deepened their opponents' resentments.

The regime's second problem was that the Democratic-Republicans channeled their frustration into chartering dozens of new banks at the state level to compete with the BUS, the Bank of New York, and their kin[144]—something Hamilton never envisioned and

140. HAMMOND, *supra* note 104, at 164–66. Outside of London, Parliament similarly allowed "country banks" to issue notes.

141. South Carolina and Vermont established *wholly* government-owned banks: the Bank of the State of South Carolina and the Vermont State Bank. HAMMOND, *supra* note 104, at 166–68. Delaware set up the Farmers Bank of the State of Delaware, for which it was the primary stockholder. *Id.* at 167.

142. ROSS M. ROBERTSON, THE COMPTROLLER AND BANK SUPERVISION 19 (2d ed. 1995).

143. Hezekiah Niles, *To Correct Abuses by the Bank*, NILES' WKLY. REG., Mar. 7, 1818, at 17, 23. *See also* Joseph Sommer, *The Birth of the American Business Corporation*, 49 BUFF. L. REV. 1011, 1054 (2001) (explaining that the problem with these banks was their "intermediate statal nexus").

144. After the Democratic-Republicans swept to power in 1800, they set up the "State Bank, Albany," arguing that the Bank of Albany, chartered in 1792, was a Federalist outfit and that Albany "needed a Republican bank." HAMMOND, *supra* note 104, at 158. Similarly, Pennsylvania chartered the Farmers and Mechanics Bank, requiring that "a majority of the bank's directors be 'farmers, mechanics, and manufacturers actually employed in their respective professions,' " i.e., that they be Republicans. *Id.* at 165. Rhode Island too set up a bank to serve "the agricultural and mechanical interest"—the Washington Bank in Westerly. And the State Bank of Boston, established in 1811 in Massachusetts, advertised itself as "cherishing Republican men and Republican measures against the wiles and machinations" of the Federalists. *Id.* at 147. Jefferson himself, once president—realizing that he could not eliminate Hamilton's banks without sinking the American economy—wrote to his Treasury Secretary Albert Gallatin, "I am decidedly in favor of making all the banks Republican by sharing deposits among them in proportion to the dispositions they show." *Id.* at 146–47. Banking was "an integral part of the spoils of politics. Federalists would grant no charters to Republicans, or Republicans to Federalists." HORACE WHITE, MONEY AND BANKING: ILLUSTRATED BY AMERICAN HISTORY 333–34 (1895). Thus, the number of banks in the country grew from twenty-nine in 1800 to ninety in 1811. HAMMOND, *supra* note 104, at 144–45.

strongly opposed.[145] When the BUS tried to tame the growing mass of banks in the 1820s, the system was strained past its breaking point. State bankers retaliated by helping to elect Andrew Jackson, who, over the course of his two terms, drove the BUS out of business and its executives out of power. A monetary collapse and economic depression followed.

These events set the stage for the emergence of the AMS. This Section examines the first step in that process—the creation of the New York model. The New York model prefigured the law forged thirty years later at the federal level, repurposing elements of the British system while diffusing and democratizing the power of banks. Instead of relying on a monopoly or an oligopoly—far more *monetarily* stable arrangements—New York allowed every community to have its own banks, with charters available to the general public on a nonpartisan basis, thus putting in place one critical element of the AMS: open access. And since New York's legislators could no longer handpick their franchisees, they also began to develop another element: supervision. They allowed the government to influence bank note issuance, examine books and records, and revoke charters at any sign of trouble. And they decided to delegate this responsibility to independent technocrats. Supervision and open access were thus coeval.

1. New York's Safety Fund Act

New York invented bank supervision between 1829 and 1851.[146] The initial blueprint was the product of a compromise between

145. When the rumors reached Hamilton of efforts to open a second bank in New York in 1791, he wrote to an executive at the Bank of New York:

> I have learnt with infinite pain the circumstance of a new bank having started up in your city. Its effects cannot but be in every way pernicious. These extravagant sallies of speculation do injury to the government, and to the whole system of public credit, . . . three great banks in one city must raise such a mass of artificial credit as must endanger every one of them, and do harm in every view. I sincerely hope . . . the joint force of two solid institutions [the First Bank and the Bank of New York] will, without effort or violence remove, the excrescence which has just appeared and which I consider as a dangerous tumor in your political and commercial economy.

HENRY DOMETT, A HISTORY OF THE BANK OF NEW YORK 42 (1884).

146. Leonard White attributes the "discovery" that something like supervisory power is necessary to "control[ ] the corporate affairs of banks" to Massachusetts in 1838, WHITE, *supra* note 29, at 475, but Massachusetts largely copied New York's scheme, *see infra* note 183 (citing the example of New York). Other sources trace supervision back to Massachusetts in 1813. *See* Mitchener & Jaremski, *supra* note 55, at 823 (citing GRUCHY, *supra* note 128, at 15) ("In 1813, the governor set up a system of three bank commissioners to enforce charter regulations . . . ."). But these sources mischaracterize Massachusetts law. In 1811, the Massachusetts legislature began to require that new banks over a certain size pay to have three "commissioners" specially appointed to certify their specie reserves before opening. *See* An Act of June 27, 1811, ch. 84, § 2, 1811 Mass. Acts 501, 501 (the State Bank); *see also* An Act of June 23, 1812, ch. 34, § 2, 1812 Mass. Acts 47,

legislators skeptical of paper currency and those loyal to banks eager to retain their charters. The skeptics had the upper hand. The charters of most of the banks in New York were due to expire, and there was limited political will to renew them absent a way to ensure the reliability of their issues. The bankers strongly objected to the medicine suggested by some: unlimited stockholder liability.[147] In 1829, Martin Van Buren, an ally of President Jackson and the governor of New York, embraced a creative alternative. Instead of making bank stockholders responsible for their own bank's monetary issues, Van Buren proposed to make banks responsible for each other.[148]

Van Buren's proposal had two parts. First, all new banks would be required to contribute three percent of their capital to a "Safety Fund" to be maintained by the state and used to pay off the notes and deposits of banks that failed. Second, all new banks would be regularly inspected by three "bank commissioners"—one to be selected by the governor, a second by the banks in the southern part of the state, and a third by the banks in the remaining, mostly rural, parts of the state.[149] (In 1837, New York changed the law to make all three commissioners government appointees.[150]) Each bank commissioner would serve for

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47–48 (the Boston Bank); An Act of June 23, 1812, ch. 38, § 2, 1812 Mass. Acts 62, 62–63 (the Union Bank); An Act of June 16, 1813, ch. 46, § 2, 1813 Mass. Acts 270, 271–272 (the New England Bank); An Act of Feb. 18, 1814, ch. 134, § 2, 1814 Mass. Acts 383, 383–384 (the Manufacturers and Mechanics Bank); An Act of Feb. 10, 1818, ch. 92, § 2, 1818 Mass. Acts 489, 489–490 (the Suffolk Bank); An Act of Feb. 3, 1829, ch. 96, § 3, 1829 Mass. Acts 1, 3 (codifying the requirements for all new banks). These one-off commissioners had no other powers or functions. *Id.* I suspect the contrary view stems from a misreading of WHITE, *supra* note 144, at 317, which Gruchy cites and which refers to provisions in the Act to Incorporate the New England Bank, authorizing these special commissioners. *Id.*; GRUCHY, *supra* note 128, at 15, 15 n.3.

147. *See* JOHN JAY KNOX, A HISTORY OF BANKING IN THE UNITED STATES 399 (1900).

148. Martin Van Buren, *The Autobiography of Martin Van Buren*, *in* 2 ANNUAL REPORT OF THE AMERICAN HISTORICAL ASSOCIATION FOR THE YEAR 1918, at 7, 221 (1920).

149. The New York Safety Fund Act, April 2, 1829, *reprinted in* 1 DOCUMENTARY HISTORY OF BANKING AND CURRENCY IN THE UNITED STATES, *supra* note 88, at 643, 645–46 (section fifteen of the Safety Fund Act). Van Buren's plan mimicked the administrative structure New York had designed to govern another infrastructure industry—turnpikes. Between 1797 and 1807, New York established county highway commissions to supervise "turnpike corporations" and their toll roads. RONALD E. SEAVOY, THE ORIGINS OF THE AMERICAN BUSINESS CORPORATION, 1784-1855, at 39–42 (1982). The commissioners were independent technocrats, and the fight over their ample discretionary power prefigures the administrative law critique of the banking agencies today. In 1806, New York authorized the commissioners to issue written orders to turnpike companies in certain circumstances. The turnpike corporations (and Chancellor James Kent) objected. *Id.* at 40–41. According to Kent, then a member of New York's Council of Revisions, the measure would vest "an arbitrary power over the interest and property of individuals which is unknown to the Constitution." *Id.* But the legislature passed the law over Kent's objection. The state regarded turnpike corporations as franchisees, wielding the statal power of eminent domain, and Governor George Clinton argued "a summary mode ought . . . to be prescribed to exact a compliance from those companies with the intentions of government." *Id.* at 40.

150. Act of Mar. 15, 1837, ch. 74, § 2, 1837 N.Y. Laws 56, 56. In 1840, New York added a fourth commissioner. *See* Act of May 14, 1840, ch. 363, § 13, 1840 N.Y Laws 306, 308, *reprinted in* THE

two years unless sooner removed by the governor for misconduct or neglect of duty,[151] and each would be a "check upon the others."[152]

These commissioners were the prototype for modern bank supervision. They were term-tenured officers of the state sworn to uphold its constitution. They were prohibited from having a personal interest in any bank.[153] They were to visit each bank every four months and could "examine upon oath, all the officers, servants, [and] agents of [each bank], or any other person, in relation to the affairs and condition of [the bank]."[154] Along with subpoena power, they had remedial authority. If the commissioners "ascertain[ed] from [their] inspection and examination, or in any other manner, that any of [the] said corporations [were] insolvent, or [had] violated any of the provisions of their act or acts of incorporation, or of any other act binding on such corporations," they could "immediately apply to the court of chancery . . . for an injunction."[155]

Van Buren defended the new law in monetary terms, in effect, as an outsourcing arrangement. The "chief duty" of the state, he told the legislature, "is to see that the farmer, when he exchanges his produce or estate—the mechanic his wares—the merchant his goods—and all other classes of the community their property or services for

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BANKING SYSTEM OF THE STATE OF NEW YORK 113, 123 (John Cleveland & G.S. Hutchinson eds., 2d ed. 1980).

151. The New York Safety Fund Act, April 2, 1829, *reprinted in* 1 DOCUMENTARY HISTORY OF BANKING AND CURRENCY IN THE UNITED STATES, *supra* note 88, at 1188 (section twenty-three of the Safety Fund Act). Section 23 is one of the first for-cause removal statutes in U.S. history. *See* Jane Manners & Lev Menand, *The Three Permissions: Presidential Removal and the Statutory Limits of Agency Independence*, 121 COLUM. L. REV. 1, 43–45 (2021).

152. KNOX, *supra* note 147, at 404.

153. *See id.* at 405. While the Safety Fund bill created the first *bank* supervisors, state oversight of money-issuing franchises dates to at least the eighth century. *See* DESAN, *supra* note 113, at 56 (explaining that eighth century Anglo-Saxon kings "supervised moneyers within their kingdom"). In the mid-twelfth century, Henry II adopted a system called "free minting," in part because it allowed for fewer, more highly supervised mints. As Desan explains,

> Although moneyers originally performed their own tests [on coins], the process was gradually improved and standardized . . . . [E]ach sheriff, anticipating that he might personally lose if the coin he brought in failed to meet the sterling standard would take "good care . . . that the moneyers placed under him [did] not exceed the limits of the appointed standard" or stretch the bullion further by adding more alloy.

Id. at 75; *see also* MARTIN ALLEN, MINTS AND MONEY IN MEDIEVAL ENGLAND 164–69 (2012) (discussing the state's efforts to ensure that privately operated mints complied with government standards); Mavis Mate, *Monetary Policy in England, 1272-1307*, 41 BRIT. NUMISMATIC J. 34, 37 (1972) (same); THOMAS J. SARGENT & FRANCOIS R. VELDE, THE BIG PROBLEM OF SMALL CHANGE 48 (2002) (explaining that medieval "mints were contracted out to private entrepreneurs").

154. The New York Safety Fund Act, April 2, 1829, *reprinted in* 1 DOCUMENTARY HISTORY OF BANKING AND CURRENCY IN THE UNITED STATES, *supra* note 88, at 643, 646 (section seventeen of the Safety Fund Act).

155. *Id.* at 646 (section 18 of the Safety Fund Act).

bank paper, may rest contented as to its value."[156] According to Van Buren, the law's "system of supervision," "if fairly carried into effect," would do this: it would "preserve the fund, and . . . give our paper currency the utmost credit and stability."[157] Despite an aggressive campaign by Wall Street bankers to block the proposal,[158] the bill became law on April 2, 1829.[159]

2. New York's Free Banking Act

A decade later, New York took another major step toward the modern practice of supervision when it expanded access to bank charters by passing a general incorporation statute. The shift was the result of Jackson's successful war on the BUS, whose charter expired in 1836.[160] When the monetary system collapsed the following year, state banks suspended cash payments (i.e., they stopped redeeming their notes or allowing withdrawals in gold and silver coins), and the country plunged into a deep depression.[161]

Although Jacksonian ideology had caused the collapse, most people did not see it that way. Aspiring bankers had an easy time convincing Americans, who were always in need of currency, that there were too few banks and that the existing banks exercised oppressive power.[162] A breakaway sect of the Democratic Party called the Loco-Focos argued that the severe credit scarcity was due to undemocratic and subversive bank "monopolies," most of which were Safety Fund banks. The Loco-Focos demanded that the legislature stop granting special privileges to handpicked citizens and instead recognize the

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156. Annual Message by New York Governor Martin Van Buren Recommending Bank Reform and the Safety Fund, January 23, 1829, *reprinted in* 1 DOCUMENTARY HISTORY OF BANKING AND CURRENCY IN THE UNITED STATES, *supra* note 88, at 636, 639.

157. *Id.* at 641–42.

158. Wall Street banks opposed the new law and "tried to force the hands of the state government by pretending to wind up their affairs." FRITZ REDLICH, THE MOLDING OF AMERICAN BANKING: MEN AND IDEAS 266 (2d ed. 1968). But the BUS stepped into the breach and expanded lending to New York merchants and country banks, foiling these efforts. *Id.*

159. Amendatory Act of April 2, 1829, ch. 94, § 1, 1829 N.Y. Laws 167, 167, *reprinted in* THE BANKING SYSTEM OF THE STATE OF NEW YORK, *supra* note 150, at 29, 29–38.

160. Jackson's war was due in part to lobbying from Wall Street banks eager to eliminate federal regulation of money issuance and to break Philadelphia's grip on American finance. Philadelphia served as the headquarters for the BUS. And Wall Street banks had not forgotten Biddle's 1829 intervention, which thwarted their efforts to block the Safety Fund Act. *See supra* note 158. Moreover, these banks could not benefit from the seven percent rate of interest permitted by that Act because the BUS's New York City branch offered discounts at six percent interest. *See* JOHN THOM HOLDSWORTH & DAVIS R. DEWEY, THE SECOND UNITED STATES BANK 265, 269 (1910).

161. J.G. Forbes, C. Starr & T. Cary, *Annual Report of the Banking Commissioners*, *in* 3 DOCUMENTS OF THE ASSEMBLY OF THE STATE OF NEW YORK No. 64, at 8 (1841).

162. *See, e.g.*, HURST, *supra* note 107, at 88, 167–68; KNOX, *supra* note 147, at 397 (discussing corrupt chartering in New York).

"natural" "rights of the people to compete with the incorporated banks in dealing in money and credit."[163]

Many Democratic officials agreed with the Loco-Focos and thought that the answer to the contraction was more banks. State senator Samuel Young, for example, complained that the Safety Fund system had spawned "unmitigated inequity in the distribution of [bank] stock" and "demoraliz[ed] the public through the process of getting charters."[164] Young wanted "free banking"—free, meaning open access[165]—with no limit on the number or duration of bank charters and no involvement of the legislature in deciding whether to authorize a bank to open for business.[166]

In 1838, Governor William Marcy, seeking to avoid a schism within his party, pushed free banking into law, beginning a radical experiment in money creation.[167] New York's new system—often mistaken today for a deregulatory scheme—was anything but. Instead, it represented the unique compromise at the heart of the AMS. It opened the business of banking to "full and free competition, under such general restrictions and regulations as are necessary to [e]nsure to the

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163. REDLICH, *supra* note 158, at 189.

164. *Id.* at 197. Even the bank commissioners agreed. *See* KNOX, *supra* note 147, at 405 (quoting the commissioners report, which stated that "[t]he distribution of bank stocks created at the last session" has prompted "violent contention and bitter personal animosities, corrupting to the public mind and destructive of the peace and harmony of society").

165. *See, e.g.*, ROBERTSON, *supra* note 142, at 23 ("To the people of the time the adjective 'free' meant that any individual or group of individuals, upon compliance with certain procedural steps in the statute, could start a bank."). "Free banking" is often misinterpreted today to mean "subject to minimum regulations." *See, e.g.*, White, *supra* note 71, at 19.

166. New York first used free incorporation to address concerns about the legislature's role in dispensing privileges in 1784 when it began to administratively charter religious institutions. *See* SEAVOY, *supra* note 149, at 9–10. (Pennsylvania did this first in 1791. *Id.* at 32 n.2.) One of the earliest advocates of free banking was the Columbia professor of political economy John McVickar, who proposed it in 1827. *See* JOHN MCVICKAR, HINTS ON BANKING: IN A LETTER TO A GENTLEMAN IN ALBANY; BY A NEW YORKER (1827) (critiquing bank incorporation by the legislature as corrupt, self-dealing, and ineffective).

167. HAMMOND, *supra* note 104, at 583. *See* REDLICH, *supra* note 158, at 196 (explaining that "but for the crisis of 1837 and the collapse of American banking which followed in its wake," free banking would never have happened). Although, during the early 1830s, Jackson expressed interest in replacing the BUS with a Treasury-run institution, there was not much support for this idea in either party. HAMMOND, *supra* note 104, at 360–61 (explaining that Jackson, for a time, envisioned a national bank with a branch in each state subject to the supervision of the Treasury and quoting Jackson as preferring an "entirely *national*" bank); *see also* Message by President Andrew Jackson Vetoing the Bank Recharter, July 10, 1832, *reprinted in* 2 DOCUMENTARY HISTORY OF BANKING AND CURRENCY IN THE UNITED STATES, *supra* note 88, at 816, 827 (arguing that Congress has exercised its power to coin money by establishing mints and "if they have other power to regulate the currency [i.e. through issuing bank money], it was conferred to be exercised by themselves, and not to be transferred to a corporation"); *id.* at 817 ("Every monopoly and all exclusive privileges are granted at the expense of the public . . . ."). Those who had championed the BUS were suspicious of a wholly government-owned bank, which they feared the government would use to avoid levying taxes. *See, e.g.*, *supra* note 133 and accompanying text; *see also* Briscoe v. President & Dirs. of Bank of Ky., 36 U.S. 257, 329–50 (1837) (Story, J., dissenting).

public a large and sound currency."[168] At the same time as New York opened access, it also imposed separation and supervision.

Indeed, "free banking" as pioneered by New York, and copied by many other states,[169] was a *regulatory* measure. New York's law required that all banks back their notes with government bonds and that they deposit these bonds with the state comptroller.[170] In the event that a bank failed to redeem its notes, the law authorized the state comptroller to sell the bonds, pay the noteholders, and close the bank.[171] The law prohibited banks from commencing business without paid-in capital of $100,000 (a substantial sum),[172] and all banks were required to keep a specie reserve of 12.5 percent of the value of their outstanding notes.[173] Any bank creditor or shareholder with at least $1,000 on the line could appeal to the chancellor to conduct "a strict examination . . . of all the affairs" of the bank "for the purpose of ascertaining the safety of its investments, and the prudence of its management."[174] And all banks were required to publish financial statements.[175]

Soon after the law took effect, the need for stronger, full-time discretionary oversight became evident.[176] In 1840, New York amended the law to require anyone "carrying on banking business," including the

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168. REDLICH, *supra* note 158, at 190 (quoting Marcy). As Hurst explains, "the implicit policy which emerged was one favoring delegation of money functions to private management, out of belief that liberal delegation would best muster the energy and resources to spur the economy." HURST, *supra* note 107, at 154. Gulian Verplanck, a state senator sitting on the Court of Errors, the highest court in New York at the time, put it this way:

> Strong public opinion and the requirements of trade were thought, by a large majority of the [l]egislature . . . to demand some legislation whereby the business of banking could be thrown open, under proper restraints, to all who might choose to engage in it, and this without dependence upon political patronage.

Warner & Ray v. Beers, 23 Wend. 103, 139 (N.Y. 1840).

169. Drawing from New York's draft legislative text, Michigan passed a similar law in 1837. *See* HAMMOND, *supra* note 104, at 572, 582. As the Supreme Court of Michigan explained in 1844, a general incorporation act for banks was "unknown in the history of legislation, either in this state or any other state or country." Green v. Graves, 1 Doug. 351, 355 (Mich. 1844).

170. The New York Free Banking Acts of April 18, 1838 and May 14, 1840, *reprinted in* 2 DOCUMENTARY HISTORY OF BANKING AND CURRENCY IN THE UNITED, *supra* note 88, at 1183, 1183–91. Under certain conditions, some mortgages on New York land might also be pledged. *Id.* at 1185 (sections seven and eight of the Act of April 18, 1838).

171. *Id.* at 1184, 1187, 1190 (sections 4, 12, and 27 the Act of April 18, 1838).

172. *Id.* at 1186 (section 15 of the Act of April 18, 1838).

173. *Id.* at 1191 (section 33 of the Act of April 18, 1838).

174. *Id.* at 1188–89 (section 25 of the Act of April 18, 1838). The chancellor, however, could not take any direct action and could only publish a report along with his opinion. *Id.*

175. *Id.* at 1189 (section 26 of the Act of April 18, 1838).

176. 1 WILLIAM GRAHAM SUMNER, A HISTORY OF BANKING IN ALL THE LEADING NATIONS; COMPRISING THE UNITED STATES; GREAT BRITAIN; GERMANY; AUSTRO-HUNGARY; FRANCE; ITALY; BELGIUM; SPAIN; SWITZERLAND; PORTUGAL; ROUMANIA; RUSSIA; HOLLAND; THE SCANDINAVIAN NATIONS; CANADA; CHINA; JAPAN 313 (1896). For example, new banks were abusing their franchise by avoiding redeeming their notes in specie on demand.

"free" banks, to be "subject to the inspection *and supervision* of the bank commissioners."[177] In 1843, due in part to concerns about the impartiality of the commissioners,[178] New York transferred responsibility for bank oversight to the state comptroller,[179] elected every three years by the legislature.[180] New York also stripped banks of their power to print their own notes, shifting that responsibility to the comptroller, who would register and issue notes only on receipt of the required securities.[181]

Those involved in developing the New York model, as well as those legislators in other states who copied and refined it, understood the originality of their project and the key role discretionary administrative oversight played in rendering a more diffuse banking system sustainable.[182] For example, in 1837, one Massachusetts state senator noted that the bank commissions recently established in New York, Vermont, and Maine exercised a salutary *informal* power over banks—precisely the sort of power under attack today. As he put it,

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177. Act of May 14, 1840, ch. 363, § 11, 1840 N.Y. Laws 306, *reprinted in* THE BANKING SYSTEM OF THE STATE OF NEW YORK, *supra* note 150, at 113, 122 (emphasis added). New York's legislature, at this early date, is already distinguishing between the power of examination and the activity of supervision—the informal control exercised by examiners over a bank's affairs.

178. KNOX, *supra* note 147, at 403 (quoting one New York legislator explaining that the commissioners "were placed there like cur dogs to watch a meat market, and were as easily subsidized by suitable food").

179. Act of Apr. 18, 1843, ch. 218, § 6, 1843 N.Y. Laws 299, *reprinted in* THE BANKING SYSTEM OF THE STATE OF NEW YORK, *supra* note 150, at 136, 140–41.

180. This appears to have been done in part to assuage the banks who disliked the commissioners and their broad investigatory powers and in part because, as Millard Fillmore explained, the reforms of 1837 had "brought [the commissioners] within the vortex of the great political whirlpool of the State; and the place was sought for and conferred upon [partisan] aspirants, without due regard in all cases to their qualifications to discharge the delicate trust committed to them." *See* State of N.Y. Comptroller's Off., *Annual Report of the Comptroller* (Jan. 4, 1849), *in* 1 DOCUMENTS OF THE ASSEMBLY OF THE STATE OF NEW YORK no. 5, at 51 (1849). In 1846, New York adopted a new constitution, which subjected the comptroller's office to popular election biannually. N.Y. CONST. of 1846, art. V, § 1.

181. *See* KNOX, *supra* note 147, at 419.

182. As A.C. Flagg, New York's comptroller from 1833 to 1839 and 1842 to 1847, explained:

> After repudiating the British form of government, we adopted her paper system, in a form much more loose and insecure to the people, than was ever tolerated even in England. . . . The acknowledgement of the necessity of [strict] restrictions in England, . . . in creating debt and paper money, ought to admonish us of the necessity of new safe-guards; . . . it is of the highest importance that . . . New York, should give the full force of its example, to the establishment of a sound currency, . . . and the sacred preservation of the public faith.

State of N.Y. Comptroller's Off., *Annual Report of the Comptroller's Office* (Jan. 12, 1846), *in* DOCUMENTS OF THE ASSEMBLY OF THE STATE OF NEW YORK no. 25, at 72–74 (1846). New York's supervisors understood that deposits were also part of the currency. *See Report of the Bank Commissioners* (Jan. 31, 1831), *in* DOCUMENTS OF THE ASSEMBLY OF THE STATE OF NEW YORK no. 59, at 9 (1831) ("[C]urrency . . . may be said to consist of specie, bank notes, and deposits in banks transferable by means of checks.").

banks are incentivized "to meet the approbation of the government's officers," and accordingly, commissioners "exert a controlling influence over the banks' issues, discounts, exchanges, deposit[ ]s, in short, over all their operations."[183] As a result, commissioners "contribute, essentially, to the stability and usefulness of these institutions, by producing a uniformity in their operations, and by sustaining, towards them, the confidence of the public."[184]

To bolster this "controlling influence" and prevent bank failures,[185] the states continued to expand discretionary authority in the decade that followed.[186] Most notably, in 1847, New York's legislature introduced the concepts of safety and soundness into law,[187] mimicking similar statutes already enacted in Massachusetts, New Hampshire, and Connecticut.[188] Massachusetts law, for example, required state

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183. Debate in the Massachusetts Legislature: Remarks of Mr. Lawrence, of Hampshire, on the Bill for the Appointment of Bank Commissioners, BOS. DAILY ADVERTISER, Feb. 23, 1837.

184. *Id.* Senator Lawrence continued: "[C]ommissioners, armed with authority to enter any bank, on any day, and any hour of the day, and with ample powers, to ferret out mischiefs, if any exist . . . would exert a most salutary restraint on their managers . . . . It would abolish all discordant customs among the banks, and introduce a uniform system of usages and modes." *Id.*

185. For example, by 1847, of the 117 free banks incorporated in New York, forty-three had already been closed, thirty of these by the comptroller. State of N.Y. Comptroller's Off., *Annual Report of the Comptroller* (Jan. 6, 1847), *in* 1 DOCUMENTS OF THE ASSEMBLY OF THE STATE OF NEW YORK no. 5, at 54 (1847).

186. New York's supervisors sought enhanced authority as early as 1842. *Annual Report of the Bank Commissioners*, *in* 2 DOCUMENTS OF THE ASSEMBLY OF THE STATE OF NEW YORK no. 29, at 22 (1842). The commissioners also complained about window dressing and proposed the first "call reports." *Id.* at 20.

187. Act of Dec. 4, 1847, ch. 419, § 3, 1847 N.Y. Laws 519, *reprinted in* THE BANKING SYSTEM OF THE STATE OF NEW YORK, *supra* note 159, at 146, 149–50 (1864) (emphasis added):

> Whenever in the opinion of the comptroller, there [is] good cause to suspect that any bank . . . has made an incorrect or imperfect quarterly return, or is in an *unsound or unsafe* condition to do banking business, it shall be his duty to have . . . such bank . . . examined [and] . . . report . . . the result of such examination.

The 1847 statute, in its choice of words, resembles the text of an 1846 Ohio law expanding the oversight powers of the Board of Control of Ohio's bank branching system. *See* Act of Jan. 6, 1846, § 2, *in* 2 THE VERIFIED REVISED STATUTES OF THE STATE OF OHIO: INCLUDING ALL LAWS OF A GENERAL NATURE IN FORCE JAN. 1ST, 1890, at 2299. The existing literature tracks safety and soundness law to 1933. *See, e.g.*, Schooner, *supra* note 74, at 188 ("Principles of safety and soundness have been a source of directors' duties since as early as 1933 when Congress authorized removal proceedings against national bank directors for unsafe or unsound banking practices."); DALVINDER SINGH, BANKING REGULATION OF UK AND US FINANCIAL MARKETS 70 (2007) ("Safety and soundness . . . was first incorporated in US bank regulation with the enactment of the Banking Act 1933 . . . ."); Thomas L. Holzman, *Unsafe or Unsound Practices: Is the Current Judicial Interpretation of the Term Unsafe or Unsound?*, 19 ANN. REV. BANKING L. 425, 428 (2000) (noting that its "origin presents somewhat of a mystery as does the lack of debate surrounding its adoption" in 1933). I examine the evolution of this standard in separate work focused on resurrecting the history of state banking law. *See* Lev Menand, *The Monetary Basis of Bank Supervision* (unpublished manuscript).

188. Each state used slightly different language. *Compare* An Act Concerning Banks, § 14, *in* PUBLIC STATUTE LAWS OF THE STATE OF CONNECTICUT 94 (1839) ("Whenever in the opinion of the bank commissioners the charter of any bank shall be forfeited [i.e. the bank shall have violated

judges to issue injunctions *before* holding "a hearing of evidence to satisfy [their] own mind" merely "on the complaint of the bank commissioners" that a bank's "condition is such as to render its further progress hazardous to the public."[189] New York subsequently gave its officials a similar power to proceed against banks when, in their opinion, banks were in an "unsound or unsafe condition."[190] Today this distinctive language serves as the lynchpin of the federal government's statutory authority over banks.

Officials once again explained the need for strict oversight in outsourcing terms:

> When the State assumes to authori[z]e a person, or associations of persons, to stamp paper dollars, and literally force them into the hands of the citizen, in exchange for his labor and his property, it is an incumbent duty to compel the manufacturer of the currency to secure such citizen[ ] against loss . . . .[191]

According A.C. Flagg, New York's comptroller, "the holder [of New York bank paper] ought to feel as safe, so far as the action of the government is concerned, as he does with coin stamped at the mint."[192] In 1849, the future President Millard Fillmore, who succeeded Flagg as comptroller, explained that "[t]o furnish this currency, so far as it consists of paper or credit, is an exclusive privilege granted by the State, and the State should take care that in granting it the people are secured from imposition and loss."[193] For the founders of the AMS, then, money

the provisions of the Act], or the public are in danger of being defrauded thereby . . . ."), *with* Act of July 4, 1837, ch. 140, § 27, *in* REVISED STATUTES OF THE STATE OF NEW HAMPSHIRE 266 (1843) ("If such commissioners, upon an examination into the affairs of any bank or for other good cause, shall deem it unsafe for the public interest . . . ."), *and* Act of Feb. 23, 1838, ch. 14, § 5, *in* SUPPLEMENTS TO THE REVISED STATUTES: GENERAL LAWS OF THE COMMONWEALTH OF MASSACHUSETTS 60 (1849):

> If upon examination of any bank . . . said commissioners shall be of [the] opinion that the same is insolvent, or that its condition is such as to render its further progress hazardous to the public, or to those having funds in its custody, and also that said bank . . . has exceeded its powers, or has failed to comply with all of the rules, restrictions and conditions provided by law . . . .

189. Commonwealth by Bank Comm'rs v. President of Farmers & Mechs. Bank, 38 Mass. 542, 549 (1839). In 1839, the Supreme Judicial Court of Massachusetts, in what it described as a "very important case," upheld the power, explaining that its "object was to prevent [banks] becoming dangerous to the public by their mismanagement and breach of the laws," and that it was a proper exercise of legislative authority, especially "[w]hen it is considered how important it is to all the great interests of the community, that banks should be managed uprightly and with integrity . . . and how important it is that they should enjoy the confidence of the community." *Id.* at 549–51.

190. *See infra* note 197.

191. State of N.Y. Comptroller's Off., *supra* note 182, at 72.

192. State of N.Y. Comptroller's Off., *Annual Report of the Comptroller* (Jan. 5, 1848), *in* 1 DOCUMENTS OF THE ASSEMBLY OF THE STATE OF NEW YORK no. 4, at 64 (1848).

193. State of N.Y. Comptroller's Off., *supra* note 180, at 54.

creation was a sovereign prerogative, and it followed that delegating this power to private actors required close public control.

In 1851, New York extended public control over banks even further by transferring supervision to a full-time independent agency, the New York Banking Department,[194] a clear precursor to today's banking agencies and the first such body in the United States.[195] This was supervision in a modern key, as the state fully embraced an ongoing oversight role. New York charged the department with ensuring that the state's monetary system functioned properly and that credits issued by the state's banks maintained a stable value in gold and silver coins. In 1854, it empowered the superintendent to "refuse to issue or deliver any registered notes to" a bank in "*an unsound or unsafe condition*," "until such time as he shall be satisfied that such bank . . . is in a *sound and safe condition* to do [ ] banking business."[196] This provision allowed the superintendent to suspend a bank's business not just when the bank violated a rule but whenever the superintendent thought the bank was being mismanaged. In the subsequent decades, the department was repeatedly strengthened,[197] gaining the authority to institute insolvency proceedings against banks and "take possession" of "unsound" banks outright.[198]

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194. Act of Apr. 12, 1851, ch. 164, § 3, 1851 N.Y. Laws 309, *reprinted in* THE BANKING SYSTEM OF THE STATE OF NEW YORK, *supra* note 150, at 179, 180.

195. The Banking Department had a precursor in a powerful independent agency New York created in 1784 to oversee its education system: the Regents of the University of the State of New York. New York empowered the Regents to charter, examine, and supervise schools. *See* SEAVOY, *supra* note 149, at 13–15; Revised Statutes of the State of N.Y., Part I, Chap. XV, Title 1, Art. 1 (1829) (providing the organizational structure and powers of the Board of Regents).

196. Act of Apr. 15, 1854, ch. 242, § 3, 1854 N.Y. Laws 551, *reprinted in* THE BANKING SYSTEM OF THE STATE OF NEW YORK, *supra* note 150, at 200–02 (emphasis added). Section 3 also provided that the superintendent could restrict note issue if he determined that the business of the bank was "not transacted in the manner prescribed by law." *Id.*

197. In 1882, New York authorized the bank superintendent, in conjunction with the state attorney-general, to institute insolvency proceedings whenever a bank "has committed a violation of its charter or of law" or "is conducting business in an unsafe or unauthorized manner." Act of July 1, 1882, ch. 409, § 223, *reprinted in* BANKING LAWS: AN ACT TO REVISE THE STATUTES OF THE STATE OF NEW YORK RELATING TO BANKS, BANKING AND TRUST COMPANIES 86 (2012). In 1892, New York amended the law to provide that the superintendent may "take possession" of a bank if he has "reason to conclude that [it] . . . is in an *unsound or unsafe condition* to do banking business." Act of May 18, 1892, ch. 689, § 17, *reprinted in* 2 THE REVISED STATUTES OF THE STATE OF NEW YORK 1038 (1896) (emphasis added).

198. The term "sound" was an adjective commonly used to describe monetary instruments—notes and deposits—that could be converted into base money (then gold and silver coins) on demand at par. In forthcoming work, I argue that the first use of the term in this sense was probably in the 1810 Report of the Bullion Committee, an assessment by the British Parliament of whether the Bank of England's 1797 suspension of cash payments (i.e., its refusal to redeem its notes and deposits in gold and silver coin) had triggered inflation. HOUSE OF COMMONS, REPORT FROM THE SELECT COMM. ON THE HIGH PRICE OF BULLION (1810), *reprinted in* THE PAPER POUND OF 1797-1821, at 6 (Edwin Canaan ed., 2d ed. 1969). *See also* HC Deb (7 May 1811) (19) cols. 994–95 (Lord Castlereagh) ("When I speak of our circulation in a sound state, I mean a circulation,

B. Federal Transformation

Three decades after the collapse of the BUS, the federal government began to create the institutional framework that would comprise the modern AMS. In doing so, it drew heavily on the New York Model. First, in 1863, Congress created the OCC to charter and oversee hundreds of national banks to serve collectively as a sort of "Third Bank of the United States." Then, in 1913, it created the Fed to coordinate national banks and extend federal supervision to a growing mass of banks chartered by state governments. Both agencies were designed to manage our open-access monetary system by ensuring that the private managers and shareholders of banks create sound money.

1. The National Bank Act

After the demise of the Second Bank in 1834, it took thirty years and a war to build our modern monetary order. By 1862, there were approximately 1,500 state banks, creating most of the money supply by lending to business firms. These banks were primarily concentrated in the seventeen states that had enacted free banking laws modeled on New York's.[199] A handful of states employed a publicly controlled "branching system," with a government-run Board of Directors

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composed of Bank-paper and coin, in such proportions as will enable any man to convert, at his pleasure, his notes into coin."). But the use of the word "sound" to describe money long predates paper currency as it was common to speak of "sound" pennies (i.e., silver coins that were current and not clipped or damaged). *See, e.g.*, DESAN, *supra* note 113, at 125; A. BARTON HEPBURN, A HISTORY OF CURRENCY IN THE UNITED STATES 31 (Augustus M. Kelley Publishers 1967) (suggesting that the term "sound" originated from an "auricular" test whereby a coin was dropped and its quality would be determined based on the sound of the resulting ring). In 1840, Maryland, in its annual report to Congress on its banking system, proclaimed that "[t]he end of the design for which the [state's] banks were created was to secure a sound and redeemable paper currency—a paper currency at all times payable on demand in specie." H.R. Doc. No. 26-172, at 378 (1840). At the end of the century, A. Barton Hepburn, a bank supervisor, gave this same definition: "Sound money as applied to paper or token money of any kind means that which is redeemable in money wherein the commercial value of its bullion equals its coinage value." HEPBURN, *supra*, at 30–31. So, when New York empowered supervisors to ensure that banks were "sound" they were referring to, as A.C. Flagg put it, "efforts to make the paper issues of [banks] equivalent to gold and silver, or as nearly so as practicable . . . ." State of N.Y. Comptroller's Off., *supra* note 182, at 72.

199. *See* ROBERTSON, *supra* note 142, at 16. Rhode Island, an exception with eighty-eight banks by 1863, adopted a robust supervisory scheme. *See* KNOX, *supra* note 147, at 373 (noting the statutory and supervisory limits placed on banks); An Act in Relation to Banks, § 7, *in* PUBLIC LAWS OF THE STATE OF RHODE-ISLAND AND PROVIDENCE PLANTATIONS AS REVISED BY A COMMITTEE AND FINALLY ENACTED BY THE GENERAL ASSEMBLY AT THE SESSION IN JANUARY, 1844, at 290 (1852) (providing that the bank commissioner might enjoin any bank if "in his opinion . . . [that] bank has forfeited its charter at law, or is so managing its concerns that the public are in danger of being defrauded thereby").

supervising privately capitalized branches.[200] The remaining states prohibited banking entirely or still operated parastatal oligopolies on the Hamiltonian model.[201]

For states like New York and Massachusetts, with appropriate restrictions and strong supervision, the system worked tolerably well.[202] And, although trade both within and between states was somewhat impaired by the variegated money supply (households and businesses spent and received thousands of different paper notes), private solutions facilitated commerce.[203]

But as with so many aspects of the American state, the monetary system could not meet the demands of the Civil War.[204] Military necessity compelled Congress to appropriate more and more money, and the Treasury found that it did not have enough tax receipts to cover its expenditures. First, Treasury Secretary Salmon Chase turned to borrowing, draining gold and silver bullion out of the state banks. In December 1861, when rumors spread that Britain might enter the war, panic hit.[205] With much of the country's gold sitting in Treasury warehouses, banks were unable to make good on their obligations. Banks in nearly every state suspended payments on their notes and deposit accounts.[206]

With neither banks nor the Treasury redeeming the country's paper money in coin, the Lincoln Administration prevailed on Congress to roll back delegation by passing the Legal Tender Act. The Act was a break with seventy-five years of practice. It authorized the government to issue its own paper notes called "greenbacks," expanding the money supply directly rather than through privately operated banks. But as the state banks started using greenbacks as reserves on which to issue even more of their own notes, the value of the dollar dropped.

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200. Indiana pioneered this approach in 1834. After Ohio and Iowa followed suit, in 1845 and 1858, respectively, *see* KNOX, *supra* note 147, at 679–80, 766–67, Illinois, Kentucky, Tennessee, Delaware, and Vermont adopted the same type of system, *see* ROBERTSON, *supra* note 142, at 28.

201. ROBERTSON, *supra* note 142, at 23. Nine states outlawed banking in the 1840s and 1850s. South Carolina, Missouri, and Ohio maintained restricted systems and partial state ownership until the Civil War. *See id.*

202. *See* L. Carroll Root, *New England Bank Currency*, 2 SOUND CURRENCY, June 1, 1985, at 6–8 (noting that only three banks failed in Massachusetts between 1840 and 1865); L. Carroll Root, *New York Bank Currency*, 2 SOUND CURRENCY, Feb. 1, 1895, at 24 (noting the exceptional strength of New York's paper currency).

203. *See, e.g.*, J. THOMPSON, THOMPSON'S BANK NOTE AND COMMERCIAL REPORTER, Nov. 5, 1853 (assessing the relative value of various bank notes).

204. RICHARD FRANKLIN BENSEL, YANKEE LEVIATHAN: THE ORIGINS OF CENTRAL STATE AUTHORITY IN AMERICA, 1859-1877, at 238–303 (1990).

205. Wesley C. Mitchell, *The Suspension of Specie Payments, December 1861*, 7 J. POL. ECON. 289, 320 (1899).

206. *Id.* at 322–24. Ohio, Indiana, and Kentucky—the exceptions—all had government-run state banking systems with private branches. *Id.* at 324.

The Administration feared direct monetary expansion by the government combined with state banking would end in disaster.[207] The natural solution—rechartering the BUS to replace greenbacks and restrict state bank issues—was politically toxic.[208] Instead, the Administration proposed to federalize the New York Model. It argued that the United States should charter national *banks*, plural, which would issue a "uniform currency" in exchange for U.S. bonds. Congress would not pick winners, nor would it limit the power to monetize debt and allocate credit to just a few hands. Anyone with enough capital, willing to abide by the rules and to subject their operations to state oversight, would be permitted to supply a part of the nation's money. With the help of John Sherman, the powerful senator from Ohio, Chase secured passage of the National Bank Act ("NBA") on February 20, 1863. Lincoln signed it five days later.[209]

The Act was a compromise. Farmers and workers, especially in the West and the South, opposed private banking and celebrated greenbacks. They wanted public control over the money supply,[210] with money issued directly by the government.[211] In their eyes, banking delegated this public power to private actors and concentrated wealth in the hands of special interests.[212] The NBA, by continuing delegation, was, in this respect, a conservative measure.[213]

At the same time, the NBA was also a radical act of creation: It federalized the money supply by establishing the OCC as a bureau within the Treasury Department and empowering it to charter and supervise a new system of "national banks."[214] These banks were not

207. If notes were not convertible into gold and silver on demand, most policymakers thought people would lose confidence in their value, triggering inflation. *See, e.g.*, CONG. GLOBE, 37th Cong., 3d Sess. 842 (1863) (Statement of Sen. John Sherman).

208. *See, e.g.*, KANE, *supra* note 128, at 23–24.

209. A revised version of the Act was passed in 1864, which is the version discussed herein. *See* The National Bank Act, June 3, 1864, *reprinted in* 2 DOCUMENTARY HISTORY OF BANKING AND CURRENCY IN THE UNITED STATES, *supra* note 88, at 1383, 1383–1411.

210. *See* GRETCHEN RITTER, GOLDBUGS AND GREENBACKS: THE ANTIMONOPOLY TRADITION AND THE POLITICS OF FINANCE IN AMERICA, 1965-1896, at 96–98 (1999).

211. Alexander Campbell, Lecture Before the Mercantile Association of Chicago: The True American System of Finance, Adapted to the Genius of Our Institutions, the Present Wants of the Government, and Business Interests of the Country, and a Guaranty for the Future Integrity of the Union (Oct. 1, 1862); ALEXANDER CAMPBELL, THE TRUE AMERICAN SYSTEM OF FINANCE: THE RIGHTS OF LABOR AND CAPITAL, AND THE COMMON SENSE WAY OF DOING JUSTICE TO THE SOLDIERS AND THEIR FAMILIES: NO BANKS, GREENBACKS THE EXCLUSIVE CURRENCY (1864). *See also* EDWARD KELLOGG, LABOR AND CAPITAL: THE RIGHTS OF EACH SECURED AND THE WRONGS OF BOTH ERADICATED 252 (1849) (arguing that all the money circulated in the United States should be issued by a National Safety Fund).

212. RITTER, *supra* note 210, at 96–109.

213. *Id.* at 78.

214. The National Bank Act, June 3, 1864, *reprinted in* 2 DOCUMENTARY HISTORY OF BANKING AND CURRENCY IN THE UNITED STATES, *supra* note 88, at 1383, 1383.

designed to facilitate private wealth creation, but to serve as premodern independent agencies. As Representative Samuel Hooper, the law's primary drafter, put it: "It will be as if the Bank of the United States had been divided into many parts, and each part endowed with the life, motion, and similitude of the whole . . . ."[215] National banks, like the BUS, would be privately managed to prevent overissue[216] and politicized asset allocation.[217] As Senator Sumner put it: "[The national banking system] is an instrument in the public service . . . . Is it not an instrument? Is it not as much an instrument as your navy yard, your arsenal, or your mint?"[218] National banks are "essential instruments" of the government, another member declared.[219] The public status of national banks is reflected in the law itself, which recaptured profits generated by money issuance by collecting royalties[220] and refers to

215. CONG. GLOBE, 37th Cong., 2d Sess. 616 (1862) (statement of Rep. Samuel Hooper).

216. Salmon P. Chase, *Letter to Horace Greeley (Jan. 28, 1863)*, *in* 3 THE SALMON P. CHASE PAPERS 376 (1996):

> A circulation issued directly by the Government cannot be made a good currency. The difficulty is partly in the *nature of the thing* and partly in the *nature of men*. The total difficulty is insurmountable & so says all experience. The only remaining way which has had trial enough to warrant reasonable expectation of success is through banking Institutions. Local Banks were tried in the war of 1812 & failed disastrously . . . . The Bank of the United States has been twice tried & nobody is bold enough to propose a third trial. There seems to remain only a National Free Banking System. A state Free Banking System has been tried in New York for three million[ ] . . . people with the best results on State credit and individual well being;

CONG. GLOBE, 37th Cong., 3d Sess. 842 (1863) (statement of Sen. John Sherman):

> The only answer [to the question "why look at all to the interests of the banks; why not directly issue the notes of the Government"] is that history teaches us that the public faith of a nation alone is not sufficient to maintain a paper currency. There must be a combination between the interests of private individuals and the Government;

John Sherman, *The National Banking Project; The Certainty with Which It Will Give Us a Sound National Currency*, N.Y. TIMES, Feb. 2, 1863, at 4 ("The well-guarded Free Banking system proposed by Mr. C[hase], commends itself in that it promises the needed currency. The central idea of that measure is the establishment of one sound, uniform circulation, of equal value throughout the country, upon the foundation of National credit, combined with private capital.").

217. U.S. TREASURY SEC'Y, REP. ON THE STATE OF THE FINANCES FOR THE YEAR ENDING JUNE 30, 1962, REFERRED TO THE H. COMM. ON FIN., 37TH CONG., 16–17 (3d Sess. 1862) (explaining that when the federal fiscal stance returned to a "healthy normal," it would be impossible for the federal government, by spending money, to provide greenbacks "in sufficient amounts for the wants of the people," forcing the government to lend notes into circulation, which "would convert the treasury into a government bank, with all its hazards and mischiefs").

218. CONG. GLOBE, 38th Cong., 1st Sess. 1894 (1864) (statement of Sen. Charles Sumner).

219. CONG. GLOBE, 38th Cong., 1st Sess. 2200 (1864) (statement of Sen. Jacob Collamer).

220. Salmon P. Chase, *Letter to John Bigelow (Oct. 7, 1862)*, *in* 3 THE SALMON P. CHASE PAPERS, *supra* note 216, at 290, 293; CONG. GLOBE, 37th Cong., 3rd. Sess. 1146–47 (1863) (statement of Rep. John B. Alley) (arguing that "the people are entitled" to the profit from money creation, and "the government is really the party who should have all the profit of the circulation" and is "entitled to the whole benefit").

each bank as a "franchise."[221]

National banks were also given standardized names (reflecting their status as government instrumentalities). Thus, the first bank to secure a charter in Baltimore was the First National Bank of Baltimore and the fourth bank to secure a charter in New York was the Fourth National Bank of New York.[222] And the NBA required national banks to deposit United States bonds with the comptroller and authorized the comptroller to issue notes to each bank in an amount equivalent to ninety percent of the value of the deposited bonds.[223] The NBA required national banks to maintain specie reserves equal to between fifteen and twenty-five percent of their monetary liabilities.[224] And it imposed supervision, copying key elements of New York's law. Specifically, the Act empowered the comptroller to "thorough[ly]" inspect national banks "as often as shall be deemed necessary or proper" to depose the officers and agents of the bank under oath and to publish a full and detailed report.[225] If the examiners identified legal violations,[226] or if a bank refused to redeem its circulating notes in gold and silver coin,[227] the comptroller could bring suit against the bank and seek to dissolve it. The Act also delegated a series of plenary approval powers to the comptroller,[228] which meant banks often needed government cooperation to operate effectively.[229]

Secretary Chase imagined that the new banks would completely replace the existing state banks, forcing those banks to convert to

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221. The National Bank Act, June 3, 1864, *reprinted in* 2 DOCUMENTARY HISTORY OF BANKING AND CURRENCY IN THE UNITED STATES, *supra* note 88, at 1383, 1385 ("Such association shall have power to adopt a corporate seal, and shall have succession by the name designated in its organization certificate . . . *unless the franchise shall be forfeited* by a violation of this act . . . .") (emphasis added); 12 U.S.C. § 24 (Second) (noting that the "franchise becomes forfeited by reason of violation of law"). *See also* CONG. GLOBE, 38th Cong., 1st Sess. 1412 (1864) (statement of Rep. John Pruyn) (noting that national banks operate under a "franchise granted by the Government"); CONG. GLOBE, 38th Cong., 1st Sess. 2204 (1864) (statement of Sen. Edgar Cowan) (noting that national banks possess a "franchise" granted by the federal government).

222. *See* ROBERTSON, *supra* note 142, at 49.

223. The National Bank Act, June 3, 1864, *reprinted in* 2 DOCUMENTARY HISTORY OF BANKING AND CURRENCY IN THE UNITED STATES, *supra* note 88, at 1383, 1391–92 (sections nineteen and twenty-one of the National Bank Act).

224. *Id.* at 1396–97 (sections thirty-one and thirty-two).

225. *Id.* at 1407 (section fifty-four).

226. *Id.* (section fifty-three).

227. *Id.* at 1396–97, 1403–06 (sections-thirty two and forty-six through fifty).

228. For example, comptroller approval was required before a bank could reduce (or increase) its equity capital. *Id.* at 1388 (section thirteen).

229. For example, here is how Senator Steele of New York described the supervisory authority embedded in the original NBA—modest by comparison to many of the states at the time: "[These banks] will be entirely at the mercy of the Treasury Department, and therefore to that extent subject to its control and dictation . . . ." CONG. GLOBE, 38th Cong., 1st Sess. 1432 (1864) (statement of Sen. William Steele).

national charters or disband.[230] In 1865, Congress imposed a prohibitive ten percent tax on state bank notes, and by 1868, the number of state banks had fallen to less than 250 (an eighty-five percent reduction).[231] "The banks created by the national banking act," the Department of Justice explained fifty years later, "were, and were designed to be, local institutions and independent of each other, but under national control and supervision. Nationalization without centralization was the keynote of the law."[232] The plan was "so radical in its character and so destructive to the existing system of state banks," one of its supporters explained, that it was explicable only as an incident of war.[233]

While the passage of the NBA marked the birth of modern banking law, the Act did not give the OCC all its modern powers. Like in New York, these would come in time.[234] Formally, for many decades, the comptroller could act only when examiners identified violations of the Act's bright-line rules. In practice, however, and as opponents of the NBA anticipated prior to enactment,[235] the comptroller exercised substantial informal discretionary authority, more than was common in most states. Supervisory letters, precursors to today's MRAs, were routine.[236] Minor rule violations were widespread,[237] and bankers who violated the Act faced severe sanctions; bank directors faced personal liability, and bank employees faced criminal sanctions.[238] Rule violations were also grounds for examiners to revoke a bank's charter. Accordingly, the comptroller used them as leverage.[239] "Strictly speaking," an official OCC history explained, "the Comptroller had to rely on cooperation from officers and directors of banks in order to

230. HAMMOND, *supra* note 104, at 725, 728.

231. ROBERTSON, *supra* note 142, at 53.

232. *Stock Exchange Practices: Hearings on S. Res. 84 and S. Res. 239 Before a Subcomm. of the Comm. on Banking and Currency*, 72d Cong. 2032 (1933) (opinion of Frederick W. Lehmann, Solicitor General).

233. HAMMOND, *supra* note 104, at 725 (quoting Senator Sherman).

234. Indeed, as at other points in U.S. history, supervision was fiercely contested: bankers and others fought, usually unsuccessfully, to limit government oversight. *See, e.g.*, *supra* note 229.

235. CONG. GLOBE, 38th Cong., 1st Sess. 1433 (1864) (statement of Rep. William Steele) ("Under this power of examination any one of these institutions that happens to incur the displeasure of the Department can be broken down [through repeated, onerous, and costly examinations].").

236. KANE, *supra* note 128, at 465 ("Here comes the man who writes those letters to the banks telling them how they should conduct their business.").

237. According to one longtime official, "[P]robably seventy-five per cent[ ] of the examiners' reports, and about the same percentage of reports of condition made by the banks, disclosed violations of law of one kind or another . . . ." *Id.* at 366.

238. The National Bank Act, June 3, 1864, *reprinted in* 2 DOCUMENTARY HISTORY OF BANKING AND CURRENCY IN THE UNITED STATES, *supra* note 88, at 1383, 1407 (section fifty-three, directors); *id.* at 1407–08 (section fifty-five, employees).

239. KANE, *supra* note 128, at 366.

correct [unsafe practices]. Nevertheless, the growing prestige of the Office and the weight of authority that grew with it, plus the latent threat of charter revocation, soon gave the Comptroller . . . adequate coercive power."[240]

The comptroller's monetary outsourcing function was obvious to both advocates and critics of the new system.[241] Indeed, Senator Sherman justified the Act, and its preemption of state banking, by reference to the Constitution's monetary clauses. "No state," Sherman explained, "has the power to interfere with this exclusive authority in Congress to regulate the national currency."[242] "If you give to an individual or a corporation[, as the states had,] the power to issue . . . note[s] as money at a time when he is not restrained by the necessity of paying in gold and silver," Sherman argued, "you give him practically the power to coin money." Thus, "[w]henever specie payments are suspended," as they were during the War, "the power to issue a bank note is the same as the power to coin money."[243] This is a privilege, Sherman continued, "that no nation can safely surrender to individuals or banks."[244] On Sherman's view, the NBA recaptured control over this privilege and franchised it out to new nationally chartered entities because "history teaches us that the public faith of a nation alone is not sufficient to maintain a paper currency."[245] Rather than rely on Treasury notes, Sherman concluded, Congress might instead "combin[e] . . . the interests of private individuals and the Government" by establishing national banks and putting them under the supervision of special government officials.[246]

The comptroller's office shared Sherman's view—supervision was entailed by the outsourcing model. As Comptroller A. Barton Hepburn explained in his annual report to Congress in 1892: "[I]t [is] the duty of the Government to provide and regulate a circulating medium for the people, [and accordingly,] the Government examines and supervises [national] banks to see that all laws in respect to

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240. ROBERTSON, *supra* note 142, at 71 n.13.

241. *See* Robert Hockett, *Money's Past Is Fintech's Future: Wildcat Crypto, the Digital Dollar, and Citizen Central Banking*, 2 STAN. J. BLOCKCHAIN L. & POL'Y 221, 226 (2019) (arguing that " 'comptroller' is merely archaic English for 'controller' " and that the "OCC, housed in Treasury, was effectively [established to serve as] the 'controller'—the administrator—of our national currency system").

242. HAMMOND, *supra* note 104, at 726.

243. Speech by John Sherman [Ohio] on the National Banking Bill, February 10, 1863, *reprinted in* 2 DOCUMENTARY HISTORY OF BANKING AND CURRENCY IN THE UNITED STATES, *supra* note 88, at 1355, 1360.

244. *Id.* at 1361.

245. *Id.* at 1362.

246. *Id.*

circulation are fully complied with."[247] And as banks "are so intimately connected with business transactions and their soundness so essential to business prosperity . . . governmental control has gone one step further and seeks to protect the public against loss—to protect a bank's creditors."[248] According to Hepburn, while "[t]he affirmative action of the banks in their competition for business is left to the enterprise of their managers, prompted by the desires of shareholders for dividends," it is "[t]he function of the Government . . . to restrain, [and] to [e]nsure good banking, by enforcing the prohibitions against unsafe practices, which the law provides."[249]

2. The Federal Reserve Act

There were two major flaws in the national banking system. First, neither the comptroller nor the Congress had the ability to actively coordinate national bank money issuance, a problem that was particularly acute during periods of stress. Second, the rise of checking accounts led to a resurgence of state banks, and state banks were not subject to federal oversight. Although Congress had tried to drive the states out of the money business, it overlooked the fact that deposit accounts, and checks drawn on them, could substitute for notes. In the late 1880s and 1890s the number of state banks grew once again as an increasing portion of commerce was transacted using deposits. The Panic of 1907—which featured runs on this account money—brought the point home. In its wake, Congress established a National Monetary Commission to figure out what had gone wrong and to come up with a solution. The commission concluded, among other things, that notes were now a small part of the money supply and that what had become the larger part—deposit accounts—was not sufficiently regulated.[250] Officials recognized that for a supervisory scheme to work it had to be tailored to the dominant form of money in circulation; in this case, it had to superintend deposit expansion by state chartered entities.

In 1913, to improve federal control of deposit money, especially at the state level, Congress passed the Federal Reserve Act—an "Act To provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, [and] to establish a more effective supervision of banking in the United

247. COMPTROLLER OF THE CURRENCY, ANNUAL REPORT, 52d Cong., 2d Sess., at 40 (Dec. 5, 1892) [hereinafter ANNUAL REPORT (1892)].

248. *Id.*

249. *Id.*

250. *See* GEORGE E. BARNETT, STATE BANKS AND TRUST COMPANIES: SINCE THE PASSAGE OF THE NATIONAL-BANK ACT 11–12 (Nat'l Monetary Comm'n ed., 1911).

States"—reasserting once again the federal government's power over the nation's monetary architecture.[251] The Act established the Federal Reserve System, a monetary authority composed of a government Board in Washington and regional Federal Reserve Banks ("FRBs") situated in twelve "districts." Oversight of the FRBs was split between the Board and state and national banks in each district. These "member banks"—the national banks plus those state banks opting to join the System—appoint six of the nine directors of each FRB. The FRBs issue a paper money—Federal reserve notes—which is an "obligation[] of the United States . . . receivable by all national and member banks and Federal reserve banks for all taxes, customs, and other public dues."[252] The FRBs would also coordinate the clearing and settlement of payments by check.[253] And banks joining the System as "members" are subject to examination and required to maintain specie reserves against their account money.[254]

The Board was the lynchpin of the Act, and it revolutionized the AMS by giving public officials, acting through the FRBs, the ability to loosen or tighten the ability of banks to expand the money supply. Wall Street was adamantly opposed to this partial de-delegation—the country's bankers thought that the Federal Reserve System should operate like the BUS, with a board controlled by directors selected by private shareholders. But William Jennings Bryan, who had spent the better part of the prior two decades fighting for democratic control of the money supply, insisted on a "Government Board." For then-Secretary of State Bryan, his ally Treasury Secretary William McAdoo, and the Democratic members of Congress who wrote the actual bill that became law, banks, including state banks, exercised *delegated* power.[255] As Senator Burton put it, in the final debates before passage: "Those engaged in the business of banking are but the agents of the people. In

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251. Federal Reserve Act, Pub. L. No. 64-43, § 16, 38 Stat. 251 (1913) (codified as amended in scattered sections of 12 U.S.C.).

252. *Id.* §§ 2, 10.

253. *Id.* § 16.

254. *Id.* § 19 (requiring twelve to eighteen percent for demand deposits and five percent for time deposits). The Act also amended the NBA to require fixed salaries for bank examiners and impose strict conflict of interest rules. *Id.* §§ 21-22. In doing so, the Act extended the "salary revolution in American government" to the banking agencies, *see* NICHOLAS R. PARRILLO, AGAINST THE PROFIT MOTIVE: THE SALARY REVOLUTION IN AMERICAN GOVERNMENT, 1780-1940 (2013), following decades of efforts by successive comptrollers to persuade Congress to eliminate the earlier fee-based model, *see* KANE, *supra* note 128, at 240–41.

255. *See, e.g.*, William Jennings Bryan, "The Cross of Gold," July 8, 1896, in 3 DOCUMENTARY HISTORY OF BANKING AND CURRENCY IN THE UNITED STATES, *supra* note 88, at 2009, 2011–12 ("[T]he right . . . to issue money is a function of government . . . it is a part of sovereignty, and can no more with safety be delegated to private individuals than we could afford to delegate to private individuals the power to make penal statutes or levy taxes.").

no line should a higher standard of care and integrity be required."[256] It was because banks were agents of the public that the public, acting through the Board, should be empowered to oversee bank issues and limit bank risks, both at the state and federal levels.

C. Roosevelt and the New Deal Consolidation

But for a variety of reasons, the Fed failed to tame the ever-growing mass of state banks, and competitive deregulation between the states and the federal government eroded separations and precipitated a wave of bank failures in 1932 and 1933.[257] In 1933, the AMS almost collapsed. Calls rose up for Congress to nationalize the money supply. Instead, Congress once again steered a middle course and reaffirmed the AMS: it restored the separation of banking and commerce that had deteriorated in the 1920s, it explicitly backstopped bank deposits for the first time, and it strengthened supervision, importing New York's safety and soundness law into the U.S. Code. Supervision was at the heart of the New Deal consolidation: it was how President Roosevelt justified continued monetary outsourcing to the American people. This Section examines Roosevelt's reforms and reveals the federal legislature's persistent commitment to informal supervisory oversight stretching to the present day, even in the face of efforts to temper other aspects of the administrative state.

1. The Banking Act of 1933

Contemporary supervisory law was built in the depths of the Great Depression and in the fifty years that followed. Congress decided that both Lincoln's national banking plan and Wilson's Federal Reserve System placed too much monetary control to private hands. Accordingly, it reclaimed powers that had been delegated to bank shareholders and managers by, for the first time, permitting the

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256. 60 CONG. REC. 686 (1913) (statement of Sen. Theodore E. Burton).

257. *See generally Operation of the National and Federal Reserve Banking Systems: Hearings on S. 4115 Before the S. Comm. on Banking and Currency*, 72d Cong., 1st Sess. 358, 395 (1932) (statement of Eugene Meyer, Governor, Federal Reserve Board, Wash., D.C.):

> [E]ffective supervision of banking in this country has been seriously affected by competition between member and non-member banks . . . [and] competition between the State and National banking systems has resulted in weakening both steadily.

National banks, which were granted limited powers by the NBA, pushed into various forms of financial commerce in the 1910s and 1920s. *See, e.g.*, ARTHUR E. WILMARTH, JR., TAMING THE MEGABANKS: WHY WE NEED A NEW GLASS STEAGALL ACT 31–32 (2020); VINCENT P. CAROSSO, INVESTMENT BANKING IN AMERICA: A HISTORY 279–99 (1970). They also succeeded in loosening branching requirements. *See* CAROSSO, *supra*, at 242 (eighty-seven banks had branches in 1900; 775 banks did in 1928).

banking agencies to take remedial actions whenever they determined banks were operating in an unsafe or unsound manner.

Strengthening discretionary bank supervision was a priority for President Roosevelt—one of the few specific financial measures he articulated as a candidate (along with restoring the separation of banking and securities dealing)—and it helped him fend off more radical proposals.[258] As Roosevelt put it in his inaugural address: "[T]here must be a strict supervision of all banking . . . so that there will be an end to speculation with other people's money; and there must be provision for an adequate but sound currency."[259]

Soon after Roosevelt took office, Congress authorized the Fed to remove officers and directors who "continued unsafe or unsound practices in conducting the business" of member banks[260]—just as Congress had empowered the president to remove the heads of agencies like the Interstate Commerce Commission and the Fed Board itself.[261] Congress also empowered the OCC, whenever a director or officer of a national bank violated a law or "continued unsafe or unsound practices," to refer the matter to the Fed for removal proceedings.[262] The OCC had been seeking this power for nearly forty years. "For many . . . offenses," Comptroller John Skelton Williams complained in 1914, "the only penalty which can be enforced by the Comptroller's office is the forfeiture of the bank's charter by suit in the United States court."[263] But, often this "would prove a great hardship to innocent stockholders and depositors, and [thus] can only be resorted to with

258. *See* FRANKLIN D. ROOSEVELT, LOOKING FORWARD 227 (1933) ("The events of the past three years prove that the supervision of national banks for the protection of depositors has been ineffective. I propose much more rigid supervision.").

259. Franklin D. Roosevelt, Inaugural Address (March 4, 1933), *in* 2 THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT 13 (1938).

260. This is the second mention of the standard in federal law. Safety and soundness first appeared in section 4 of the Emergency Banking Act of 1933. The Emergency Banking Act, March 9, 1933, *reprinted in* 4 DOCUMENTARY HISTORY OF BANKING AND CURRENCY IN THE UNITED STATES, *supra* note 88, at 2697, 2698. Its monetary meaning is indisputable. *Id.* (authorizing the secretary of the Treasury to restrict banking activities in an emergency so as to "provide for the safer and more effective operation of the National Banking System"; "preserve for the people the full benefits of the currency provided for by the Congress through the National Banking System"; and "relieve interstate commerce of the burdens and obstructions resulting from *the receipt on an unsound and unsafe basis of deposits subject to withdrawal by check*" (emphasis added)).

261. *See* Manners & Menand, *supra* note 151, at 74.

262. *See* Banking Act of 1933, Pub. L. No. 73-66, § 30, 48 Stat. 162. Senator Carter Glass, this provision's champion, thought that authoring the Fed to remove bad bankers would bolster support for America's disaggregated banking system and satisfy those who believed that banks had failed because of unprofessional conduct and reckless management. SUSAN KENNEDY, THE BANKING CRISIS OF 1933, at 209 (1973).

263. COMPTROLLER OF THE CURRENCY, ANNUAL REPORT, 63d Cong., 3d Sess., at 17 (Dec. 7, 1914).

much reluctance."[264] According to A. Barton Hepburn, comptroller in 1892, "[t]he existence of the power [to remove officers and directors] would deter many who now keep the letter, only to violate the spirit of the law."[265]

Just as importantly, Congress established the FDIC and gave it the power to supervise participating banks and, if needed, put those banks into receivership as a "means to reasonably protect the [insurance fund] against the consequences of unsound or dangerous practices on the part of insured banks." Congress empowered the FDIC to do this whenever its board concluded that an insured bank continued "unsafe or unsound practices in conducting the business of the bank."[266] Deposit insurance helped to federalize bank regulation. It also put the government's imprimatur on banks' monetary liabilities.[267] Deposits appeared less like a private product, and their supervision by federal officials was now a condition in the insurance contract as well as in national bank charters.

The decision by Congress to extend oversight through deposit insurance, to substantially strengthen agency power by tying new remedies to discretionary determinations regarding "unsafe and unsound practices," and to restore separations, which had eroded over the prior thirty years,[268] reflects a compromise struck between bankers and businessmen and those who thought that private actors should be stripped of their ability to expand the money supply.[269] As Albert C.

264. *Id.*

265. ANNUAL REPORT (1892), *supra* note 247, at 43.

266. Banking Act of 1935, Pub. L. No. 74-305, § 101(i)(1), 49 Stat. 684 (codified as amended at 12 U.S.C. § 228). As Carter Glass put it, the law "authorized" the FDIC to "discontinue the insurance of banks which offend against sound policies, and to dismiss them from the privileges of the Corporation." 79 CONG. REC. 11,776 (1935).

267. Mark D. Flood, *The Great Deposit Insurance Debate*, 74 FED. RSRV. BANK ST. LOUIS REV. 51, 70–71 (1992) (recounting Senator's Glass's effort to "unify" banking regulation at the federal level through federal deposit insurance).

268. Politically, Congress's efforts to enhance supervision actually *depended on* restoring separations: arch segregationists voted for the dramatic expansion in federal power because the reforms also pushed ownership and management of banks back into local hands. IRA KATZNELSON, FEAR ITSELF: THE NEW DEAL AND THE ORIGINS OF OUR TIME 256 (2013). Southern banks were run by southerners and operated "entirely on segregated principles." *Id.*

269. *See, e.g.*, Rex Tugwell, *The Compromising Roosevelt*, 6 W. POL. Q. 320, 333 (1953) (describing the Act as "a compromise" and arguing that "the humiliating compromises concluded during this era with the financiers were mistakes"). Many considered the Act an interim measure—a partial corrective that would have to suffice until Congress and the Roosevelt Administration could come up with a permanent solution. *See, e.g.*, PHILLIPS, *supra* note 134, at 59 (stressing that the Act would be only a "bridge or a transition rather than . . . a permanent solution for the situation" (quoting Adolf Berle)); HELEN BURNS, THE AMERICAN BANKING COMMUNITY AND NEW DEAL BANKING REFORMS 1933-1935, at 97 (1974) (explaining that the Act "was compromise legislation designed to correct obvious defects in the federal banking laws and to afford a degree of protection to the bank depositors of the country" and that "[i]ndications were, that at a later date, the administration would again turn to bank reform").

Agnew, general counsel of the Federal Reserve Bank of San Francisco, put it: "Either the bankers of this country will realize that they are guardians of the moneys committed to their charge and will conduct their business accordingly, or banking [i.e., money augmentation] will cease to be a private enterprise and will become a purely governmental function."[270]

Indeed, in May 1933, Congress revived greenbacks, authorizing the Treasury secretary to issue up to $3 billion in new notes.[271] And not just the organized left, but a significant number of academics and advisors to Roosevelt thought that the President should go even further and eliminate "fractional reserve" banking altogether. For example, Rex Tugwell, a Columbia economist and influential member of the President's "Brains Trust," argued that the government would be a more effective banker than the profit-seeking business community.[272] Eight prominent professors at the University of Chicago proposed shifting to "narrow" banks, which would be permitted to invest only in government-issued currency.[273] In the words of the economist Henry Simons, the so-called "Chicago Plan" would secure the "abolition of private credit as an element in the circulating media" and the "concentration of complete and direct control over the quantity of media in the hands of the central monetary authority."[274]

Roosevelt steered clear of these measures and instead strengthened the original AMS. But while Roosevelt—like Lincoln and Chase (and Hamilton and Gallatin and Van Buren)—"did not believe in a government-owned and -operated bank,"[275] and while he too rejected the greenback alternative, he *did* believe that banks were extensions of the government. "Bankers are not merely partners of the government," Roosevelt at one point planned to tell a gathering of the American Bankers Association in 1934:

> The new relationship enters into the picture—*the relationship of agency*. Banks and bankers are . . . in a very true sense *the agents of government itself*. Why is this so? All you have to do is to read the history of the United States. You are probably at least as familiar as I am with the growth of the control of government over banking. . . . [Continually,] Federal supervision was strengthened. . . . [Now, banks] are *once and for all under the supervision and the agency of the government of the United States*. . . . The

270. Albert C. Agnew, *Some Thoughts About the Future of American Banking*, CAL. BANKER, June 1933, at 193, 194–95.

271. Agricultural Adjustment Act of 1933, Pub. L. No. 73-10, § 43, 48 Stat. 52.

272. KENNEDY, *supra* note 262, at 167. *See also* Charles Albert Hawkins, *Our Present Banking Situation and the Remedy*, N.Y. TIMES, Mar. 7, 1933 (arguing for government control of banking).

273. PHILLIPS, *supra* note 134, at 47–48.

274. *Id.* at 50.

275. BURNS, *supra* note 269, at 99 ("He believed that depositors should be protected against bad bankers, that banking should be strictly supervised, and that the ethics of banking should be maintained.").

> nearest parallel that I can think of is the example of Trustees appointed by one of our Courts to administer an Estate or a Trust. These Trustees must operate under certain definite rules laid down by the Court and, at the same time, the Trustees are responsible to the beneficiaries of the Trust itself.[276]

As in New York, the basis for this agency relationship was monetary. "We had a bad banking situation," Roosevelt explained in his first fireside chat:

> Some of our bankers had shown themselves either incompetent or dishonest in their handling of the people's funds. They had used the money entrusted to them in speculations and unwise loans. . . . It was the Government's job to straighten out this situation and do it as quickly as possible.[277]

After Roosevelt closed the banks, he assured people he would reopen them once they were "found to be sound," meaning once people could rest assured that their bank money was as good as base money.[278] Modern supervision was built to tame "once and for all" an open access monetary system.

2. The Quiet Period

In the decades that followed, modern supervisory practice took hold even as procedural reformers sought to constrain the growing powers of the administrative state. Indeed, throughout these years the "federal control of banking" was widely lauded with supervisors attentive to the health and viability of their franchisees and bankers careful not to take advantage of their monetary powers for short-term gain. Two developments during this "Quiet Period" bear special attention: (i) the approving treatment of administrative reformers of the banking agencies and (ii) the repeated efforts by Congress to reinforce and strengthen informal supervisory power.

a. The Administrative Procedure Act

Before the ink was dry on Roosevelt's New Deal legislation, skeptics were working to rein in what they saw as the excesses of the expanded administrative state. They were particularly concerned with procedural fairness and judicial review of agency action. But they treated the banking agencies differently. Banks were not like other

276. Roosevelt, *supra* note 46, at 2–3 (emphases added). The speech as delivered did not include these lines.

277. President Roosevelt Delivers His First "Fireside Chat," March 12, 1933, *reprinted in* 4 DOCUMENTARY HISTORY OF BANKING AND CURRENCY IN THE UNITED STATES, *supra* note 88, at 2709, 2711.

278. *Id.* at 2709.

businesses; they were the government's monetary instrumentalities, and their overseers were entitled to special solicitude.[279]

For example, in 1940, the Justice Department established a special committee on administrative procedure, which published a report and a series of fourteen monographs on administrative agencies, including two on the banking agencies. Although the committee recommended that some of its general reform proposals apply to the banking agencies, it otherwise endorsed the informal and "summary" nature of supervisory power, which it explicitly recognized as a longstanding feature of American banking law.[280]

As the committee put it, "The nature of banking and of the public interest in banks shape the procedural aspects of bank supervision in forms different from those encountered in other branches of administrative regulation." In the committee's view, supervision was procedurally tolerable because the structure of the banking system constrained both the banks and the agencies:

> The paradox in the situation is that the sanctions are so compelling that the authorities almost never use them. Because the banks are so important in an industrial-commercial economy, compulsive steps [by the agencies] which might shake confidence [in the banks] are withheld. Although there is in fact an iron hand within the velvet glove of the banking authorities, the glove is seldom removed.[281]

The committee was aware that the banking agencies were opaque.[282] It also recognized that banks were "subjected to a general supervision through examination the intensity of which has few, in any, parallels in

279. *See, e.g.*, *Joint Statement on Behalf of the Minority of the Attorney General's Committee on Administrative Procedure: Hearings on S. 674, S. 675, and S. 918 Before a Subcomm. of the Comm. on the Judiciary*, 77th Cong. 1394 (1941) (noting that the Treasury points to its "fiscal and monetary functions" in requesting that the comptroller of the currency "be exempted in connection with the regulation of national banks" from the formal procedures in the APA).

280. ATT'Y GEN.'S COMM. ON ADMIN. PROC., *Federal Control of Banking: Comptroller of the Currency and Federal Deposit Insurance Corporation*, *in* ADMINISTRATIVE PROCEDURE IN GOVERNMENT AGENCIES PT. 13, at 2 (1940) [hereinafter *Federal Control of Banking*]. "Banks and banking presented complex problems calling for special knowledge and continuing and detailed supervision, not possible for either Congress or the courts . . . ." ATT'Y GEN.'S COMM. ON ADMIN. PROC., REPORT OF THE COMMITTEE ON ADMINISTRATIVE PROCEDURE, APPOINTED BY THE ATTORNEY GENERAL, AT THE REQUEST OF THE PRESIDENT, TO INVESTIGATE THE NEED FOR PROCEDURAL REFORM IN VARIOUS ADMINISTRATIVE TRIBUNALS AND TO SUGGEST IMPROVEMENTS THEREIN 15 (1941). These conclusions are consistent with those reached by the Brownlow Commission. *See* THE PRESIDENT'S COMM. ON ADMIN. MGMT., ADMINISTRATIVE MANAGEMENT IN THE GOVERNMENT OF THE UNITED STATES 40–41 (1937) (explaining that banks are "federal business corporations" chartered "by a supervisory agency," that their statutes confine "their operations to a unitary purpose and describe their organization, powers, and relationships in considerable detail," and that these "special supervisory agencies" should "give continuous and careful scrutiny to [banks'] affairs," if necessary, independently from executive control).

281. *Federal Control of Banking*, *supra* note 280, at 18.

282. *Id.* at 43. ("[T]he exercise of supervisory powers over banks has traditionally been attended by a secrecy antithetical to the publicity which marks most regulatory activities.").

other fields of regulation."[283] But according to the committee, the "intimate nature of this type of control precludes its exercise through a formal procedure."[284] The committee's conclusions were also consistent with those reached by a major reform initiative spearheaded by the American Bar Association. That initiative exempted the banking agencies from a law that would have created a special appeals court for administrative agencies.[285]

The reform that ultimately prevailed—the APA—preserves supervision. This is because the APA's procedural protections are triggered by formal actions, while the banking agencies are designed to proceed informally.[286] Moreover, when the banking agencies do take formal actions, they are often subject to a generous standard of review.[287] In 1946, the Fed even argued that its decision to remove a banker from office was unreviewable under section 10 of the APA because removal was "committed to agency discretion" by law.[288] Although the Supreme Court did not accept this argument,[289] two Justices thought the Board's judgment was reviewable only for abuse of discretion,[290] and the agencies have successfully avoided judicial review on these grounds in other cases.[291]

Meanwhile, both tacitly and explicitly, leading administrative law scholars acknowledged that supervision was distinctive. For

283. *Id.*

284. *Id.* Even in agencies like the Federal Communications Commission, which dispenses licenses, applications can only be denied after opportunity for a formal hearing, which serves as a basis for judicial review. *Id.* By contrast, the committee noted, applications to organize national banks are denied without any opportunity for hearing. *Id.* The Committee concluded that the inutility of public hearing procedure in banking was well recognized and that "ex parte investigations may constitute an adequate basis for decision." *Id.*

285. *See* Landis, *supra* note 49, at 1084–85 (explaining that the banking agencies along with a handful of other agencies were exempt from review under the terms of the Walter-Logan bill proposed by the American Bar Association to reform the administrative state).

286. *See* Davis, *supra* note 122, at 193 (lamenting that the APA "by ignoring the supervising power, has left untouched some of the most troublesome areas of the federal regulatory process"). This was likely intentional. The Treasury Department requested that the comptroller be fully exempted. *See also Joint Statement on Behalf of the Minority of the Attorney General's Committee on Administrative Procedure: Hearings on S. 674, S. 675, and S. 918 Before a Subcomm. of the Comm. on the Judiciary*, 77th Cong. 1394 (1941).

287. *See, e.g.*, Camp v. Pitts, 411 U.S. 138, 143 (1973) (holding that the comptroller's decision to deny an application to form a national bank is subject to arbitrary and capricious review, that the court cannot force the agency to hold a hearing, and that it must uphold the comptroller's decision to deny to issue the charter because the relevant community was already fully banked if there is evidence to support that conclusion in the administrative record).

288. Brief for the Petitioners at 28–34, Bd. of Governors of the Fed. Rsrv. Sys. v. Agnew, 329 U.S. 441 (1946) (No. 66), 1946 WL 50159, at *28–34 (1946).

289. Bd. of Governors of Fed. Rsrv. Sys. v. Agnew, 329 U.S. 441, 444 (1947).

290. *Id.* at 449 (Rutledge, J., concurring). According to Justices Rutledge and Frankfurter, "Congress has committed the [banking] system's operation to [the Board's] hands." *Id.* at 450.

291. *See, e.g.*, Jones v. Off. of Comptroller of Currency, 983 F. Supp. 197, 203 (D.D.C. 1997).

example, when James Landis reviewed administrative agencies in 1960, he left the banking agencies out entirely.[292] And Kenneth Culp Davis wrote in 1966: "I have long been and continue to be an admirer of the manner in which the banking agencies have effectively used sensible systems of supervision and have generally avoided the cumbersome procedure of formal adjudication."[293]

This positive treatment is perhaps unsurprising given that, for most of American history, administrative authority was widely perceived, not as a threat to liberty, but as "a means of protecting liberty and the public interest against private power."[294] And banks were an example of such power in a government-backed form and the source of intense political dispute up until the New Deal.

It is likely for that reason that the Supreme Court in 1963 endorsed supervisory governance as perhaps the "most successful . . . system[ ] of economic regulation" to which "we may owe, in part, the virtual disappearance of bank failures from the American economic scene."[295] The "governmental controls of American banking," the Court explained, "are manifold . . . [b]ut perhaps the most effective weapon of federal regulation of banking is the broad visitatorial power" with its "frequent and intensive" examinations permitting "virtually a day-to-day surveillance of the American banking system."[296] According to the Court, "As a result of the existence of [a] panoply of sanctions, recommendations by the agencies concerning banking practices tend to be followed by bankers without the necessity of formal compliance proceedings."[297]

b. The FISA

If the years leading up and through the passage of the APA promised that bank supervision would remain an important part of American public administration, the 1960s reaffirmed that commitment. During this decade, Congress passed the Financial Institutions Supervisory Act ("FISA"), giving the banking agencies, among other things, the power to issue cease and desist orders targeting

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292. JAMES LANDIS, 86TH CONG., REP. ON THE REGULATORY AGENCIES TO THE PRESIDENT-ELECT (Comm. Print 1960).

293. Kenneth Culp Davis, *Administrative Procedure in the Regulation of Banking*, 31 L. & CONTEMP. PROBS. 713, 715 (1966). Davis was also critical of the banking agencies. He thought, for example, that their decisions on chartering and branching should be more "open" to public review. *Id.* at 713.

294. WHITE, *supra* note 49, at 464.

295. United States v. Phila. Nat'l Bank, 374 U.S. 321, 330 (1963).

296. *Id.* at 327, 329.

297. *Id.* at 330.

practices that, in the opinion of the agencies, are unsafe or unsound.[298] This authority allowed the agencies to force banks, in their discretion, to change aspects of their business, from hiring to underwriting to balance sheet management.[299]

Congress passed the FISA at the behest of the Johnson Administration, which was concerned about risky bank lending that was difficult for the agencies to combat using their existing toolkit. The Administration explained that the "supervisory agencies in varying degrees have been seriously handicapped in their efforts to prevent irresponsible and undesirable practices" because the remedies were too "drastic" and "cumbersome." In other words, it was hard to threaten bankers with severe sanctions like removal just for aggressively pursuing profits.

Congress, in granting the "administration's request for additional flexible and effective supervisory powers," justified the move on monetary grounds, once again adopting an outsourcing model. The "vital importance of [a] sound and effective system of banks," the Senate's FISA report explained, "is clear" as the "banking system is a fundamental part of our monetary system and the Nation's $130 billion of demand deposits represents the principal element in the Nation's money supply."[300] Wright Patman, the chairman of the House Banking Committee, explicitly invoked the Constitution's monetary clauses.[301]

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298. Financial Institutions Supervisory Act of 1966, Pub. L. 89-965, § 202(b)(1), 80 Stat. 1028 (codified at 12 U.S.C. § 1818 (b)).

299. Congress, in drafting the FISA, relied on a memorandum by John Horne, the chairman of the Federal Home Loan Bank Board. *Financial Institutions Supervisory and Insurance Act of 1966: Hearings on S. 3158 and S. 3695 Before the H. Comm. on Banking and the Currency*, 89th Cong. 49 (1966). Horne explained that "safety and soundness" was a legal standard and that "[f]or this reason, it would be virtually impossible to attempt to catalog within a single all-inclusive or rigid definition the broad spectrum of activities" that it embraces. *Id.* Indeed, the "formulation of such a definition would probably operate to exclude those practices not set out in the definition, even though they might be highly injurious to an institution under a given set of facts or circumstances or a scheme developed by unscrupulous operators to avoid the reach of law." *Id.* at 49–50.

> [A] particular activity not necessarily unsafe or unsound in every instance may be so when considered in the light of all relevant facts. Thus, what may be an acceptable practice for an institution with a strong reserve position, such as concentration in higher risk lending, may well be unsafe or unsound for a marginal operation.

Id. at 49. Horne nonetheless offered something of a definition:

> Generally speaking, an "unsafe or unsound practice" embraces any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance funds.

Id. at 50.

300. S. REP. NO. 89-1482, at 5 (1966).

301. 112 CONG. REC. 24,983 (1966) (Statement of Rep. Wright Patman) (arguing in favor of 12 U.S.C. § 1818 on the grounds that "we in Congress, in carrying out our mandate under article I,

The FISA empowered the agencies to make case-by-case judgments about bank operations. “To be effective,” one Fed official explained, the agencies “must scrupulously avoid imposing conditions ‘too quickly and too great,’ but he must be even more alert to avoid committing the unpardonable sin of bank supervision of doing ‘too little, too late.’ ”[302] For example, in a bank where asset quality is deteriorating, a supervisor must “try to determine whether there had been a weakening in the loan servicing procedures or in the bank’s basic lending policies.”[303] And if a supervisor finds “[a] noticeable increase” in problem loans, the agency might issue “a transmittal letter urging the directors to review the bank’s lending policies and to take such action as is necessary to obtain additional security for weak loans, reductions or definite repayment programs.”[304]

This sort of authority is difficult to explain if we view banks as private businesses working primarily to generate returns for their shareholders. But it is perfectly intelligible if we recognize that banks work primarily for the public as part of a system to augment the money supply for the benefit of the nation’s households and businesses. This theory of banking, the one that has grounded the AMS for more than 150 years, does not see banks as private entities. Instead, it sees banks as franchisees, serving a key role in economic governance.

c. Further Statutory Enhancements

Even as policymakers lost sight of this theory of banking and conflict emerged between banks and the banking agencies, Congress continued to buttress supervisory governance.[305] To take just a few examples, in 1978, Congress passed the Financial Institutions Regulatory and Interest Rate Control Act, authorizing the agencies to issue cease-and-desist orders against individuals, levy civil money penalties against both institutions and individuals, and remove executives in a greater range of circumstances.[306] In 1983, Congress

section 8, clause 5, of the Constitution to assure the public of a sound monetary system, must be constantly alert to possible weaknesses in our financial system”).

302. Orville O. Wyrick, *The General Nature of Bank Supervision*, *in* BANK SUPERVISION 1, 5 (Federal Reserve Bank of St. Louis 1963).

303. Wilbur H. Isbell, *Review and Appraisal*, *in* BANK SUPERVISION, *supra* note 302, at 27, 29.

304. *Id.* at 31.

305. *See, e.g.*, First Nat’l Bank of Eden v. Dep’t of Treasury, 568 F.2d 610, 611 (8th Cir. 1978) (recognizing the comptroller’s authority to require the First National Bank of Eden to, among other things, “discontinue its investment in criticized assets” and “correct deficiencies in its internal control and audit procedures”).

306. Financial Institutions Regulatory and Interest Rate Control Act of 1978, Pub. L. No. 95-630, 92 Stat. 3641 (codified as amended in scattered sections of 12 U.S.C.).

enacted the International Lending Supervision Act,[307] section 908 of which limits judicial review of agency orders regarding bank capital. And in 1989, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act,[308] further narrowing the scope of judicial review.[309]

Nor did Congress's commitment to supervisory governance fade in the new millennium. In 2001, when it repealed longstanding structural barriers separating banking from other financial activities, it added new approval authority tied to agency judgments about the quality of bank management.[310] And in 2010, when Congress passed the Dodd-Frank Act, it created new methods of "enhanced supervision" for large financial conglomerates, requiring, among other things, periodic stress testing. As the Tenth Circuit explained in 2012, while the law sometimes "leaves banks in the position of enduring any vicissitude attending the exercise of the regulator's discretion, Congress is permitted to prioritize the safety of the banking system over banks' interest in avoiding subjective or even harsh agency decisions."[311]

III. THE POLITICAL ECONOMY OF BANK SUPERVISION

The history of the AMS presents a puzzle. On the one hand, the AMS, with bank supervision at its core, has a long pedigree and has

307. International Lending Supervision Act of 1983, Pub. L. No. 98-181, §§ 902-913, 97 Stat. 1153, 1278 (1983) (codified at 12 U.S.C. §§ 3901-3912). Section 908 effectively nullified *First Nat'l Bank of Bellaire v. Comptroller of Currency*, a case where the Fifth Circuit ruled in favor of a bank challenging an OCC order directing the bank to increase its equity levels. 697 F.2d 674, 685–87 (5th Cir. 1983). *See* 12 U.S.C. § 3907(b)(1) ("Failure . . . to maintain capital at or above its minimum level . . . may be deemed by the appropriate Federal banking agency, in its discretion, to constitute an unsafe and unsound practice within the meaning of section 1818.").

308. Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (codified as amended in scattered sections of 12 and 18 U.S.C.).

309. *See, e.g.*, H.R. REP. No. 101-54, at 392 (1989) (Conf. Rep.). The status of banks at this point was very much in dispute, with consensus having shifted toward the licensing model. But key members of Congress retained an outsourcing view. For example, the chairman of the Senate Banking Committee, William Proxmire, asked H. Robert Heller, one of the Fed's governors, whether he thought banks were "essentially private sector entities which perform certain public sector services or . . . quasi-public financial utilities on which societal demands can be loaded?" Heller, a champion of the cresting deregulatory wave, told Proxmire that banks were "not public utilities." Yet even Heller noted that banks "perform a number of specialized functions that are vital to the effective functioning of the nation's monetary system." Adopting the "agent theory" and a moral hazard frame, Heller argued that the "public financial commitment implied by [deposit insurance and direct access to a lender of last resort] . . . requires a regulatory framework designed to establish safe and sound operation." *Oversight on the Condition of the Financial Services Industry: Hearings Before the S. Comm. on Banking, Hous., & Urb. Affs.*, 100th Cong. 513 (1988) (written response of H. Robert Heller, Member, Bd. of Governors of the Fed. Rsrv. Sys.).

310. *See* Jeremy C. Kress, *Solving Banking's "Too Big To Manage" Problem*, 104 MINN. L. REV. 171, 184 (2019).

311. Frontier State Bank Oklahoma City, Okla. v. FDIC, 702 F.3d 588, 597 (10th Cir. 2012).

endured numerous shocks, only to be strengthened time and again. On the other hand, as we saw in Part I, the practice of supervision has been steadily dismantled and reconceptualized over the last thirty years, and the outsourcing model underlying it has fallen out of the academic (and political) consciousness, replaced by a licensing model that treats banks as mere intermediaries. Today, supervision is often seen as vestigial or worse, a malignancy.[312] What explains the erosion of this longstanding pillar of American public administration?

This Part attributes it to structural decay: the emergence of shadow banking and the rise of universal banking.[313] It argues that supervisory governance requires more than just broad statutory powers; it must be sustained by a particular political economy that supports bank franchise value and limits bank activities. When these foundations eroded, supervision became vulnerable to intellectual attack. As often happens, ideological change followed political and economic transformation.

A. Mixing Banking and Commerce

The AMS began to deteriorate in the 1950s, prompted by the emergence of financial economics as a discipline and the rise of "shadow" banks (firms that issue money instruments similar to deposits but do not have a banking charter). Financial economics abstracted away from money as a social and political construct—ignoring the need to create a monetary unit and build a system for buying and selling in that unit—and modeled banks as financial intermediaries, firms with assets and liabilities of various durations.[314] This approach allowed for advances in economic theory,[315] but collapsed the distinction between money substitutes and other debt. It also assimilated banking to private finance, implicitly recharacterizing banking laws as "interventions"

312. *See, e.g.*, CONTI-BROWN, *supra* note 60, at 169 ("[W]e lack a clear theory of what bank supervisors are even supposed to do in a world with long lists of federal and state statutory compliance requirements.").

313. *See supra* Section II.B.

314. *See, e.g.*, *supra* notes 51–54; Mark Flannery, *Deposit Insurance Creates a Need for Bank Regulation*, FED. RSRV. BANK PHILA. BUS. REV., Jan.–Feb. 1982, at 17 ("Bankers insured by the Federal Deposit Insurance Corporation (FDIC) can benefit *privately* by undertaking risks that the *society* as a whole considers excessive. Restrictive bank regulations can thus be viewed as an effort to undo (or at least to limit) the distortive impact of deposit insurance on bank decisions.").

315. Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958); 16 HARRY M. MARKOWITZ, PORTFOLIO SELECTION: EFFICIENT DIVERSIFICATION OF INVESTMENTS (1971).

instead of acts of constitution. These intellectual currents replaced the outsourcing model with the licensing model.

The licensing model was able to take hold, in part, because of fundamental changes in the business of banking. First, after 1936,[316] the Fed became the exclusive issuer of physical bank notes. Paper money issued by privately owned banks disappeared. Although these banks continued to issue its monetary equivalent, account money, account money only exists on the books of the bank and not in the physical world. The result is that scholars and policymakers often lump it together with other debt liabilities, making a theory of banks as mere financial intermediaries appear more plausible.[317]

The other major change, and the most important, occurred in the 1950s when the Fed began treating Wall Street securities dealers similarly to banks and assisting them in expanding the money supply even though they lacked a banking charter.[318] The result was a decline in the franchise value of banks, a concomitant rise in the importance of securities dealers, and the erosion of the New Deal monetary architecture.[319]

These changes in banking and finance, along with the rise of money market mutual funds (another issuer of deposit substitutes), prompted responses that further eroded the AMS. For example, in the 1980s, policymakers began to break down the separation of banking and commerce. With bank profitability squeezed, and bankers complaining of increased competition from shadow banks, the OCC and the Fed sought to level the playing field by removing restrictions on the asset side of bank balance sheets. The OCC, for example, reinterpreted the

316. KENNETH D. GARBADE, BIRTH OF A MARKET 328–31 (2012).

317. Our jargon has not helped in this regard: although it is common to say that a bank "takes" a deposit, the stock of deposit liabilities is, in fact, *issued*. *See* Ricks, *supra* note 51, at 760–62 (arguing that the rise of the financial intermediation paradigm can be attributed to the decline of bank notes and the rise of financial economics).

318. The banks strongly objected. *See* N.Y. CLEARING HOUSE ASS'N, A STUDY OF THE INTERRELATIONS OF THE MONEY MARKET AND THE GOVERNMENT SECURITIES MARKET: REPORT TO THE FEDERAL RESERVE BANK OF NEW YORK 17 (Oct. 22, 1957):

> The repurchase agreements entered into by dealers with nonfinancial corporations not only impair the investment market for short-term U. S. obligations; they represent in substance a nullification of the intent of the Banking Act of 1933 . . . to forbid banking activities outside the supervised banking system, and to exclude payment of interest on demand deposits. They tend to reduce deposits in money market banks and remove resources which could be available for loans to dealers.

319. *See* Gary Gorton & Andrew Metrick, *Regulating the Shadow Banking System* 273–74 (Brookings Papers on Economic Activity, Paper No. 2, Fall 2010), https://www.brookings.edu/bpea-articles/regulating-the-shadow-banking-system-with-comments-and-discussion [https://perma.cc/JN9T-DDD2].

NBA to permit national banks to purchase derivatives.[320] According to the OCC, the execution and clearance of customer transactions in securities, futures, and options, regardless of the nature of the underlying asset, was an attribute of the "business of banking" and was, therefore, permissible. As Saule Omarova explains, defining "the statutory concept of the 'business of banking' as a broadly understood process of financial intermediation . . . rendered [the] concept meaningless as a potentially limiting device."[321]

Once banks began engaging in nonmonetary activities—in "financial commerce"—policymakers began to scrutinize other aspects of the system. They challenged laws prohibiting banks from combining with other types of financial intermediaries.[322] Alan Greenspan, who became chair of the Fed in 1987, pressed Congress to repeal statutory barriers separating banks and securities dealers.[323] And the Fed issued new rules permitting companies that owned banks to earn up to twenty-five percent of their revenues from previously prohibited broker-dealer and corporate finance activities.[324] In Greenspan's view, there was no reason to prevent bank holding companies ("BHCs") from engaging in these businesses; if anything, permitting BHCs to enter the securities business would strengthen them by increasing their profitability.[325]

Damage to one key pillar of the AMS—separation—led to intensified scrutiny of another: supervision. As the difference between banks supervised by the banking agencies and other financial intermediaries diminished, agency leaders and other policymakers began to question why banks should continue to be subject to onerous government oversight.[326] Economists at the Fed, in particular, concluded that traditional supervision was costly and inefficient and that big, complex financial conglomerates were best disciplined by

320. Saule T. Omarova, *The Quiet Metamorphosis: How Derivatives Changed the "Business of Banking*,*"* 63 U. MIA. L. REV. 1041, 1044–46 (2009).

321. *Id.* at 1047. *See also* NationsBank of N.C. v. Variable Annuity Life Ins. Co., 513 U.S. 251, 254 (1995).

322. *See* Arthur E. Wilmarth, Jr., *The Road to the Repeal of the Glass-Steagall Act*, 17 WAKE FOREST J. BUS. & INTELL. PROP. L. 441 (2017).

323. Alan Greenspan, Chairman, Bd. of Governors of the Fed. Rsrv. Sys., Remarks at the 27th Annual Conference on Bank Structure and Competition: Banking in the 21st Century 2 (May 2, 1991) (transcript available from the Federal Reserve); *Testimony Before the H. Subcomm. on Fin. Insts. Supervision, Regulation & Ins. of the H. Comm. on Banking, Fin. & Urb. Affs.*, 100th Cong. 1 (1987) (testimony of Alan Greenspan, Chairman, Bd. of Governors of the Fed. Rsrv. Sys.).

324. Bd. of Governors of the Fed. Rsrv. Sys., Notice, Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, Docket No. R-0841 (Dec. 20, 1996).

325. *Testimony Before the H. Subcomm. on Fin. Insts. Supervision, Regulation & Ins. of the H. Comm. on Banking, Fin. & Urb. Affs.*, 100th Cong. 1–3 (1987) (testimony of Alan Greenspan, Chairman, Bd. of Governors of the Fed. Rsrv. Sys.).

326. *See* Menand, *supra* note 17, at 1564–71.

market forces. Greenspan and his colleagues also suspected that substantively overseeing risk-taking by financial conglomerates would be difficult; accordingly, they developed ways for bank shareholders and creditors to discipline banks instead.[327] To these skeptics, supervision was an anachronism. The contemporary business of banking was far more sophisticated than its early-century antecedents. Its complexity demanded *less* government oversight and *more* faith in markets.

The Fed and its sister agencies thus shifted toward intricate capital rules, which they believed would control bank risk more efficiently. These capital rules required shareholders to maintain a certain amount of the skin in the game. The agencies thought that such equity stakes would incentivize shareholders to monitor bank executives.[328] Meanwhile, the agencies would use their safety and soundness authority to ensure market participants had access to accurate information about bank risks. Their new policy, known as RFS, involved policing processes—governance frameworks, internal controls, and risk management techniques. RFS was designed to prevent bank executives from hiding material information from investors.[329] Market incentives, rather than informal oversight, would ensure that the banking system ran smoothly.

Policymakers also discouraged Congress from regulating shadow banks. Accordingly, repo and commercial paper markets expanded rapidly, and the money market mutual fund industry grew to $3 trillion.[330] By 2008, national banks supervised by the OCC and other financial businesses like broker dealers played similar monetary roles. Whereas broker dealers once financed themselves with equity and long-term debt, by 2008 they used deposit substitutes, even though they were not supervised for safety and soundness and had no formal access to government liquidity programs.[331]

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327. *Id.*; Alan Greenspan, Chairman, Bd. of Governors of the Fed. Rsrv. Sys., Remarks to the American Bankers Association: The Evolution of Bank Supervision 3–4 (Oct. 11, 1999) (transcript available from the Federal Reserve) ("[I]n contemplating the growing complexity of our largest banking organizations, it seems to us that the supervisors have little choice but to try to rely more—not less—on market discipline—augmented by more effective public disclosures—to carry an increasing share of the oversight load.").

328. Alan Greenspan, Chairman, Bd. of Governors of the Fed. Rsrv. Sys., Remarks to the American Bankers Association: Innovation and Regulation of Banks in the 1990s, at 5 (Oct. 11, 1988) (transcript available from the Federal Reserve) ("The key to engendering market incentives," Greenspan explained, "is to require that those owners who would profit from an institution's success have the appropriate amount of their own capital at risk"); *id.* ("There is no better way to ensure that owners exert discipline on the behavior of their firm than to require that they have a large stake in that enterprise.").

329. *See* Menand, *supra* note 17, at 1567–74; Meyer, *supra* note 65, at 99–101.

330. RICKS, *supra* note 104, at 33–34, 34 fig.1.2.

331. The crisis was a product of this decay. Deposit substitutes were not insured by the government, and although the businesses and individuals who held them did not consider

By the early 2000s, two of the four pillars of the AMS had been severely weakened. The new monetary order retained delegation and open access: administratively charted, privately owned corporations, not the government, still created the bulk of the money supply. But the crucial separation of money creation and commercial dealing eroded. Desupervision followed close behind.

B. Desupervision

This Section connects on the level of theory the structural changes in the political economy of finance to the shift away from supervision. It explains how the emergence of shadow banking and the rise of universal banking created a mismatch between supervisors' jurisdiction and their monetary function, undermining one of the normative underpinnings of supervisory governance. Whereas banks once embraced,[332] or at least did not effectively resist, discretionary government oversight, today they successfully undermine informal methods.[333]

1. The Problem with Shadow Banking

The first part of the structural mismatch is between the scope of private monetary expansion and the bounds of banking agency jurisdiction. Shadow banks like securities dealers, foreign firms, and money market mutual funds now issue huge amounts of deposit substitutes, used primarily by businesses and institutional investors. When Congress imported safety and soundness into the U.S. Code in 1933 and expanded supervisory authority in the 1960s, these deposit substitutes did not exist. By the mid-1990s, they rivaled deposits as a µ

This sort of shadow banking is not new.[334] Indeed, the 2008 crisis was eerily reminiscent of the panic of 1907 and the 1933 collapse. All

themselves to be investors in the issuers, they badly misjudged. *See* Kathryn Judge, *Information Gaps and Shadow Banking*, 103 VA. L. REV. 411 (2017); PISTOR, *supra* note 104, at 92. When it became clear that the issuers might fail and that the government did not stand behind these instruments, panic ensued. *See generally* GARY B. GORTON, SLAPPED BY THE INVISIBLE HAND: THE PANIC OF 2007 (2010).

332. *See, e.g.*, *Hearings Before a Subcomm. of the S. Comm. on the Judiciary on S. 674, S. 675, and S. 918*, 77th Cong. 1478 (1941) (Statement of Acting Attorney General Francis Biddle) ("[B]anking representatives themselves have never complained concerning the absence of formal hearings, but, on the contrary, prefer the present methods.").

333. *See supra* note 21.

334. *See* Hugh Rockoff, *It Is Always the Shadow Banks: The Regulatory Status of the Banks that Failed and Ignited America's Greatest Financial Panics*, *in* COPING WITH FINANCIAL CRISES: SOME LESSONS FROM ECONOMIC HISTORY 77 (Hugh Rockoff & Isao Suto eds., 2018) (discussing twelve examples of great American financial "panics" and the role shadow banks played in bringing them about).

three disasters were the product of runs on money instruments that policymakers had failed to perceive and regulate as such. In 1907 and 1933, those instruments were deposits issued by state chartered entities. In 2008, they were deposit substitutes issued by securities dealers, money market mutual funds, and foreign financial firms.

The contemporary jurisdictional gap undermines supervision. First, it prevents supervisors from monitoring and disciplining important issuers. Government agencies cannot effectively manage monetary outsourcing if only some private money issuers are subject to their oversight. Second, the gap undermines a key rationale for state oversight. Why should banks submit to special supervision when their charters no longer confer the same valuable privileges? Third, and perhaps most importantly, monetary expansion by firms that are not regulated like banks undermines the franchise value of banks. One reason banks in recent decades may routinely resist costly risk reduction measures imposed by the government is that these measures are no longer tied to a charter that generates offsetting gains.

2. The Problem with Universal Banking

The second part of the structural mismatch is between the purpose of state oversight and the activities of today's banking conglomerates. As discussed in Part II, when the statutes that comprise the AMS were enacted in the 1860s, 1930s, and 1960s, bank balance sheets were strictly limited to high-quality credit assets: government bonds and various types of senior debt. The regulatory regime—safety and soundness law—was designed for these assets.

With the emergence of new and riskier forms of financial investments and activities, and new and more complex financial conglomerates, the old tools became less potent. Safety and soundness law, with its broad scope and sharp remedies, was not designed to put government officials in the middle of market making, asset management, underwriting, commodities dealing, or private equity investing (banks were not permitted to engage in these activities at the time the laws were written). These activities were considered financial commerce, and banks, given their quasi-governmental status and power, were to steer clear of commerce. Nor did policymakers expect supervisors to be able to reach timely and accurate judgments about bank solvency when volatile and complex assets dominated the left-hand side of bank balance sheets.[335]

335. *See, e.g.*, Menand, *supra* note 17.

This mismatch fuels supervisory disarmament. In the late 1990s, the Fed crafted RFS in part because it believed supervising the asset-side activities of financial conglomerates would be hard if not impossible.[336] And today, financial conglomerates demand procedural protections of the sort enjoyed by the nonbanks they compete with in so much of their business. Mixing banking and commerce, in other words, obscures the normative assumptions underpinning the outsourcing model (delegated state power requires close state control).

The result is a less stable equilibrium, both practically and politically. For example, the tension between informal, discretionary oversight and modern finance erodes the norms that govern and sustain the banker-supervisor relationship. When banks were small and dispersed, they were critical infrastructure in their local communities. Accordingly, the agencies had to work with them to solve problems—bankers had a certain degree of leverage. Today, by contrast, many banks are expendable, as large conglomerates operate nationwide. And while large conglomerates are not expendable, they are less vulnerable to discipline. This means that many soft constraints on supervisory overreach no longer exist. Meanwhile, large conglomerates are more capable of resisting supervisory direction, leading to further conflict.

For generations, supervision was paired with portfolio-shaping rules that prohibited banks from engaging in fast moving, difficult-to-monitor financial dealing. Structural laws also limited banks in size and scope and gave them an effective monopoly on satisfying money demand. During this period, the banking agencies were built to succeed. But allowing banks to merge and engage in speculative financial activities undermined supervisory efficacy. It also disrupted the ability of nonbanks to compete in these markets. The banking agencies now face a difficult task: monitoring financial conglomerates engaged in a range of complex activities. In such an environment, relinquishing oversight threatens further instability. In fact, the urgency of supervision is greater in a banking system without separation. Desupervision under the current regime means private actors are more likely to exercise public power for private purposes, pocketing gains and socializing losses.

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336. Greenspan and his colleagues thought that the capital rules would prevent excessive risk-taking because market participants would do what supervisors could not. But shareholders and managers, rather than reining in such risk-taking, often promote it, as they stand to gain from increased returns and banks, due to their monetary functions, can expect support from the state if their risks do not pay off. *See* Macey & O'Hara, *supra* note 53, at 97–99.

CONCLUSION

This Article began with a question: Why did Congress grant the banking agencies supervisory power? Part I considered several answers, none of which drew on the relevant legislative history or considered the operative statutory text. Part II recovered this history and analyzed this text. It traced the rise of the American Monetary Settlement, locating the origins of that settlement alongside bank supervision in antebellum state law, and it showed how New York, Massachusetts, and their sister states commissioned special government officials to outsource money creation to private actors and still ensure that the money those actors issued was sound. It revealed that the federal government imported New York's model during the Civil War and refined the model during the Great Depression with the same ends in mind. It categorized supervision as a type of administrative law in which the government acts as an outsourcer rather than as a regulator of private activity. And it showed how even reformers in the mid-twentieth century treated this distinctive form of governance as necessary and legitimate.

It then identified the root cause of desupervision today—a mismatch between the rationale for supervisory oversight and the scope of supervised conduct. In the process, it showed why recent challenges to the legitimacy of post-crisis supervisory initiatives are misplaced. "Safety and soundness" is not a "black hole." Nor are the stress tests an instance of aberrant government overreach. Bank supervision—and the scrutiny of banks by expert government officials—is one of the central planks of a public-private monetary system whose legal structures, norms, and practices predate the Civil War.

The AMS, however, may be permanently damaged and shadow and universal banking here to stay. If so, policymakers must confront the twin deficits of our current system: instability and rent extraction. Monetary regimes dominated by private control are fragile. And the government's efforts to prevent them from melting down during recessions transfers wealth from the public to special interests.

This suggests, at the very least, maintaining oversight, not diminishing it. Stress tests are critical tools in this effort—they allow the government to constrain risk-taking, limiting instability and reducing rent extraction. In that way, they are a modern variation on an old theme, designed to counteract the new pressures posed by conglomeration. To sacrifice their rigor in the name of administrative law regularity would jeopardize public welfare based on an ahistorical and ungrounded reading of the American banking tradition and American banking law. It is telling that our principal response to the last financial crisis was to fortify and update a traditional form of oversight. Abandoning bank supervision now, only a decade removed from catastrophe, and in the midst of a new economic crisis, would reject wisdom hard-won over centuries.