A Synopsis of the Development of Financial Regulation

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The development of regulation gives an insight into why regulation of banks is the way in which governments seek to protect customers allows financial crises pre-date modern Banks. "Tulipmania"[1] (Price, 2008) in 1637 and the South Sea Bubble of the 1720s (Balen, 2012) were financial crises. These two financial crises that happened before modern banks, show that it is not just banks or bankers that cause financial crises and exemplify that the problems of banks are just not caused by banks or bankers, but have customers and even the state as willing parties. In each of those crises there was irrational speculation by ordinary investors, who thought that they would make large profits, but lacked the experience or background knowledge to make wise decisions. (Price, 2008)[2].

With the development of banks in their modern form there have been numerous banking crises and increasing political involvement (The Economist, 2014). In the 1820s banks in England and Ireland were hit by crises. In Ireland 16 banks failed in 1819/20 and in England over 100 banks failed in 1825/1826. Huskisson, the President of the Board of Trade declared the country 'was within four-and-twenty hours of a state of barter'. (Turner, 2009). Forty years later, the Overend, Gurney failure involved not only the Bank of England, but the Chancellor of the Exchequer and Parliamentary debates.[3] Central banks, such as the Bank of England, developed to become 'Lenders of Last Resort' to assist banks that had temporary liquidity crises. This was the substantive recommendation of Bagehot in "Lombard Street" (Sowerbutts R, 2016).The role of 'lender of last resort' was exercised in relation to a crisis involving Baring Brothers in 1890 (Turner, 2009). It has, however, developed from assisting banks with temporary liquidity problems so that the central bank and government, in effect, guarantee depositor's funds (Goodhart & Schoenmaker, 1995) (at page 541) (Milne, 2008).

Where there has been a bank failure, customers who have lost money, which they entrusted to the failed bank, ask questions as to why they were not protected. As a result of the outcry from depositors facing the loss of, perhaps, their entire savings and from the media and politicians demanding that the state should take action, the state becomes involved in protecting depositors either through a deposit guarantee scheme[4] or by supporting the bank itself through government intervention providing cash or emergency guarantees. A further fear for the state is that if one bank fails there

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[1] "Tulipmania" was a speculative bubble in trading in tulip bulbs that grew during the "Dutch Golden Age", which then collapsed. Whilst it is now suggested that this was not as economically serious as has previously been maintained (Price, 2008). The South Sea Company competed with the Bank of England for a contract to convert government bonds and equity. From March 1720 until September 1720 prices of shares rose rapidly and then fell to their original price. This was quoted as an example of irrational investor behaviour.

[2] Such excesses can be compared to the credit boom before the Financial crisis 2007-2008 (see **Error! Bookmark not defined.** above) and the current credit boom in relation to car purchase and credit card borrowings (Wallace, 2017)

[3] On the day after Overend, Gurney suspended payments , named by the Times "Black Friday", (11 May 1866) the Chancellor of the Exchequer, William Gladstone wrote to the Governor of the Bank of England "Her Majesty's Government cannot doubt that it is their duty to adopt without delay the measures which seem to them best calculated to compose the public mind, and to avert the calamities which may threaten trade and industry." (Sowerbutts R, 2016)

[4] In the UK the Financial Services Compensation Scheme would pay up to £85,000 per person for authorised bank or building society deposits

can be a "domino effect" and a systemic run, which ultimately, could result in the collapse of the economy of the country.[5]

Bank rescues are expensive. According to the National Audit Office, the cost of providing support to British banks at the peak of the 2007-2009 financial crisis was £1,162 billion[6] (£1,162,000,000,000). (National Audit Office (UK), n.d.). By contrast, the amount of total taxes, borne and taxes collected, from banking activity amounted to approximately £63.0bn, or 11.6% of total UK government tax receipts. (Price, Waterhouse, Coopers, 2012). It has been calculated that the fiscal costs after recoveries could average 13.3% of GDP and could be as much as 55.1% of GDP.[7] (Laeven, 2008) (at page 23).

The problem for bank customers is that when they place their savings with a bank they transfer title of the money to the bank. This contrasts with the situation where a customer deposits an item for repair or cleaning. The legal title of item remains with the customer and, if business defaults, the customer can recover his/her property. Prior to 1811 money in depositors' accounts belonged to the depositor. However, in Carr-v-Carr [1811], the Court held that money paid into a bank deposit was 'paid in generally', and not as a 'specific deposit'. This was followed in Foley-v-Hill [1848], in which the High Court stated,

> "There is a fallacy in likening the dealings of a banker to the case of a deposit to which in legal effect they have no sort of resemblance, money paid into a banker's account becomes immediately a part of his general assets and he is merely a debtor for the amount" (per Lord Cottenham) ((Tomlinson, 2010)

The effect of these decisions has allowed bankers to use depositors' monies as part of their business resource and it is the threat to those depositors' funds, which has made depositors funds a political issue. When a banking problem arise, it becomes a banking crisis and has a significant political as well as financial cost. The public and politicians expect the state to control banks to prevent the risk of bank runs or bank failure. There are various opportunities for the state to exercise such control; namely, licensing, disclosure and reporting, regulation, supervision, capital adequacy controls, activity restrictions (e.g. "ring fencing"), the requirement to be rated by a credit ratings agency licensing, disclosure and reporting requirements. This chapter will consider

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[6] The UK government provided two kinds of assistance to banks during financial crisis of 2007-2008. These consisted, firstly, of cash such as loans to the Financial Services Compensation Scheme and to support deposits and the purchase of shares in Lloyds Bank and Royal Bank of Scotland. Secondly, the government provided guarantees and non-cash support. These included the Credit Guarantee Scheme, the Special Liquidity Scheme and the Asset Protection Scheme. The figure of £1,162 billion is the peak of support was calculated by the National audit office taking figures from various sources and as a result the peak support figure is not at one single time.

[7] "The fiscal costs of a financial crisis can be broadly divided into two categories: a) direct costs relating to equity injections, debt assumed by the state and asset guarantees as well as (emergency) liquidity support for financial institutions, and b) indirect costs arising from lower tax revenues and higher government spending as a result of a crisis-induced recession, but also including e.g. increased interest costs resulting from higher debt levels (and contingent liabilities). (Schildbach, 2010)

the control that is arguably considered to be the most important, that of Capital Requirements (also known as Capital Adequacy).

The state has always been involved with money (Davies G, 2002) at location 778) and as banks are involved with money, so has the state been involved with banks who are the distributors of money and credit. State involvement in private banking to protect depositors goes back at least as far as the Napoleonic wars. Francis Baring in 1793 referred to 'dernier resort'[8] (Milne, 2008)). Shortly after this, in 1802, Henry Thornton wrote:

> "If any bank fails, a general run upon the neighbouring banks is apt to take place, which if not checked in the beginning by a pouring into the circulation of a very large quantity of gold, leads to very extensive mischief."

This action, according to Thornton, was to be by the bank of the government, the Bank of England:

> "…. If the Bank of England, in future seasons of alarm, should be disposed to extend its discounts in a greater degree than heretofore, then the threatened calamity may be averted." Thornton at page 182 in (Kelly, 1978). Cited by (Milne, 2008) at page 25

Central banks, such as the Bank of England were, in the late 19th century, still private banks, although their relationship with government gave them a special position. The Bank of England did not acquire powerful public-sector responsibilities until 1914. Central banks were regarded as a first among equals and, whilst Bagehot suggested that the Bank of England be the Lender of Last Resort, there was resistance to this concept, unless there was a systemic bank run; the Bank of England should protect against temporary liquidity problems, but not insolvency through bad management. (Sowerbutts R, 2016). Indeed, it was felt that the reluctance of the Bank of England to assist with the rescue of Overend, Gurney collapse[9] was due to commercial rivalry (Goodhart & Ors, 1998). By the end of the 19th century it appeared to be accepted that the Bank of England would become involved in rescuing banks that had liquidity problems. The Baring Brothers rescue of 1890 showed that the Bank of England was now ready to accept its role as 'Lender of Last Resort'. Baring Brothers[10] were very highly regarded as a bank. However, Barings lent to Argentina and, when there was a financial crisis in that country and the Argentinian government defaulted on its interest payments, there was a run on the Argentinian banks, which affected confidence in

[8] There has, in fact, always been involvement between the State and banking either through control of lending or because the state needed to borrow to fund wars and other activities. (Davies G, 2002)

[9] **Overend, Gurney and Company** were established in 1800 and became a well-respected wholesale bank specialising in discounting bills of exchange. They became known as the "banker's banker". It was run from 1807 until his retirement in 1856 by Samuel Gurney whose family had a well-established bank in Norfolk. After Samuel Gurney's death it is a business model changed and it took on long-term debt and invested in railways. A loss of confidence ultimately caused a bank run. The Bank of England, a private bank at the time stepped in and provided market wide lending. In effect becoming the lender of last resort (Sowerbutts and Schneebalg , 2016)

[10] **Barings Bank**: 'A merchant bank founded in 1762, and was considered the reputable and stable banks in the world., Barings collapsed in 1995 when "rogue trader", Nick Leeson, became involved in unauthorised speculation of derivatives at its office in Singapore and ere unable to meet their cash requirements

Barings. In November 1890, Barings informed the Bank of England of their difficulties. The Bank of England and the government were concerned in case there were to be a systemic run on English banks. However, an inspection of Baring's books revealed that it could be rescued and group of banks assisted with the rescue. There was little impact on the market and Barings were relaunched as a limited company.[11] (Goodhart & Ors, 1998).

Deposit Protection Schemes[12] have made the traditional idea of "Lender of Last Resort", as described by Bagehot, to assist with temporary cash flow/liquidity problems less relevant, and the term is used nowadays as a general term for central bank support for failing banks.

A number of academics have argued that state involvement, as the Lender of Last Resort or in supporting failing banks has exacerbated. the problems of banks. They suggest it encourages banks to use more leverage (i.e. lend more) and therefore increase their Return on Equity[13] in the knowledge that if there is a fundamental problem the government will step in to assist. In other words, by becoming the Lender of Last Resort, the State has made the problem worse by implicitly insuring bankers' risky behaviour and with each successive crisis amplifies it. De Grauwe argued that to prevent this, governments are obliged to supervise and regulate (De Grauwe, 2008). John Kay argued that there should be reforms to create a system of "narrow banking" so that all deposits were attached to secure assets (i.e. the share capital of the bank). With such a system, Kay argued if a bank failed, it could be wound up without resort to public funds ((Kay, 2009). Milne and Wood considered the Northern Rock collapse. They suggested that the "unusual business model" of Northern Rock made it vulnerable to liquidity problems and suggested that in future there should be an orderly closure, deposit insurance and transfer of customer accounts without "encouraging bad, imprudent or even reckless, banking" (Milne, 2008)[14]

When Henry Thornton was writing in 1802, it could have been thought there was less need for regulation. Banks were small were small partnerships limited to 6 members. However, the partners had unlimited liability for the debts of the bank and therefore had a very personal interest in its success. "One based on a few specifically defined and closely related people, most of whom were likely to be significantly involved in

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[11] **Barings Bank** were less fortunate in 1995 when it was declared insolvent following fraudulent speculative trading in derivatives at its Singapore office by self-styled rogue trader, Nick Leeson. (Greener, 2016). The Bank of England did attempt to coordinate a rescue, but it was unsuccessful. (Tickell, 1999). Whilst in 1890 Barings, as a merchant bank, were too big to fail, this was no longer the case in 1995 (Cassis, 2013)

12 Definition of Deposit Insurance: many countries have schemes by which depositors are insured up to a certain limit against the failure of their banks. Banks contribute towards this deposit insurance. . Schemes vary however as to the protection limits. Such schemes are normally run by governments and the United States and in the United Kingdom by Financial Services Compensation Scheme, which In the UK guarantees individual savers deposits of up to £85,000.

14 Northern Rock bank failed because of liquidity rather than solvency problems (i.e. through faulty borrowing rather than faulty lending). It had not been for the Financial Crisis 2007-2008, then it may have been rescued. (Brummer, 2008). Shareholders in the failed Northern Rock Bank have since its collapse in 2007 continue to complain that the UK state has profited at their (Fantato, 17)

management" (Ireland, 1984). By contrast, the shareholders in joint-stock companies "could dispose of *a* part or the whole of (their) share in the undertaking without receiving the consent of the others concerned" ((Scott, 1910). As Ireland points out joint-stock companies were economic rather than legal forms at the beginning of the 19th century. Incorporated banks were allowed in 1826. However, it was believed that the unlimited liability of shareholders protected depositors. Nevertheless, through the 19th century there was debate as to the validity of that belief that unlimited liability provided protection to depositors. Firstly, it was suggested that, if the shareholders were of limited wealth, by their nature could only provide limited funds, if called to meet their unlimited liability. Secondly, it was suggested that the existence of unlimited liability had not prevented the numerous banking failures of that period. It was argued that limited liability with fully paid-up capital would attract wealthier shareholders, who would provide better management with regular audited accounts both of which would provide depositors with protection. Banks incorporated with limited liability, which protected shareholders up to the limit of their shareholding was allowed after 1858. However, there was virtually no formal system of supervision and regulation. Following the failure of the City of Glasgow Bank in 1878 the rules affecting banks were altered again. The Companies Act (1879) introduced a reserve liability which required banks to set aside a fixed proportion of capital with the sole purpose of protecting depositors and independent auditing for banks, but rejected ideas of extended liability (i.e. a shareholder would be liable up to 2 or 3 times paid-up capital). (Turner (2009).[15],

Regulation was, in effect, undertaken internally because from the 1880s until 1925 there were a series of mergers and acquisitions within the UK banking sector[16], in effect, created a cartel.

It is suggested by this author that given the 'first above equals' position at that time, the Bank of England would have found it advantageous for the mergers of the late 19th century to take place, as it would have been easier to deal with a few larger banks when undertaking a rescue of any bank in difficulty. In addition, with a smaller number of banks (i.e. the big 5 and a few more), it was easier to obtain the commitment to conservative banking behaviour and agreement for mutual support amongst a "cosy cartel".

"Within the City of London, and to some degree outside it, there is nostalgia for a time when the Bank of England acted as co-ordinator of a self-regulating club of financial institutions. The implicit deal was that financial institutions were permitted to act as a cartel in return for a commitment to conservative behaviour. In times of difficulty, they would provide mutual support, which the Bank would co-ordinate, in order to maintain financial stability. The Bank of England, in turn, acted as advocate of City interests within government." ((Kay, 2009) page 7).

Until 1948 the Bank of England was a private company. In that year, it was nationalised and operated with the Treasury in setting interest rates until It was given independence

[15] The situation can be contrasted with that in the United States where banks develop from the 19th century were disparate and relatively weak. There was no central bank until the federal reserve was established in 1913 (?) This allowed for the development of stock markets, investment banks and a shadow banking system with competing regulators. Canada, as a further example from the foundations of the early part of the 19th century had a far more concentrated system with a single regulator that incorporated both property lending and investment banking. (BORDO, 2015)

[16] In 1870 there were 387 banks working in the UK. By 1920 there were only 75 of which 20 were based in England and Wales (Braggion page 11) including the big 5 of Barclays, Lloyds, Midland, National Provincial, Barclays and Westminster

to set interest rates, within guidelines set down by the government, by the Bank of England Act 1998.

However, initial post-war changes to financial services sector regulation were limited relying on self-regulation in relation to banks. This cosy, rather bureaucratic, structure continued until the 1960s and 70s with little change, as it suited both government and the Bank of England. It made it easier to implement monetary policy with a few market players rather than many. However, the traditional banks were coming under pressure from competing financial organisations and computerisation. (Billings, 2007) (page 143). Growing competition for working class deposits from building societies and pressure from government to restrict lending to counter inflationary pressure led to competitive pressure on the cartel of the big 5 banks. (Booth, 2004). This threatened and ultimately made self-regulation impossible, because with increasing competition banks, were not willing to be guided by “raising of the eyebrow of the Governor of the Bank of England” (Binham C. , 2015)

The subsequent decades witnessed growing concerns about the self-regulation of the financial services sector. The Securities and Investment Board Limited (SIB) was established under the Financial Services Act 1986 to supervise the self-regulating bodies such as the Financial Intermediaries, Managers and Brokers Regulation Association (FIMBRA). Various scandals in the 1990s, cumulating in the collapse of Barings Bank, led to political demands for the end of self-regulation in the financial services industry. The SIB became the Financial Services Authority in 1997 and was given statutory recognition in the Financial Services and Markets Act 2000. Not only did the Financial Service Authority regulate insurance companies, financial advisers and general insurance as well as mortgages, it took over the regulation and supervision of banks from the Bank of England[17].

However, from the 1970s, not only was there increasing financial regulation within the UK, but increasing international bank interdependence the Bank for International Settlements, through the Basel Committee for Banking Supervision, a developed international banking standards and the Basel Accords.

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[17] the FSA received criticism for its “light touch” regulation and supervision of the banks during the financial crisis 2007-2009 including before the Treasury Committee of the House of Commons on 25 February 2009 (Pratley, 2009) (Kay, 2009)

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