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Title: The Chinese cornerstone of modern banking : the Canton guaranty system and the origins of bank deposit insurance 1780-1933

Date: 2012-10-24

SUMMARY: THE CHINESE CORNERSTONE OF MODERN BANKING

1. Introduction.

This is a study of the Chinese idea that inspired bank deposit insurance in the United States of America. The idea of being held responsible based on membership in a group has ancient roots in Chinese history. The unifying first Emperor Qin Shi Huang Di employed collective responsibility in military and social organization. The principle also had its financial application, being used to compel the payment of money to the state much in the same way it was used to compel action by subjects of the Emperor. In the eighteenth century, Qing Dynasty regulators required merchants who conducted certain key businesses monopolized for the benefit of the imperial court to assume collective liability for the debts of other firms in the monopoly. The hong merchants of Canton, China, who held a monopoly of China's maritime foreign trade with the West, were forced to accept collective liability for the unpaid foreign debts of other guild members in 1780. This practice, validated by association with the famous hong merchants of Canton, was taken by the legislature of the State of New York in 1829 as inspiration for the first bank deposit insurance statute ever enacted. This Safety Fund (1829-1866) inspired the adoption of similar programs by thirteen other American states in turn. While all of these programs had failed by the early 1900s, strong interest had grown in a national insurance plan, as an improvement on the state guarantee fund concept. National deposit insurance was implemented in the United States under the Banking Act of 1933, adopted in the economic crisis of that year, and has been in force ever since. Judged to be a success, much as the State of New York had understood the Chinese experience in 1829, the American model of national deposit insurance has been followed around the world. Explicit bank deposit insurance programs exist today in over one hundred nations, for which the inspiration can be traced back to Qing Dynasty China through the early national United States of America.

2. Parallel crises (1829).

The transplantation to the United States occurred in the context of parallel financial crises in the year 1829. At Canton, in China, the group of hong merchants who were licensed to conduct China's maritime foreign trade was depleted in number, deep in debt, and experiencing severe difficulty recruiting new members. In the State of New York, in the United States, a series of bank failures had raised concerns about the trustworthiness of the paper currency which the state permitted private banks to print and circulate. The public was alarmed about the reliability of private banknotes, politicians were blamed for chartering weak banks, and the legislature responded by refusing to either renew old bank charters or grant any new ones until the issue was resolved. Although the world was closely bound by ties of international trade in 1829 and information was moving with increasing speed between East and West, news of these crises did not travel. Just as the crisis in New York was unknown in Canton, the crisis in Canton was likewise unknown in New York. The British East India Company pressed the Chinese authorities at Canton for urgent trade reforms. Unsuccessful, it imposed an embargo of trade which ran from October through February 1830. The embargo also accomplished nothing. In January of 1829, in Albany, in the State of New York, reform proponent Joshua

Forman premised his novel proposal for bank deposit insurance on the following confident words:

> "The propriety of making the banks liable for each other was suggested by the regulation of the Hong merchants in Canton, where a number of men, each acting separately, have by the grant of the government the exclusive right of trading with foreigners, and are all made liable for the debts of each in case of failure. The case of our banks is very similar; they enjoy in common the exclusive right of making a paper currency for the people of the state, and by the same rule should in common be answerable for that paper. This abstractly just principle, which has stood the test of experience for seventy years, and under which the bond of a Hong merchant has acquired a credit over the whole world, not exceeded by that of any other security, modified and adapted to the milder features of our republican institutions, constitutes the basis of the system."

While the New York legislature did receive accurate information about the idea of collective liability for foreign debt among the hong merchants of Canton, it did not learn of the problematic actual experience of the Canton Guaranty System.

3. <u>The development of the Canton Guaranty System</u>.

The Manchu rulers of Qing Dynasty China developed the system which licensed and regulated the hong merchants. After years of careful preparation, the Manchu took Beijing in 1644 and achieved a surprisingly rapid conquest of Northern China. Progress proved more difficult in the coastal South, where the struggle raged on another forty years. After the devastated region was brought under control, the Kangxi Emperor opened the South to maritime foreign trade. The regional economy responded quickly and positively to the stimulus. The Manchus sought the benefits of trade, but at the same time felt it important to maintain public order among the trading communities and to assure the flow of customs tax revenues to Beijing. During the eighteenth century a body of rules was evolved through experiments and a series of crises to advance these objectives. The regulatory structure that was developed for Canton – the "Canton System" -- drew on Manchu and Chinese traditions, discussed in Chapter Two of this study.

The Canton System relied on licensed official merchants (*guan shang*), known popularly as the hong merchants. The Chinese government granted these merchants a monopoly of maritime foreign trade but required that they perform security and tax collection functions in return. A collective guaranty of the foreign debts of guild members -- the Canton Guaranty System (1780-1842) -- was imposed on the hong merchants in 1780 as a modification of formal foreign trade rules which had originally been promulgated in 1760. Collective liability for debt had previously been imposed on merchants who operated other businesses monopolized for the Emperor by the Manchu Imperial Household Department (*neiwufu*), but no clear record survives of the sequence of or reasons for introduction of the practice in these enterprises. The practice of collective liability was introduced among the hong merchants of Canton in several stages, starting in 1754.

Foreign creditors frequently asserted claims against the hong merchant body under the collective guaranty in the years after 1780. Their claims were received by the Canton officials in an orderly process, significantly better than that available to

Chinese subjects seeking to collect debts, in which claims were allowed (or disallowed) under Chinese law and ordered paid by the hong merchants over a period of years without interest. The evolution of this system of regulations, and the Chinese processes for enforcement of debt, are examined in Chapter Three of this study.

Payments from the hong merchants under the collective guaranty, and other obligations from the hong merchants to the state, were paid out of the Consoo Fund, which was established in 1780. The fund received a modest initial cash contribution from the hong merchants, and thereafter received the proceeds of the *hangyong* tax on foreign trade. Levied from 1780 until the end of the Canton System in 1842, the *hangyong* tax was collected in the base amount of 3% but was occasionally increased to as much as 7% depending on the exigencies of the moment. The Consoo Fund was originally held in the form of specie in chests in the Consoo House, the guild hall of the hong merchants. This cash was exhausted within a decade and while the fund continued to receive the proceeds of the tax, no effort was ever made to adjust the amount of that tax to actual or anticipated loss contingencies. Funds required to make payments from the Consoo Fund were collected from the hong merchants as needed on a cash call basis.

The Qing government enacted laws to prevent the losses that were required to be paid from the Consoo Fund. Loans from foreigners to hong merchants were declared illegal under laws regularly proclaimed from 1760 forward. These laws were not enforced. Furthermore, disincentives existed which discouraged enforcement of protective laws by officials. Foreign traders made imprudent loans to hong merchants, and the indebted merchants engaged in desperate practices in unsuccessful attempts to raise the money needed to pay their debts with interest in the years after 1780. Stern enforcement of harsh penalties for debt, including beatings and the banishment of failed hong merchants to Xinjiang, did not help matters. All the while, Qing officials assisted foreign lenders in collecting these illegal loans.

4. Strains on the Consoo Fund.

The Consoo Fund was strained from its beginning in 1780. Despite the resources devoted to it, the guild stood depleted in number, reduced by the massive failures of the year 1780 and saddled with 600,000 taels ($833,333) in foreign debt ordered paid over ten years on account of those failures. Although several firms were admitted in the twenty year period through 1799, many failed. Hong merchant scholar Weng Eang Cheong speaks of "a wholesale extinction of merchants recruited before 1790." These firms were casualties of the perennial dilemma of inadequate capital and lack of access to affordable credit with which to conduct a growing trade. The failures also mark the end of the period in which the Canton trade was dominated by chartered European state trading corporations and hong firms that specialized to their needs. Additional failures resulted in further draws on the Consoo Fund in the period 1780 through 1799, analyzed in Chapter Four. In the last years of the eighteenth century, the Consoo Fund was also heavily drawn on by the Chinese government and officials, both for military needs and pirate suppression in these increasingly troubled times, and also in the form of exactions for venal purposes.

Foreign creditors, notably the now dominant British East India Company, recognized that the Consoo Fund was experiencing strain in the early years of the nineteenth century. The trade was sharply impacted in these turbulent years by cycles of European wars, and by domestic problems including piracy that threatened trade on the China coast. For a few hong merchants, these were years of opportunity and gain. Most hong merchants knew this as an arduous period. The record of Conseequa provides a dramatic example of the problems experienced by hong merchants in this transitional era. Admitted to the guild in 1796, Conseequa was ambitious and traded with many different foreigners. He extended large amounts of credit to the newly arriving Americans in the years before and after 1800. These credit extensions to independents soured due to wars and the American trade embargo of 1807-1809, and Conseequa found himself massively indebted to the British EIC. This history is discussed in Chapters Five and Six of this study.

For its part, the British EIC understood by 1800 that calls on the collective guaranty inevitably brought price increases from the guarantors, or led to more hong failures which decreased competition among sellers to it. It therefore exercised restraint as a creditor during the period 1800-1814, the subject of Chapter Five of this study. The British EIC avoided making demands on the collective guaranty, and instead sought to collect debts outside the guaranty system if possible. Yet its two main attempts at evasion ended badly. Its attempted 1810 receivership of the hongs of Gnewqua II and Ponqua was promptly terminated by the Canton authorities, who arrested the Chinese receiver and banished him to Xinjiang. The 1813 trusteeship of five junior hong merchants, including Conseequa, was not terminated because no attempt was made to interfere with operations under official license. In both cases, massive losses were ultimately charged to the hong merchant body under the collective guaranty. This period also saw heavy government exactions from the guild. The Canton officials drew on the Consoo Fund for myriad purposes, ranging from military campaigns and the suppression of coastal piracy (largely successful as of 1810), to Yellow River flood control, to famine relief, to the Emperor's birthday in 1809 (at a cost of 120,000 taels [$166,667]), and also for venal uses. In contrast to the average annual collective guaranty charge for unpaid foreign debt in the period 1780-1799, some 81,050 taels ($112,569), the average annual charge of 113,733 taels ($157,963) for the period 1800-1814 had increased sharply, up forty percent (40%) from the average for the prior period.

5. <u>'Too big to fail' and the end of the Canton Guaranty System</u>.

The period 1815 to 1828 is the subject of Chapter Six of this study. These years saw a rebound of trade, with the end of the wars, and ongoing business changes related to the rise of the illegal trade in opium and increasing operations by merchants who traded outside of the official monopoly. Four of the five junior hongs which had been placed in receivership by the British EIC in 1813 failed in this period, including Conseequa's Liquan hong which was formally shuttered after the proprietor's death in 1823. The average annual charge under the collective guaranty during this period was 123,214 taels ($171,130), an eight percent (8%) increase from the prior period. The hong merchant body had become sharply divided by this point, separated between a very few successful firms and a majority that struggled to survive.

While information on government exactions during this time period is scant, an 1839 memorial to the Emperor shows official recognition that the hong merchants were at their financial limit. The hong merchants had committed in 1819 to pay 600,000 taels ($833,333) for Yellow River flood control work, and then committed in 1826 to pay another 600,000 taels ($833,333) to support the war in Kashgar. Payment of these pledges, absolute on their face, was then repeatedly deferred on imperial approval through 1839. Twenty years later, 136,151 taels ($189,098) of the 1819 pledge still had not been paid, and none of the 1826 pledge had been paid. It is apparent that the Qing government had, in effect, recognized certain leading hongs as being "too big to fail." While these firms might theoretically have been pressed to pay all tax and guaranteed foreign debt, the Canton officials realized that a high risk existed that they too could be broken and that, without them, the entire Canton System would fail. In this context, functional "too big to fail" status protected, notably, the preeminent Yihe hong of the senior hong merchant Wu Bingjian (Howqua II) from excessive government exactions, in contrast to the direct or indirect state subsidies that characterize modern "too big to fail" doctrine.

In the last years of the Canton Guaranty System, the hong merchants suffered massive losses and the system was then brought to an end by the First Anglo-Chinese or Opium War (1839-1842). This final fourteen year period, the subject of Chapter Seven of this study, begins in 1829. In that year the British EIC imposed a local trade embargo in an unsuccessful attempt to force reform of the Canton System, and the New York legislature took the distant Canton System as inspiration for banking reform. Within five years, the China monopoly of the British EIC had been terminated. As the EIC closed up its operations, Chinese and foreign creditors alike began to question the ability of the hong merchants to continue to trade profitably. Creditors had counted on the hong merchants' stable long term contracts with the EIC as supporting their ability to pay debts – both individual debt and collectively assumed debts. Without the EIC contracts, the ability of hong debtors to repay debt could no longer be readily assumed.

A crisis of confidence ensued, which was worsened by two massive hong failures that occurred as the depression of 1837 swept around the globe. The hong merchants told foreign creditors that they would not be able to pay the debts involved for many years. British creditors began to look to the Qing government, which had enforced the guaranty system, to pay these large private debts. The average annual charge the hong merchants were ordered to pay under the collective guaranty during this period stood at 186,266 taels ($258,703), a dramatic forty percent (40%) increase from the prior period. Only a small part of these amounts had been paid as of the outbreak of the Opium War. In accordance with the British Treaty of Nanking, a $3 million lump sum repayment of hong merchant debt was delivered to the British consul at Canton on 23 July 1843.

6. <u>Transplantation of collective responsibility</u>.

There was a belief at the time of each of the transplantations considered in this study that the idea had enjoyed prior success, but that the idea as received would function best with some modification. Thus, although the Chinese idea of collective responsibility for debt was understood to have "stood the test of experience for seventy years," some adjustment was warranted. It was accordingly "modified and adapted to the milder features of our republican institutions," in the words of reform proponent Joshua Forman. The guaranty fund, with mandatory public supervision, that New York implemented in 1829 was considered enough of a success to be followed by thirteen other states which adopted their own guaranty fund plans. The troubled experience of these state guaranty funds did not tarnish the idea of a collective guaranty fund that would pay depositors in case of bank failure, but rather increased belief that a larger national pool and a program more in the nature of insurance was required. This history, the subject of Chapter Eight of this study, produced national bank deposit insurance in the United States of America, enacted in the banking crisis of 1933.

Years of banking calm, following national adoption of deposit insurance, validated the plan in the United States. Its success was never free of controversy, which surrounded, for example, the gradual adoption of a 'no depositor loss' policy in the early years of the program, and the "too big to fail" policy of more recent years. The American deposit insurance experiment has since been followed, with substantial local variation, in more than one hundred nations around the world, as discussed in Chapter Nine of this study. This progress is doubly remarkable. First, an idea that is collectivist in its essence became a cornerstone of banking regulation in the United States, a nation which is often thought of as highly individualistic. Second, this collectivist idea has traveled from the United States across the globe.

During the sixty-two years in which it was enforced, the Canton Guaranty System produced significant benefits as well as severe problems for the merchants and officials who worked with and within the system. It encouraged more open dealing with all members of the guild, and also avoided disruptions of trade by providing a system for the orderly determination and payment of foreign debts, which contributed to the strength of the hong merchant brand. It also encouraged reckless behavior by hong borrowers and foreign lenders. The failure of many hong firms was hastened by the heavy debts they were forced to pay under the collective guaranty. Some of the problems experienced under the Canton Guaranty System are strikingly similar to problems critics have noted with modern deposit insurance programs. Its history speaks to issues of the extent of guaranty, proper tax level, protective laws and their enforcement, evasions of the system, imprudent behavior by depositors and bankers (moral hazard), too big to fail institutions, and even confidence in the guaranty system itself, all of which are of global concern today. These topics are addressed in Chapter Ten of this study, its Epilogue.

The historical record of the Canton Guaranty System, never previously examined, offers a number of valuable lessons to the modern world. These include: (1) that the tax that supports a guaranty fund must be based on measured risk of loss; (2) that the fund and its insureds must be made subject to strong independent supervision; (3) that laws enacted to avoid risk contingencies must be enforced; and (4) that both corruption and the diversion of fund assets must be strictly prohibited. None of these controls were observed at Canton between 1780 and 1842. Perhaps most important, (5) guaranty funds should avoid the unlimited commitment to pay losses, as was promised at Canton. Unlimited coverage impaired the economic incentives for insureds to protect themselves under the Canton Guaranty System, and the mounting burden of unlimited liability for losses incurred brought the system itself and those exposed under it to the edge of ruin.