

BANKING INNOVATION IN THE 1920s: THE GROWTH OF NATIONAL BANKS' FINANCIAL SERVICES

*Eugene N. White
Rutgers University*

"In this day of our complicated and highly specialized civilization, departmental financial emporiums are inevitable."

James A. Bacigalupi, President of the Bank of Italy National Trust and Savings Association, 1929 [2]

For an economic historian, the rapid changes in the American financial system in the 1980s bear a strong resemblance to developments in the 1920s. Like today, the appearance of new financial instruments and the dissolution of barriers between different types of financial institutions threatened to drastically alter the character of the banking industry. This trend was reversed during the New Deal when policymakers concluded that the proper sphere of activity for commercial banks was a limited one. The failure in the long run of the legislation designed to restrict banks' activities suggests that the New Deal regulators misunderstood what had originally attracted banks into new fields.

This paper describes the movement of national banks into trust operations and investment banking in the 1920s. There were apparently strong complementarities between various kinds of financial services. Many trust companies and investment banks successfully combined commercial banking with their other activities, presenting a serious challenge to undiversified commercial banks. National banks had to expand their operations in order to compete with rival intermediaries and to adjust to the decline of their commercial loan business. Without these changes, national banks would have lost their position as the most prominent financial intermediaries.

ORIGINS OF THE NEW FINANCIAL SERVICES

In writing the National Banking Act of 1864, Congress sought to restrict national banks to a narrow range of financial activities. A national bank's prescribed role was to invest its funds in short-term, self-liquidating loans to finance goods in the process of production or exchange. But, whatever Congress' original intention was, national banks could not conduct such a limited business and survive in the tough competition of American financial markets. The banks did have one important loophole in the Act: they were permitted to perform such "incidental" activities as

were necessary to their operations. They took advantage of this opening wedge and, supported by many favorable court decisions, increased the scope of their business. As early as 1903, national banks were observed to engage in such "incidental" activities as foreign exchange trading, the safekeeping of securities, and the offering of loans on collateral of stocks, bonds, and mortgages [18, pp. 9-15].

From the turn of the century to World War I, banks' greatest competition came from the fast-growing trust companies. Their advantage over national banks was that they could combine banking and fiduciary powers to give their customers a more complete range of financial services [26, pp. 35-42]. National banks were anxious to compete with the trust companies; however before 1913, they were prohibited from engaging in trust operations. Some banks found a means to obtain fiduciary powers by setting up state-chartered facilities. One of the first major affiliates was the First Trust and Savings Bank of Chicago, which was created by the First National Bank of Chicago in 1903. The most common method of organizing and controlling one of these affiliates was for the parent bank to declare a special dividend that was used for the capital of the new institution. The same board of directors was appointed, and all outstanding stock certificates of the national bank were called in and stamped to register that each certificate carried with it a proportional amount of the affiliate [18, p. 54]. Although it might have been more advantageous for banks to open their own trust departments, affiliates enabled parent banks to indirectly supply fiduciary services and thus retain business that might otherwise have gone to the trust companies.

While national banks had been forced to conduct all trust business through the device of state-chartered affiliates before 1913, they were directly involved in several aspects of investment banking. National banks had no explicit power to engage in the business of buying and selling investment securities, but many of them did so under their "incidental" powers. All national banks had some experience with securities markets because the National Banking Act of 1864 had required them to buy US government bonds to back their banknotes. The courts decided that the Act's permission to discount and negotiate promissory notes and other evidence of debt allowed national banks to buy and sell obligations of the US government, states, municipalities, and corporations [18, pp. 44-50]. On the other hand, national banks were strictly prohibited from investing or dealing in common stocks because these were not evidence of debt.

In addition to transactions on their own accounts, banks began to give investment advice and sell bonds on commission. These activities appear to have been in a legal gray area. Whenever dissatisfied customers sued, the courts held that national banks could not, under any circumstances, carry on this business because it was *ultra vires* or beyond their corporate powers. In all cases, contracts were declared unenforceable with no recourse to recover damages [18, pp. 45-48]. Although surprising, the intent of the *ultra vires* rulings was consistent with the purpose of the National Banking Act that national banks not be subject to large and uncertain liabilities that could jeopardize the interests of their depositors. The *ultra vires* ruling apparently served more as a reminder of *caveat emptor* than as a substantial handicap as banks continued to act as brokers for their customers.

WORLD WAR I AND THE CHANGING FINANCIAL MARKETS

Up until World War I, the "incidental" trust and investment banking activities of national banks represented a minor but growing part of their business. This changed with the advent of the war, which drastically altered financial conditions and accelerated many banking developments. The massive bond sales during the war had an important impact on both the banks and the public. Participating in the campaigns to distribute the Liberty and Victory bonds, many banks handled their first security issues; from them, thousands of patriotic Americans purchased their first bonds. The sales of government securities to the public was immensely successful. Some financial writers have even claimed that the wartime bond drives changed the savings habits of the public, interesting them in securities for the first time [4, pp. 240-41].

The experience and profits banks gained from selling government bonds in wartime whetted their appetite for the securities business, but there were also factors pushing them into new financial activities. Most notable was the drop in traditional business that forced bankers to seek new sources of earnings. Much to their dismay, banks found that the demand for commercial loans was declining. For national banks, the percentage of commercial loans to total earning assets declined from 57.5 percent in 1920 to 37.0 percent in 1929 [9, p. 698]. The most careful study of the decline of the commercial loan was done by Lauchlin Currie [9] who believed that the most important factor was the change in the borrowings by corporate customers. Examining the commercial bank borrowings of 729 prominent companies in thirty industries, Currie found a switch in the way they financed their inventories. Over the period 1922 to 1928, bank loans as a percentage of inventories fell from 17.1 percent to 8.4 percent. Furthermore, the largest companies, in general, had no bank loans outstanding. Successful companies preferred to raise funds from retained earnings out of their growing profits and new stock issues. Only the smaller and weaker firms were dependent on banks as they found it difficult to raise funds through a bond or a stock issue. According to Currie, the motivation behind this trend was a desire to reduce their leverage and protect themselves from any future decline in earnings.

The decline of the commercial loan is also reflected in banks' earnings from their traditional major source of income, the interest on loans and discounts, which hardly grew in the twenties. For most of this period, unfortunately, earnings on loans and discounts cannot be separated from interest and dividends on investments. These formed an increasing share of national banks' portfolios, replacing many commercial loans. But, even as banks tried to maintain revenue growth, total interest earnings increased slowly. Between 1920 and 1929, interest earnings grew only 22.2 percent. Earnings from nontraditional activities had risen. The profits on the sales of securities, trust operations, commissions on insurance premiums, fees from handling real estate mortgage loans and bonds, and other services grew by 141.4 percent in the same period. The change in the composition of national banks earnings is illustrated in Table 1. By 1930, the percentage of gross earnings from all interest payments had fallen from 91.3 percent in 1920 to 85.9 percent while income from new

services rose from 6.3 percent to 11.9 percent. These earnings figures also understate the new activities' importance. The data provided by the Comptroller of the Currency only came from the national banks and excluded income from their investment and trust affiliates.

Table 1

Percentage of Gross Earnings for the Principal Categories of Income for National Banks, 1920-1930

Year	Interest Earnings	Domestic Exchange and Collection Charges	Foreign Exchange Profits	Fees from Trust, Securities, and other Departments
1920	91.3	2.4	n.a.	6.3
1921	92.0	1.7	1.7	4.5
1922	89.5	1.5	1.5	7.5
1923	89.6	1.4	1.1	7.9
1924	89.9	1.4	0.7	8.0
1925	86.8	1.5	1.2	10.5
1926	87.8	1.5	1.2	9.5
1927	86.6	1.3	1.1	11.0
1928	85.9	1.3	1.0	11.8
1929	86.9	1.3	0.8	11.0
1930	85.9	1.3	0.9	11.9

Source: US Comptroller of the Currency, Annual Report, (Washington, D.C.: U.S. Government Printing Office, 1920-1930). Yearly earnings are recorded from June 1 to May 31.

As more traditional types of business ceased to grow, banks moved into new activities. The most important of the new operations were fiduciary services and investment banking. Given a boost by the changes in the financial environment brought about the war, these lines of business developed rapidly in the twenties.

TRUST OPERATIONS IN THE TWENTIES

The barrier to the direct exercise of trust powers by national banks fell in 1913 with the passage of the Federal Reserve Act. This gave the Federal Reserve Board the authority to grant national banks a special permit for trust operations. Section 11 (k) of the Federal Reserve Act allowed a national bank the exercise of fiduciary powers as a (1) trustee, (2) executor, (3) administrator, (4) registrator of stocks and bonds, and (5) receiver. The conditions under which national banks could exercise these

powers was determined by Regulation H adopted in February 1915. This required national banks establishing a trust department to provide a separate place for the safekeeping of funds and securities held in trust with separate ledgers and accounts. These were to be examined regularly by the Comptroller of the Currency [23, pp. 417-19].

Directly granting national banks trust powers threatened to eliminate the advantage of combining commercial banking and fiduciary operations enjoyed by state-chartered trust companies. Trust companies vigorously opposed Section 11 (k) of the Federal Reserve Act and, after 1913, continued to fight the exercise of fiduciary powers by national banks in the state and federal courts. Here, too, they were wholly unsuccessful. The Supreme Court and Congress reaffirmed, and even expanded, the trust powers of national banks. In 1918, Congress added trust powers enabling national banks to act in the capacity of (6) guardian of estates, (7) assignee, on (8) committees of estates of lunatics, and in (9) any other fiduciary capacity that state banks or trust companies did in the state where the national bank was located [23, pp. 420-21]. National banks now had the same basic trust powers as any state-chartered institution. The last obstacle to complete equality was cleared by the McFadden Act of 1927 that gave national banks perpetual charters ensuring that a bank's charter could not expire and threaten the trusts it had undertaken [5].

This equalization of trust privileges between national banks and state-chartered institutions led to the gradual disappearance of national bank trust affiliates. Those remaining probably owed their survival to the fact that they were used to carry out securities operations [18, pp. 53-56]. National banks preferred, if possible, to have all activities including a trust department within one organization to encourage cooperation in providing complementary services to the public.

The banks that absorbed their former trust affiliates were not as numerous as those who took advantage of Section 11 (k) and the changes brought about by World War I to open new trust departments. When applications were first opened in 1915, over 350 banks were authorized to engage in trust operations. By 1921, their numbers had swollen to 1381; and in 1930, 2465 or 34.0 percent of all national banks had been granted some fiduciary powers by the Federal Reserve [3]. Data provided by the Federal Reserve Board is spotty, but it does present a picture of steady expansion. From 1921 to 1928, the trust funds administered by national banks rose from \$825 million to \$3297 million. National banks' trust department earnings grew from \$5 million in 1924, when they were first reported separately to \$22 million in 1930. The provision of trust services was also well diffused. In California, the Bank of Italy [2] reported that all of its 292 branch offices were exercising trust powers. The national banks in the major financial centers led — but did not dominate — trust operations. In 1927, the share of national banks' total assets in the three largest Federal Reserve districts, New York, Chicago, and San Francisco, was 48 percent while their share of trust assets was 61.3 percent. Even in small towns, many banks [6; 19] provided trust services to their customers.

The experience of one small bank, the First National Bank of Coos Bay in Marshfield, Oregon [6], illustrates how some banks entered the trust

business. The massive sales of US government bonds during the war, distributed partly by the banks, gave the public securities and documents that needed safekeeping. Obliging its customers, the First National Bank of Coos Bay acted as a "gratuitous bailee" and placed these items in their vault. When the demand exceeded the available space, the bank decided to charge for its services and established a trust department and installed safe deposit boxes.

Articles in the professional journals of the period [1; 5; 6; 8; 12; 19] provided encouragement and information on how to set up and run a trust department. The touted attraction of offering trust operations was that it would give banks a new and important source of profits. In an article in the American Bankers Association Journal, entitled "Trust Service: An Essential of Modern Banking" [2, p. 400], the president of the Bank of Italy, James Bacigalupi, argued that

in this day of keener banking competition and the insatiate demand of the public for more and various gratuitous personal service, it is not only advisable but almost necessary that banks turn to this newly cultivated field of the trust department as a certain and most effective means of restoring narrowing banking profits.

He also emphasized that the new financial service departments would help a bank retain deposits that would otherwise be attracted to competitors offering more services.

In addition to the edge that trust operations gave them in competing with other financial institutions, national banks found that their new fiduciary powers were complementary to their commercial and investment banking activities. As one banker explained

Beyond the commissions charged, we have profited largely by the contact thus formed with investors of funds who have learned to lean upon our judgment and some of whom have prepared their wills or left their estates to our supervision [1, p. 506].

Bankers also discovered that their commercial banking operations generated information that could be used to build up their trust business. One article in the American Bankers Association Journal suggested that trust customers could be found by examining customer balances and safe deposit registers. It recommended that professional men and wealthy individuals were good prospects for a voluntary or living trust, young married couples for a life insurance trust, and small businessmen and the well-to-do for estate management [19, p. 707]. The most common trust business concerned wills and estates. Having already built up customer relationships, many banks found it easier to persuade people to make out their wills naming the bank as executor and trustee or co-executor and co-trustee. Mortgages and deeds of trust to secure loans could be prepared by a trust department for a fee; if there was a bond department, the bank could obtain the fees for the sales of securities to

the trusts it managed, rather than seek an outside broker or investment banker [12, p. 169].

The First National Bank of Coos Bay felt that one of the most important benefits of having a trust department was its enhanced ability to handle mortgages. From a commercial banking point of view, the bank found itself faced with a demand for more mortgages than it wanted to offer [6, p. 420]. This was a common problem for many banks in rural areas and small towns [1, p. 506]. The bank was also aware of a strong demand for investments by many of its customers. The indivisibility of mortgages often prevented borrowers and lenders from getting together directly, but the trust departments of banks found ways to repackage mortgages that were attractive to investors. If the mortgage was too big for any one investor, the trust department could hold the original mortgage in trust and sell certificates of interest that effectively split ownership of the mortgages. Sometimes mortgages were pooled to reduce the risk inherent in holding just one mortgage. Investors were issued trust participation certificates with the mortgages as security. By these and other devices, banks were able to participate in the rapidly growing market for real estate mortgages. Most national banks made few if any loans on real estate. The development of a real estate loan department in conjunction with the trust department for handling these new fee-based operations gave them entry into an expanding market while the commercial loan market remained stagnant [14, p. 399].

Trust operations fit in well with the other activities of national banks. Without fiduciary powers, national banks would have been severely handicapped in competition with trust companies. With trust powers, national banks ably expanded by developing new lines of business.

THE GROWTH OF SECURITIES OPERATIONS

While national banks' trust operations expanded at a steady pace, their securities business grew even faster. Banks increased their securities dealings through their bond departments and, more visibly, through their securities affiliates. These affiliates were based on the model of the trust affiliates. However, they were incorporated under the general laws of incorporation rather than under state banking and trust company laws. This meant that the affiliates could engage in virtually any type of financial transaction not governed by banking or trust laws.

The first security affiliate was the First Security Company created in 1908 by the First National Bank of New York. The main purpose of this early affiliate was not so much to develop an investment banking business but rather to acquire stocks of other banks and investments that the national bank could not legally hold. This also seems to have been true for the next affiliate, the National City Company, formed in 1911 by the National City Bank of New York. The security affiliates had a rather inauspicious beginning, and it was not until World War I that they seriously moved into investment banking. In 1916, the National City Company began to build up its securities business. In the following year, the Chase National Bank obtained a new charter for its securities affiliate, the Chase

Securities Corporation, with the express objective of establishing facilities for underwriting and wholesaling of securities [18, pp. 61-64].

There were three basic methods of organizing a security affiliate. The first and most common was where the stockholders of the bank were given a pro rata interest in the stock of the affiliated company. In the second, the affiliate was carried as an investment of the bank; in the third, the investment company was owned by a holding company that also owned the parent bank [20]. Typically, the affiliate had a name that was very similar to that of the parent bank, and it usually had offices in the same building. While it was not a department within the bank, the affiliate was carefully located to provide the bank's customers with investment banking service.

Although affiliates were more visible, many more banks handled their securities business through their bond departments. The Comptroller of the Currency unofficially approved of security operations within banks, but most activities were still classified as ultra vires until the McFadden Act of 1927 formally conferred on national banks the power to sell investment securities. The principal limitation of conducting a securities business through a bond department was that transactions involving common stocks were forbidden. These could only be handled by an affiliate.

Whether directly or indirectly engaged in the securities business, national banks' investment banking grew rapidly. The identification of all banks in the securities business is difficult. W. Nelson Peach [18] compiled a list of national banks mentioned in the Securities Dealers of North America. His compilation of banks operating a securities business through their bond departments or affiliates is reproduced in Table 2. The number of banks with security operations peaks at 237 in 1931. However, Peach's table appears to report only those national banks prominently engaged in underwriting and distribution. An examination of Securities Dealers of North America [22] shows that almost all of these banks were located in large and medium-sized cities. In the Annual Report of the Comptroller of the Currency, many more banks reported profits on securities sold. Smaller banks generally did not participate in the distribution of new securities. Many of them would only recommend securities or execute a customer's order upon request. Thus, while over 200 banks could be classed as important securities dealers, trading on a limited basis was much more widespread.

Many of these banks first became involved in the securities business during World War I campaigns to sell bonds. After purchasing their Liberty bonds from the banks during the war, the public returned to its bankers for advice and assistance with other securities purchases. Banks found themselves in a position where they could readily accommodate their customers. They already had bond departments to evaluate and purchase bonds for their own account, and it was simple enough to use some of this expertise to assist their depositors. As demands for service grew, banks increased the staff of their bond department, and some became active in distribution. National banks had a ready retailing network that had worked exceedingly well during the war. Unlike private bankers who generally had a small clientele of the well-to-do, commercial banks had

large numbers of depositors who could each buy a small number of securities.

Although it was later charged that they had recklessly entered the securities industry, banks in the twenties felt their security operations benefitted both themselves and their customers [16]. Rather than trust some unknown bond salesman, an investor could turn to his banker for sound financial advice. Banks' customers could often buy securities with smaller commissions than brokers charged. Banks appear to have acted as "discount" brokers. It was reported that while "brokerage fees vary ... about one quarter of the New York brokerage commission in stock deals is the typical charge by a bank" [20]. In the large cities, investors were served by many investment bankers and brokers, but banks were important for opening up security markets in the hinterland. In Securities Dealers of North America, the proportion of banks and their affiliates to all dealers in small towns and rural areas was much higher than in the regional and national money centers.

Table 2

The Number of National Banks and Their Affiliates Engaged in the Securities Business, 1922-1933

Year	Operating Through Bond Departments	Operating Through Security Affiliates	Total
1922	62	10	72
1923	78	17	95
1924	97	26	123
1925	112	33	145
1926	128	45	173
1927	121	60	181
1928	150	69	219
1929	151	84	235
1930	126	105	231
1931	123	114	237
1932	109	104	213
1933	102	76	178

Source: W. Nelson Peach, The Security Affiliates of National Banks (Baltimore: The Johns Hopkins Press, 1941), p. 83, Table 1.

In all parts of the country, banks in the securities business concentrated their activity in bonds. Only very late in the decade did banks move into the trading of common stocks. Even an industry leader like National City Co. did not begin to deal in common stocks until 1927 [18, p. 106]. Most banks strongly emphasized the selection of investment grade bonds for their customers. One example of a medium-sized bank

that provided a securities service for its customers was the Wachovia Bank and Trust Co. of Asheville, North Carolina [17]. The management felt that it was important to assist its depositors who wished to diversify their investments beyond savings deposits. The bank focused on the safety of the principal and income in recommending bonds. In order of preference, the bonds it suggested to its customers were: Liberty issues, North Carolina bonds, municipals, railroads, public utilities, industrials, and real estate mortgage bonds.

There were strong complementarities between the various aspects of the securities business, and banks found that their ability to distribute bonds drew them into other areas. In the floatation of new issues, banks with agencies for distribution were in a preferred position to obtain desirable participations in underwriting syndicates. The issuing investment house wanted to have securities purchased not by speculators but by investors who would deposit them in safe deposit boxes and await their dividends or coupon payments [18, p. 75]. The practice of acting as a participating distributor became quite common. By the end of the decade, many banks in money centers underwrote, distributed, and dealt in most types of bonds. Outside of large cities, national banks specialized in originating and underwriting local issues of municipal and real estate mortgage bonds.

The complementary aspects of commercial and investment banking offered the managers of a bank and its affiliate an opportunity to strengthen both lines of business by providing their customers with a full array of financial services under one roof. On the commercial banking side, banks could take advantage of the larger, more specified research staffs enabling them to better judge purchases on their own account and loans made on collateral of securities [15]. In addition, investment affiliates allowed banks to circumvent geographical restrictions on their activities. Unlike national banks, an investment company could establish branches without limit. Some banks used this opportunity to expand across the country. By 1930, National City Co. had 60 branches; Chase Securities Corp., 26; First National Old Colony Corp., 17; and Continental Illinois Co., 12 [21].

On the investment banking side, an affiliate's parent bank gave it an advantage in competing with private bankers and brokerage houses. As previously mentioned, a large distribution network placed the affiliate in an advantageous position in underwriting syndicates and participations. Parent banks could use any of their offices to sell securities for their affiliates. In California, where banks were permitted extensive branching networks, affiliates maintained no separate offices and extended services to banks' clients through the parents' branches. In other states, securities affiliates tied to bank holding companies or chains handled the bond business of banks in the group. The First National Bank Stock Corporation of Minneapolis controlled about 100 banks; its affiliate, First Securities Corp., handled the bond business of all its banks [18, p. 101]. The Northwest Bank Corporation had a similar arrangement [15]. These advantages in distribution were significant enough to worry the investment bankers. They bitterly complained at their 1929 convention that competition from group and chain banks was cutting down on their members' volume of business [7]. One further advantage that investment affiliates had over investment

banks was their ability to borrow from their parent banks in the event of a particularly attractive opportunity or other need [21].

The advantage of tying commercial and investment banking together allowed national banks to successfully penetrate the securities business. Two measures of market penetration offered by Peach [18] are a testament to national banks' tremendous success. From 1927 to 1930, the percentage of bond issues originated by national bank affiliates rose from 10.1 percent to 27.6 percent. Including state bank affiliates, state banks, and trust companies, the total, bank-controlled originations rose from 22.0 percent to 44.6 percent. Private investment banking houses thus saw their share drastically decline from 78.0 percent to 55.4 percent. While no figures are available for the volume of securities distributed by banks, Peach found a rising level of participation in all bond issues. National bank affiliates' participations rose from 12.6 percent in 1927 to 33.6 percent in 1930. For all commercial banks and their affiliates, the total share increased from 36.8 percent to 61.8 percent. Commercial banks had become a major force in all aspects of investment banking on the eve of the Glass-Steagall Act.

CONCLUSION

The New Deal banking legislation dealt harshly with commercial banks. While they retained their trust services, the Glass-Steagall Act removed them from the field of investment banking. What the New Deal regulators did not see was that banks' new financial services were not begun as part of a speculative lark but because of strong complementarities between different types of banking business. National banks were rapidly drawn into new fields because of competition from other intermediaries that had already combined commercial banking with other activities. The appearance of national bank "financial emporiums" in the 1920s represented a move by these firms to offset the decline of their traditional business and meet the challenges presented by trust companies and investment banks.

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