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Developments in British Banking: Lessons for Regulation and Supervision

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The British banking system has experienced significant stress in the last decade or so. In this paper, the authors examine the sources of this stress and study the reaction of British banking policy to these changes. Like their American counterparts, the British are striving to maintain a stable banking environment in the face of increasing competitive pressures.

During the last two decades, the economic and technological environment in which financial institutions operate has undergone important changes. Improved communications, electronic data processing and a volatile economic environment have combined to challenge the extant structure of the financial industry and its supervision and regulation by banking authorities. In the United States, these developments have resulted in the creation of new nonbank competitors, essential elimination of deposit rate regulation, and weakened prohibitions against interstate banking activity. They have also contributed to serious strains on and loss of confidence in portions of our financial system.

The purpose of this paper is to examine the recent changes in banking policy that have occurred in the kindred financial system of the United Kingdom. Despite many similarities, British and American banking policy differ significantly in the ways they achieve financial stability as well as in their impacts on the efficiency of their respective banking systems. In particular, British policymakers historically have relied more heavily on "self-regulation" by the banking industry, and have tolerated pricing cartels and restrictions on entry. The high levels of concentration in the British banking sector also facilitated a supervisory approach that, while more informal than that practiced in the United States, was also more intimate. Furthermore, the British approach involved banks more directly in national economic policy initiatives.

By the 1970s, British policy had stimulated the growth of nonbank competition that was undiversified and entirely unsupervised by any regulatory authority. The failure of these fringe institutions precipitated a crisis of confidence that threatened the entire British banking system.

The British experience illustrates the strength of natural competitive forces, particu-

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TABLE A.2

Estimates of Percentage Change in GNP Price Deflator (Annual Rate)**

	p(−15)	p(15)	p(45)	p(75)	p
1976:1	4.0	3.7	3.6	3.7	3.9
1976:2	4.4	5.0	5.4	5.5	3.8
1976:3	5.0	4.4	4.2	4.5	5.1
1976:4	6.4	6.5	6.0	6.0	6.7
1977:1	5.7	5.6	5.5	5.7	5.9
1977:2	6.5	7.1	7.5	7.6	7.1
1977:3	5.4	5.3	5.1	5.1	6.3
1977:4	6.6	6.6	6.6	6.3	6.5
1978:1	7.5	6.8	6.8	6.8	5.5
1978:2	8.4	10.7	11.5	11.8	12.0
1978:3	7.4	7.4	7.5	7.2	9.0
1978:4	8.9	8.6	8.6	8.7	9.7
1979:1	9.1	8.6	8.8	8.9	8.7
1979:2	9.8	9.1	8.6	8.7	8.4
1979:3	8.2	7.9	7.7	8.3	8.8
1979:4	8.6	8.3	8.2	7.9	7.4
1980:1	10.2	9.4	9.2	9.4	9.8
1980:2	9.7	9.3	9.5	9.5	9.9
1980:3	10.1	9.7	10.5	9.4	8.9
1980:4	12.1	11.7	11.2	11.1	11.7
1981:1	8.3	8.4	10.9	10.6	12.1
1981:2	6.2	5.9	6.5	6.3	6.5
1981:3	9.3	9.4	9.6	10.0	10.3
1981:4	8.3	7.9	8.9	9.1	7.9
1982:1	4.5	3.5	3.4	3.7	4.4
1982:2	5.0	5.4	4.9	4.7	5.5
1982:3	6.6	5.4	4.7	5.1	3.4
1982:4	4.4	4.2	3.6	3.6	3.4
1983:1	4.5	6.0	5.8	5.7	5.2
1983:2	4.3	4.8	3.8	3.6	2.9
1983:3	3.5	3.7	3.5	3.9	3.3
1983:4	4.2	4.1	4.4	4.1	4.7

**Variables are defined analogously to those in Table A.1 (i.e., p(−15) is the flash estimate of p). The percentage change in the GNP Price Deflator was obtained by subtracting the change in Constant Dollar GNP from the change in Current Dollar GNP.

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larly in an environment where implicit central bank protection is provided asymmetrically to various financial institutions and bank restrictions on entry and portfolio composition exist. This interpretation is supported by recent changes in British banking policy that would appear to be moving Britain toward a system with relatively free entry, but also one with more intensive supervision and examination of financial institutions.

We turn now to a brief review of the evolution of the British banking structure. This discussion is followed by an analysis of current efforts to reform banking policy. The paper concludes with a brief summary and interpretation of recent events in British banking.

I. The Structure and Evolution of the British Banking System

Examining the evolution of British banking institutions in the context of changing economic policy illustrates how regulation, market structure, and the performance of the banking system interacted in a way that resulted in considerable instability. The following discussion does not attempt to encompass the range of institutions making up the British banking system, but rather, focuses on those banking entities salient to the main issues of this paper. These entities include the "clearing banks" (roughly analogous to U.S. commercial banks), the "building societies" (resembling mutual savings banks in the U.S.), and, finally, the fringe group of bank-like financial organizations known as the "secondary banks." Together, these three groups account for over 75 percent of total deposits in the U. K., although they do face some competition from various other British banking institutions.[1]

The London Clearing Banks

Before the early 1960s, clearing banks were overwhelmingly the most important providers of demand deposits in the British banking system. They continue to control about 35 percent of total U.K. deposits, and are active in both commercial and consumer lending.[2] The group derives its name from its exclusive ownership and control of the nation's major funds transfer and check clearing system.[3] This privilege has restrained competition from other institutions for checkable deposits, or "current accounts" as they are known in the U.K.

The clearing bank industry historically has been highly concentrated. Indeed, today, only 4 major London banking groups own or effectively control almost all the clearing banks and their subsidiaries.[4] It was not until relatively recently that British banking policy addressed the problems stemming from this market structure.

Historically, the Bank of England only gradually assumed the supervisory and regulatory functions of a modern central bank. The concentrated nature of the clearing bank industry fostered the development of a supervisory system that was informal and therefore flexible. Moreover, within this system, the Bank of England may have benefitted from according the clearing banks a privileged competitive position in exchange for their cooperation in carrying out the Bank's monetary and other policy objectives.[5]

The concentrated character of the clearing bank industry is due to a history of legislative barriers to entry imposed to a significant degree by the Bank of England. As a result of these barriers, very few new banks formed after the mid-19th century.[6] Instead, there was a period of extensive amalgamation of smaller banks. Protected from competition from new banks, competition between existing banks took the form of rapid branching.

Through the first half of this century, the Bank of England essentially ignored the effects of the clearing bank cartel's collusive pricing and monopoly of the clearing mechanism on the British banking industry, including the possibility that the clearing banks enjoyed supranormal profits.[7] The *quid pro quo* of this arrangement was that the banks would comply with the Bank of England's "requests" regarding monetary and other policy objectives without requiring explicit, formal regulation.[8]

Supervision of the clearing banks was likewise simplified due to the concentration of the industry. No explicit legislation regarding bank supervision was perceived to be necessary given the overall stability of the industry. Instead, the Bank generally relied on "moral suasion" to influence the clearing banks, as well as the implicit threat of refusing to maintain a bank's account. Consequently, supervisory efforts consisted of relatively informal discussions with senior management about the nature and quality of its business, including its management, and an annual review of the banks' accounts.[9]

Before 1979, Britain lacked an equivalent to U.S. deposit insurance. However, clearing bank control of the nation's funds transfer and clearing mechanism, the general intimacy between the Bank of England and the clearing banks, and several historical precedents contributed to the general perception that, in the event of a major financial crisis, the Bank would step in to uphold the continued operation of the clearing banks.

Until the early 1960s, the British banking system was highly concentrated and dominated by a cartel of clearing banks enjoying oligopolistic benefits. This situation resulted in a banking industry that, for many years, was stable and easy to control from the point of view of the Bank of England.[10] However, during the 1960s and 1970s, a number of interrelated factors upset the *status quo* and jeopardized the stability of the system. In the postwar era, restrictions on the clearing banks, including lending and interest rate ceilings and portfolio restrictions, in combination with rising interest rates and a higher standard of living resulted in the emergence of lucrative banking opportunities for other institutions. Consequently, despite the relatively protected status of the clearing banks, competition emerged from several quarters.

Building Societies

At present, building societies comprise important competition for the clearing banks, controlling some 33 percent of total deposit liabilities. They were formed during the industrial revolution to provide a mechanism for financing the home purchases of workers drawn to new industrial centers. They were then, and remain today, "mutual societies" in that most of their liabilities take the form of "shares." This arrangement leaves management authority, at least in concept, in the hands of depositors.[11] Since their formation, they have been viewed by British policymakers as a mechanism for promoting and financing home ownership in the United Kingdom. Their assets have consisted, therefore, primarily of mortgage loans.

Competition within the building society industry has been more vigorous than that among clearing banks throughout the societies' history. A cartel was formed in the 1930s to stabilize the industry, but after some 50 years of operation, the maverick behavior of members disabled its effectiveness; the cartel was dismantled in 1984.[12] However, the number of building societies in the U.K. has fallen sharply since the turn of the century and market share has become increasingly concentrated in a few firms from a five-firm concentration ratio of 39 percent in 1930 to 55 percent in 1983. The largest society now has over 20 percent of total industry assets. However, unlike the case of the clearing banks, the building society sector did not face significant barriers to entry. Consequently, some 210 institutions exist today with extensive branch networks throughout the United Kingdom.

Overall, the building societies played a relatively minor role in the British financial industry until the 1950s and 1960s when reform of the tax treatment of owner-occupied housing increased the demand for residential mortgages. The combined effect of increased residential mortgage demand, tax advantages, and an ability to compete for deposits at competitive rates then stimulated rapid growth in building societies. Their share of total deposits relative to the clearing banks rose from less than 30 percent in 1955 to almost 90 percent in 1985.

Unlike their American analogs in the thrift industry, British building societies were not subject to Regulation Q-type deposit rate ceilings. They were thus able to pay shareholders and depositors returns consistent with those enjoyed elsewhere in the marketplace. The clearing banks had tied rates of interest paid on non-checkable deposits to the Bank rate, which was frequently lower than rates paid elsewhere.

The building societies also received more favorable tax treatment than the clearing banks in that depositors received their interest on an after-tax basis. The tax on interest earnings was paid at a so-called "composite" rate by the building society, thus no further tax obligation was incurred by resident depositors. Since the composite rate, historically, has been lower than the very high marginal personal tax rates in the U.K., building societies were very attractive to retail depositors. In addition, the societies have been insulated somewhat better from interest rate and credit risk than their American counterparts because of their policy of making adjustable rate mortgage loans and government policies which provide funds for mortgage payments to the unemployed. Building societies are supervised by the "Chief Registrar of Friendly Societies."

Despite relative advantages such as the ability to pay market rates of interest and preferential tax treatment, the extent to which the building societies were able to compete with the clearing banks has been restrained. Restrictions on the composition of building society assets did not permit deposit account overdrafts—a major mechanism in the British system for making loans—and thereby precluded societies from offering "checkable" current accounts. In addition, the clearing banks' monopoly of the clearing and settlement mechanism has also impeded building societies from offering effective competition.

The Secondary Banking Sector

The fringe financial institutions in the British banking system, frequently referred to as "the secondary banks", did not become important until the post-war period when restrictions on clearing banks induced the development of other institutions to take advantage of new and unexploited banking opportunities in the then generally favorable economic climate.

During the 1950s and early 1960s, the Bank of England discouraged clearing banks from lending to individuals or to property interests, hoping thereby to channel investment into the industrial sector. Meanwhile, post-war personal income was rising and generating more demand for consumer goods. The secondary banks emerged during this time to exploit the new lending markets. In general, they engaged in activities such as the finance of auto and household goods purchases and equipment leasing to businesses. They freely obtained deposits from the newly developing wholesale money markets. And generally higher market interest rates combined with interest ceilings on clearing bank deposit accounts induced depositors to seek higher yielding deposit alternatives from them.

By the 1960s, as lending and other restrictions continued to handicap the clearing banks, the secondary banking sector presented increasingly strong competition. However, the rapid development of this fringe banking sector, generated by restraints elsewhere in the industry, introduced elements of risk that threatened the traditional stability of the British banking system.

First, these institutions were largely undiversified, lending only to the narrow sectors to which they had access. Consequently, these banks were left with more risky activities and engaged in more speculative ventures than the clearing banks had been wont to do. Whereas the clearing banks had traditionally eschewed investment in equity shares of other companies, the new financiers participated actively in holding and dealing in shares, takeover activities and investment management.

A second element of risk stemmed from the complete lack of supervision of these institutions. Growth in this new banking sector occurred so rapidly that the supervisory scope of the Bank of England was not expanded to incorporate it. Neither were codified standards of prudential management proposed. [13] Finally, unlike the clearing banks, there was no entity to function as a lender of last resort to the secondary banks; the money placed through the wholesale markets was (and is) entirely unsecured.

The Crisis

In 1971, the Competition and Credit Control policy was introduced that loosened many of the lending restrictions on clearing banks. This act encouraged the clearing banks to compete with other financial institutions as well as among themselves in previously restricted markets at competitive interest rates. The Bank of England had expected the number of fringe financial institutions to contract under this increased competition and thereby free more investment credit for industrial uses. Overall lending did skyrocket as a result, but the clearing banks also began to compete with the secondary banks for lucrative property development and other lending markets. By mid-1972, the clearing banks were once again restricted from lending in the property market. Their competition, however, had forced the unsupervised fringe banks to extend themselves even farther into property markets and other more speculative dealings.[14]

When the ensuing monetary boom began to manifest itself in rising inflation rates in 1973, the Bank of England abandoned the Competition and Credit Control policy, re-imposed interest rate ceilings, and introduced a form of noninterest-bearing reserve requirement on the clearing banks.[15] The Bank also pursued a tighter monetary policy that raised interest rates.

The resulting fear of the effects of higher interest rates on asset valuations of property companies and their creditors, as well as fear of a rent freeze and a new development tax, generated considerable uncertainty in the property market. In late 1973, a sizeable finance company collapsed and sparked a crisis in confidence in the secondary banking sector. The incident initiated a flight of funds from the unprotected fringe to what was perceived as the "safe haven" of the clearing banks.[16]

The Bank of England recognized the need to prevent the secondary bank crisis from affecting the banking system proper and stepped in to initiate a rescue operation named "the Lifeboat".[17] The Bank backed a group of clearing banks in essentially "recycling" deposits (originally withdrawn from the secondary banks) back to illiquid fringe institutions. By 1974, the number of troubled institutions had multiplied as a result of the collapse of property values. As the security (property) behind their lending melted away, these institutions' debts mounted, often at increasing interest rates. Consequently, the overall cost of the lifeboat operation to the Bank of England and the clearers was considerable.[18]

II. Directions of Change in British Banking

We have discussed how a history of policy decisions contributed to the concentrated and segmented nature of the British banking industry. British policy makers, like their American counterparts, have attempted to achieve a workable balance between soundness and vigorous competition within the banking industry, assuming that vigorous competition alone would lead to socially excessive levels of risk-taking.[19] The British historically have maintained this balance by restricting entry into commercial banking, permitting coordinated pricing and by tolerating the high concentration of banking activity in a relatively few institutions with which the Bank of England had a productive, albeit informal, relationship.

Events in the early 1970s, including the secondary banking crisis, revealed two basic flaws in this strategy. First, the lack of complete coverage of portfolio and entry restrictions and supervisory authority resulted in an inability to protect the clearing banks from competition from building societies and other non-bank deposit takers ("the secondary banks").[20] Second, as a consequence, the hoped-for protection of the banking system from the destabilizing effects of excessive risk-taking on the part of individual financial institutions was not realized. Indeed, the coexistence of an implicitly protected clearing bank sector and an unprotected secondary banking sector actually may have exaggerated the flight of deposits from the secondary banks to the clearing banks that necessitated the "lifeboat" operation in 1973. In this section, we examine the modifications in policy that have been used to redefine the balance between soundness and competition in British banking markets.

Changes in Supervisory Policy

After the initial responses to the secondary banking crisis—abandoning Competition and Credit Control policy and imposing other restrictive policies—British policymakers sought legislation to extend the supervisory authority of the Bank of England to cover the previously unregulated, secondary banking sector. They achieved the extension with the passage of the Banking Act of 1979. The Act extended the supervisory authority of the Bank of England to all deposit-taking institutions, with the exception of Building Societies, which remained under the aegis of the Registrar of Friendly Societies. All depository institutions thus were required to meet minimum managerial and financial requirements and to file periodic statements of condition with the Bank of England. This change represented a significant increase in the extent and formality of bank supervision by the Bank of England, although by American standards, supervision remains relatively mild.[21]

The Banking Act of 1979 also sought to reemphasize the distinction between clearing banks and other banking sectors by creating a new category of institutions called "Licensed Deposit Takers." This classification embraced most of what we have referred to above as secondary banking institutions. The rationale for re-emphasizing this distinction was that, in the public's mind, a true "bank" had come to be regarded as an institution that enjoyed a special and protected relationship with the Bank of England. Indeed, given the historical exclusivity enjoyed by clearing banks, such perceptions were probably not unrealistic.

In reaction to the events of the 1970s, British policymakers also increased pressures to institute deposit insurance as a bulwark against runs on deposit-taking institutions. Prior to the 1970s, neither government nor the financial industry had expressed much interest in deposit insurance. They relied instead on credit controls and rate-setting cartels in the building society and banking sectors to control potentially destabilizing risk-taking.

However, as discipline in the building society cartel deteriorated, the Building Societies Association independently devised a Voluntary Depositor Protection Scheme to protect the industry from associations with individual societies weakened by excessive risk-taking. The voluntary depositor protection scheme covers 100 percent of all deposits and 90 percent of all shares in participating institutions. As of 1984, over 80 percent of all building societies were participating in the deposit insurance scheme, with the result that over 95 percent of all shares and deposits in the building society industry enjoyed protection.[22]

The Banking Act had specified that banks and other licensed deposit-takers be subject to a compulsory deposit insurance plan. This plan, which took effect in 1983, has features similar to the programs administered by the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC) in the United States.[23] It differs, however, in several important respects. First, the Compulsory Depositor Protection Scheme insures only 75 percent of a depositor's funds up to a maximum of 10,000 pounds sterling. Thus, unlike its American counterparts, the scheme is designed to provide protection only for small depositors and, even then, to provide them with an incentive to maintain active personal surveillance of financial institutions, since less than 100 percent of their deposits will be recovered in the event of failure.

Second, the depositor protection scheme is designed to function only as a first line of defense against capricious runs initiated by unsophisticated investors. The Bank of England and the clearing banks remain *de facto*, if not *de jure*, the main sources of emergency liquidity in the British banking system. Indeed, the clearing banks opposed the creation of the Compulsory Depositor Protection Scheme precisely on the grounds that it afforded them no relief from their responsibilities but required them nevertheless to be major contributors to the insurance fund.[24] In recent policy papers on the Building Society industry, it has been recommended that the Compulsory Depositor Protection Scheme currently in place be extended to the building society sector to replace its current voluntary plan.

In summary, the debut of deposit insurance and the extension of the Bank of England's supervisory authority represent a move toward less reliance on self-regulation and competitive restraint as the means of bringing stability to the U.K. banking system. Supervisory mechanisms remain *pro forma*, however, in comparison with the procedures followed in the United States. In addition, the features of the Depositor Protection Scheme (the low insured maximum and investor co-insurance) suggest that British authorities still regard industry self-regulation, investor prudence and a strong clearing bank sector as the main lines of defense against financial instability.

Addressing the Competitive Balance

The new supervisory and insurance measures signal a recognition on the part of British policymakers that the forces of competition frequently regarded as potentially destabilizing in banking markets are difficult to suppress. In some ways, the clearing banks' loss of market share to building societies and the secondary banking sector in the 1960s and 1970s and the Secondary Banking Crisis were to British policymakers what the cycles of disintermediation and growth of money market mutual funds and other "nonbanks" were to U.S. policymakers in the same time period. Both sets of events alerted policymakers to the strength of the forces of financial innovation and the weakness of extant regulatory devices. In the U.K., this change in policy perception is manifested in a number of significant changes in the competitive "playing field" of British banking.

First, the Banking Act of 1979 provides a mechanism by which a nonbanking institution may formally enter the retail banking business. The institution may become a retail bank, and use the word "bank" in its corporate title, if it has operated successfully for a specified period of time, subject to approval by the Bank of England. (The British operations of a foreign bank automatically are eligible for retail bank status if they belong to a *bona fide* bank in their home country.) This time provision represents a relaxation of former barriers to entry into the demand deposit-taking, retail banking sector. Current statistics of the Bank of England identify 140 institutions in the retail banking sector, including in addition to former nonbanks, the clearing banks and subsidiaries of foreign banks.[25]

A second, and perhaps more important, concession to clearing bank competitors is the granting of access to the Bankers' Clearing House to entities other than the handful of original clearing banks. A bank may gain access to the Clearing House if it can demonstrate that it handles one percent or more of total daily payment volumes (that is, checks and electronic funds activity). Access to the clearing house is particularly important for institutions wishing to compete economically with the clearing banks for demand deposit ("current account") and credit card customers. The U.K. representatives of large foreign banks have been the first to seek access to clearing facilities. Lack of such access—as well as the difficulty of establishing *de novo* a branch system to rival the extensive networks of the clearing banks—may explain the difficulty foreign banks have had in competing with clearing banks, despite their perception of the market as a profitable one and the availability of considerable resources from their overseas parents.

The third major area of reform involves the role of the building societies. Building societies have been, and are likely to remain, the main source of increased competition for clearing banks. Unlike foreign banks and secondary banks, the building societies have long-established and extensive branch networks throughout the United Kingdom. The largest building society has nearly 1,000 branches, and the roughly 200 societies in existence have roughly 7,000 branches in total throughout the U.K. This long reach provides the building societies a geographically diversified clientele, familiarity with local credit needs and conditions, and name recognition not enjoyed by clearing banks' other potential competitors.[26]

Public policy toward building societies is moving rapidly toward giving them the same treatment as banks. In 1983, for example, legislation was passed giving building societies greatly improved access to wholesale deposit markets. In addition, a variety of proposals made by the Chancellor of the Exchequer to the Parliament in 1984 would give building societies certain powers now only enjoyed by banks. Under the proposals, expected to become law in 1987, building societies would, for example, be able to invest up to 10 percent of their assets in commercial loans.[27]

In addition, most of the current restrictions on the provision of money transmission services by the building societies would be removed, allowing them to offer, for example, point-of-sale electronic debit services, automated funds transfer on behalf of customers between institutions, check guarantee cards, and other services. Relieving them from these restrictions would substantially eliminate the competitive disadvantage building societies have faced by being unable to offer true demand deposit services.[28] In addition, it has been proposed that building societies be permitted to sell insurance products and offer real estate brokerage services in addition to their traditional product lines.

While giving societies certain bank powers, public policy also is eliminating the preferential tax treatment building societies have enjoyed. The preferential treatment of building societies under corporate tax law, for example, in essence will have been eliminated by this year.[29] The asymmetric treatment of interest paid to depositors at building societies versus banks, which many argued worked to the competitive advantage of the building societies, also was phased out this year.[30]

Building societies and banks already are responding to the existing and pending changes in their competitive environment. Building societies formally abolished their interest-rate cartel in 1984, and are now competing more vigorously among themselves and with the banking sector for deposits and mortgage assets.[31] The building societies also have begun to explore the use of a shared automated teller machine (ATM) network that could be expanded to allow depositors to pay bills or transfer funds. Some of the clearing banks also have hastened to establish correspondent relationships with the building societies. Through "sweep"-type arrangements with clearing banks, the building societies can provide checking services to their customers.

The clearing banks, for their part, also are reacting to the actual and potential increase in competition by altering their price and service strategies. In a sharp break with tradition, few of the clearing banks are offering interest, for example, on current account deposits. Some also have extended banking hours, expanded their customers' access to credit, and taken steps to improve the efficiency of their internal operations.[32] Others are experimenting with home electronic banking, point-of-sale debit systems, and expanding their ATM networks rapidly.

III. Conclusions and Implications for U.S. Banking Policy

The attitude of British policymakers toward their banking system has changed significantly since the late 1960s. Generally speaking, they have allowed and encouraged the British banking system to evolve toward one that permits greater competition albeit with a deeper overlay of government supervision, insurance and oversight. The previously informal nature of banking regulation—facilitated by the existence of interest rate cartels, restricted entry, and fraternal relationships with the central bank—appears to have been codified and formalized, although policymakers indicate a preference to retain some elements of "self-regulation." In sum, relationships between the banking community and the British central bank are becoming increasingly more formal as the competition for domestic markets has grown more vigorous.

Whether the new regime will increase the long-term efficiency of the British banking sector depends largely on whether the greater efficiency brought about by competition is offset by greater public expenditures on supervising and examining financial institutions. The latter is needed to maintain the stability that has characterized the British financial system throughout most of this century. All that can be said at this time is that the economic environment and the pace of financial innovation have made it impossible to ignore the role of competitive forces in the U.K.

The British banking experience may inform U.S. banking policy in a number of ways. First, the British have learned that although it is possible to affect the structure of the financial industry through credit controls, portfolio restrictions, and tax policy, competitive forces run counter to attempts to manage credit flows. For example, both rapid growth in the building society industry and the existence of the secondary banking sector are, to a considerable extent, the results of restrictions on clearing bank activity and other credit allocation policies.[33]

Second, the U.K. has learned that banking activities cannot remain segmented without the appropriate economic conditions and stable regulatory policy. When British policymakers relaxed some of the controls on clearing banks in 1971, the market found it difficult to adjust. The change contributed to weakness in the secondary banking sector and eventually led to a crisis of confidence in the entire payments mechanism. It was not until nearly a decade later that deregulation in the British financial system could safely resume.

Third, the British experience illustrates the hazards of asymmetric treatment of like institutions concerning receipt of "protection" from the central bank or benefitting from deposit insurance mechanisms. The coexistence of a "protected" clearing bank sector and an "unprotected" secondary banking sector that also accepted deposits may have exacerbated the problems experienced by the secondary banking sector in 1971–1973 as depositors sought a safe haven for their funds in the clearing banks. British policymakers reacted, probably not inappropriately, by extending supervision and depositor protection mechanisms to virtually all depository institutions. The same problem may arise in the United States given the presence of unprotected or only privately insured depository institutions in a few markets. Indeed, U.S. policymakers appear to be reacting to these cases by trying to extend insurance and supervisory coverage to those institutions as well.

Finally, American observers of the British banking system often cite its structure as an indication of how U.S. banking might appear in the absence of geographic branching restrictions and deposit rate regulation. In fact, as we have pointed out, the structure and high levels of concentration observed in the British banking industry are at least partly the result of British banking and antitrust policy. While it is true that British banking has developed without certain restrictive regulations imposed upon its American counterpart, its structure also is partly the consequence of attitudes toward managing a perceived trade-off between competition and payments system stability.

FOOTNOTES

1. These other institutions include wholesale banks such as merchant banks, foreign and consortia banks, and discount houses. In addition, the British system includes several deposit-taking institutions serving primarily small individual savers. These include the Trustee Savings Banks, the National Savings Bank, and the National Girobank. For a comprehensive explanation of these institutions see Cooper, *The Management and Regulation of Banks.*

2. Since a considerable portion of their deposit base is made up of liquid retail deposits, the generally conservative clearing banks have preferred to lend by overdraft, recallable at very short notice.

3. The Committee of London Clearing Bankers (CLCB) operates most of the nation's cash distribution and money transmission activities primarily through the Bankers' Clearing House or the Automated Clearing Services, both of which are owned by the London clearing banks.

4. These four major banks are: Barclays Bank, Lloyds Bank, Midland Bank and National Westminster Bank. Besides these, there are two other London clearing banks (Coutts & Co. and Williams and Glyns Bank), three Scottish clearing banks and four Irish clearing banks. The four major London clearers own outright or have very substantial interests in nine of the other clearing banks. Two of the Irish clearing banks are independent. The Committee of London Clearing Bankers will be supplanted in the near future by an enlarged trade group to be known as the Committee of London and Scotland bankers. This new group initially will have seven members, all of whom were members of the London or Scottish Committees of clearing banks.

By way of comparison, even U.S. state-level 4-firm concentration ratios are nowhere near this high. In 1984, for example, California—which permits statewide branching and comprises a large economy itself—had over 450 banks and a 4-firm concentration ratio of less than 64 percent.

The 5-firm, 55 percent concentration ratio observed among building societies in Great Britain, however, more closely matches U.S. experience. In California, for example, there are approximately 200 savings and loan associations (and no other mortgage lenders such as mutual savings banks), and the 5-firm concentration ratio is 40 percent.

5. In the past, this cooperation has frequently taken the form of clearing bank compliance with directives by Bank of England on such issues as the volume and direction of bank lending and the composition of balance sheets.

6. The Bank Act of 1844, introduced by the Bank of England and repealed in less than 15 years, temporarily restricted entry to the British banking industry. Already-existing banks—many the forebears of the main contemporary clearing banks—were consequently sheltered from competition for a period of time. This period of relative freedom, enhanced by the advantages of acceptance into the Committee of London Clearing Bankers in 1854, allowed those banks to entrench themselves in the banking sector at the expense of any competitors. William T. McCaffrey, *English and American Banking Systems Compared*, pp. 28–29.

7. One example of such collusive pricing behavior was later to become a competitive disadvantage, as discussed below. For many years, the cartel made the interest rate paid on noncheckable deposits two percentage points below Bank Rate, or the Bank of England's lending rate (somewhat like the Federal Reserve Bank's discount rate). Likewise, borrowers paid a set rate above Bank Rate.

8. For example, during the post-war period, on the Bank of England's recommendation, the clearing banks channeled their lending into the rebuilding of the industrial sector—a policy that was to affect the entire banking system considerably, as discussed below.

9. This process was facilitated by the social homogeneity of both clearing bankers and the Directors of the Bank of England. They belonged to the same class, attended the same schools, or met at the same clubs.

10. Cartels in the financial industry may have functioned as an alternative to regulation in that they have attempted to regulate interest rates to achieve a lower risk, lower return equilibrium in loan portfolios. (See "Building Societies: A New Framework, p. 27).

11. Building societies are analogous, in this sense, to mutual savings banks in the United States.

12. In the 1970s, in an environment of high interest rates, a few very large building societies broke away from the cartel, threatening its risk-optimizing function. Discipline continued to erode until, in 1984, the interest rate cartel officially was abandoned although the Building Societies Association continues to publish recommended deposit and mortgage rates.

13 Many of the secondary banks possessed certificates, issued by the Board of Trade, stating that they engaged in *bona fide* banking business for the narrow purpose of exempting these institutions from the Money Lenders Act of 1900. This certification created the illusion that the companies were recognized by a responsible government department.

14. M.K. Lewis and B. Chiplin, *De-Regulation and Competitive Pressures upon British Banks.*

15. In September 1973, the Bank of England imposed a ceiling of 9.5 percent per annum on interest that could be paid on bank deposits of less than £10,000. This ceiling was withdrawn in February 1975. The Supplementary Special Deposits Scheme, or the "corset", put up to 50 percent of deposit increases into noninterest bearing reserves and constituted an important tool of British monetary policy during that period.

16. See Margaret Reid, *The Secondary Banking Crisis, 1973–75.*

17. "While the U.K. clearing banks appeared secure from the domestic effects of any run, their international exposure was such that the risk to external confidence was a matter of concern for themselves as well as for the Bank." (Bank of England, "The Secondary Banking Crisis. . .")

18. The recycled deposits were "loaned" at a market rate of interest plus a premium for the perceived riskiness of the loan. The Bank of England agreed to assume responsibility for financing 10 percent of the amounts outstanding. Although no precise data are available, it has been estimated that the total financing of the Lifeboat amounted to about £3 billion. Losses from the operation could have

been as much as £50 million for the clearing banks and £100 million for the Bank of England. Reid, *op. cit.*, pp. 190–92.

19. This notion rests on the view that runs on essentially sound institutions can occur as the result of the failure of similar institutions. Risk-taking that is rational from an individual institution's point of view may impose costs in the form of increased risk of failure on other institutions.

20. Indeed, the Competition and Credit Control policy that some feel precipitated the secondary banking crisis was instituted partly to redress the diminishing dominance of the clearing banks. (See Lewis and Chiplin's account of this policy.)

21. The Bank of England, for example, does not conduct on-site or surprise examinations as do the supervisory authorities in the United States. It relies instead on a rather arms-length review of the submitted reports of condition. In recent months, these have been argued to be insufficient. (See "A Juicy Summer Scandal is Rocking the City of London," *Business Week*, August 19, 1985, page 44.)

22. The Depositor Protection Scheme employed by the building societies was enabled by permissive language in the 1962 Building Societies Act. The Scheme is run by the Building Societies Association (BSA), although participation is not reserved to BSA members or participants in the BSA cartel.

23. The Depositor Protection Scheme in Britain is funded by a fee based upon the level of short-term deposits at each institution, with stipulations for a minimum and maximum contribution. It is administered by a special commission composed of representatives from the Bank of England and affected sectors of the financial industry.

24. The clearing banks recalled the burden imposed upon them by the "lifeboat" operation begun in 1973. Their feeling was that, should a major banking panic occur, they once again would be called upon to shoulder a large portion of the burden of re-establishing stability in the banking system. The proposals for reforming the building societies are presented in a so-called "Green Paper" titled "Building Societies: A New Framework," presented to Parliament by the Chancellor of the Exchequer, July 1984.

25. No statistics are available on the size of the licensed deposit-taker institutions that have not achieved retail bank status. Conversations with experts on British Banking suggest, however, that the conversion of licensed deposit-takers to retail banks has not been rapid.

26. These factors, combined with preferential tax treatment of interest earned at building societies, caused the share of building society deposits relative to deposits at clearing banks to rise from approximately 50 percent in 1965 to 90 percent in 1975.

27. Currently, approximately 80 percent of building society assets are in mortgage loans; the remainder is invested in liquid and other securities.

28. Some building societies employ "sweep"-type arrangements with clearing banks to provide their customers with checking-like services.

29. Building society corporations traditionally faced a 40 percent tax rate on corporate profits, whereas banks faced a 52 percent tax rate. However, banks were able to reduce their corporate tax liability through leasing activities not allowed building societies. In 1984, policymakers considerably reduced the tax advantages enjoyed by leasing operations and began a progressive reduction of the corporate tax rate to 35 percent—applied uniformly to banks and building societies. In addition, the building societies' ability to count income from the sale of certain types of securities as capital gains rather than ordinary income was eliminated in 1984.

30. Prior to 1985, building societies paid interest to investors net of a composite tax rate, which was slightly lower than the basic income tax rate. Interest payments by clearing banks, in contrast, were paid gross of tax, subjecting the taxpayer to the basic rate and, thus, a lower after-tax rate of return, *ceteris paribus*.

31. Clearing banks traditionally had not involved themselves in the residential mortgage market. As recently as 1980, their loan portfolios contained essentially no mortgage assets. Since BSA policy frequently kept mortgages issued by building societies in short supply, the absence of clearing banks from the mortgage market must not have been a matter of choice but the result of credit restrictions imposed on clearing banks by the Bank of England. Today, the clearing banks hold approximately 5 percent of their assets in the form of mortgages.

32. The Clearing House Automated Payment System (CHAPS), for example, will facilitate the interbank transfer of sterling funds.

33. In terms of deposits, building societies and clearing banks in Britain today are virtually identical in size. By comparison, savings and loan associations, an American counterpart to the building society, have deposits equal to only about one-third of the deposits of commercial banks. Thus, a much greater share of total deposits in Great Britain resides with highly undiversified, mortgage-oriented financial institutions. Some argue that this places the British financial system in greater jeopardy should some systemic problem affect the quality of mortgage loan assets.

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