

# ***English Commercial Bank Stability, 1860-1914***

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British banking developed a reputation for an unusual degree of systemic stability even in Victorian times. It is a remarkable fact that there were no significant commercial bank failures after the liquidity problems of 1878 when both the City of Glasgow and West of England banks collapsed. In subsequent international liquidity pressures, such as occurred in 1890 and 1906/07, there were no commercial bank failures of even moderate significance, and certainly no serious challenge to systemic stability. The contrast with experience overseas was to be even more marked in the economic crisis of the 1930s. Despite the collapse of export sales, sharp rises in the number of corporate bankruptcies, record unemployment rates, shocks to international financial markets and the forced devaluation of sterling, British retail banks remained sound. There was no need for extensive state intervention to bolster a collapsing banking system, as occurred in many other leading economies, including Germany, much of central Europe, Belgium, Italy and the United States of America (Collins 1998).

Extraordinary as it may seem, before World War I the British commercial banks attained this enviable stability within a largely unregulated environment. At that time, there was no state-owned central bank. The Bank of England was closely involved in government financing but it was an independent, profit-seeking corporation with no formal regulatory powers. From 1833 its notes had been legal tender in England and Wales, and it was legally obliged to maintain the convertibility of those notes into gold. Largely for this reason it had become the *de facto* repository of the nation's monetary reserve of precious metal (the Bank held no foreign currency reserves except for gold and silver). In the money

markets, it is true that commercial banks' powers of issuing notes were restricted, most notably by legislation of 1844, but precious little else of their business was subject to legislative control. In fact, even as early as 1875 commercial bank notes in circulation were only £10.7 million (over one-half in Scotland) compared to the £446.2 million of commercial bank deposits where most of the banks' business lay (Collins 1988, p. 40). It is also true that at the very beginning of our period banking companies' shares could not carry limited shareholder liability but, as we shall see, this constraint was soon removed. Indeed, the great bulk of the banks' business was unregulated. Remarkable as it may seem from the perspective of a twenty-first century in which a great deal of the energy of the world's monetary authorities is spent on trying to impose minimum regulatory standards, in pre-1914 Britain there were no official stipulations regarding capital ratios or reserve requirements, and there were no official restrictions on banks' investments or loans. Thus, the commercial bank stability emerged in an essentially unregulated environment.

This article considers some of the major reasons contributing to this stability before 1914, although because the contemporary legal system was (and present-day archive collections of the Scottish banks still are) largely separate, the focus is on the banks of England and Wales. Two main elements of systemic bank stability are highlighted in this article. First, the article discusses changes to the corporate structure of commercial banks over the period. Secondly, attention is focused on changes in the composition of commercial bank assets. We are especially interested in the banks' loans to the business sector because practice there strongly implies that micro-economic practices may have contributed significantly to systemic stability. However, before looking directly at the commercial banks the article draws attention to another major element in the stability of the monetary framework in which those banks operated, namely the Bank of England's role as lender of last resort.

### **Bank of England as Lender of Last Resort**

By the start of the twentieth century it was widely accepted that the Bank of England accepted some lender of last resort responsibilities

towards the London money markets and, thus, towards the domestic banking system. However, as the Bank was not a state-owned bank – and, indeed, it remained an independent, privately-owned, profit-making institution throughout – there was no legislative regulation governing any lender of last resort function; nor was there any formal statement from the Bank accepting such a role. Moreover, the practice at the Bank of England (in contrast to that at the Banque de France) of holding minimum gold reserves, left open the possibility, in times of severe pressure for liquid assets, of it not being able to meet its legal obligation to maintain the gold convertibility of sterling. In such an occurrence, the Bank would not, of course, have been able to lend freely to financial institutions – that is, to act as lender of last resort. Given the absence of any formal responsibility, this perceived threat to the gold reserves, thus, carried an implied limitation to the Bank's lender of last resort function. The market, therefore, had to judge the dependability of Bank intervention on the basis of experience. In fact, the Bank's historical record relayed a number of mixed messages although, over time, its *de facto* acceptance of the responsibility definitely grew firmer.

The legislative framework did not make this development inevitable. The 1844 Bank Charter Act was the main piece of legislation governing the Bank's functions and it said nothing of lender of last resort responsibilities. Indeed, as is well known, the Bank's management initially interpreted the strictures of the 1844 Act as absolving the Bank from any 'public responsibilities' to the money markets and in the early stages of the banking crisis of 1847 they refused to lend from their depleted resources (Collins 1988, pp. 181-97). In a similar manner, after the crisis of 1857 the Bank tried to create some distance between itself and the London money market by discontinuing bill discounting facilities for the discount houses (which were a major intermediary through which the commercial banks could gain access to Bank funds). Also, the decision in 1866 not to rescue the leading discount house, Overend's, signalled clearly to the market that there were definite limits to the Bank's preparedness to help individual institutions during liquidity pressures (Batchelor 1986, pp. 44-9).

Gradually, though, the Bank became more supportive. Thus, in

successive liquidity pressures there was a number of high profile bail-outs. For instance, in the crisis following the collapse of the City of Glasgow Bank, the Bank of England helped stem a run on one of the country's largest commercial banks, the London and County Bank, by providing £1.8 million in cash immediately it was approached for assistance in the middle of January 1879. Perhaps most famous of all, was the Bank's organisation of a rescue of Barings merchant bank in 1890 (Clapham 1944, vol. 2, pp. 326-39; Pressnell 1968; de Cecco 1964, pp. 88-98). At the time it was accepted that the collapse of Barings would have undoubtedly threatened the international standing of London bills of exchange (probably the most important contemporary means of international credit) and seriously damaged the business of the City of London. Fortunately for Barings, they were able to persuade the Bank of England that the firm was solvent, if illiquid. Even so, there was hesitation at the Bank. From the Bank of England's point of view, the amounts of money involved were inhibiting. It was feared that as much as £10 million might have to be advanced to enable Barings just to meet their immediate commitments. This was a substantial amount at a time when the Bank of England's 'normal' reserve of coin and bullion stood at only £20 million. The Bank, therefore, had no intention of acting alone. After unsuccessful attempts to get the British Treasury to take the burden, the Bank organised a consortium of leading financial institutions to guarantee Barings' liabilities for at least three years. But, as the Bank's historian has said, the Bank only acted after minimising its own potential liabilities and '...it seems that collapse might have been allowed to occur after all, if guarantors had not been found outside the Bank' (Sayers 1986, p. 3). In other words, the Bank's intervention of 1890 was not truly that of a bold, unambiguous lender of last resort. Even so, the Bank did take the leading role in the rescue and the collective guarantee did effectively stem the liquidity panic in Britain.

In sum, the historical record shows the Bank increasingly acting as *de facto* lender of last resort, but also shows that there were limits to its commitment and that there was ambiguity in its signals to money markets. Sayers offers the following synthesis:

It was to be...expected that reflection on the events of 1866 (when

the crash of Overend, Gurney & Co. had all but broken the country's financial structure) should shift opinion decisively both inside and outside the Bank, and after the publication of Bagehot's *Lombard Street* in 1873 every student of the subject was brought up on the doctrine that the Bank had an inescapable duty as lender of last resort irrespective of anything said in the Bank Charter Act. So when in 1890 the threatened failure of Barings brought the financial structure to the brink of catastrophe, the Governor knew he had to act...But what such an extraordinary episode implied by way of continuing responsibility through more ordinary times, was not as unequivocally established. Neither the publication of *Lombard Street* nor the successful handling of the Baring Crisis made a complete break with the past, and the Bank's conduct continued to be inhibited, in varying degree, by its status as a private company, by the traditional statutory framework and by the habits of thought associated with that framework. (Sayers 1986, p. 3)

By the time of the liquidity pressures (no longer, 'crises') of 1906 and 1907 the Bank had built up a wealth of experience in reconciling the need to defend sterling convertibility in the face of low gold reserves and its responsibilities to the money markets. During 1906/07 it used frequent changes in Bank rate as well as loans from other central banks (most notably, the Banque de France) to ensure its own liquidity while continuing to supply the market with cash. Significantly, the impact of the pressures of 1906/07 on the stability of Britain's financial institutions was marginal.

Thus in the event, consolidation of the Bank's position as lender of last resort has to be acknowledged as a major institutional factor contributing to the high degree of stability exhibited by the British banking system. Even the lack of certainty over the Bank's formal responsibilities may, in fact, have been an element for stability, by offsetting the 'moral hazard' problem. If banks were never wholly confident of Bank of England bail-outs in a crisis this may have tempered their risk-taking activities and may have encouraged them to hold a more liquid portfolio. Certainly, the knowledge that in times of liquidity pressure, they may have to borrow from, or discount bills (via the discount houses) at, the Bank of England meant that the commercial banks had to hold a sufficient amount of bills

that were acceptable as security at the Bank. Rules governing acceptability varied over time but, in essence, such bills were short-term (with sixty-three to ninety-five days to run, by the early years of the twentieth century) and carried only first-class names (two of which had to be British, one the acceptor). Thus, in order to ensure ready access to cash from the Bank, the commercial banks had to both accumulate (non-interest bearing) cash balances at Threadneedle Street and to retain a supply of these acceptable bills. In this way, the Bank's role as lender of last resort and its rules on acceptable securities directly affected bank asset portfolios. This encouraged the commercial banks to hold a reserve of near-cash assets and this, too, may have contributed to commercial bank stability.

### **Branch Banking and Bank Mergers**

In the UK, the half-century before 1914 was one of increasing monetarisation of the economy and of growing financial sophistication. A central feature was a wider extension of the 'banking habit', as more individuals and firms opened bank accounts. As a result, there was greater use of cheques and other bankers' drafts in the settlement of transactions rather than notes and coin. In terms of monetary balances, deposits held at the commercial banks came to dominate. Thus, in the twenty-five years prior to World War I commercial bank deposits accounted for about 85 per cent of the stock of money of the UK (the figure had been about 65 per cent in the middle of the nineteenth century). In fact, deposits were growing faster than both the population and income. The value (in constant price terms) of UK commercial bank deposits per head of the population rose from an average £13.30 in 1873-77, to £20.50 in 1898-1902, and to £21.50 in 1910-13 (Collins 1988, Tables 2.1 and 2.2). Similarly, as a ratio to Gross National Product, commercial bank deposits rose from 38 per cent in 1873-77 to 44-45 per cent at the start of the twentieth century.

A significant part of this growth was achieved through the commercial banks' policy of opening more branch offices in order to reach a bigger customer base. Unlike some countries, such as the USA, no legislative or regulatory restrictions prevented the commercial banks operating

throughout the country (with the *de facto* exception arising from the fact that the banking systems of England and Wales, of Scotland, and of Ireland, operated largely as three separate systems for retail banking purposes). Thus, the commercial banks opened offices in the high streets of every modest-sized town in the country, and developed their suburban offices in the larger conurbations. In this way, British banks sought actively to promote the growth of retail deposits. The policy is particularly associated with the joint-stock banking companies, rather than the private banks whose range of activities was restricted by both managerial and capital constraints. From the middle of the nineteenth century, the English joint-stock banks began to develop extensive branch networks, initially within limited geographical regions but, ultimately, on a national level (with head offices usually based in London and branches throughout the country). The expansion of offices was particularly strong in the last decades of the nineteenth century and the early years of the twentieth. Thus, the total number of commercial bank offices in England and Wales rose from 1,094 in 1850, to 1,959 in 1875, 4,570 in 1900, and 6,573 in 1913 (Collins 1994, Table 10.5). An indication of the scale of organisational change this required for individual banks is given by the growth in the average number of offices operated by each bank. For instance, the average number of offices per English joint-stock bank rose from fewer than six in 1850 to over fifty by 1900; and it was as high as one hundred and fifty seven by 1913. A small number of banks were spearheading the movement and were, in fact, operating much larger branch networks than the average. By 1908, for instance, the Midland Bank had six hundred and thirty branch offices, Lloyds Bank five hundred and fifty four and the National Provincial Bank two hundred and forty seven – not surprisingly, they were also amongst the largest banks in the country at that time (Holmes and Green 1986, p. 89).

Significantly for the issue of systemic stability, the growth of individual bank size was not derived solely from internal expansion but, instead, arose largely from amalgamations amongst existing banks. Once again, the regulatory framework was benign. There was no anti-trust legislation in Britain and the authorities did not impose any restrictions on the scale of banking activities, did not try to prevent the suppression of competition

by the bankers and, until 1918, did not place obstacles in the way of a small number of banks seeking to dominate the market. In the event, the successful banks sought to increase the scale of their operations rapidly and to increase their share of the market. Bank amalgamations occurred throughout the period but they tended to come in bursts. In Scotland, there had been major waves of merger activity earlier, in the 1830s and 1840s (Checkland 1975, p. 465). In England, there were frequent bank mergers from the 1860s, again with high activity waves (in the 1880s and 1890s), and the largest banks continued to amalgamate until government restrictions were introduced in 1918 (Capie and Rodrik-Bali 1982). Over the period as a whole, the leading English banks engaged in scores of mergers. According to one estimate, by the end of 1913 Barclays Bank comprised ninety-six separately merged banks, the National Provincial Bank consisted of seventy, the Westminster Bank of sixty-three, the Midland Bank of eighty-eight, and Lloyds Bank of one-hundred-and-thirty-four component banks (Sykes 1926, pp. 196-217). Most mergers were the result of agreement between the senior management of the banks concerned, rather than the consequences of hostile take-overs. Mergers occurred between large and small banks, private banks and private banks, joint-stock banks and joint-stock banks, and private banks and joint-stock banks. They also covered banks of dissimilar size as well as more-or-less equal sized partners.

One consequence of the bank merger movement was a noticeable increase in market concentration. Table 1 provides some figures for the size of liabilities to the public (essentially deposits) of the five largest banks in 1875, 1900 and 1913, and their market share. As can be seen, no one bank dominated, with the leading bank accounting for less than ten per cent of total deposits even in 1913. Instead, the figures reveal the emergence of oligopoly power in the early years of the twentieth century, with the share of total deposits of the top five banks rising from 22.1 per cent in 1875, to 27.7 per cent in 1900, and to 40.7 per cent in 1913. In fact, mergers were to continue during the war and by the end of the conflict, '...the "Big Five" – Barclays, Lloyds, the Midland, the National Provincial and the Westminster – were amongst the largest banks in the world and accounted for some 80 per cent of domestic deposits in England.' (Collins 1994, p. 282)

For individual banks, the strong personalities and effective strategic planning of senior managers, such as J. D. Goodman and Edward Holden at the Midland Bank, were vital to the realisation of rapid corporate growth. Maintaining reasonable rates of dividend and persuading the public that bigger banks meant safer banks, the new corporate banks successfully nurtured the loyalty of both shareholders and depositors as they pursued their 'imperial' aims of creating national banks (Alborn 1998, pp. 145-50). Personalities and politics were, thus, important but so, too, were the underlying economic imperatives behind the move to a greater scale of retail banking.

<b>TABLE 1: The Five Largest British Banks, 1875, 1900 and 1913</b>		
<b>1875</b>	<b>Deposit liabilities (£ million)</b>	<b>Share of total bank deposits in the UK (%)</b>
London & Westminster	28.8	5.5
National Provincial	25.6	4.9
London & County	23.6	4.5
London Joint Stock	19.4	3.7
Union Bank of London	18.3	3.5
	<b>115.7</b>	<b>22.1</b>
<b>1900</b>	<b>Deposit liabilities (£ million)</b>	<b>Share of total bank deposits in the UK (%)</b>
Lloyds	53.5	6.7
National Provincial	51.6	6.3
London & County	47.0	5.7
London, City & Midland	39.8	4.8
Barclays	34.6	4.2
	<b>226.5</b>	<b>27.7</b>
<b>1913</b>	<b>Deposit liabilities (£ million)</b>	<b>Share of total bank deposits in the UK (%)</b>
London, City & Midland	100.0	9.7
Lloyds	99.0	9.6
London County & Westminster	96.0	9.3
National Provincial	68.7	6.7
Barclays*	55.8	5.4
	<b>419.5</b>	<b>40.7</b>
* June figure.		
Sources: Bankers Magazine; Capie and Webber 1985: Table II(1) for total deposits (gross).		

The gains from economies of scale were a prominent feature. In order to secure and expand both their deposit resources and their customer services (chequeing, remittance and lending facilities) the retail banks needed to have offices located on sites convenient for the general public. Economies could arise in one of the banks' core activities, the maintenance of effective remittance facilities. Routinely, the banks carried out the transfer of cash, bills, commercial information, and documents. In the early and mid-nineteenth century these services were operated through a series of agency arrangements between small, local banks. Once a bank established an extensive branch network, however, such remittance business could be conducted 'in-house'. The large banks also opened offices in London and gained access to the bankers' clearing house. They increased their access to the highly liquid markets of the City which both facilitated their ability to vary their asset holdings and provided flexible and varied employment for their funds. There could also be gains from the reputation effects accruing to larger banks with a broader and more stable customer base. This could directly affect credit ratings and access to lender of last resource facilities from the Bank of England. Greater stability would be derived from the reduction and spreading of risk associated with operating a large, geographically dispersed branch network. As we have argued previously:

"Business would be less concentrated on particular economic sectors...profits would depend on a great diversity of accounts, and losses on certain customers' accounts in particular parts of the country...could be more easily absorbed through the buoyancy of business elsewhere. In contrast, the business of a bank whose offices were unfortunately confined to an economically depressed region could be seriously undermined." (Collins 1994, p. 281)

Economies on bank capital holdings may have also been derived from amalgamations and growth in company size. The suggestion here is that such economies could arise from two sets of circumstances. First, the more successful the bank in attracting deposit balances from the general public (through the opening of new branches, etc.) the less the need for the bank to rely upon its proprietors' capital for resources. Secondly, growth in bank size might instil greater confidence amongst

customers that the banks would not fail. The greater confidence could derive from a variety of sources. Thus, there may be a perceived reduction in risk attendant upon a more diversified and geographically spread business. The greater transparency of accounts and other aspects of business associated with large public companies (compared to smaller banks with a limited number of proprietors) might have a similar impact. So, too, the reputation effects associated with a successful, expanding banking business. If there is any validity in these suggestions, then it could have been the case that British banks would have been able to reduce the proportion of their resources raised from proprietors' capital. Over time, British banks could have maintained a given level of customer confidence with a lower capital ratio. To check on the historical accuracy of this assumption, Table 2 presents estimates of the relevant liability ratios for the English and Welsh banking sector. It can be seen there that throughout the whole period from the 1860s the banks derived the great bulk of their resources from customer deposits, with the average ratio of deposits to total liabilities ranging from 84-90 per cent of total liabilities. In contrast, for the German universal banks deposits were less than half of their total liabilities in 1900, and still only 60 per cent in 1913 (Fohlin 1999, p. 147), so that intermediation for these German banks was far

**TABLE 2: Average Liability Ratios for All Banks in England and Wales, 1860s-1913\***

	<b>Ratio of Proprietors' Capital to Total Liabilities</b>	<b>Ratio of Public Liabilities to Total Liabilities**</b>
1860-69	13.2%	86.8%
1870-79	13.6%	86.4%
1880-89	16.0%	84.0%
1890-99	13.6%	86.4%
1900-09	11.8%	88.2%
1910-13	9.8%	90.2%

\* The averages are means, weighted by size of bank according to the value of total liabilities.  
 \*\* Public liabilities consisted overwhelmingly of deposits, but also included a very small and declining proportion of notes (Collins 1988: 40).

Source: Internal records of the commercial banks (see Collins and Baker 2001).

more concerned with employing shareholders' capital than was the case for the English banks, which were largely employing balances deposited by the public.

As regards the average capital ratio, this was about 13 per cent in England and Wales in the 1860s and 1870s, but it then rose to a peak of 16 per cent in the 1880s. It is possible that this was a reaction to changes in company law in 1879 which resulted in many banks adopting a special type of limited liability (known as 'reserved liability') on their shares, whereas previously it had been normal practice to retain unlimited liability on such shares (Collins 1988, pp. 100-101; Crick and Wadsworth 1936, pp. 33-4). In that context, the higher capital ratios maintained in the 1880s may have been part of the price the banks' proprietors had to pay in order to offset the adverse effects of limiting their liability. Significantly, after the 1880s the capital ratio declined progressively, to just under 10 per cent in the years immediately before World War I. In other words, from the 1880s onwards there was a decline in the capital ratio (rise in deposit ratio) which is consistent with our hypotheses about larger banks retaining (or increasing) public confidence at the same time as expanding their deposit base. Of course, the maintenance of confidence and of systemic stability was directly related to how the banks employed their deposit resources. The next section looks at this critical aspect of bank stability.

### **Transaction Banking Practice and Liquidity**

It is our strong contention that the British banks' adoption of what is termed 'transaction banking' practices, greatly enhanced the stability of the banking system.

Partly because of their heavy reliance on retail deposits, and because of the short-term nature of those deposit liabilities, the British commercial banks never exhibited as deep an involvement in their business clients' affairs as some other European banks (including those in Germany, Austria, Belgium and Italy). Although individual industrial clients in the UK might have retained an account at the same bank for a very long period, the banks have been associated with an arm's length approach to industry, to a lending policy more akin to 'transaction banking' rather

than 'relationship banking'. In its extreme form, 'transaction banking' occurs where banks treat each loan as a separate transaction and deal with it on its own merits (wealth of borrower, collateral, duration, interest charges, etc.). No detailed, privileged information is available to the creditor; the banks' procedures pay no particular regard to the long-term client/bank relationship; and clients are largely free to approach other potential lenders for the most competitive terms. Transaction bankers will lend for shorter periods and hold a much more liquid portfolio than relationship banks. The likelihood that the banks do not get involved is, of course, increased if the business firms are reluctant to allow dilution of control by conceding too much information and influence to creditor banks (that is, if firms do not seek more bank assistance).

It is argued here that this transaction bank stereotype is useful in highlighting the distinguishing features of bank lending to the corporate sector in a banking system, such as existed in Britain. Within transaction banking of this sort, 'control theories' offer some insight into how creditors might try to offset the dangers inherent in client default. Thus, bankers will engage in the careful screening of would-be borrowers (assessing the applicants' net worth, establishing the purpose of the loan, and so on); they will filter applications to exclude high risk/low quality; they will show a strong preference for short maturity loans subject to frequent review; and they will impose collateral and other requirements that will enable the easy and low-cost recovery of debt in case of client default. In sum, the focus of controls is more on ensuring the safety of the bank's investment, rather than on the client's requirements.

One important beneficial outcome is that, if successfully applied, transaction banking practices strongly underpin the stability of the whole banking system. The main drawbacks of the alternative, German or 'continental' system arise from the much closer relationships between banker and borrower. This can lead to a distortion in the flow of funds - say, where both banker and industrial client give each other privileged status to the exclusion of other borrowers and/or lenders. Very close personal relations between bankers and industrialists can also distort the creditors' judgement about the borrowers' prospects with, for instance, personal considerations being given undue weight. From a firm's point

of view, there are also costs associated with providing information to the bank and with 'sharing' entrepreneurial control with the bank's management (Hoshi, Kashyap and Scharfstein 1990). A firm could also find itself 'locked-in' to a particular bank with which it had developed a relationship (Rajan 1992; von Thadden 1998). Transfer to another bank can be costly as the interest rate on loans will probably be higher in order to compensate the new creditor for the greater risk associated with less information. Thus, relationship banks may develop a quasi-monopoly creditor position and, in an attempt to reduce their dependency, firms may rely unduly on short-term investments. The allocation of resources may, thus, be sub-optimal. Also, if greater bank commitment leads to the banks holding a greater proportion of their portfolio in illiquid securities, and to the tying up of a large proportion of bank assets in a small number of client firms, it can significantly magnify the consequences for bank stability of any subsequent customer default. Of course, if banks in general maintain an illiquid asset portfolio, it can undermine the stability of the whole sector in the event of a general downturn in the business cycle. Historically the hazard has been real - in fact, this was a major problem for a number of European banking systems in the inter-war years, and has been no less a problem for the Japanese system since the early 1990s.

Recent research shows that in England, at least, the banking system largely avoided such difficulties because of its adherence to transaction banking practices. The research reveals two important features of commercial bank behaviour: the highly liquid nature of English bank asset portfolios; and the arm's length approach adopted by the banks to lending to the business sector.

New estimates of the asset composition of balance sheets show not only that the English commercial banks normally held a high proportion of their assets in highly liquid assets but also that that proportion increased on trend (Collins and Baker 2001). Moreover, it has been shown that the long-term rise in bank liquidity is partly related to the bank merger movement in that larger, nation-based banks tended to have more liquid asset portfolios than smaller, regional banks and that when the former merged with the latter the combined bank usually held liquidity ratios closer to the higher levels of the larger banks (Collins and Baker 2001a).

In other words, one impact of the merger movement was to increase the liquidity of the system as a whole. Table 3 provides decadal averages of the ratio of 'cash and near-cash' assets to the banks' total assets. This category of assets consisted of the banks' holdings of currency and precious metal (coin, bank notes and bullion), balances at the Bank of England (where many banks held an account) and money lent on call or very short notice with money market institutions such as the discount houses. As can be seen, this ratio rose strongly from about 13 per cent in the 1860s to over 20 per cent in the 1880s. It then remained fairly stable through the 1880s and 1890s before continuing its upward trend. In the years before World War I the English banks were holding fully one-quarter of their total assets in this extremely liquid form. Irrespective of other consequences, such a large holding of liquid assets must have instilled a powerful element for stability in the banking system, enabling it to cope easily with variations in the public's demand for cash. If there were to be an unusually heavy demand for cash, the banks could draw on their balances at the Bank of England or on their short-term loans to London money market institutions. In both instances, of course, the Bank of England's capability to service such a run-down would have been critical (as argued above).

In addition to maintaining a high level of liquidity, the English banks also followed other transaction banking practices which added to their security. Extensive research has been carried out on surviving internal records of the English commercial banks in the period with the overall objective of establishing the extent and nature of the commercial banks'

**TABLE 3: Average Ratio of English Commercial Banks' Holdings of Cash and Near-Cash Assets to their Total Assets, 1860s-1913\***

1860-69	13.3%
1870-79	17.1%
1880-89	20.2%
1890-99	20.9%
1900-09	23.9%
1910-13	25.3%

\* The averages are means, weighted by size of bank according to the value of total assets.

involvement in the finance of the domestic business sector. Two sets of results are emphasised here: the general characteristics of loans made by the banks to the business sector; and the behaviour of banks during periods of client distress.

On the general characteristics of loans to the business sector, the results confirm that the bulk of commercial bank support for industry in the period, 1880-1914, was in the form of short-term credits (Capie and Collins, 1999). Less than five per cent of the sample of industrial loans examined were granted formally for longer than twelve months and, even though renewal of overdrafts was common, the actual duration of loans averaged no more than nineteen months. The records also show that the English overdraft system was used mainly to provide industrial firms with a ready means of meeting cash flow and working capital requirements. In fact, about three-quarters of the business loans examined were granted for these two purposes only. The financing of firms' fixed capital requirements accounted for 11-20% (depending on period) of all loans, but even here relatively short-period loans were the norm. Another finding of the study is that, whereas two-thirds of industrial loans were unsecured in the early 1880s, this contracted on trend and by 1914 it was common for the banks to take collateral against industrial loans, with three-quarters of the sample loans being secured by the latter date. Moreover, the value of such loan collateral almost always covered the full value of the loan outstanding. Thus, if borrower default should occur, the banks were well placed to recover all their money.

Over three hundred episodes of financial distress amongst industrial clients have been identified and the response of the banks investigated (Baker and Collins, 1999). This analysis shows that the English commercial banks did not engage in any deep involvement in client firms' affairs, even in periods of client distress. Theirs remained an arm's length approach, although the banks almost always continued to provide financial support for industrial firms during these difficult periods. Moreover, there is no evidence that the banks tried to exploit their stronger bargaining position during periods of client distress by raising interest charges on the account at the expense of distressed clients, despite the higher risks of default on such distressed accounts. In this sense, the

English commercial banks continued to support their industrial clients during periods of distress. However, the reasons for the banks' ability and willingness to continue support lay in the effectiveness of the screening and control procedures that lay at the heart of their transaction banking approach. They were able to minimise loss to shareholders through the effective screening of both clients and loan applications (in order to minimise risk), by confining their business to loans of short formal duration which ensured frequent reviews, and by stipulating adequate collateral requirements. As a result, bank losses were very low indeed, even on these troublesome accounts. In fact, the banks' procedures were adequate to confine losses to only 1.9% of the total sample industrial loans examined, and on only 0.2% of those loans was there complete loss for the banks. Even in the distress cases, losses occurred on only 22% of these high-risk accounts and, even then, prior collateral stipulations confined those cases in which there was total loss of the banks' loans to under 3% of the distressed cases. In summarising these results on the outcome of cases of client distress, it can be said that normal bank practices regarding the short duration of loans, collateral arrangements and the initial screening of business applications, enabled the banks to retain highly liquid loan portfolios and to minimise loss.

In general terms, then, the English commercial banks were applying prudent criteria and revealing a strong preference for short-term credits in their provision of finance to industrial firms. The great bulk of business loans were short-term, they were used largely to cover fluctuations in cash flow and working capital costs, and they involved minimal engagement by the banks in their clients' business. Importantly for present purposes, such transaction banking practices minimised bank losses and undoubtedly added great stability to this part of the commercial banks' core business.

## **Conclusion**

British commercial banking achieved a high level of systemic stability in the decades before 1914. In the article we acknowledge the contribution made to this by the Bank of England's evolving role as lender

of last resort. However, our main aim here has been to emphasise the importance of the practices adopted by the largely unregulated commercial banking sector. One significant set of factors was the institutional change undergone by banking companies and, in particular, the growth in scale consequent on the extension of retail branch banking and the intensive horizontal merger movement amongst existing banks. In the absence of anti-trust regulations, the 'average' commercial bank grew rapidly in size and market concentration increased markedly.

At a micro-economic level, the other significant factor in growing systemic stability was the widespread adoption and refinement of transaction banking techniques by the commercial banks. They adopted a cautious approach, but it was an approach underpinned by a strong economic rationale. They nurtured a highly liquid asset portfolio and they carefully controlled their commitments in the potentially high-risk area of corporate finance. As has been shown, the commercial banks concentrated on short-term loans subject to regular review, they maintained sufficient collateral stipulations to ensure repayment of loans in case of customer default, and they retained an arm's length approach to the business of their industrial clients. Losses were kept to a minimum, and shareholders' and depositors' interests safeguarded. The British banks are sometimes criticised for eschewing relationship banking and its greater commitment to the business sector, but full acknowledgement is not always made of the more positive side of transaction banking, of the resultant systemic stability it brought to British commercial banking.

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