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Abstract

This dissertation seeks to understand why banking regulation has not led to banking stability. In broader terms it looks at how the state tries to control the market and why this fails. Specifically this dissertation questions why the introduction of new forms of bank regulation in the UK in the 1970s started off recurring financial crises. It examines four case studies in UK bank regulation history from 1970 to 2010 and finds that: 1) Bank regulation operates in a cumulative cycle with bank activity, which can best be understood as Minsky's financial cycle with a regulatory component; 2) The regulation itself is formed for political rather than economic reasons and represents compromises derived from divergent interests, ideas and institutional forms; 3) These compromises introduce perverse incentives to the financial system which allow banks to circumvent the regulation itself. This leads to a gradual widening of bank activity; 4) The state's failure to control banking has led it to ape banking's methods and substitute private (market-based) institutions of regulation for public (control-based) ones. This point follows Polanyi's idea of double movement to understand how the state and market interact.

The result of this cycle is that over time as the scope of banking activity has widened, the state has been less able to control market behavior. Since finance is inherently unstable, this lack of control has resulted in financial instability. The financial-regulatory cycle can be summed up as the fact that banking regulation has political causes but market effects. These are not aligned. The cause of banking instability is therefore ultimately political.
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Part 1: Theoretical core
Chapter 1: Introduction
Banks were born in chains but are everywhere free. This liberty is no welcome thing but is directly responsible for financial instability.

Banking has changed from a specific act, cut off from the wider economy except through specific lending and deposit-taking mechanisms, to one which permeates every aspect of modern Western economies. Banks are less constrained in what they are allowed to do. This increase in banking scope has gone hand-in-hand with an increase in the detail of regulation. Having widened the scope of bank activity, the state now attempts to control how this activity is conducted. This dissertation argues that the state is much more effective at widening banking scope than it is in controlling banking activity.

Regulation – the state’s attempt to control the market – has become weaker as it has become more specific. If initially banking was severely curtailed in its scope – what activities ‘banks’ were allowed to undertake – but free to do as they liked within that scope (as the period up until late 1970s is here characterized), then as banks have been allowed to undertake more activities they find that these actions are bound by small, changing, and specific rules. The state has given up an attempt at strict control in favor of specific control. In this effort the state is always, inevitably, forced to chase banking innovation and it finds that its method of control is not strong enough convincingly to influence bank activity. The state has become a mere tinkerer inside the market, rather than a determiner of the form of the market itself. The state is trying, and failing, to play the market at its own game rather than force the market to conform to its wishes.
The increase in the amount and specificity of regulations (rules) over the past four decades therefore represents a failure of the state’s banking regulation (control). This failure of regulation to control banking activity is the cause of the increase in financial activity that we have seen since the 1970s. The scope of banking has widened, the strength of regulation has weakened, and instability has grown. This dissertation seeks to understand why.

**Background and motivation**

The financial crisis showed the world what happens when banking goes bad. The real economy is starved of funds, unemployment rises and public finances come under strain. This is because of the nature of the banking system and its interrelation with the real economy. Banks are peculiar. They are institutions permitted by states to undertake certain financial activities. Primarily they hold deposits and make loans. This allows capital to flow around an economy to be put to productive use. This is the essence of capitalism.

In return for this permission banks submit themselves to certain rules and fund state activities in certain ways. The rules, activities, and funding change over time and place, but a necessary constant is the stability of banking.¹ Finance is inherently volatile (Minsky 2011), but the point of banking specifically has always been its stability. Encasing financial activity in a specific institutional form was designed to make it more dependable. It is this cloak of dependability which was rent by the crisis.

In fact, banking has become less stable over the past four decades, culminating in the financial crisis of 2007 (Barth, Caprio, and Levine 2004). Yet the number of bank laws and

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¹ Though not necessarily the stability of individual banks.
their global spread has also increased over the past four decades (Barth, Caprio, and Levine 2013). Clearly this has not led to improved bank stability.

This is the puzzle that this dissertation seeks to understand: why has bank regulation not led to banking stability? As a subsidiary question, why does bank regulation change so frequently and still not lead to stability? Under an evolutionary framework we might assume that bank regulation will keep changing until policy-makers stumble upon a stable banking framework through some combination of design, luck, and trial-by-error (Veblen 1898). This has not happened to date. Perhaps the world just needs to wait and have faith.

A review by the Cato Institute of Calomiris and Haber’s (2014) Fragile by Design took as its starting point the fact that bank regulation is not in fact concerned with stability at all but about government finance and politics (Selgin 2015). But how can we use this insight to explain banking regulation rather than to dismiss it? How does the ‘government finance and politics’ come about and, more importantly, what are its effects on bank regulation and stability? It is surely not enough to argue, as is implied, that the ‘content’ of bank regulation being stability is purely hypocritical or cynical. We do not get very far if we assume politicians or regulators are merely evil or stupid.

Perhaps, however, there is a systemic reason for why regulation is not able to stabilize banking. This would explain why significantly varied regulations all similarly fail to create a stable banking regime (pace Calomiris and Haber: bank crises can, and do, happen in any country). There might, therefore, be something in the relationship between regulation and banking itself which precludes stability. In short, looking at the banking-regulation relationship as a system might yield insights. We cannot just say, along with Calomiris and Haber, that bank regulation is not about the market. Equally we cannot say, along with
Minsky, that the financial cycle has nothing to do with regulation. We need to put these two ideas together.

This dissertation will do just that by explaining the current best understanding of bank regulation and stability, by developing this further, and by conducting a close reading of one country’s experience of bank regulatory and market development (the United Kingdom). Together these approaches will make theoretical and empirical sense of the banking-regulatory system: how bank regulation is made and why banking is unstable.

Fundamentally this dissertation argues that it follows a broken form of Polanyi’s double movement caused by the difference between private (market) and public (political) institutions.

The practical hope is that this step forward in understanding might ultimately make the world less prone to devastating financial crises.

**Conceptual relationships: Banking and finance, regulation and stability, systems and institutions**

The discussion above revolves around a number of conceptual relationships (Ball, Farr, and Hanson 1989). Fundamental is the relationship between the state and the market or, in different terms, the public and private sectors of the economy.\(^2\) This is the core concern of the dissertation, as applied to the financial sector and its regulation. This relationship presupposes a number of others, however, between different concepts. These are the relationships between finance and banking, regulation and stability, and systems and institutions. The terms in these relationship are used simply but contain complexities. Most of them indeed have entire literatures devoted to them. At the outset it is worth explaining

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\(^{2}\) Indeed the transition of ‘the state’ into ‘the public sector’ would be a good definition of the role of regulation.
what is meant by them in this dissertation. Through being clear in what we mean by these terms, and laying out how they relate together, we can lay the groundwork for the discussion to come.

**Banking and finance**

The basic distinction above is between finance and banking. We have already said that banking is a form of finance. This is true. But it is more than that. Historically banking is the foundation of finance (Ferguson 2008). Finance comes from banking. Banking may be increasingly marginalized within financial activity, but this is a very recent phenomenon (the past thirty years at most) and the 'extra', non-banking financial activity still depends on the banking sector (Noeth and Sengupta 2011).

The main problem with the word 'banking' is that it covers a large number of different activities (Calomiris and Haber 2014). From the monetary operations of central 'banks', to the stock market speculation of investment 'banks', to the targeted investments of state-run 'banks', to the deal-making of merchant 'banks', to the savings-holdings of local 'banks', to the business-lending of industrial ‘banks’, the word is characterized by its versatility. Most 'banks' do some combination of the activities schematically separated above. There are three commonalities to them all, however.

- Firstly, all activities involve moving money from one part of the economy to another (lenders to borrowers, turning savers to investors, from the public to the private sector, from surplus to deficit capital holders). This is *finance*.

- Secondly, there is a designated institutional form that structures this financial activity. This make it repeatable, consistent, and reliable. The specific form varies between the different types of 'banking'. What is common is the fact that it is institutionalized into a 'bank' of whatever sort. There is a non-market institutional
mechanism, the firm, to manage how finance operates through the ‘bank’. This institutionalization of finance within a firm is banking.

- Thirdly, the name ‘bank’ carries prestige, or put another way there is value attached to this name (Calomiris and Haber 2014). Over time this has often become a reputational value, but it is also more specific than this. To become a ‘bank’ you have to be licensed as a bank. It is a protected term. This means it is a privileged term. This gives ‘banks’ an advantage in the market place because they are permitted, by the authorities over the market (otherwise known as the state), to conduct certain activities in certain ways which non-banks are not allowed to do. It gives ‘banks’ a certain monopoly power over areas of financial activity. ‘Banking’ could be conducted in many ways – indeed, as the idea of ‘shadow banking’ shows, it is – but only through licensing does an institution become a bank.\(^4\)

Thus according to these three commonalities, we define a bank for our purposes as a privileged institution licensed to perform specific financial functions. Practically speaking, in this dissertation we will limit this definition to retail/commercial banks – those that take deposits from and lend to business and the public - since they have the most effect on the wider economy through their systemic interactions with the real economy and citizens. Because of interrelation with the economy and society politicians are most worried about this kind of banking and legislate it the most and most specifically. These banking functions are also the most long-lasting and prevalent. Nonetheless, we keep an eye on the other

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3 ‘Non-banks’ in the broad sense, not in the financial jargon.
4 The form licensing takes, and the authority which does it, can take many guises (cf. chapters two and three).
types of banking, and especially from the 1980s as they all tend to merge into global 'universal banks'\(^5\).

Banking is not, however, the only type of finance. Stock markets are the most obvious form of financial activity not involving banks. Indeed for most of history retail banks were forbidden to operate on stock markets (Kynaston 1994). These represent a market-based way of performing bank-like functions: moving surplus capital into projects which require it, in hopes of a return. Bond markets, corporate and sovereign, also form investment opportunities as do commodities and other exchanges. What these all have in common is the market mechanism for moving capital through the economy according to a regulated structure – the exchange – rather than through ‘in-house’ decisions. They are market- not firm-based. More recently, instruments such as Money Market Funds (MMFs) have also formed to create a market-mechanism which can mimic the savings-function of a bank.

There are many other ways of creating financial returns – making a profit by managing, moving, or lending money – without being licensed as a bank. Indeed as financial economies develop it is precisely in this area that innovation occurs, with banks themselves partaking more and more of this non-bank finance; as far as they are allowed to. That permission is the focus area of this dissertation.

Banking was the original form finance took in the modern era, its management of the money in an economy led it to develop financial markets, while the institutional form itself – and the permissions, protections, and limitations that go with it – incentivized cheaper, easier, less-overseen forms of finance and a corresponding loosening of banking regulation (Ferguson 2008; Boyer and Kempf 2016). Banks are the core of the financial system and its

\(^5\) In the UK context this will tend to mean the ‘big 5’ clearing banks, while looking also at some merchant (latterly investment) banks, and building societies. The Bank of England is so called because of its historical development more than its activities (since 1945), and is considered part of the ‘state’ or public sector for the purposes of this dissertation.
main intermediary with the real economy, but they are not the only financial actors. The primary focus of financial regulation still comes in the form of banking regulation, however. This discrepancy between the scopes of financial activity and its regulation will be examined to see if it be a core driver of the systemic relationship suggested in the initial section of this dissertation.

Regulation and stability

This requires us to have a clear idea of what we mean by ‘regulation’, a term no simpler than 'banking'. The crucial assumption in the initial discussion above is the one between bank regulation and stability. As is mentioned, there are many forms and aims of regulation (Llewellyn 1999). One of them, certainly, is stability. But if the main aim of banking regulation is not stability, then there is no puzzle as to why it does not provide stability. The specifics of financial regulation will be discussed much more closely in chapter 2. Here we look at what regulation is and is not in more general terms.

Put simply, and very broadly, this dissertation understands ‘regulation’ to mean the *action of the state in and on the market*. As the word itself shows, it is an act of control. Ideally it is an act of control to fine-tune or optimize otherwise wild activities. We have deliberately chosen a very wide definition of ‘regulation’, as a concept, because the *methods* of regulation can be, and are, so varied. The very aim of this dissertation is to understand how the state interacts with financial markets. Necessarily there are many possible ways it could, and indeed does, do this. Therefore we need a concept and term broad enough to encompass all these different interactions and yet still consider them together at the same time. ‘Regulation’ does that.

The problem with the word ‘regulation’ is that it means something specific too: the specific tool or instrument of the concept ‘regulation’ as discussed above. A *regulation* is the method
of regulation, or at least it is one of them. In this sense ‘a regulation’ would be a law, ruling, or requirement as determined with varying legal force by a state body, to which private market actors have to adhere.\textsuperscript{6} A regulation is therefore just one form of regulation as we understand it. In practice this ambiguity is not so severe, since it is nearly always clear from context and discussion what is being meant.

One further complication is in terms of financial market regulation, where ‘regulation’ tends to mean ‘prudential regulation’ and is linked with prudential supervision (Dewatripont and Tirole 1994). This is a specific set of capital rules for banks, as determined by banking authorities (prudential regulators and supervisors), to ensure their stability, ability to operate under adverse market circumstances, and to protect unsophisticated consumers and the tax-payer in general from bank failure. In modern times the main prudential rules come under the Basel framework and are now generally coordinated by the international Financial Stability Board (FSB). There continue to exist significant country differences nonetheless. Much of the subject matter of the case studies involves prudential regulation, since over the past few decades this has become the principal form of bank regulation. But it is important to be clear that when this dissertation discusses ‘bank regulation’ it means the overall attempt by the state to control how banking works. Where prudential regulation is meant specifically, it will be designated as such. To repeat, often and increasingly ‘bank regulation’ means ‘prudential regulation’, but they are not the same thing and are kept conceptually separate in this dissertation.

This distinction matters when it comes to the idea of stability. Prudential regulation (and supervision) as mentioned is concerned specifically with bank stability at the institutional

\textsuperscript{6} In the EU context a ‘Regulation’ is something else again, an EU law which is directly applicable within member states. It is opposed to a ‘Directive’ which is an EU law that has to be implemented, with some allowed flexibility, into domestic law through the member state political process.
level. It forms a set of specific, legalistic, concrete rules which banks must abide by, with the intention that this will limit the likelihood of a bank failure, costs to its stakeholders, and impact on the real economy and government finances (Dewatripont and Tirole 1994). In terms of bank regulation as we mean it, stability means something else or at least something more. It must mean stability of banking as a whole, since the stability of the sector is a necessary component of whatever aims and interests the state may have in banking (and financial markets more generally). This is because, in banking, ‘stability’ cannot just mean the stability of individual banks: they must be allowed to go bust, indeed most efficient financial theory would suggest that poorly managed banks must go bust (Malkiel 2005).

Equally ‘stability’ in banking cannot just mean that banking activity will always grow in an economy with no down-turns or periods of financial repression or scarce, expensive credit. Again, sometimes this is to be expected and welcomed in an economy, however many people lose out. It is perfectly acceptable for there to be a business cycle in banking.7

What stability has to mean in the context of banking is systemic stability, the stability of the banking system, not just of individual banks or of their activities within the system. This is a form of catastrophic or crisis stability, the ability for the banking system to weather economic and financial downturns and the failure of individual banks. We take ‘bank regulation’ in its broad sense because it is only in the broad sense that states develop banking systems, allow banking institutions to operate and then attempt to control these banking activities through more specific (often prudential) regulation. ‘Bank regulation’

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7 As distinct from Minsky’s financial cycle, on which much more below (this chapter and chapter 2). A simple example of both would be the financial crisis of 2007 which was systemic because it brought nearly all financial activity to a halt, required the government to step in massively to protect depositors and large, connected banks to ensure a financial value greater than GDP was not wiped out. The financial crisis following the dotcom boom, however, was not systemic since it did not lead to the total collapse of bank lending and financial value, even though there was a reduction in lending and some institutions went bust. This is not say that there was necessarily a healthy recovery (indeed it is easy to argue the poor recovery later led to the 2007 crisis), but the ‘crisis’ of the dotcom bust was not systemic, while the later one was. The first was a fall of activity within the system, the second the fall of the system.
refers to the entire attempt by states to have a stable financial system in their economy. Again, the reason ‘stability’ is a fundamental aim of bank regulation is because whatever other aims states may have for banking – tax revenues, cheap credit, economic efficiency, financial redistribution (in either direction), international integration – all presuppose a stable banking system, in the sense of not prone to catastrophic crisis, regardless of what happens to financial activity as such or individual banks.

A stable system is the base on which all banking is built, and regulation the means of securing it.

**Systems and institutions**

Discussing the banking system necessarily requires us to have some idea of how systems operate. Simply put, a system is an environment in which elements perform interactions for a purpose (Meadows and Wright 2008). There are thus three equal elements that make a system: elements, interactions, and purpose. The key point is that the system causes its own behavior; that is, it is latent in its structure. A system can best be seen as a persistent pattern (Ibid.). The relevance of this is that change in one of the three parts of the system affects all the other parts (Jervis 1999). Our definition of ‘regulation’ means the state can, and does, influence all three aspects of the system and thus the size, functioning and success (on its own terms) of the system as a whole. As the state changes, or gets involved with, one part of the system, though, it wittingly or not changes the others.

To make this discussion a little less abstract, we should turn to the banking system itself. It is made up of banks (elements), the (primary) banking activities of deposit-taking and lending (interactions), and the system’s purpose which is to move money from where it is not needed to where it is for a financial return. This should improve the overall productivity of the economy (King and Levine 1993). At least to start with this takes place all within a
domestic economy context. What we see over time is the state changes both the economy’s openness to the outside world (the actors), and also what activities banks are allowed to undertake (interactions). In so doing, we can assume the state changes the system’s purpose: the balance of economic efficiency of banking to individual actor’s interest-gaining, as well as the geographic scope of the system. All these changes will impact the system’s stability, and not necessarily in ways that were intended or foreseen. One of the characteristics of systems is that specific changes to one aspect of the system can lead to wildly exaggerated and perverse outcomes in another (Meadows and Wright 2008).

Assuming that a banking system starts off in an equilibrium state – that is, where the three parts of the system cohabit positively, without forcing changes in each other – then we might suppose that state involvement in one aspect might cause a shock which knocks the system out of an equilibrium. There is no particular reason why we should assume the system will then find another equilibrium, let alone a satisfactory one (Baumgartner and Jones 2009). Looking at the empirical record is here the only way to see what has happened historically which might give us a generalizable insight.

To connect this rather abstract look at systems and the banking system back to reality we need to have an idea of institutions. The term has come up time and again in this discussion, and will come much more before we are out. This is because institutions are the units of analysis of this dissertation. Institutions are long-lasting, analyzable since non-arbitrary, and repeating. Individual actors will of course be discussed, especially in the case studies, but the way to generalize answers out of individual action is to see it in terms of the institutions that action represents. The aim of an institution is to create a certain reliability in individual action by making humans conform to an established pattern (North 1994).

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8 That is, opening up the elements called ‘banks’ to the outside world might turn the function (‘purpose’) of a banking system from moving capital within, e.g., the UK economy to within the EU economy.
Very simply, an institution is a *humanly-devised constraint which patterns human action* (Peters 1999). The repetition gives the point. Human action is both the input and the output of an institution, which thus, in anything other than a static analysis of one point in time, becomes to some degree a feedback loop. Humans construct institutions, which then change human action, which then alters the context in which institutions operate or causes humans to alter the institution. According to this understanding, institutions also exhibit path-dependence which means that the initial form of the institution will persist until it is knocked off course and changed by events or deliberate action (Goodin 1996). Institutions exhibit inertia in the physics sense. They therefore not only structure human action but also make it persist.

There is a vast literature on institutions, how they are formed, why they persist, how they operate and why they matter. This will be discussed at length in the next chapter, along with institutions in a specific banking and regulatory sense. At this point, though, it is worth flagging up the very different logics behind private and public sector institutions (Coase 1937; Posner 1974). For ease of understanding, private institutions aim to profit-maximize while public ones aim to produce publically-desired outcomes. This second point is not simple: it depends on where the institution derives its legitimacy from, who controls it, and who will benefit from it. Looked at another way, public institutions involve the political process of hierarchy, popular support and control, while private institutions operate through firms operating in markets, according to available information and price signaling. The interaction between the two types of institutions is one way of understanding the banking-regulatory system. Change from one type (public) to another (private) could be a major driver in banking activity.

As discussed above, regulation is the action of the state in the market. In short, it is the interface between public and private institutions in the banking system. The institutional
actors of the banking system are not just the private institutions of banks but also the public institutions of regulation (government, regulatory authorities, central banks etc.). By examining banking regulation directly, we will therefore have to understand how these two different kinds of institutions interact in the banking system, and then see what the systemic effects of this interaction are. This will answer the puzzle as to why bank regulation has not led to bank stability.

The political economy of states and markets

So far this discussion is very firmly on the ground of political economy literature. It looks at how institutions interact within systems according to political and economic processes. For such a broad question it is no surprise that a number of ways have been devised to answer it. Some of these have been discussed above, and will be discussed in more depth in chapter 2. The point of this discussion of the relationship between different concepts has been to ground this dissertation in this literature early on, to establish some common understanding of complex terms and concepts, and to grope our way to an approach to answer the question we have set to solve the puzzle we have found.

The aim now and in the next chapter is to draw these general concerns, questions, and approaches more specifically into the realm of banking regulation. Later this will be done by moving the discussion to a specific time and place – the UK between 1970 and 2010 – which will make the conversation more concrete. Before that we will look specifically at the literature on banking and financial regulation and on financial market activity itself.

Banking and finance, and their regulation, are special sectors of modern capitalist economies because of their size, dominance, and centrality. The financial crisis of 2007 has not just knocked out a wealthy sector of the developed economies, but has severely damaged all sectors of these economies and government finances. This is to be preferred to a general socio-economic (and indeed political) collapse as happened in the 1930s, but it
has left a toxic legacy: both in financial markets and further afield. Examining banking and its regulation is worthwhile for itself, therefore.

But finance also presents specific challenges and conceptual interest. As far as is possible it seems to be a perfect market: in the sense that there is very little physical movement of goods needed, time and space are reduced almost to zero in importance, price is everything and there are very many actors of all sorts. This is not to say that they should be perfectly competitive markets – though some might have argued that before 2007 – but rather that it should be very easy to see cause and effect in these markets. The sheer scale of the markets and the fact that they operate as the infrastructure for all real economy markets means that governments are, rightly, very concerned with how banking works, who it works for, and how it is developing.

The point is that the political economic literature is a solid and well-established foundation to look at banking and its regulation, but we will have to spring off quickly into more specific areas to understand how regulation works in the banking system. This is good, since we will be able to be more precise, and since this should then help us export insights gleaned back into the traditional areas of political economy. We examine how finance and regulation interact, but this is just one form of the ongoing political economy concern as to how states and markets interact. Political economic theory can help us understand financial regulation, and what we understand about financial regulation can help us strengthen political economic theory.

Research questions and answers

From puzzle to research question

The puzzle, therefore, is to understand why banking regulation has not led to banking stability. But this presupposes we know what those terms mean. Below we shall discuss the
concepts themselves, and then in the next chapter delve into the literature that makes use of
them. But as well as simply using these terms, this dissertation hopes to unpack them, and
work out exactly how we should understand regulation and stability in banking. For that
reason the research agenda of this dissertation needs to be more positive: to see how
regulation and market activity (stability) actually interact in banking. Only on this empirical
foundation can we build a real understanding of the processes at work, as opposed to a
theoretical and conceptual one.

Thus while the puzzle is about regulation and stability, the research question needs to be
more specific and neutral. To understand the dynamic, particularly with a systems
approach, we first need to answer one question.

*Research question: how does banking regulation interact with banking activity?*

Answering this question will let us solve the discrepancy noticed at the start: that regulation
does not seem to lead to stability. In itself, however, this question is still answerable along
many lines of inquiry. We still need to split the research question up in separate,
manageable parts. On ‘the left-hand side’ of the question above, we need to understand
what we mean by banking regulation and how it develops (King, Keohane, and Verba 2006).
This will explain why we see the banking regulatory outcomes we do – from what processes
it comes – and why regulation takes the shape it does, with the aims it has. The first
subsidiary question, therefore, is:

*First subsidiary question: how is banking regulation made?*

Once we have an answer to this, we will need to see how this regulation then moves into the
market-place, how banking changes because of the regulation itself: the ‘right-hand side’ of
the question. Obviously the answer could simply be that banks do as they are told according
to the regulation and this has the desired effects with no side effects. But it is unlikely to be
the case, and anyway even that would be an interesting, indeed shocking, finding especially when thinking in systems-terms. Thus the second subsidiary question must be:

Second subsidiary question: how does bank activity respond to regulation?

By answering those two subsidiary questions we will be in a position to answer the research question above. Through separating it into two parts, seeing the dynamics of both halves of the question – the state and the market sides, for ease of explanation – we will then be able to answer the more pertinent question as to how they interact. But this interaction needs to be built up on the basis of an understanding of the dynamics of each part. What makes the financial-regulatory relationship so hard to pin down is that both parts are constantly moving; both sides of the relationship can be modeled as a system in their own right. It is only through developing an understanding of each side, and then looking at their interactions that we will be able to answer our research question.

Once we have a positive answer to the research question as to how bank regulation and activity interact, then we will be in a position to approach our original research puzzle as to why we have not seen an increase in bank stability with bank regulation. First we answer the ‘how’, then we can give an answer to the ‘why’. To lay it out clearly again, the research agenda of this dissertation is as follows.

- **Empirical Puzzle**: why has banking regulation not led to banking stability?
- **Research Question**: how does banking regulation interact with banking activity?
  - **First subsidiary question**: how is banking regulation made?
  - **Second subsidiary question**: how does bank activity respond to regulation?
Approach to a research answer

Clearly to answer these questions we need to start from the bottom up – from the subsidiary questions, to the research question, to the puzzle. We also need an approach which will bind them all together. This is, broadly speaking, an institutionalist systems theory. As discussed above, institutionalism takes individual institutions as the main unit of analysis, which allows us to understand persistence over time. It also allows us to put individual human action, the subject matter of history and the world around us, into a coherent framework of analysis. Otherwise all we are left with is purely contingent events.

These institutions themselves, however, need to be understood in terms of systems theory. This allows us to examine the relationship – interactions – between different institutions – elements – and to question what the purpose of the banking system is and how it can change. In short, systems theory gives us a way to look at all the parts of the banking system in one go, without forcing an arbitrary choice as to where the relationship dynamic ‘starts’. In Meadow’s words "systems happen all at once" (p. 5). The boundedness and feedback inherent in a system rightly stress the interconnectedness and mutual reactions of each element. Indeed, it is this which makes it a system. This helps us develop an answer because it shows how small, specific changes in one part of the banking system (which, as above, includes both market and regulatory institutions) can have large and unintended outcomes. These outcomes might then require further changes in the initial part. It is this cycle of reaction which we hope to understand.

With these two approaches – institutionalist and systems theory – we can begin to develop an argument that will lead us to an answer to our research question, from a logico-deductive point of view. Clearly much has been written on this area. In chapter 2 we will look closely at how these questions have been answered before, and see where the gaps in these answers may lie, to build out the argument developed here within the framework of
existing literature. This will give us confidence in the logic of this argument, and make it relevant to the existing literature. But before weaving our argument through the thread of current theory, it is clearer to work out our prior propositions. It is these that we shall develop and flesh out with theory in the next chapter, then test with the case studies to see in the conclusion how useful they are to explain the puzzle of banking stability and banking regulation.

**Propositions**

We turn each of the questions around, on the basis of our institutional and systems argument above, to give propositional answers for testing.

**First proposition (in answer to the first subsidiary question):** Banking regulation is a public institution. Therefore it is made, maintained, and altered according to a political process involving competing vested interests wielding different ideas.

This proposition says, fundamentally, that banking regulation is an institution. As such it needs to be analyzed according to institutionalist theory. This will be explained and exploited in the next chapter. Obviously institutionalism itself is contentious with many competing viewpoints on how it should be understood, but a prime concern of how institutions are made and altered is the struggle for control over these institutions by various vested interests (Olson 1977). This struggle for control involves the development of support from existing influential institutions, changing the environment in which institutions live, and control of the process of formal institutional development (Goodin 1996). A key part of this contestation is the wielding of ideas: both the construction of new ideas and the ability to turn existing ideas into institutional form, into capturing institutions (Blyth 2002). The struggle for institutional change therefore takes place through ideas,
interests and environment. The outcome of this struggle is the maintenance of existing institutions or their change into something new.

**Second proposition (in answer to the second subsidiary question):** Bank activity consists of private institutions. Therefore it operates according to market logic, which means the institutional aim is to maximize its own profits.

This is a very different proposition to the first. This proposition suggests that bank activity is dedicated to maximizing its own welfare (of the banking system in general or of an individual bank depending on your level of analysis). This means that it may not react in a straightforward way to bank regulation. There are questions here over the rationality of bank activity – it is by no means certain that individuals or banks will be able to correctly predict or establish how their welfare would be maximized (Kahneman and Tversky 2013) – and especially when we take into account the time horizon of welfare. Activity that is maximizing in the short term might be minimizing (or at least less positive) in the long term. We will explore these ideas in the next chapter by looking at the main theories of banking and finance, which can be simplified as neo-classical and heterodox (Minskian) – such as delineated by Friedman (1962) and Minsky (2011).

**Third proposition (in answer to the research question):** Banking regulation and banking activity interact in a systemic way. This means that both institutional forms – public and private – operate in one environment.

The importance of seeing the two sets of institutions operate in a system is that it explains why change in one part makes unexpected and disproportionate change in another. The difference in institutional logics of the two sectors explains why there is an unusual feedback loop between the two and why there can be change in form. In a sense the two institutional types are not speaking the same language. Thinking in systems terms helps our
analysis because it forces us to think of the purpose or goal of the banking system. Sometimes this is targeted directly as a policy aim, sometimes not. But it will always change when the internal elements of the system change. The crucial point of this proposition is that there is an ongoing feedback loop between the two sets of institutions within the system which cannot be stopped because of the imperfect matching of institutional forms. In other words, the scope of action of banking regulation does not match the scope of action of banking activity, and therefore there can be no systemic equilibrium in banking.

**Fourth proposition (in answer to the research puzzle):** Banking regulation does not lead to bank stability because it is developed for political reasons not for financial (market) reasons.

This is a simple, simplistic, answer to the question but we can assert it confidently at the end of this argument. While banking regulation may have bank stability as its content, its cause is the political contestation outlined in the first proposition. For this reason it may not map well onto actual bank activity. The second and third propositions explain why this mismatch causes bank instability and the need for further regulation.

Taken together these logically deduced propositions provide a thesis that can be tested in this dissertation. In the next chapter we will flesh out the argumentation, relevance, and implications of this thesis according to the literature, move it towards the more concrete language of banking regulation, and explain the methodology for testing it.

**Value and limitations**

This dissertation therefore aims to build on the existing understanding of the causes and effects of banking regulation. This is important because there are currently many different ways of approaching the topic. None has precedence *per se* and all offer useful insights. Where there is a gap in understanding, or an area for development, is in tying these diverse
strands together. This will become more obvious as we mine the existing literature for insights and approaches to the question next chapter. In this sense this dissertation does not aim to create a new theory of banking regulation but to use existing theories together to understand more clearly the precise mechanisms that have led to change in banking regulation and in the banking market.

To speak more specifically, this dissertation argues that a good way of understanding the dynamic between banking and regulation is through the conceptual framework of Polanyi’s ‘double movement’ (Polanyi and Maclver 1957). In short, it argues that the double movement has broken down in banking, which explains financial instability. A primary aim of this dissertation therefore is bring Polanyi’s idea of the double movement up into the area of contemporary banking. Polanyi argued that the twentieth century saw the ‘great transformation’ away from classical liberalism into ‘embedded liberalism’ (Ruggie 1982) through the permitted growth of the market and society’s idiosyncratic reaction to control it. In practical terms this became the post-war welfare state. Polanyi also stressed that ‘fictitious commodities’ (land, labour, and capital) had no right to be treated through pure market mechanisms and the attempt to do so would lead to social crisis.

Evidently, the welfare state broke down in the 1970s, the dominant ideational paradigm shifted in the 1980s to ‘neoliberalism’ (that is, disembedded liberalism), and capital began to be treated not just as a ‘natural’ commodity but in some senses as the most pure commodity. All taken together these changes led to the dismantling of controls around banking, structurally and geographically, and the weakening of social protection. In Polanyi’s terms, there was a deliberate (‘planned’) boost to market growth and a reduction of society’s defense. This, as Polanyi argues theoretically, would lead to inequality, instability, and eventually a collapse of the system. This dissertation argues that this is exactly what we have seen in international banking markets. This argument will be
developed at length through the next chapter. The value of this argument is that it gives a clear, well-established theoretical framework for understanding the relationship between banking and regulation.

As it stands, of course, this is a very theoretical take on how banking has developed over the past forty years, so this dissertation will step-by-step chisel down from the Polanyian argument through other theories of institutional change and financial markets – especially Myrdal’s theory of cumulative causation and Minsky’s theory of financial instability (Myrdal 1956a; Minsky 2011) – to clarify certain causal relationships, to put the Polanyian argument into a wider financial context, and to apply it to real world cases. Thus this dissertation hopes also to add value by clarifying how Polanyi’s idea works causally in the contemporary environment.

The dissertation has its limitations, of course. A fundamental criticism of the dissertation could be that of the Cato Institute review of Fragile by design mentioned above: ‘everybody knows’ regulation is about vested interests’ gain rather than bank stability, so therefore there is no puzzle and the whole dissertation is a straw-man. It may be clear to the enlightened few proponents of free banking at the Institute, but the fact the review needed to state it, and the fact that Calomiris and Haber clearly disagree, suggests that this point is not a given. Whether it is taken to support or undermine the idea of stabilizing bank regulation, this dissertation will be a useful contribution to the ongoing debate. As it happens, this dissertation tends to support the review’s assertion, and furthermore thinks that Calomiris and Haber are probably not that far removed from it themselves.

An additional criticism might be that on one level the theoretical eclecticism of this dissertation might add confusion to our analysis of how the banking system works. By merging different theoretical streams together, it could be that a clear dynamic becomes
harder to discern. In that sense a new theory or a simple test of an established theory might be a more useful addition to the literature. There is also an argument to be made that the step this dissertation takes forward from the current state of the literature is of minor value in itself, that the usefulness of seeing banking regulation in light of Polanyi’s double movement is nugatory. Naturally the dissertation rejects that view, since having a clear, historical, established framework for understanding a phenomenon is the only way to being able to think about how to engage with it and what next steps might be made. Nevertheless, the criticism is worth considering.

On another level, the historical account of one single country could be criticized for not being representative of the wider world, or not generalizable to other situations. This is perhaps the most serious criticism of this dissertation’s research design. The idea would be that by looking not just at the UK’s development of its banking-regulatory system but also of a number of other countries’ would give confidence in the validity of the argument expounded. This is undoubtedly true, but it is hard to see where the limits lie. Having a comparison of three developed countries, might give more confidence, but one of five, or ten, might give more. There is no obligation, nor need, for a comparison of the entire population to test the usefulness of an idea. Indeed the increase of complexity and idiosyncrasy will tend to make any test or generalization more difficult, not less (Van Evera 2015). In that sense a single-country case study is appropriate since it holds other sources of variation as constant as possible to allow the importance of the variables under examination (in our case public and private financial institutions) to be as clear as possible.\footnote{A close argument for the methodology chosen comes at the end of chapter 2 in the research design section.}

A comparison across time within a single country therefore gives us comparative signal with less localizing noise. It is a form of Most Similar Systems Design, MSSD (Przeworski
and Teune 1970). Single-country cases are furthermore well-established, and offer a level of detail for analysis that would not be possible by casting the net wider.

As a further value from this analysis, stemming from the limitation above, we could in a sense see this UK set of case studies establishing a ‘prior’ (in an analogy to the Bayesian sense) which can then be tested, amended, amplified, or rejected by later looking at other countries’ banking market development. It establishes an area for further research, rather than closes one off. The main value and limitation of the dissertation are therefore really one and the same: it ties together many strands of thought and applies them to a single case. This allows us to see how the theory works in the real world, perhaps to amend the theory according to historical experience, but by increasing its accuracy it may reduce its generalizability. This tension is inevitable in all political science research and not, in itself, something to shy away from: it is how research progress is made (John Gerring 1999, 357-393). But it is necessary to be aware of the tension and try to resolve it where possible.

By looking at one country’s political and financial processes, this dissertation tries to understand the dynamics of that relationship. It is the assumption, and hope, of this dissertation that the answers from this investigation will be useful at a general theoretical, as well as geographically wider, level.

Structure of the dissertation

This dissertation is structured simply. Part 1 (chapters 1 and 2) develops the analytical framework; Part 2 (chapters 3-9) examines the historical record; Part 3 (chapter 10) explores the results and concludes.

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10 This, and other, avenues of further research will be discussed at greater length in the concluding chapter.
Chapter 1 lays out the area of discussion, explains its relevance and motivation, and introduces the reasoning behind this research agenda. Chapter 2 sees how previous scholars have answered this question, and builds an argument as to how their work can be put together. It ends by explaining the methodological research design of this thesis and how we can test this argument.

Part 2 moves into the historical section of the thesis. Chapter 3 is a short background chapter of UK banking up to 1970. This is necessary because banking in the UK at that point was almost unimaginably alien to how we currently think of it. Understanding this goes a long way to explaining why the process explained in the case studies ever began. Chapter 4 is the first case study proper. It explains why the Bank of England through its policy of 'Competition and Credit Control' (C&CC) tried to 'liberalize' banking, how it got it wrong, and how the Secondary Banking Crisis followed. This was the first UK systemic banking crisis in over a hundred years and gives us an archetype for our story of political loosening and wild markets. Chapter 5 (the second case study) picks up the story with the government’s reaction to the Secondary Banking Crisis, the first banking statute in UK history: the 1979 Banking Act. This for the first time tried to delineate in law what a bank was and what it could do, and to place state action (whether government or Bank of England) in finance into a coherent framework. Its immediate failure was clear with the Johnson Matthey Bankers (JMB) affair three years later, which showed that the exact wording and form of the law was flawed. These two chapters show a systemic and an individual bank failure at the domestic level.

Chapter 6 is a short excursus on Thatcher’s broad reforms of the City and the UK economy more widely. It explains the 1979 liberalization of exchange controls, ‘Big Bang’ and the Financial Services Act. These dramatically recreated UK finance in all its areas and can be seen as the green light that heralded a policy of globalization and competition in the UK
economy. Not for nothing was it called the 'City Revolution'. Nothing would be the same again. Chapter 7 (the third case study) looks at how the 1987 Banking Act responded to this changing City, and to the JMB failure which in many ways came at a useful time for a government looking to change banking law. This Act simplified the banking framework but complicated its regulation dramatically. This came to light with the failures of BCCI and Barings Bank in the 1990s, which once and for all destroyed the Bank of England's reputation for banking supervision, and showed up some of the problems of banking regulation in a globalized environment. Chapter 8 (the fourth and final case study) then takes the story on to the contemporary era: New Labour's 1997 attempts to rationalize the City with the FSA and Bank of England monetary independence so as to boost London's competitiveness in a global, growth environment. While this seemed to work during the 'Great Moderation' it catastrophically failed with the global financial crisis of 2007 and following. The chapter ends by looking at the three great UK bank failures of this crisis - Northern Rock, HBOS, and RBS – showing how the regulatory regime of 1997 enabled and encouraged the activities that would lead to these banks failures. Taken together chapters 7 and 8 show individual bank and systemic failure at the international level mediated through the domestic regulatory framework. Chapter 9 is a short epilogue to this history, explaining the post-crisis state response to finance, taking us up to the present day: the end of the Coalition government in 2015. Fortunately that end-point means we do not have to engage closely with the Brexit quagmire of 2016.

Part 3 concludes the dissertation and consists of one chapter (10). This chapter starts by examining the similarities and differences between the four cases. Along the different axes of political-economic and domestic-international, it sees what internal consistency there is for this idea of a financial-regulatory feedback loop. The second part of the chapter concludes the dissertation as a whole. It tests whether the historical record as here
elaborated supports the argument explained in part 1, highlights where it fails to add explanatory value, and proposes certain adjustments. It ends by reiterating the value of this dissertation for opening up a wider research agenda for financial regulation policy, both geographically and conceptually.
Chapter 2: Literature and Argument
Structure of the chapter

The relationship of the state to the market is the core concern of political economy. It is also the core issue of this dissertation. The puzzle is to work out why banking regulation has not led to banking stability. That is, how state institutions and market institutions interact over finance. This dissertation’s approach is to argue that regulation, in the sense it is used here, is the interface between state and market: it is the state in the market. The development and use of regulation therefore becomes the crucial element in our analysis. The institutional form regulation takes is vital. Understanding this will explain how the state and market operate together, and answer the question of banking regulation’s role in financial stability.

It will be necessary to have a broader understanding of how the state and market coexist in general, how this has changed and what the implications of this are. For this we turn to what has already been written by experts. There is no better place to start than with Polanyi, who explained the historical relationship between the two spheres of activity. We will then need to zoom in on the workings of the economy specifically and finance within it, since our basic understanding of financial theory will determine how we think banks are supposed to operate. This will broadly speaking be a discussion that starts with the neo-classical free-market consensus and runs through the different forms of heterodox economic and financial thought, most prominently Minsky’s financial instability theory.

From here we will need to look closely at how scholars have understood the role of banking regulation in finance, what it is supposed to do, and how it is supposed to work. This will conclude the first part of the literature review – consisting of the relationship between state and market, financial theory, and banking regulatory theory – and show us how banking regulation is seen as fitting into finance, the economy and society (in the sense of the state-market combination) more generally.
The second part will look at the process of the development of regulation itself: how it comes about. Since regulation is an institution, and operates among other institutions, we will need to understand how to analyze institutions, how institutions are formed, how they change, and how they interact. This discussion will be grounded in the historical institutionalist literature, but then move on to examine the role of ideas in institutional change. An idea is a complex concept, and there is a case to be made for their primacy before institutions in driving change in political economy. However, it is a basic assumption of this dissertation that for ideas to have an impact on the real world they need to be mediated through institutions. For that reason, this dissertation takes a primarily institutionalist approach to the question posed, seeing ideas as variables that effect how institutions act, rather than as operators in their own right. Institutions change due to ideas as well as due to the impact of their surroundings. This necessitates an understanding of the institutional environment of banking regulation, of the system in which it operates. Systems effects themselves alone can shift the way institutions, in our case bank regulation, works and can force it to change. All of this is a far cry from the clear separation of the state and market relationship we started the chapter with.

Following on from this literature review, therefore, we will be able to expound the argument of the dissertation. That systems effects operating through two different kinds of institutions – public and private – explain frequent change in banking regulation and explain why this does not manage to introduce stability into the banking system. The short answer for bank regulatory stability failure is ‘politics;’ that is, that regulation is made for political ends and aims, not primarily financial or economic efficiency reasons. But the reason for this ‘politics’ is institutional systems effects: changes in the market lead to changes in the institutional form of regulation through apparent regulatory failure, from
shifts in the interest-analysis of political actors (in a broad sense) who decide to change regulation, which leads to changes in the market.

For the systems reasons discussed in the first chapter, there is no stable equilibrium within the banking system, which explains why the statutory, almost legalistic, and precise form of banking regulation which has taken over in the last few decades cannot provide systemic stability, or an end to regulation and re-regulation. In moving into this form of regulation from the previous, less formal, kind, policy-makers changed the kind of system banks operated in (from public-institutional regulation to private-institutional regulation), and set in motion the current endless cycle of bank-regulatory change which forms the core area of investigation for this dissertation. The irony is that this change in regulatory institutional form precisely reverses what British policy-makers thought they were doing: moving regulation onto the statute-book made it more a private institution than when it was ‘informally’ administered through a ‘private’ Bank of England.

Having laid out the dissertation’s argument following the literature review, this chapter will end with an explanation of the methodology for testing this argument. This is, simply, a comparative case-study approach using qualitative data. This section will explain the choice of cases, the reason for a single-country approach, and the pedigree of this methodology: what it can and cannot do. This will then lead us into part 2 of the dissertation, the case studies and empirical core.

**Literature Part 1: The Political Economy of Banking**

*State and Economy*

The starting point for any examination of public life must be its separation into two spheres, the political and the economic. Adam Smith can be viewed as the first thinker to delineate them so clearly and treat them apart (Smith 2005). This eventually separated out into the
study of economics as we know it today. The fundamental assumption of this is that there exists, naturally, a separate sphere of public activity – the economy – which operates according to its own laws for its own purposes. Theoretically it will produce the best aggregate outcome if left to its own devices, independent of formal constraints – with the caveat that in some circumstances it may be appropriate to restrain and control this economy if there are external reasons as to why it cannot function purely on its own.\textsuperscript{11}

Through further thinkers such as Ricardo, Bentham and Mill, this developed into classical economics and the nineteenth century doctrine of laissez-faire (Mill 1884a; Bentham 1879; Ricardo 1891). There were always some moral – social – constraints on economic activity which placed it in a wider context, such as for example the banning of the slave trade and eventually laws against child labor. In that sense it is not correct to argue that the economy has always been seen as a completely separate sphere of activity. These were, however, extreme examples, activities which crossed the boundary of economic, political and social life (in the sense of the people’s wider culture, philosophy and norms). Nonetheless, it shows a point: the economy may, as per classical economics, be a separate area of activity which deserves to be as limited from politics as possible, but it remains in a wider, social context (or public context, for a less loaded term).

Keynes in his \textit{General Theory} (Keynes 2007), however, showed that while an economy may tend to an equilibrium, it will not necessarily of its own accord be a good equilibrium (i.e. in his terms one which reaches full employment). Therefore the state has a duty to shift this equilibrium point towards the good through deliberate policy (in his argument through demand management). This seems like a relatively minor or subtle adjustment to classical theory, but it fundamentally undermines it by saying that the economy, left on its own, will

\footnote{This is a very simple explanation of classical economics – a pastiche almost – but it serves to situate our discussion.}
not necessarily produce efficient outcomes and the state has a positive role in managing the economy.

Picking up this point, Polanyi takes it one step further, and shows how the state in fact itself created the market, and did not just have a role in improving it (Polanyi and MacIver 1957). In so doing he turned classical economics completely around. Far from the economy being a naturally existing part of public life which was gradually encroached upon by laws and legislation – which could only distort, and therefore weaken, its output and benefits, according to classical theory – Polanyi showed that the economy was constructed, as a discrete activity, by law and political decisions. That is, the state created the market through specific legislation which ‘disembedded’ it from society. As Polanyi put it: “Laissez-faire was planned; planning was not.” While Keynes made his point theoretically, and in the quantitative language of economics (in a sense infiltrating the discipline), Polanyi wrote a qualitative history showing exactly how the state had built up the market and through deliberate policies allowed it to grow in societal importance. With this foundation, Polanyi then argues that the growth of the market threatened other aspects of social life, and therefore drew forth a counter-action of demands for protection for aggregate welfare through political means. This is his ‘double movement’. Practically speaking, this mainly took the form of labor force protections, such as pensions, minimum wages, forms of insurance against illness and incapacity, so as to provide a defense against pure market mechanisms, which would on their own ‘commodify’ labor in the Marxian sense and threaten social wellbeing. Polanyi further explained that in his view labor, land, and capital were not real commodities since they were not created for the market, but rather existed

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12 ‘Society’ and its cognates is a complex term, as these frequent asides show, but here unless specifically stated otherwise, it simply means the area of public, cooperative life where individuals interact. It therefore combines, and in a sense contains, both political and economic spheres and is colored by the national culture or philosophy and morals.
(as different concepts) *ab initio*. Thus any attempt to commodify them into normal market products would lead to social tension and crisis. All three have been commodified since the 1970s. This dissertation's argument is precisely that the commodification of 'money' into capital in the neo-liberal era was not counter-acted by a reactive public movement to embed this new market in society, which has led to the financial crisis (and indeed would argue to the political and social crisis of 2016, though this goes beyond the scope of this dissertation).

This idea of softened capitalism grew over time, in all developed economies though more so in Europe, into the welfare state and the “compromise of embedded liberalism” in Ruggie's phrase (Ruggie 1982). That is, the 'liberalism' of a free economy was 'embedded' through quite strict legislation into the wider social context, thus formalizing Polanyi’s double movement and ensuring that market growth would be matched by growth in social protection. At this point we have reached a very different understanding of how the state and market interact than we began with. No longer are they two separate spheres that should be left apart as far as possible, but the idea is that the state created the market through deliberate policy choices and then has a right and interest in ensuring this market develops in socially-acceptable ways.

The question therefore becomes one of how the state can manage this market development and control. Intrinsic in the ideas presented above is the mutual reaction the state and market have. Change in part, or attempt to control the other, forces a change in the other which then rebounds upon the protagonist. This mutual reaction can be characterized in any number of ways. The first way is the Marxist use of Hegel’s dialectic (Marx 1975), which says that this reaction happens necessarily and antagonistically tending towards a good end. The mechanism is simple and is clear. It could be characterized as an ever decreasing pendulum swing. While in terms of Marxist economics his reasoning is very precise, as an
approach to change in society a lot remains to be said about the precise causes of this
dialectic, if indeed that oppositional binary perspective is the best way of looking at it (as
picked up by neo-Marxists such as, for example, Kane (Kane 1981)). Polanyi gives one
version of this dialectic but in a constructive rather than destructive sense: he sees the two
sides as driving changes to accommodate each other’s development, rather than attempting
to cancel each other out. For him the major difference is that state-led economic
liberalization was a deliberate policy while the social reaction to this was piece-meal and ad
hoc. This is perhaps true for when he was writing in 1944, though it would be hard to argue
that the European welfare states which embedded the post-War managed liberalism were
not thought through.

To understand Polanyi’s version of this double motion in political economic development,
therefore, we need some understanding of how change can build upon itself constructively
rather than in the Marxian destructive sense. This is where Myrdal comes in to the story
with his idea of ‘cumulative causation’ (Myrdal 1956b). This shows how domestic and
international socio-economic integration is mutually causative through a form of path
dependence. The development of one institution necessarily, in Myrdal’s view, creates a
harder boundary with different institutions which are then incentivized themselves to
develop along their own paths. Over time the two, or more, institutions grow themselves
precisely because of their relationship with the other institution. Jones (2003) argues that
taken with Polanyi’s insights, Myrdal’s cumulative causation results in the “reactive
diversity [of] distributive politics.” That is, how one institution will react to a change in its
environment (that is, in another institution with which it interacts in some way) depends on
sectional interest due to distributive issues. In other words, the reaction of the second
institution will depend on whether or not it stands to gain or not, and in what way, from the
initial institution’s change. The usefulness of this idea will become apparent in the second
part of this chapter as we trace out the causal mechanism between change in bank regulation, change in the banking market and back again.

Posner (1974) argues that this reaction of institutional change can be seen in two broad senses, either through 'public interest' or 'regulatory capture'. The first argues that economic regulation is developed in response to the public’s need for a correction of imperfect markets; the second that regulation is supplied due to demands from interest groups who use it to maximize their economic gains. While Posner himself generally, and cautiously, falls down in favor of a public interest understanding of regulation, many others have taken a different route, which, it must be said, fits better the Polanyi-Myrdal framework of interacting, competing institutions. These institutions are the financial market institutions we have been discussing: regulation, bank activity, and the regulatory and private organizations themselves. Zysman (1984) shows exactly how economic institutions play political roles, and thus how the type of financial system determines relations between government (the state) and industry. By explaining money as a means of control in society – on top of its economic functions as means of exchange, store of value and unit of account – he operationalizes the financial system as an independent variable to explain changes to national political economy. In a specific way, he shows how concrete financial institutions - such as the Bank of England - lobby directly on behalf of finance within government. As with Jones’s idea of Polanyi’s reactive diversity, this highlights again the idiosyncrasy and diversity of reaction between public and private institutional development. This is the beginning of 'Varieties of Capitalism' (VoC) literature.

Hall and Soskice (2001) expand on this insight substantially and really create VoC literature. They show how the form of a financial system determines the type of capitalism at work in a society: who benefits or who loses from economic growth. The political and economic institutions of a society provide actors with strategic capabilities to further their aims. By
splitting capitalism into two basic archetypes – Liberal Market Economies (LMEs) and Coordinated Market Economies (CMEs) – they argue that for historic and cultural reasons certain political economic institutions arise which then condition the development of the economy along liberal or consensual lines. This is path dependence, an argument which says that where you start off, in institutional terms, determines where you end up. The nature of the economic system that results then influences the form of social protection needed. They show that CMEs have greater social protections than LMEs because of the nature of the institutions in society (including ideational institutions). This explains the different varieties of capitalism in the world. Thus in VoC literature there is a direct link between the type of financial system and the social structure of a nation, including its distributional nature and welfare system. This literature initially neglects the international drivers of financial systems.

Following the 2007 financial crisis, the role of finance in society became an urgent issue. Hardie and Howarth (2013) update the basic Hall and Soskice VoC argument by adding in a third category: market-based banking. This focuses on changes to banks and banking itself to explain financial systems change (and failure). In their view market-based banking has the problems of market-based finance (LMEs) without the coordinating benefits of bank-finance (CMEs). The development of this third VoC-type due to liberalization and globalization then directly led to the systemic financial crisis. Because of the decline of bank ‘patient capital’, as they see it, banks were not able to act as buffers between industry and financial markets, leading to the persistent low growth of the previous seven years. They expand the political economy literature by looking at how banks actually function in modern western economies, but do not substantially alter the Hall and Soskice VoC model.

As we have seen, all these scholars delve down from the higher Polanyi-Myrdal level of seeing how the state and market interact in general terms and examine specific
relationships between state, market and finance. There is a triangular model based on an institutionalist approach. This sees finance as the intervening institutional arrangement between state and (real) economy. Strange (1998) turns this around and places the state, rather than finance, as the intervening institution. That is, while previous scholars saw finance as a catalyst or hindrance to economic development and political outcomes, she argues that politics is itself the intervener between finance and the economy. In other words, the state’s role is to arbitrate between finance and non-finance and so decide which sector of the economy gains. Hers is basically a simple economic model, and she argues that traditional political economic inquiry has been focused on the demand-side of credit (i.e. industry), while equally important is its supply (i.e. finance). Because accelerating technological change requires increasingly high capital investment, she argues that finance comes to dominate political economic systems. She makes the state a victim of the market economy; whichever side between finance and industry manages to dominate the state can then entrench its position. Because of the state’s need for finance and the increasing reliance of industry on capital she explains decreasing state power in the economy and the increasing dominance of finance to society.

Thus at this point from the broad institutional political economy literature we end up with an understanding of how state and market interact historically and in aggregate, through a form of cumulative causation which depends upon diverse institutional sectoral reactions to change in other institutions. We also have the beginnings of an understanding as to how finance fits into this mainly binary scheme between politics and economics. The relationship becomes triangular, and gradually finance, in later-stage capitalist economies, takes precedence in terms of state economic policy and functioning of the economy. So having developed a conception of how state and finance interact, we need to understand much more clearly what this ‘finance’ is. The characteristics of this half of the equation are
vital for understanding what drives the economic part of our relationship. We have a general theory of cumulative causation in a double movement of public institutions, and we have a view on how the political and economic institutions feed off each other. Now we need a theory of finance.

**Theories of Finance**

The most basic theory of finance stems directly from neoclassical economics. It argues that finance is the putting to use of surplus capital for productive purposes, while the capital owner gains a share of the returns. Finance is therefore market-enhancing, since it helps the economy use its total resources more efficiently as it moves productive capacity within the economy from where it is idle to where it is needed. It is based upon the triple assumptions of rational decision-making, utility maximizing and marginal decisions. The main, though in many ways different, proponents of this way of thinking are perhaps Hayek and Friedman (Friedman and Schwartz 2008; Hayek and Hamowy 2013). This neoclassical theory could be seen as having been weaponized into neoliberal political decisions through the 1980s and onwards, which took the theoretical assumptions of neoclassical economics and tried to use them to force political realities. For sure market failure features in this model of the economy, and requires government action, but this is to ‘correct’ problems in the market which are characterized as exogenous to the ‘normal’ or proper market functioning. The neoliberal understanding of finance sees the price mechanism as both incentive and information-carrier, so anything which interferes with correct competitive pricing – such as market restrictions or market power – will need ‘correction’. This is also an economic argument for financial conduct regulation (i.e. anti-fraud). Thus the ‘traditional’, consensus understanding of finance argues that disruption in the financial system comes from outside the system, either through economic effects incorrectly transmitted through the financial
system – for example from a policy-driven housing bubble – or directly through regulatory interference in the financial market.

For many, heterodox, thinkers this approach was not satisfactory and did not begin to explain the frequency and naturalness of financial instability. Minsky (2011) is the primary driver of this idea with his financial instability hypothesis. This argues, very simply, that financial crises are endogenous to the financial system. That is, they occur naturally in a cycle as economic growth leads to financial returns. With more competition, financial profits are squeezed, which results in actors seeking greater to use greater leverage to increase their returns. It does that but at the ‘cost’ of an increase of risk taken. This is fine so long as the market environment is benign but when an event occurs (now known as a ‘Minsky moment’) which challenges the growth assumption of investments, it causes an economic and financial downturn which is exacerbated by rational attempts by investors to minimize their losses. This results in firesales and the pass-through of losses down the investment chain. This prolongs and deepens the financial downturn until at some point either the government or central bank steps in (what Minsky calls ‘Big Bank’ and ‘Big Government’) to put an end to the turmoil, or the financial system simply fails. Eventually, as economic growth picks up again, the incentives to finance investment grow again and the cycle begins anew. Minsky delineates this cycle into three stages according to the leverage of risk from debt accumulation: hedge, speculative and Ponzi financing. Hedge finance is when a borrower can pay off both interest and principal from the return on investment, speculative only the interest can be paid off, and Ponzi when the assumption is that asset appreciation will allow the borrower to refinance. At each stage the fragility of borrowing increases, the accumulated (private) debt in the economy increases, and the stability of the system decreases. The inability of the Ponzi borrower to refinance for whatever reason (either an interest rate raise to stymie inflation or a stalling real economy) pops the bubble
and leads to a retraction of finance from the economy which exacerbates the economic downturn and further harms the financial sector.

This theory was given a boost by Kindleberger who essentially documented precisely this cycle from the 17th century onwards in *Manias, panics and crashes* (Kindleberger and Aliber 1978). His mechanism was more behavioral and could best be thought of in terms of Keynes’ ‘animal spirits’ but the cycle he shows is the same as Minsky’s, involving an excess of ‘spirit’ in market participants who act more and more recklessly in the pursuit of financial gain on the assumption of everlasting growth, which turns to panic after some bad news and leads to a crash. Reinhart and Rogoff (2009) in *This time is different* even more precisely pinpoint the similarities that recur before and during each financial crisis, highlighting the routine nature of this cycle so that they even make predictions on the back of it. Thus it would be fair to say that there is now a second consensus, by no means dominant in academic economist circles but growing in importance in policy spheres as well as in political science departments, that the Minsky-type financial cycle can well explain the inherent nature of the financial system: that is, it operates along an unstable cycle of growth and collapse. This has been shown theoretically and historically.

Where this theory does not offer much insight is in the realm of financial regulation or the unique role (if any) of banking specifically. Of course the role of regulation in the financial sector comes into their accounts, usually through its role in allowing more financial activity to be undertaken, also in its monetary decisions (post-Gold standard and Bretton Woods). It also has a crucial part to play in the mop-up operation in the downturn of the cycle in the form of central bank Lender of Last Resort (LOLR) functions and recapitalizing the sector once a systemic collapse has begun. Nevertheless, a theory which has financial growth and collapse as an endogenous cycle has no room for regulation to have a meaningful effect. At best it is epiphenomenal or might shift things on the margin: by definition “eight centuries
of financial folly” (Reinhart and Rogoff 2009) do not suggest that ‘one and a half centuries’ of regulatory change have had any meaningful, positive effect on financial stability. So on top of our understanding of the mutual causation of banking markets and political reaction, and the theory of the financial cycle itself, we need to understand how banking regulation can be fit into this framework.

**Approaches to Banking Regulation**

Naturally enough most ideas of banking regulation start from the needs of policy-makers. It is a practical issue that derives its importance from how it can affect the real-world operation of financial markets. Essentially, much of the literature looks at the Net Regulatory Burden on banks: how much do banks win or lose from the ‘tax’ and ‘subsidy’ that is regulation (Story and Walter 1997)? Any theory of banking regulation is an attempt to draw generalities out of specific actions. The critique of this is that it can lead to policy-action without a clear understanding of what the aims, costs and benefits of regulation are (Currie 2005; Allen and Carletti 2013). Indeed Allen and Carletti argue that is precisely the situation the world is in today with the Basel Accords which are based, according to them, on nothing more than historic bank practice and international bargaining. A first step, post-crisis, in dealing with this was the development of macroprudential regulation alongside microprudential to try to guarantee specifically systemic stability (Hanson, Kashyap, and Stein 2011). Nevertheless, the similarity in approaches is striking, and while it is welcome that the remit of prudential regulation has been expanded, the basic lack of theoretical underpinning remains (Duncan and Nolan 25 September 2015).

The starting point for understanding banking regulation therefore must be to develop a theoretical approach. This means we must think about how banks and state operate
together. Calomiris and Haber (2014) argue that banking is determined by government. Just as Polanyi argues at the high level that states constitute markets and react to them according to national diversity, so do Calomiris and Haber show that ‘the great game of bank bargains’ explains how banking develops in each country differently. In a sense, a country gets the banking system it deserves, according to its political institutions.

“The property rights system that structures banking has not evolved in response to some efficiency criterion in an anonymous ‘market’ for institutions. Rather it is the product of deals arranged and enforced within an existing set of political institutions and hammered out by coalitions of market participants and the group in control of the government.” (Calomiris and Haber 2014)

This grounds our discussion of bank regulation on the side of political institutions, giving them a causative effect for the creation of banks. Needless to say it is at odds with a neoclassical ‘free-banking’ approach to bank formation (cf. the free banking literature of e.g. White (1984)). If we allow that political institutions create banking institutions, it then becomes acceptable to think of how these political institutions then use, recreate, and alter banking institutions – for their own sake and to control ‘banks’ themselves (a form of banking institution). We thus have an idea of the endogeneity of banking regulation to the financial cycle: the ‘political side’ of the cycle is no longer an epiphenomenon, but is causative of the financial side. At the very least it should be, under Calomiris and Haber’s understanding of bank formation, causative of the Minskian financial cycle. But the use the financial cycle theorists above gave to forms of bank regulation such as central bank LOLR action shows that there is some scope for regulatory action within the financial cycle as well. Thus we must see political institutional reaction to banking activity as part of the financial cycle and not just a ‘primum mobile’ that sets it going.
McDonnell (2013) modeled how this financial-regulatory cycle could work, positing three potential ways regulation could respond to the financial cycle. He concludes that the effects of regulation are pro-cyclical and exaggerated. That is, that they swing wildly from under-regulation during the boom to over-regulation in the bust that only exacerbates the financial cycle. It is thus counter-productive; ideally regulation should have an anti-cyclical effect, that is, that it should dampen financial cycles. This point is also made briefly by Rajan (2009). McDonnell further notes, without really following it up, that regulation is multi-dimensional and likely to exist in a feed-back loop with financial activity.

Borio (2014) supports this idea of the endogeneity of regulation to financial activity. Although the main thrust of his argument is to include the financial cycle in standard business cycle models, one of his key conclusions is that the “length and amplitude of the financial cycle depends on policy regimes.” That is, we should expect financial or banking policy to alter financial activity.

Increasingly there is an academic consensus, though, that as White (2014) put it, “complex behavior need not necessarily be accompanied by still more complex regulation.” This is the key point of the Bank of England’s Andy Haldane’s ‘dog and frisbee’ speech in which he argues that simple heuristics can often be more effective than complex, mechanical ones for carrying out complex tasks - just as a dog is better at catching a frisbee than a robot is (Haldane 2012). For this reason, ‘intuitive’ regulation may be more effective (i.e. less pro-cyclical) than increasingly complex rules-based regulation. All these experts echo Minsky’s warning at the end of *Stabilizing an unstable economy* that “there is no possibility that we can ever set things right once and for all; instability, put to rest by one set of reforms will, after time, emerge in a new guise” (Minsky 2011). Thus while these scholars assert that the desirable effects of bank regulation should be anti-cyclical, they find that instead bank regulatory change itself is pro-cyclical. In other words, bank regulation fails to dampen the
financial cycle, so the regulation itself changes: this exacerbates the financial cycle. Put another way, financial activity drives change in bank regulation and bank regulation drives change in financial activity. We are back to an idea of cumulative causation between public and private institutions with idiosyncratic effects due to diverse institutional reactions depending on their historical paths.

We therefore need to bring in the differentiation between the logics of private and public institutions. Coase (1937) is the starting point for this. He explains why, in a market environment, firms exist. That is, why are the agents that partake in markets not themselves market-based (i.e. operating according to price signals) but are institutions that operate according to formalized patterns of behavior (based on laws, contracts and norms)? His answer is to do with transaction costs that arise when imperfect information makes market-based action more costly than firm or institutional action. This starts up the literature branching economic activity into institutional or market based. Posner (1974) and later Kane (1997) take up Coase’s moral argument between private and public (‘political’ in Posner’s language) action: “market behavior is normally motivated by fairly narrow consideration of self-interest... while [in political decisions an individual] can hardly avoid confronting the moral implications of his action and the moral code may constrain him from voting in that manner” (Posner, 10). That is, we should expect market-participants to try to maximize their self-interest (which normally will mean their profit), while political actors will try to promote what they understand to be the common good: even if within that criterion, naturally, we should expect a ‘common good’ which at least does not harm their private interest and perhaps also improves it. In Posner’s words (ibid.): “I am assuming that [politicians] take at least some of their monopoly profits in the form of satisfaction from imposing on the public their conception of the public interest (which might differ from the conception held by the electorate and from the desires of any particular interest group).”
Posner (p. 8) therefore sees political institutions as another type of firm, albeit one where “the costs of production [legislation and regulation] are extremely high and ... rise very sharply with increases in output. The reason is that legislative ‘production’ is a process of negotiation among a large group.”

We thus derive from Coase and Posner two separate concepts of private and public institutions, why they exist and how they work. Put simply, private institutions operate in the market to maximize their profits through lowering the transaction costs for this market activity; public institutions operate in the public, political sphere, have high transaction costs and attempt to maximize their interests which include political ‘morality’ or doing what is best for the political community and stakeholders (accepting that this is not externally-given, but depends on their ideas of self-interest, public interest and how the world works). We therefore now have a usable theory of the difference between private and public institutions. Our task is to see how they interact.

**Literature Part 2: Institutional change and the role of ideas**

To understand that, we need now a clearer way of how institutions respond in general, what they respond to, and how they interact. This will help us move the discussion on from the insights above onto understanding precisely how these different institutional types interact in financial markets, and how they respond to banking regulation.

An institution is “any constraint humans devise to shape their interactions” (North 1994) and acts as the “rules of the game” in any given society. They function by structuring incentives for human action and defining and limiting the set of choices for actors or other institutions (ibid.). What this means is that the existence of an institution produces a regularity in human behavior that can be relied on by other actors – individual or
institutional. As such they increase certainty in human interaction, allow patterns of
behavior to persist, and channel the way gains (and costs) from human interaction accrue to
the diverse actors. At the same time they limit the individual’s range of action. By definition
if an institution patterns your behavior, you have less than total freedom of action.
Institutions therefore offer benefits for social action but also impose individual constraints.
That is the trade-off.

The question becomes who gets to decide the trade-off structure and who has the option of
accepting it or seeking an alternative. As North (1994) explains, there exist many types of
institutions the basic division of which is between formal and informal institutions: that is,
those which have some legal force and conscious structuring versus those patterns which
arise naturally through human interaction and then persist through participants’ preference
and interest. The operational relationship between formal and informal institutions is
complex and non-generalizable. But it is important to note that they coexist and change in
one set does not necessarily lead to change in another: there can be tension between
competing institutions. One simple example of this would be a law change (formal
institution) without a corresponding change in social attitudes (informal institution) which
leads to non-compliance with the new law. The point is that while formal institutions can be
changed formally – that is through a political or at least public process – informal
institutions can change unintentionally, privately, or asymmetrically, merely through the
repeated outcome of individual choices. Who gets to decide the trade-offs of an institution is
in many cases unanswerable because nobody chooses, but everyone lives with its effects.
The only answer, if an institution threatens your welfare in some sense, is to try to change
the institution formally or informally, or to outcompete it with a ‘better’ or more fit
institution of your devising. As North explains it, institutional change comes from
entrepreneurs changing institutional behavior at the margins (1994). This is a material
interest-based approach: institutions change in order to alter the pay-off (or benefit more generally) that stake-holders gain from the institution.

This points to a key aspect of institutions: their persistence. We have seen that one function of institutions is to make some pattern of human behavior last, but the patterns themselves (the institutions) also persist. As per North’s idea of marginal change above, if change comes at the margin, then by definition the bulk remains the same. That is, institutions persist in the same form but grow in different directions. This is otherwise known as path-dependence, the idea of historical institutionalism which says that where you start off, institutionally speaking, will determine where you end up (Peters 1999; Hall and Taylor 1996). Or in other words: “history matters” (North 1994). The question then moves on to how history matters, and how this directional ‘growth’ takes place. As Goodin puts it: “the influence of the past on the present... is precisely what is central to institutionalism” (Goodin 1996). The starting point of this investigation comes with Veblen (1898) who argues that the evolutionary approach offers the clearest sense of development. Following biological theory this stresses the role of competition and fitting an environment for institutional longevity. Changes in the environment will therefore force institutions to adapt or fail.

Institutional change at that point, however, will begin to change its environment since by creating a ‘new’ institutional actor into the context it changes the relative competitive advantage of all the other actors. In this sense we end up with a form of Myrdal’s cumulative causation, or in other language Giddens’ ‘structuration’, which argues that individual (in our case institutional) action constitutes the structure around it, which then patterns further action (Giddens 1979). To break out of the simple circle of mutual causation, Krasner (1984) introduces the idea of ‘punctuated equilibria’ whereby there are multiple potential equilibria in any institutional setting (that is, balance of institutions) but due to some
external event or change the system jumps from one to another without incremental change in between. What this means is that we may observe institutions failing or being created that do not simply develop along historical paths. Innovation and design exist for institutions just as much as within them. Institutionalism tries to explain patterns of behavior and does so by looking at the patterns themselves. This matters because it allows us to explain public decisions and change (Peters 1999). But we also need a sense of how exactly the institution goes about its response to change and what it is that motivates institutional change itself. For this we turn to the constructivism literature. Institutionalism explains persistence, constructivism explains change.

*Ideas in action*

Kicking back off the argument that institutional change comes from purely interest-based reasons, Blyth (2002) adds ideas back into the mix. He argues that the way “things work” (that is institutions) depend on the way people think they work: “ideas matter.” Institutional change therefore becomes a function both of material interests (as above) and the ideas people hold of their interest (and more widely). Blyth uses this understanding, in his view, to move Polanyi’s theory on from “comparative statics” to one which can causally explain (endogenous) change in institutional order. Following on from Blyth, Matthijs (2012) argues that as well as ‘ideas mattering’ it is important how these ideas are narrated. Ideas do not just ‘exist’ but have themselves to be constructed and told in a way that gains consent. Then the idea can be mobilized through institutional forms: this is most apparent in times of economic crisis. Both authors stress that the interpretation of a crisis naturally leads to its response. Or, turned around, an actor can determine institutional change by influencing the narration of a ‘crisis’ moment (or critical juncture in less sharp language). “Ideas tell agents what to do” (Blyth 2002). The fundamental point is that different ideas lead to different policy responses, conditioned by their environment (Berman 1998).
Once an idea has been converted into action, however, its legacy is not yet done. In a certain sense similarly to institutional path dependence, Parsons (2003) uses the European experience of supranational integration to show how certain ideas preclude other ideas: that is, there is a virtuous or vicious circle in ideational development. The institutional legacy of previous ideas forces new actors to conform or at most alter existing institutions, in the vast majority of cases, rather than implement their own preferred, competing idea: “over time, the accumulation of [certain] initiatives recast[s] the framework for […] politics. Once-powerful alternative ideas [are] crowded out as active possibilities” (Parsons 2003).\(^{13}\) This leads to a narrowing of ideational possibilities over time which constrains future action.

As shared beliefs and experience between different actors in a system grow (even of differing kinds of actors or with differing aims and backgrounds), a consensus forms around the seemingly ‘successful’ idea. This translates naturally into a shared institutional form (McNamara 1998). This explains morphological attraction and similar outcomes from diverse actors. As Jabko (2006) explains, however, this ideational consensus can be used as a catch-all term that then allows an actor to promote its specific interest. In a way this is similar to Matthijs’s argument about control of narrative for determining crisis outcomes. Jabko shows how the use of an open-ended idea can become all things to all people, and thus allow the institution which embodies or promotes the idea to advance its own agenda, whatever it may be. Ideas therefore do not just form or alter institutions, as we saw before, but then even become an institution in their own right as they are used to corral support for political action.

\(^{13}\) NB the quotation has been edited to move it from the specific European issue to a general level, perhaps in a way that Parsons would repudiate: “the generality of the political world is an open question” (Ibid., 3).
The basic point of the constructivist literature is to assert that “economies [or political economic outcomes] might vary substantially for non-material reasons,” specifically because of collectively held ideas (Abdelal, Blyth, and Parsons 2015). This adds to the explanation of how institutions are formed and change through the reliance upon held ideas. Ideas, however, can also be used actively: if not as weapons then at least as tools. If Blyth, Parsons and McNamara essentially show the impact of prior-held beliefs on institutional outcomes, Matthijs and Jabko show how by constructing the belief, idea or narrative, actors can deliberately assert their advantage. This combines the concepts of material interest, ideas and institutions into a single framework that shows how ideas and interests structure institutions which then influences the success of the idea and understanding of the interest. They work in a loop, which is not necessarily reinforcing or conflictive.

So the mutually causative role of ideas and institutional change brings us to an understanding of how banking regulation can fit into the political economic framework we explored at the start of this literature review. By examining both private and public banking institutions in the same financial-regulatory system we see that change in one institution forces a requisite change in the other. These institutions change through changing interests, ideas and aims. As they do so, the nature of the banking system changes, whether planned or not. It is to the specifics of banking change that we have to move to as we build up our argument about the nature of bank instability in the UK.

Part 2. Argument: Banking regulation as the state in the market

Above we separated institutions into two kinds: market and state. This follows Polanyi. The literature suggests we should put them together in a financial-regulatory cycle. This
intuition needs fleshing out. Minsky shows how market development is cyclical on its own. Regulation is superfluous to his theoretical argument. Yet, Calomiris and Haber show that ‘the market’ is itself a product of ongoing regulation. The task is to reconcile these positions.

The Polanyian separation of market and state gives us a lead: these are different sets of institutions that operate according to different logics in the same environment. We can therefore examine how they have changed over time. In fact it becomes quite clear that actually Polanyi was right even seventy years ago and talking more generally than on financial regulation: as one side moves the other has to react, either against the initial move or along with it. This gives an answer.

The argument of this dissertation therefore is that we have seen an increasing use of market institutions to implement state policies. That is, government policy becomes implemented by private institutions instead of public ones. This is another way of explaining (neo-) liberalism. Regulation has over time come to be seen as a market institution - relying on price and information in efficient markets – rather than a state one, relying on power and control. The state in this view enables market regulation but does not provide it. The more regulation is quantified in terms of market processes, the more it becomes a market institution and not a political one – whatever form the constraint takes (e.g. whether enforceable by law or by revoking a license). What matters is that the institution operates according to private logic and not public. The public sector may have imposed and enforce the institution, but the institution itself runs through private action along private mechanisms (i.e. profit-maximizing and through market-information). In concrete British terms, this is the shift from a ‘reputational’ form of bank regulation by the Bank of England (until the 1970s) based on whether a bank was considered ‘responsible’ or not, to a ‘prudential’ form which relied on impersonal, market metrics (how much capital a bank held).
Conceptually along Polanyi’s lines, there was a growth in financial markets, the first ‘move’, but the ‘marketization’ of state policy left it without a corresponding state ‘second move’ to counterbalance it, because the state role had been taken over by markets. This explains an unbalanced, non-covered double move, which leads to financial, economic, political and social instability. Finance became disembedded. The reason for this initial move need not be exogenous or ideas-based. Just as with the idea of using market institutions to provide state policy (stability), institutions need to change to fulfil their purpose in a changing environment. Thus institutional interests made it worthwhile for the state side (central bank and government) to use market institutions (the protected, historic institutions which are ‘banks’, looking to profit maximize) because it seemed to offer what they wanted: financial and economic growth and an increase in public revenues. After policy changed this way, then the idea of marketization (liberalization) grew as a way of explaining it. There were increasing returns to continuing this policy direction: it was path dependent. However small or un-controversial the initial policy change, it relied on further changes to function properly.

As institutions developed in the market, there was a need for further liberalization to make sense of the first step: on its own it would fail so then it would need more liberalization. This led also to a liberalization of government institutions according to the same logic: control/influence institutions can only distort price/information environments. If you commit to the latter then the former can only be problematic. This changed the framework of the state-market compact, because suddenly, due to its own internal logic, one side of the scales collapsed into the other. The banking system ended up with only market institutions. Eventually (in 1997) even the Bank of England was removed from the public sector. Again,

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14 This is also the logic of European integration/functionalism and spill-over effect.
this is best understood through the concept of path dependence, increasing returns, and institutional persistence.

The point is to look at the two institution types – market and state – and see how they interact and change over time. The thesis is that there has been a marketization of state institutions (they have changed their internal logic) for institutional reasons: i.e. to better achieve their aims. This led to a problem because there was no counterbalance to market forces – a single movement – because without a restraining force in the financial-regulatory cycle each step egged-on and bolstered a further step. There was a liberalizing arms race, with growing increasing returns. This only ended when it spun out of control into the catastrophe of the financial crisis.

**Bringing the state back into the market**

The gap the literature identified is precisely how regulation and activity interact in financial markets (banking specifically). The literature also suggested that one way to get a grip on the question is through the concept of institutions operating in systems.

This dissertation takes these literatures and uses them to put the state back in to financial markets through regulation. Initially the state used state institutions but then it came to use market institutions for state ends. As soon as it made one foray into this area, path dependence and the logic of increasing returns meant it had to continue along this line, to the point where even state institutions themselves became marketized (in normal language this would be ‘privatized’). This changed the wider framework from one of more or less of embedded liberalism following Polanyi’s double movement (with the state restraining markets) to one of a single movement or neo-liberalism (the market restraining the state). State and market moved in the same liberalizing direction, leading each other on. This explains the unidirection of financial development (ever more integration and geographic
widening) and also its increasing volatility because there was increasingly little dampening of the market from state control.

How states and markets interact over time changes and specifically in how state/market institutions provide public policy aims. The lack of balance later on had empirically negative outcomes (the financial crisis). The fundamental mechanism is that as public and private institutions (regulation and market activity) have to coexist as elements within the same banking system, they are in a sense in competition with each other. Put simply, because the banking system is designed to be a private (market-based) system, private institutions manage to outcompete public ones. That is, institutions based on price-signals and utility-maximization outcompete those using legal authority and the formal hierarchical process. This is because they are more adapted to their environment, and as such can respond to it more efficiently: rapidly, successfully and with less disruption. This is another way of looking at the obvious truth that it takes longer to introduce a bank regulation than it does to innovate a new form of banking activity that might require regulation. Thus public institutions in banking (regulation) either die out (stop being effective and get dropped) or they have to adapt and become like private institutions.

This is the dynamic that we have seen since the 1970s in the UK. Banking regulation has become more like a form of private institution than a form of state control. Ironically it was the move to using statutory law which made this happen, since it created the 'level playing field', legalistic approach to banking regulation (which has ended up in modern prudential regulation) that encouraged control of the banking sector through private institutional means - prudential requirements on banks – rather than through the political processes of dominance and hierarchy as it had been under ad hoc, arbitrary use of 'the governor's eyebrows'. The reasons for this change were competition and the method of the change was as above: both a change in the ideas of actors as to what bank regulation 'should' be and
how government ought to act in markets, as well as a change in interest from the main actors. The private banks, faced with a new environment of non-bank and international finance, decided they would maximize their profits better through a ‘liberalized’ banking market than through the previous cartelized one. Idea change and interest change led to institutions change, which led to a change in the ‘elements, interconnections and function’ of the financial system: from delivering stable, though relatively tight, financing to domestic industry to one producing very large returns for global bank shareholders, management, and for the government's tax-receipts. This is not to make a cynical argument. There was not necessarily the intention of turning the functioning of the system from one to the other, but this was the outcome of the changes that were made for other reasons.

One other outcome was the greater propensity for financial system collapse from the shift in the institutional logic of bank regulation (from public to private). If we accept that the ‘state-in-market’ (i.e. regulation) increasingly just became another part of the market, then it becomes clear why regulation has not been able to control market activity: that is, why regulation cannot provide stability. Through its evolution into private institutional form, regulation has been degraded as a means of state control and become a means of market competition. This is essentially the same point as Calomiris and Haber make about bank formation, but looking at it not at the beginning of the story but through the financial cycle. This, then, also brings regulation into Minsky’s financial cycle: as market participants increase their debt and risk levels in the upside of the cycle, there is a simultaneous reduction of external control on financial activity (regulation). This explains the increasing mania (in Kindleberger’s language) and how normal economic growth turns into a bubble. It also explains how, after the Minsky moment, regulation is at that stage ineffective – or proves to have been ineffective – to restrain the crash, just as it was unable to restrain the boom. Accepting banking as a state-licensed form of market activity (Calomiris and Haber),
we can show through this argument of private-public institutional competition how bank regulation fits into and encourages Minsky’s financial cycle endogenously – as part of a financial-regulatory cycle. This new cycle then explains the ‘single movement’ that banking and finance has taken in western economies over the past forty years and how banking has been disembedded from the economy and from society.

In short, this dissertation argues that the answer to the puzzle why bank regulation does not provide bank stability is simply that: banking regulation is no longer a form of regulation but is now a form of banking. This has happened because of the victory of private institutions over public ones in banking markets, which came historically with the opening up of the UK banking market to the wider world. One initial move, through the systemic institutional mechanisms described above, led to a self-reinforcing loop. In so doing it fundamentally changed the function and functioning of the banking system: from providing stable finance (in the public interest) to providing unstable returns (in the private interest). The state lost its role in controlling banking and became just another element within banking.

**Part 3. Methodology: Testing the argument**

This is not a shocking argument – though hopefully it advances our understanding of the role of banking regulation - but it does require backing up through more than logic, insights and literature. This is where the next part of the dissertation comes in, the empirical test. This will give us confidence in the internal validity of the argument presented above, and allow us to make judgements later on its external validity. To test this argument we will use the qualitative comparative method.
The comparative method

Comparison is the key method with which to check theories. Theory is the basis of political science as it is studied today. Through the influence of the scientific method, theory drives all political enquiry. The universally-accepted and rational logic of scientific enquiry requires a researcher to pose a hypothesis, to test it against some empirical observations and then to confirm, reject or refine the original theory. In a perfect system this process would be replicable by anyone else at any time (King, Keohane, and Verba 2006).

We therefore need a way to test these theories. Obviously in the social sciences it is not possible to perform an experiment to test a theory, and only rarely do we have suitable data points or statistics to perform an analysis. By far the most common method to test a hypothesis is the comparative one. This sees in world history a series of ‘natural experiments’ which can be compared to each other to test a theory. Clearly, however, because this could otherwise be a nebulous exercise, a rigorous methodology has been developed to make sure that researchers are comparing in a valid manner.

JS Mill first outlined the comparative method still in use today (Mill 1884b). His basic approach is what is at the core of any comparative experiment: maximize experimental variance, minimize error variance, control for external variance. That is, try to find an experiment (or for us, set of cases) where the difference in outcome is as wide as possible (so as to see the clear effects of your experiment), where there is as little room for error as possible (to know that your results are valid), and where there is as little outside influence on the experiment as possible (to know that your results really come from what you are investigating and not for some other reason).

He explained that the logic of comparison suggests two ways of comparing cases: the method of difference and the method of agreement. In the method of difference, you find
two cases which are close to identical in all things except for the one variable you want to examine. Thus you can ‘control’ for external variables and in theory isolate the effect you are interested in. The method of agreement is the inverse: the two cases are exactly different in every possible way except in the one aspect you are interested in. Thus you can check to see what is so special about this one thing which means that two completely separate cases share a commonality: you can eliminate the irrelevant variables. Przeworski and Teune (1970) updated this approach with their Most Similar Systems Design (MSSD) and Most Different Systems Design (MDSD). Rather confusingly, MSSD corresponds with Mill’s method of difference, while MDSD corresponds with the method of agreement. Both Mill and Przeworski and Teune use the comparative method to make up for the lack of experimental opportunities with political theory. Thus they use comparison to control: the two methods or system designs at heart try either to hold everything else equal, or to hold stable the one variable of interest. Through this they hope to identify a causality. At heart, as Sartori (1991) put it, the comparative method should be used as ‘checking’ to see if a theory holds. Through this comparison in time and place, we can determine internal and external validity of a theory – internal being the fact that a theory holds, external that it holds in other cases too: that it is generalizable.

There are problems with this approach. Is it, in fact, possible to treat the areas of interest of political science (essentially, global history), as a vast ‘natural experiment’? Not to sound too obvious, to be able to use the comparative method, you need things to compare. These must be of a similar order to avoid Sartori’s incommensurability problem. Because of this, comparative politics tends to use concepts as variables. This leads to endless definitional and categorization problems. In an attempt to create more rigor in comparative politics, researchers end up as semanticists, wielding the pen to cut out unwanted elements. The trouble with this is that it can easily lead one to define a concept in terms of what one is
hoping to find, or to beg the question that one is asking. Or, in order to avoid too
prescriptive a question, it can lead one to expand the definition of a concept to cover more
and more cases: conceptual stretching. While this widens the extension of a concept
(making it more externally valid through covering more cases), it reduces the ‘intension’ of
it, meaning that it becomes less and less useful as a concept. It tells us less. Compared to
other scientific methods, comparison is relatively unrigorous, unempirical and prone to
human biases. It is, nevertheless, really the only method we have.\textsuperscript{15}

One significant problem is selection on the dependent variable, as explained by Geddes
(1990). This is when you select your cases according to the effect you are seeking to
investigate. There are numerous problems with this, not least of which is selection bias. This
means that you are, even unconsciously, selecting cases which will support your thesis, but
ignoring those that do not, thus creating a false positive. This can lead to circular reasoning,
and invalidate your results. Selecting on the dependent variable can also lead to the base-
rate fallacy, a cognitive bias whereby people ignore the likelihood of something happening
to the whole population, and only focus on the sample they have drawn. There are some
ways around this problem of selecting on the dependent variable, the main one of which
goes back to the logic of the scientific method: falsifiability. Always look for cases that could
disprove your theory, and try to find as many varying cases as possible. As per Mill:
maximize experimental variance.

The qualitative comparative method is not perfect, but for political economic research is
about the best there is. It is also a well-established approach to take, and one we shall take
here. It allows us to draw mid-level generalizable trends out of specific and detailed cases,
and to test them according to criteria of both parsimony and explanatory value. To use this

\textsuperscript{15} Perhaps a certain similarity with Churchill’s view of democracy suggests itself.
method, therefore, we have to compare cases. This requires us to build our cases. Process tracing therefore is the appropriate methodological approach (Waldner 2012). This allows us to see what happened, form a historical understanding of change – especially of critical junctures – and evaluate the most plausible explanations of what happened. The key to process tracing is to move consistently through the narrative following the development of the relevant actors and trends across time and, crucially, through critical junctures (Capoccia and Kelemen 2007). This allows you to create an analyzable narrative.

*Case design: single country, separate times*

Key therefore to this dissertation is the choice of cases. The fundamental decision is to look at a single country, the UK. This was for a number of reasons. In terms of research design, focusing on one country allows us to offer a ‘natural experiment’ as close as possible to Most Similar Systems Design (MSSD) (Przeworski and Teune 1970). That is, everything else remains as equal as possible – in the political-economic framework – allowing us to focus our interest in what matters and what changes: changing financial regulation and activity. A comparative approach, of course, has to compare. To form comparisons, therefore, we split the one country into a number of historical cases (below). That is, unity of place, diversity of time.

Once we have decided on a single country case, it is easy to choose the UK. It is a financially-dominated country, with the longest ongoing history of finance in the world, it has long had a world financial center (if not always the single most dominant one), with stable institutions and public organizations in the market place. It has had a relatively stable, central independent currency, a strong central bank, and a highly stable political-economic system which exhibits great longevity, continuity and traditions. Change comes slowly historically. This political system is a centralized parliamentary democracy, which allows us to see clear changes in policy from changes in power, government, public opinion and track
it through to specific outcomes. The UK is also an open economy, international, that takes part in the two main trends of the era – globalization and Europeanization. These two trends are 'modeled' in this argument as exogenous. It can be argued that they should not be, but since our focus is on the domestic financial-regulatory cycle this is justifiable. It can always be opened up in future research.

There is also the benefit that the UK, along with the USA, is by far the most studied national economy, especially in terms of finance. Bagehot (1873) is perhaps the first theorist of bank regulation in the world, and his explanation of how a central bank should act in a crisis remains the core of LOLR policy today as well as the foundation of thinking about how best to control banking markets. His answer, as he admits, was contingent on the form of banking as it had developed in London up to that point and was not intended as a general rule for ‘good banking’: it was more a handbook for the Bank of England. Nonetheless, he kick-started thinking about finance as a discrete area of the economy requiring specific regulation (of whatever form) and his influence can be seen right through the neoliberal consensus of correcting market failures, as well as the heterodox approach of people like Minsky. The Minskian ‘Big Bank’ which is how he incorporates regulation into his financial cycle (the post-crash mop-up) is really just a generalization of Bagehot’s principles for the Bank of England. This strand of UK financial regulatory theory continues to inform the wider approach to banking regulatory theory (Llewellyn 1999; Markus K Brunnermeier, Andrew Crockett, Charles A Goodhart, Avinash Persaud, Hyun Song Shin 2009)

Having decided on the UK, we then have to choose on the individual cases. This is actually quite easy; they chose themselves. The fundamental case design is to look at a change in public policy and then trace how this effects the market. Each case has these two parts, of equal value. We start in 1970 for the simple reason that that is when financial instability began in the UK (Reinhart and Rogoff 2009). For 150 years there had not been a bank run or
financial crisis in the UK, not during the two world wars, the great depression, nor from changes in the international monetary system and the UK’s shift in role within it. This is quite remarkable. Then from 1973 onwards all that changed, and there was essentially some form of bank crisis every decade. By coincidence, therefore, essentially each of our cases will follow a decade though that was not the aim. The aim and design was to see a change in financial policy/regulation and trace it through to the market effects, from the 1970 singularity onwards.

**Case 1 (1970-1975)** therefore starts in 1970 with the development of the Bank of England’s ‘Competition and Credit Control’ policy (C&CC). This can and will be shown to start the whole process of liberalization and instability. It led to the 1973-75 financial crisis (the secondary banking crisis). These two halves form the first case study. From then on each case is a continuation of this story, process tracing onwards.

**Case 2 (1979 – 1982)** starts with the attempt to clean up the mess from the first case study, and starts with the first UK bank statute, of 1979. This failed because it was poorly thought through and led to a bank collapse in the early 1980s, directly because of the operation of this new law.

After a short, separate excursus on Thatcher’s wider reforms (1979-1986), **case 3 (1987-1995)** looks at policy change from the second bank law, the 1987 Act, and then shows how this too failed to get to grips with the environment around it: from the boost to bank liberalization from Thatcher’s City policy to the growing internationalism of banking. This framework was not robust enough.

**Case 4 (1997-2009)** explains how New Labour doubled down on the Thatcherite approach and took it to its logical conclusion: the most market-based ‘neo-liberal’ form of financial regulation in the world or for the UK. This seemed successful and was praised. But it was
done for by the financial crisis. It did not cause this crisis per se, but it channeled it into the UK and led to its drastic effects.

Buttressed by an initial background chapter to explain UK banking prior to C&CC (1945-1970), the Thatcherite excursus mentioned above, and a short epilogue detailing the Coalition Government’s policy response to the financial crisis (2010-2015), these four case studies form the empirical core of the dissertation, reflecting the historical record from 1945-2015 or more specifically 1970-2010.

Research methods: three steps

Lastly, the conduct of research. Each chapter and case has been research along two lines: archival and media. This has naturally been supplemented by secondary literature – analytical and historical. It is very doubtful that any of this research individually would count as a major new finding – the ground is well worn, with a field crowded by many former practitioners and policy-makers who naturally have a far greater knowledge of what happened than any external researcher. Nor was the intention to gain any 'scoop’. The evidence was gathered to understand what happened, why, and to confirm or contradict what has been written before. In short, this is a work of political economic analysis using the historical record to test our argument, rather than a history for its own sake.

The three research strands – archival, media, literature – explain the reasons for a given policy change, internally (archive), and then show how they, externally, effected the market (media, along with some company records). The literature contributes to these explanations and gives other analyses for consideration. The point of all this is to give confidence and detail to the story told from a number of angles. Since we are interested in interactions, it makes sense that we look at a number of different approaches. They are all unashamedly qualitative.
On to the test

Therefore the literature uncovers a gap, points us to a question and builds us an answer. It helps us develop our argument with internal logical validity that would seem to fit the state of the literature. This now has to be tested according to the historical record to see if our argument corresponds with reality. Part 3 of the dissertation will evaluate the argument advanced according to the evidence given.

We have argued that banking instability comes from politics: time to lift the rock of that murky world and see what scuttles out.
Part 2: Historical Case Studies
Introduction

British finance was very strange in the years between 1945 and 1970. The City was a divided, bifurcated, restricted entity which operated along semi-planned lines. This was not due so much to Labour’s move towards socialism in 1945 but due to the characteristics of British finance and the way it had grown up and responded to Britain’s changing role in the world over the first half of the twentieth century. To understand the City in this period – which forms the backdrop to our first case – we need to focus on three things: the nationalization of the Bank of England; the growth of the offshore market; and the domestic cartelized banking system.

The nationalization of the Bank of England

The nationalization of the Bank of England was a significant step in the evolution of banking regulation in the UK. It marked the beginning of overt political control over the banking sector. This would eventually end up in statutory regulation (see second case study). For all that this control remained indirect – inasmuch as government interests were channeled to the City through the Bank of England – and was largely a formalization of the Bank’s practice that had built up between the wars, the Bank’s nationalization removed its awkward, hybrid status as a public-private institution. There would no more be any doubt who the Bank was working for, or for what ends. Nonetheless, the reasons for the Bank’s nationalization, why it took the form it did, and what implications this had for the City are worth exploring.

The nationalization of the Bank of England was a key part of the first Labour government’s plans to restructure the British economy along socialist lines, i.e. planning (Kynaston 1994).

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16 Previously the Bank was a private company, governed by specific legislation, but for over a century it had had some public roles in guaranteeing financial stability.
The Bank was to ensure that British finance was placed in the service of Britain’s wider industrial needs; crucially this for the first time means Britain as the United Kingdom, rather than Britain the Empire. The method hit upon for achieving nationalization was to have the Treasury buy up all the Bank stock, and then change its governance so that the governor, deputy governor, and board members were all appointed by the crown (i.e. the government) (Bank of England Act 1946). The Bank and Treasury civil servants, however, managed to persuade the Government when it was drafting its law that these needs would best be served by allowing the Bank something along the lines of operational independence, while maintaining policy control (Hall 1999). This was accepted by Labour not just because the Bank seemed to be cooperating with its overall aim, but also because the Labour party was aware that it had poor contacts with the City and in general was not well prepared to take a direct stance on how banking should be run in a day-to-day sense. The Bank’s success at avoiding political domination was widely accepted at the time: for example the FT argued that apart from its ownership, nothing had changed at the Bank after independence (Kynaston 1994). While this may have been immediately true – and it is certainly true that socialism did not crush finance at this time, or turn the Bank into its own creature – there is no doubt that the Treasury and Government now used their supremacy over the Bank to involve themselves closely in its business.

Unsurprisingly, since politicians had just given themselves undefined power over a major part of the British economy, there was no attempt at this period to introduce any statutory regulation of the banking sector. Having given themselves discretion over finance, politicians were not willing to then bind themselves with laws. Even when defining a ‘bank’ in this Act, it merely says that a bank is whoever the Treasury considers a bank (Bank of England Act, 1946, paragraph 4 part 6). Therefore the change to bank regulation from the nationalization of the Bank of England is at once conceptually profound yet practically
underwhelming. While accepting the principle – that had in practice already been accepted under Governor Montagu Norman between the wars – of public control of the Bank, it then worked to ‘guide’ this control along the lines it already followed (Ogden 1988). If we are to look at the significance of this Act for the future development of banking regulation we must look at the shift of responsibility that went along with nationalization. Politicians were now responsible for the financial sector in a way they never had been before. As non-professionals (on the whole) in finance it is not surprising that they did not always manage to reconcile the difficulties inherent in financial activity, especially when this was bound up with the changing role of Sterling at the end of empire, and Britain’s industrial needs as a welfare state. It is probably not correct to say that the Bank of England ‘hollowed out’ financial reform in this era through co-opting its own nationalization, but more that the changes that came about from its nationalization – political sensitivity to finance and the impossibility of achieving monetary, financial, industrial, and welfare objectives all at the same time – took a while to feed through into the British banking system. This finally happened with the privately-led change to the role of the City of London from the 1950s-1970s (see below).

The Treasury was in all formal ways the master of the Bank (Bank of England Act 1946). However, the Bank was the recognized intermediary between the government and banking sector (Moran 1984). This allowed it considerable freedom of action. This action was dependent on its ability to guarantee calm in financial markets, and financial conditions favorable to the government’s economic priorities. These two aims could be at odds with each other. In these circumstances, the Bank had little choice but to do the best it could in remonstrating with the Treasury and attempt to finesse the banking sector through guidance and discretion (e.g. clarifications of ceiling lendings and requesting justifications of why they were not met: BoE 3A8/10, 9.1.1971). This meant the Bank had to manage two
sets of relationships (with government and market) which were, at times, directly contradictory in what they wanted. Simultaneously, the Bank wanted to carve out an area of independent action away from the government since it had never really accepted its nationalization in an operational sense (Kynaston 1994). Later, as we shall see, the policy of Competition and Credit Control (C&CC) would be the Bank’s last attempt to assert its authority outside of the governmental control. Its failure led to the cycle of reform and reaction which this dissertation uncovers.

The basic philosophy of the Bank of England at this time was broadly pro-market: “the authorities... must adapt their techniques to banking practice, rather than vice versa” (BoE 3A8/6, 16.4.1970). It saw banking as a fundamentally private concern which should not be unduly interfered with by the state. The Bank was clear internally and to the Treasury that it had to work with the banks, and not impose on them. Regulation had to be a voluntary measure from the banks (Zawadzki 1981). A meeting of a Bank-Treasury working group (the Douglas Allen group) in 1969 explicitly made the point that the effectiveness of control depended less on the control mechanism itself than on cooperation between the banking system and the authorities (BoE 6A74/3, 24.12.1969). This was as much to do with the Bank’s philosophy of banking as it was with worries that the banking sector would not implement the Bank’s changes if they were not consulted on them. The Bank’s traditional, unlegislated authority was a weakness for compulsion while a strength for flexibility.

Nationalization changed the role of the Bank of England in the City, but it was not immediately apparent. Only as the Bank tried to use its ‘autonomous action’ in the market did it become clear that a stronger legal position was needed. This is the story of the first case study.
Cartelized banking

The most significant aspect of the post-war banking landscape was the clearing bank ‘Cartel’. The Cartel was formed in response to the First World War (Moran 1984, 173-189). Just like all forms of UK banking before 1946, it was a private, informal arrangement that was not considered part of the state’s duty to oversee. The Bank of England was itself still private at this time, and permitted the Cartel to form, although it was not involved in the decision. As the inter-war years progressed into the post-Second World War era (when the Bank was nationalized), the Cartel remained a fixed feature of the banking landscape. At no point was it legislated or demanded by the authorities – Bank or Treasury – but it was accepted.

The Cartel’s salient feature was the lack of price competition between its five members. It worked because the Cartel agreed to pay their depositors a flat 2% less than whatever rate they were receiving from the Bank of England’s Bank Rate (the main form of interest rate at the time). They paid no interest on a current account, and lent out to industry in a fixed ratio to Bank rate plus a given amount per industry. This was intended to encourage lending to certain ‘priority’ industries – e.g. nationalized industries or local authorities. There was therefore some considerable political influence in bank lending activities: both in the aggregate amount and in where the lending ended up. This system gave banks guaranteed profits on their deposits, without having to engage in any competition or innovation. This made banking very stable, but reduced the British banking sector’s competitiveness and acted as a net welfare loss to the economy as a whole (Griffiths 1972). On the institutional level, the very stability of this system made it easier for unregulated, non-clearing banks to outcompete the big clearing banks in innovative financial markets, such as in secondary lending and in the domestic and international money markets. So far as there was competition between clearing banks, it centered on the reach of their branching systems.
and the services they could offer (Ibid., 3). The UK therefore found itself in the early 1970s in the odd situation of being over-banked, but under-lent (Capie 2010); (BoE A38/5 28.10.1969).

As noted above, the clearing banks were requested to abide by certain lending ceilings – at the aggregate level – and to prioritise certain industries in their lending. This ‘quantitative guidance’ became more technical and precise after 1965 (Moran 1984, 173-189) and covered more types of institutions (Wilson 1980, 69-70). In April 1967 the Bank attempted to undo ceilings to encourage lending and because the measures had been intended to be temporary. Without other forms of control the Bank resorted to re-imposing ceilings in November of that year (Reid 1982). As the Wilson (1980) committee noted:

“So long as the clearing banks were responsible for the great majority of banking business it was sufficient in seeking to control bank credit to place controls on them alone. But as the other banks, both British and foreign, grew in importance the control system became increasingly ineffective and manifestly unfair to the clearing banks.” (p. 70)

This led to a change of attitude among the authorities towards the end of the 1960s as to how credit should be controlled in the economy as a whole, and what form clearing banks should have specifically. This attitudinal change would eventually turn into a change in policy with C&CC.

The final major point about the clearing bank Cartel and its relation to the Bank of England and the wider banking system has to do with class. Put simply, the Bank of England considered only the clearing banks to be ‘proper banks’ (BoE submission to Wilson, 71), the rest of the banking sector were lesser banks, which could not be as well trusted, and who therefore deserved less protection from the Bank. To be fair to the Bank this point of view
was widespread (at least outside the secondary banking sector, cf. (Gordon 1993)), even after the secondary banking crisis had shown how interlinked the various forms of banking were (cf. Blanden, *Financial Times*, 29.11.1975). As one, admittedly fairly embittered, secondary banker put it:

“[T]he high street banks, the clearers, were not only geographically prejudiced and sectarian, but also extremely snobbish and high-minded towards these lowest-rung echelons, helping them with advances because it was good business, but like dog owners looking the other way, pretending that they were not a party to fouling the system.” (Gordon 1993)

Beyond a certain kind of snobbery and conservative mentality, however, this attitude had major ramifications for prudential regulation and the treatment of the various forms of bank. Because the Bank considered the clearing banks 'real banks' and everything else a lesser form of bank, it explicitly trusted them to regulate themselves, and only looked at them with a cursory glance. Until half-way through the secondary banking crisis, in 1974, the Bank of England only had fifteen people working in a supervisory capacity in the Discount Office (that is, the market-facing department of the Bank). This despite the fact that the number of banks to be supervised had increased to more than 300 banks by 1973 (Wilson, 290). There persisted the idea that the Big Five banks were somehow more worthy than other banks. Because of this, the Bank of England did not believe it had jurisdiction over the secondary banks because they were 'not really banks' and relied on the informal application of its 'ladder of status' to control the development of the banking system (Gordon 1993). The clearing and merchant banks stood at the top of this ladder and were known to the Bank as 'listed' or 'statistical' banks, because they sent information to the Bank for statistical purposes.
The clearing banks before C&CC, therefore, were a stable cartel under official lending restraints, that regulated itself with the acceptance if not blessing of the authorities, but which was losing ground to less 'respectable' but more competitive unregulated and unrecognized rivals: the secondary banks.

Secondary banking grew up because of the restrictions on cartelized banks (Wilson, 19). There was no barrier to entry into banking at this time – by the Bank of England's deliberate choice to encourage new entries and innovation – but it was hard work to be accepted by the Bank as a ‘bank’ and therefore allowed access to its discount window and lender of last resort facilities. There was a considerable commercial advantage to being considered a ‘bank proper’, since it conveyed respectability and stability (Gordon 1993). Regulation of banking at this time was conducted along a ‘status ladder’, which was a purely informal way for the Bank’s internal records of classifying institutions. It revolved around the various disparate laws that private institutions used to gain recognition as ‘banks’ and thus claim respectability and demand protections. None of these was a 'banking law' and none was intended to imply any form of banking status on an institution. At this point still, as Jim Keogh, the Principal of the Bank’s Discount Office put it: “In London a bank is a bank if I consider it one” (quoted in Kynaston 2000, 442).

As the report of the Wilson committee explained (393), there was no legal definition of a bank until 1979. The original Bank of England Act 1946 defines a banker (not a bank) as "any such person carrying on a banking undertaking as may be declared by order of the Treasury to be a banker" (Section 4 (6)) – which is an unashamedly circular definition. Nonetheless, various laws created different lists of which institutions at any time were considered ‘banks’ for various activities. The first is the 1947 Exchange Controls Act which set up a list of banks authorized by the Treasury and the Bank to engage in foreign exchange: these became known as ‘authorised banks’. The next was the 1948 Companies
Act which told the Board of Trade (before it became the Department for Trade and Industry) and the Bank to set up a list of banks which would be given certain reserve privileges under its section 8: hence these were known as ‘recognised’ or ‘Section 8’ banks. The Protection of Depositors Act 1963 restricted companies from advertising for deposits unless they had been exempted by the Board of Trade (because they were legitimate ‘banks’): these became known as ‘exempted banks’ (Gordon 1993).

Most institutions in the late 1960s and early 1970s called themselves banks on the basis of Section 123 of the 1967 Companies Act. This allowed them not to call themselves ‘moneylenders’ (a term that was stigmatized), but still to collect money owed according to the Moneylenders Acts 1900-1927 since they would be considered “bona fide in the business of banking” (Companies Act 1967, Section 123) if they had a certificate. As Gordon (1993) put it (pp. 169-70): “The sole purpose of the certificate was to allow the possessor of that certificate to enforce a debt. It had no other purpose. That was the theory and that was how the Bank saw it.” Entrepreneurs, however, saw it as a way of not being called moneylenders and therefore being considered a bank. These were the so-called ‘Section 123 banks’. The crucial part of this, however, is that it was the Board of Trade (predecessor of the Department of Trade and Industry) which granted these Section 123 certificates, not the Bank of England which had only a consultative role. The Bank therefore did not consider itself bound to recognize the Section 123 banks as ‘banks’ and therefore did not supervise them. This dilemma was put clearly in an internal Bank memo on Credit Control of 17 February 1970 (BoE 2A70/4):

“Section 123 gives us no power to stop people engaging in banking business; anyone in this country can set up a banking institution, but having done so they are in peril of the Moneylenders Act... We would have closer control if we were to bring all these institutions within our reporting system and recognize them as "statistical
banks”. We have been reluctant to do so because it would imply a recognition and perhaps a responsibility for their soundness which we are not ready or equipped to assume. It would also mean that they would have better access to uncontrolled interbank funds; this would significantly assist their expansion, although we would be fixing ceilings for them, and does not appear to be in anyone’s interest.”

In other words, the system of licensing a bank was, in the run up to the secondary banking crisis, a mess. But it was a mess with attractions to the authorities. It allowed them to approve or not of a bank’s activities at any step along the way as it attempted to ascend the status ladder and be included on more lists. It also allowed the Bank of England to deny responsibility it did not want (because of its traditional concern for ‘proper’ banks, and not wanting to be sullied dealing with these new banks) for large tracts of the wider banking sector. This meant that the secondary, fringe banking sector was essentially unlicensed and unregulated, even as it competed in sterling and euro-money markets with protected banks. The major problem was that secondary lending was unsecured and the Bank did not act as a lender of last resort as it did in the primary banking market (Wilson, 504). This made it fertile ground for a crisis should market sentiment change.

One final aspect of secondary banking that should be spelled out is that it was largely focused on the property and personal markets: to a great extent on secondary mortgages and hire purchase facilities, as well as personal overdrafts and loans. This is partly because the large banks had a history of providing credit to industry and government, meaning they had long-standing and deep relationships which it would be hard for the new banks to move into, but also because, inversely, they actively disliked loaning for ‘unproductive’ reasons and had to contend with the aggregate lending levels they had been set by the Bank. While this new source of customers gave the secondary banks space to grow, it was riskier than investing in industry. All these reasons meant that secondary banks had to be more
aggressive than the large, old banks to establish themselves, but in so doing they had to take more risks, financially penetrate the economy more than it was used to, and also antagonize the Bank of England and other banks through their aggressive and ‘ungentlemanly’ competition ([Slater 1977], 199 – admittedly a self-serving account). This is the background for C&CC in terms of the secondary banking market, and it explains why one of the policy’s barely acknowledged aims was to kill off the secondary sector (BoE submission to Wilson).

Other financial actors

To finish off this look at the financial organizations of the pre-C&CC era we need just to add in a few more players.

- **Merchant banks** were the forerunners of today’s investment banks. In some ways the term ‘bank’ is a simple misnomer, since they rarely used their own money or customers’ deposits and mainly arranged financial transactions on behalf of clients’ business strategies: they were agents and brokers. They had an international outlook and were well-established in the City of London. They represented London’s deep advantage over other financial centers in terms of the skills and experience it could offer financial markets, and is one of the reasons London continued to attract banking business even as the UK economy faltered (Moran 1984).

- **Building societies**, at the other end of the scale, were geographically curtailed mutual societies for the origination of mortgages for its members. Just like the clearing banks, they had official limits on the rates they could pay and demand, and they refused to offer second mortgages – hence why the secondary banks could pick up the business. They were regulated separately from the banking system, in which they only commercially took part through the money-markets, through the Building Societies Act 1962 (Wilson). Gordon (1993) also makes the point that the way
building societies decided who got mortgages was itself class-based to see whether you were ‘worthy’ or not, and the effect of this was social and geographic stagnation, since it disincentivized innovation. It was “class warfare instead of economic warfare” (pp. 44-46).

- **Discount Houses** dominated the London discount market, which was the only wholesale money market in London until the development of the euromarkets. This was a highly controlled market, which was used by the authorities to influence the whole banking system and therefore the credit flow in the wider economy (Moran 1984, 173-189).

- **Finance Houses** extended consumer credit and were a middle category between banks proper and the secondary banks: institutions which “performed many banking functions without laying claim to traditional banking status” (Moran 1984). Over time they became more accepted and acceptable and in 1961 the Bank attempted to bring them within its remit for giving ‘requests’ to the market, and to restrict their competition with the clearing banks (Ibid., 21). This shows how early in the 1960s the system of credit control and bank recognition began to break down from the Bank’s point of view, well before the 1970s collapse of Bretton Woods, oil price hikes, and stagflation that are often given as reasons for the Bank’s loss of control over the traditional banking market.

All in all, British domestic banking was a highly constrained, fragmented industry which cannot really be considered one single banking system or market. It was rather a series of more or less connected markets that were all dominated and regulated by different government departments and the Bank of England.
Eurodollars, offshore markets and the role of Sterling

On top of the peculiar domestic banking scene, the City was integrated idiosyncratically into global financial markets. In the aftermath of the Second World War and with the decline of the empire as an economic unit, the City of London had to find a new way to generate profits. Initially the government and Bank of England were concerned with monetary issues: how to ensure that Sterling remained a world reserve currency. Strange (1971) argues that this obsession was partly due to prestige issues, partly due to a misunderstanding as to the benefits of how reserve currencies (and other types of currency) work, and partly due to regulatory and financial inertia. The outcome of this insistence on Sterling was Britain’s poor economic performance through the 1960s and into the 1970s, which left it lagging its European partners. In order to achieve their monetary aims, the British government and Bank of England had to vary interest rates wildly over the period – unleashing inflation – had to control fiscal spending to rein back inflation, and maintain various forms of capital controls (Schenk 1998, 221-238). Financial regulation became increasingly baroque (Sheppard 2013).

Faced with this uncertain geopolitical environment and monetary turmoil, the private banks in London had to find new ways of generating a profit. More specifically after 1957, when it was forbidden for third parties to use Sterling to finance foreign trade (ibid., p. 3), British banks started to use dollars instead. This started the Eurodollar market in London, which over time grew to become one of the City’s major functions. These Eurodollar trades were encouraged and sanctioned by the Bank of England – and the government broadly – as it helped the UK’s balance of payments position, and did not seem to threaten domestic financial stability because they were by definition being carried out on behalf of third parties outside of Sterling. There was a strong break between the City’s new international role as a center for the euromarket and its place in the domestic economy (Kynaston 1994).
Key to London’s successful bid to become the main center for the euromarket was its regulatory environment (Kynaston 1994; Strange 1971; Schenk 1998, 221-238). The Bank of England encouraged the market’s development, the government argued in Parliament that it was in the national interest not to discourage these markets (Kynaston 1994), and the close relationship between regulators (at the Bank) and the private banks ensured that there was no heavy-handed response to the financial innovation. In a way, Sterling was lost but the UK took up Eurodollars instead. On top of this regulatory reason for the industry’s development was London’s long experience as a financial capital: put simply, there was the knowledge and skills base already present in London to capitalize on this financial innovation given the accommodating regulatory framework. This City shift in priorities, however, had profound implications: London was no longer a center of finance because of the large amounts of capital it was exporting, as under the Empire. Nor was it important because it held a special place in (and could essentially draw rents on) the international monetary structure (be it gold standard or the Overseas Sterling Area). London now became a capital of financial services; that is of intermediating capital flows from third parties and earning fees from this (Pringle 1973). This has so far proven successful as an adaptive strategy to maintain the importance and the profitability of the City of London, but it has significant consequences. To a large extent the British government and regulators have to accommodate international trends in finance so as to maintain London’s position: it is much harder to regulate, and almost impossible to regulate unilaterally. The price of becoming a financial services hub was the loss of regulatory sovereignty to market forces. Initially in the 1960s and 1970s this was mitigated to an extent by exchange controls and the structural break between international and domestic capital flows. This break was to be removed in the 1970s, which directly led to the ‘triumph’ of undifferentiated international capital from
the 1980s onwards and which led directly to the financial crisis of 2007 and its regulatory response.

This was of course not clear at the time, but the development of London as an international financial center through the 1960s is what led directly to the introduction and continued extension of statutory bank regulation in the UK, the need for increased international regulatory coordination, and the detrimental politicization of bank regulation. In the 1960s and 1970s, exchange controls and limitations on capital flows meant that British domestic finance could be protected prudentially from international capital flows. As this became increasingly costly to private banks who felt they were missing out on potential profit, and as it seemed to be an instance of the unreformed, ‘clubby’, and parochial City which anyway became unnecessary in the era of statutory regulation, there was little resistance to Thatcher’s ultimate decision to liberalize finance in the 1980s. This is a direct outcome of the politicization of regulation that came about from the Act of 1946.

**Banking on the eve of change**

The dominant ideology in Bank and Treasury before the mid-1970s was a form of ‘political Keynesianism’. That is, demand management by the public sector to ensure full employment, steady but positive inflation, with monetary policy as a sort of adjunct to fiscal policy (Kynaston 1994). Largely this was a form of conventional politics, where tradition counted for more than theory, and stability counted for more than rational clarity. This consensus thinking extended across both parties (e.g. with ‘Butskellism’) and encouraged fiscal expansion in good times and bad. As far as monetary policy was concerned, it was axiomatic that something as important to the general welfare should be under the democratic control of politicians, and the first whiff of monetarist thinking only came into public discourse with Goodhart and Crockett’s article in the *Bank of England Quarterly Bulletin* of 1970: ‘The importance of money’ (Capie 2010).
The primary characteristics of financial thought at this time were its pragmatism, informality, and conventionalism. It relied on close social links for dissemination of viewpoints and took place largely out of the public eye. It was a last bastion of ‘esoteric’ politics in Moran’s words (Moran 1984, 173-189), or even as Kynaston (1994) put it in the title to his final volume of the history of the City of London: a “club” (also cf. (Moran 2003)). The great benefit of this system was its stability – no banking crisis since the nineteenth-century despite world-convulsing upheavals – and its ability to respond flexibly to changing circumstances.

Nevertheless, it was messy, incoherent, arbitrary in whom it favored, inimical to scaling up, and had left the national economy under-lent and over-inflated. It did not have any intellectual rationale, but was the summation of ad hoc measures designed for emergency purposes and specific needs (especially the Cartel arrangement and lending ceilings, not to mention the various forms of banking ‘license’). Industry complained it did not have access to cheap enough capital to increase productivity against its foreign rivals (but cf. Wilson 1980, 129 for a rebuttal to this as the primary cause of poor UK productivity), while households could not get credit for personal consumption or mortgages. This system relied for any form of legitimacy on two pillars: tradition and output (that is, credit provision and financial stability). With the entrance of a large number of diverse new ‘banks’ into the system over the 1960s - leading to increasingly stiff and one-sided competition for the favored clearing banks – the argument to tradition looked ever weaker. This left credit and stability as the two legitimizing features of the system. C&CC was an attempt to ease credit conditions in the economy while maintaining stability. It succeeded in the first aim but to the drastic cost of the second. This loss of legitimacy would have profound implications for banking regulation in the UK. This is the story of the next chapter and first case study.
Introduction

In 1971 the Bank of England introduced the most radical policy change to UK bank regulation since the end of the Second World War (Capie 2010). In 1973 the United Kingdom experienced its first banking crisis since the nineteenth century (Reinhart and Rogoff 2009). The timing of these two events was not a coincidence. The policy of Competition and Credit Control (C&CC) directly created the conditions for the secondary banking crisis of 1973-1975. How this happened is the subject of this chapter.

Overview

C&CC was an attempt to rationalize the increasingly complex system of bank control in the City of London; to replace it with a uniform, market-based way of managing the level of credit expansion in the economy. It rested on two pillars: firstly, the abolition of the clearing bank ‘Cartel’ and the removal of credit ceilings on these banks. This was the ‘competition’ side of the policy. It was designed to allow the clearing banks to compete amongst themselves and with the secondary or ‘fringe’ banks. This was intended to stimulate innovation, lower prices for end-consumers and also lead the more respectable clearing banks to out-compete the less-respectable (i.e. less respected by the Bank) secondary banks. This was supposed to make the banking sector both innovative and manageable. The second pillar of the policy was ‘credit control’. That is, fearing unconstrained credit expansion in the economy if they removed administrative control through ceilings, the Bank decided to keep control no longer through administrative means (‘guidance’ on ceilings) but through market means with the price mechanism (a reform of the interest-rate system). This was to be achieved by the Bank’s new ability to call Special Deposits which would directly reduce the amount of bank credit in the economy.
Due to deliberately expansionary fiscal policy at the time of implementation, however (the “Barber Boom”), the government’s unwillingness to accept higher interest rates when the credit conditions demanded it, and the sudden releasing of long repressed credit in the economy, C&CC unleashed a boom of credit. Low manufacturing and industrial demand for the new flood of credit meant that credit expansion was channeled into a property and personal finance boom, which encouraged unregulated secondary banks to lend in ever-riskier ways. Through a network of commercial and ownership relations the clearing banks also took part in this property-led credit boom. Soon UK financial markets had all the characteristics of a speculative mania. Eventually the government was forced to change its interest rate system again and raised them, due to worries over sterling’s strength. Weak industrial sentiment due to labor unrest and international circumstances led to an emergency mini-budget in December 1973 with a sudden U-turn of government policy towards tax rises and government spending cuts. This abruptly burst the speculative bubble and led to the failure of property companies, their associated secondary banks - and, the authorities feared, potentially to the clearing banks as well.

The first failures of fringe banks took place in December 1973. This forced the Bank of England to organize a clearing-bank 'lifeboat' to rescue the secondary sector on a bank-by-bank basis. The City assumed this was a simple liquidity crisis and so the method chosen to solve it was by recycling money which had fled to the safety of the clearing banks back into the secondary banking sector. The Bank also introduced an immediate reform in its method of supervising the banking sector. The lifeboat system was in daily and evolving operation until 1975 when its lending commitments peaked at a cost of £1.29 billion. The lifeboat operation stopped the fringe banking crisis becoming a crisis of the entire banking system. More importantly, its success managed to isolate financial risk from the wider economy, and Britain’s domestic financial risk from its international commitments. The crisis ended, and
policy-makers moved on to deciding how to reform bank supervision and regulation in a fundamental sense. This culminated in the 1979 Banking Act, which is the subject of the next case study.

The C&CC and secondary banking crisis fiasco is the first modern example of a policy-induced banking crisis in the UK. It highlights the major tensions in the relationship between the political and economic dimensions of banking: the conflicting aims of diverse actors, poor information flows between sectors and within organizations, the perverse consequences of deliberate action, and the persistence of historical modes of thought, ideas, and institutions. This story shows how a public-sector decision forced and enabled change in the private financial sector, and how this change went out of control, ending up threatening the original objectives of the new policy. This led to a political realization that the policy had failed, the banking sector required massive assistance, and that a new way would have to be found to regulate finance. It is the story of a perfect feedback-loop from political action through market reaction to renewed political action. It is a story of opportunism, crisis, and failure. It serves as a relatively isolated example (in time and geography) that gives us a way in to analyzing the relationship between the political and economic dimensions of banking.

Chapter plan

The next section (2) will lay out the historical and intellectual background to the C&CC policy; following this, section 3 will explain how the final shape of this policy was reached. Section 4 will then show how the market reacted to its liberation from control, and how credit expansion turned into an uncontrollable boom. The next section (5) will trace how this boom turned into a full-blown banking bust and how, mercifully, the same Bank of England that had induced this crisis managed to form a ‘lifeboat’ which stopped the crisis from spreading beyond the unregulated banking sector. Section 6 will conclude by
interpreting this episode, and will set up the next case study: the 1979 introduction of statutory banking regulation in the UK, which was a direct consequence of the secondary banking crisis, yet which itself led to problems of bank regulation in the early 1980s.

**The background to the policy of C&CC**

To understand what the Bank of England was trying to do with C&CC, we need to understand what environment it was working in. Needless to say, it was far from the current, broadly open model of banking that has grown up in advanced economies over the past 25 years. The primary characteristic of the pre-1970s banking world was fragmentation of function with concentration of actors. That is, there were strict constraints on what a given institution could do, depending on what business it was considered to be in by the authorities; but within the confines of its business activities there was little competition and little formal regulation. It has been characterized as ‘club government’ (Moran 2003).

This world gradually began to change with the development of euro-currency markets in London in the 1960s, which introduced competitive, unregulated foreign banks to the City of London and encouraged the development of the (unregulated) secondary banking sector. Clearing banks were constrained in the amount they could lend by ‘requests’ (in fact with the force of orders) by the Bank of England not to exceed certain ceilings. This was because the Bank was worried about the inflationary effects of unrestrained bank lending. As the financial sector expanded during the 1960s these ceilings were constantly tested by the clearing banks, but they abided by the Bank’s repeated requests to try to keep below them. This meant that the cartelized clearing banks had no incentive to find new customers or to increase their advances to current clients, since it would make it harder for them to stay...
within their lending limits. This placed the Cartel banks at a competitive disadvantage to the secondary or ‘fringe’ banking sector which had no qualms in aggressively seeking out new business and ignoring the Bank of England's ‘informal’ requests.

The Bank, despite its nationalization in 1946, had no statutory power to compel banks to follow its orders. What authority it had came from its reputation and a tradition of deference by the major banks. This was as much a social form of control as a political one. The Bank's major tool of influence was its ability to recognize banks as banks, and to place them on a ‘status ladder’ of recognition. This was informal within the Bank, and relied on the Bank's position as lender of last resort for its effect. Essentially, as a bank became more established in the private banking system - by engaging in more banking activities with established counter-parties for a significant amount of time - it would be more protected by the Bank of England in the event of a crisis, individual or systemic. In return it was expected to act ‘responsibly’, that is, in line with the Bank’s recommendations and non-aggressively to its peer institutions.

This ‘club’ system of control broke down with the introduction of a greater number of diverse actors. The irony is that innovation and new-entries to the market were encouraged by the Bank of England to increase London’s competitiveness internationally. That is one reason why it welcomed the private initiative to develop the euro-currency market in the 1960s (Kynaston 1994). It is a feature of ‘esoteric politics’ (Moran 1986) that it relies on consensus, trust and informality: qualities which are easier to build in a homogenous group. It is therefore natural that as foreign banks and new bank-like institutions entered the market, the Bank's informal style of ‘club government’ would come under strain. This took the form of increasingly ignored requests, the difficulty of encouraging competition, innovation and bank lending without stoking inflation, and frequent complaints from the ‘respected’ and ‘approved’ clearing banks that they were operating at an unfair
disadvantage compared to the less-respected new 'banks' precisely because of their close ties to the Bank of England.

In short, private financial expansion had left the Bank’s traditional form of control increasingly weak, and was reducing its ability to fulfil its monetary aims. Its control methods had no guiding rationale other than convention and had started to penalize the very institutions they were intended to support. It was this system that the Bank decided to reform in 1971 with C&CC.

The Bank, therefore, started the 1970s against a backdrop of increasingly confused banking supervision, the weakening of traditional ways of controlling the banking and credit system, and decreasing institutional legitimacy. How it individually developed the policy of C&CC as a response to this situation, and how this all went wrong, are the topics of the next sections.

*Getting to C&CC and its implementation*

The banking system had grown up piece by piece and by 1970 was in a chaotic state with limited competition and innovation. The Bank of England found itself guaranteeing the stability of a banking system most of whose institutions it did not recognize as banks. Many of these banks did not instinctively recognize the authority of the Bank of England to issue them with prudential requirements. The policy of Competition and Credit Control was designed to deal with all three aspects: the sectional-cartelized banking system, the Bank of England’s ability to control credit conditions, and the growth of undesirable secondary lenders. The policy itself, however, came almost out of nowhere. For a number of years its key features were rejected as impractical and undesirable. Then suddenly, in 1971, it gained traction and was used to bundle together a range of the Bank’s different objectives into one policy development. The Bank managed to push this policy through with almost no input
from the Treasury (its nominal master), and used it to assert its initiative in the banking sector away from the government. It was the single most radical change in Bank policy, and the structure of the UK banking system, to date. It marks the last gasp of the Bank as an independent, unlegislated public authority. Its failure caused a final end to the centuries-old practice of informal and market-led banking regulation.

*Ideas leading up to C&CC*

By September 1969 there was despair in the Bank of England at the seeming impossibility of removing ceilings (BoE 3A8/5, 19.9.1969). It seemed that strict lending controls would become permanent, which would be distortionary, was never intended, and made the Bank look weak. The powers that the Bank of England Act 1946 was “supposed to provide” appeared illusory. This led to the impetus for a new approach. A document outlining (and entitled) a “new deal for the banks” (BoE 3A8/5, 30.9.1969) was drafted that tried to put some order in the growing debate of what should be done. It was far from a radical paper. It started by arguing that nothing should be done until after the current squeeze on credit, thought that the problems of moving away from ceilings and the Cartel were great, and was dismayed that no-one had thought to ask the Cartel members how they would act in a post-cartel world. It was the early days of thinking up a new scheme for the banking system.

Nonetheless, for the first time it introduced a number of the themes that would eventually end up as C&CC, not least questioning the need for credit control at all and advocating the “interest rate solution” whereby money would be rationed by price not quantity. This was especially appreciated because it relied theoretically on a free market that worked through price information, rather than administrative controls, in line with the Bank’s academic (if not practical) thinking. The major problem – other than implementation – was political. It conflicted with the government’s preference to be able to direct lending to priority areas. Nevertheless, for all that it was a Bank idea, this form of credit creation would rely entirely
on instruments controlled by the Treasury at that time: fiscal policy and interest rate policy. The ideas in this report were rejected by the Bank (BoE 3A8/5, 10.10.1969) as not dealing with what was seen as the fundamental reason for the failure of ceilings which was the problem of unused bank overdraft facilities by businesses. It was also considered that a plan this fundamental should go through the political Budget process, rather than just be thought up by the Bank on its own (Ibid., 16.10.1969). Nonetheless, this paper, along with a more quantitative redraft, marks the beginning of C&CC policy.

The proposal formed the basis of discussions at the ‘Douglas Allen Working Party’, a joint Bank-Treasury working group that was set up in October 1969 (BoE 3A8/5., 28.10.1969). As plans to deal with the unsatisfactory design of the banking system became more fundamental, the locus of authority for them shifted to the Treasury (and hence the government) away from the apolitical Bank. To the surprise of all, there was significant agreement on what needed to be done, though this was partly because no-one intended to change very much in the short term (Ibid. 29.10.1969). The interim report of the group in March 1970 called for the eventual removal of ceilings (after the upcoming Budget) and their replacement by a range of different, specific controls and guidance. It also poured cold water on the idea that calling for special deposits as a way of restricting credit in the economy would work, saying that their main value was in the “announcement effect” (BoE 6A74/3, 11.3.1970). This warning was in the end ignored. It also warned that forecasts for the next financial year did not suggest that it was a good time to ease lending restraints: something that proved to be prescient.

The Bank itself did not think that this report suggested much change from the current system: any form of guidance to the clearing banks would have to be so specific as to be ceilings under a new name, while the ‘other’ banks were unused to collective penalties for not abiding by lending restraints and so would have to be set individual targets by the Bank.
which would also in effect form a ceiling by another name (BoE 3A8/6, 13.3.1970). The Douglas Allen working party decided to wind down and turn itself more into an academic think-tank on monetary policy (BoE 3A8/6, 16.4.1970), while the solutions it had proposed did not greatly alter the unsatisfactory status quo. The Bank was aware that the Cartel, as a private agreement between the clearing banks, might of its own accord break down, and the Bank would have to act quickly in those circumstances (BoE 3A8/6, 4.5.1970): in which case it would need to consider the unity of the banking system and the relationships between the various short-term markets (BoE 3A8/6, 20.4.1970).

The Bank found itself back in the driving seat for reform of the banking system, and had developed an appetite for something more radical than before. At this point, in June 1970, the Bank found itself with a new Conservative government keen on competition and free-markets, and desperate for growth. The Bank had the desire and opportunity for change: the only question now was how far it would go and in what direction. Its answer was to tie a number of its different aims up into one policy and drive it through under cover of an expansionary government.

**C&CC: a vehicle for numerous objectives**

The fundamental point of C&CC was for all banks to be made subject to a common system of control by the Bank of England (Wilson, 19). As a note of June 1970 put it, there was a need to 'homogenize' the banking system, which was at that time in two parallel systems: one (the 'primary' banking system) was cartelized, with relatively low lending rates, a limited range of deposit and lending facilities, providing the main bulk of the national payments system; the other, secondary market, offered a range of deposits, short-term investments, and could pay what it liked for deposits. This secondary banking system virtually
monopolized the Eurodollar and parallel short-term markets. A crucial point is that the clearing banks:

“straddle[d] the two systems, having developed subsidiaries of their own to compete for a share of the other banks’ business... In the [previous] five years the clearers’ subsidiaries increased their sterling resources threefold while those of the competing other banks doubled... [and] gained a quarter of all the additional deposits attracted by these other banks as a group.” (BoE 3A8/7, 12.6.1970)

The main issue for the Bank at this point was the division of the banking system into two distinct and separate halves both of which performed the same economic function, but which were linked by the “bifurcated” clearing banks. An underlying principle was that sterling lending and deposit-taking was an essentially homogenous activity, and therefore the institutions which took part in it should be subject to the same external constraints (BoE 3A8/11, 3.2.1971). For reasons of innovation and fairness the Bank wanted to create a competitive system. Its problem was how to do this while still maintaining control of the credit supply (BoE 3A8/6, 3.7.1970). The traditional way to control credit was through lending ceilings, and their use over the past ten years had left people at the Bank unsure of what other ways there were. One idea was to allow competition within the ceilings, which essentially meant to break up the Cartel, allowing them the freedom to compete with themselves and other banking institutions, but leave credit side of the system intact (Ibid., 13.5.1970). In 1969, the larger Section 123 companies had been included in the ceiling system – showing that the Bank recognized how the Cartel's market share was diminishing to other institutions’ – but only as a way of smoothing over complaints from the finance house industry (themselves included in control since 1965) that argued they were losing market share to unregulated lenders. There was no sense of a thought-through plan from the Bank for credit control and the banking system, and the reasoning for only including the
ten leading Section 123 companies was purely that the Bank did not have the administrative resources to monitor all 1,900 of them (BoE 2A70/4, 29.12.1969).

One further boost to the clearing banks was to set required prudential ratios for them of 12.5% reserve ratios, down from the 8% cash and 28% liquidity ratios they currently held under private convention (i.e. without being required to from the Bank). The Bank did not feel there was any particular reason for these ratios (BoE 3A8/5, 30.9.1969), and so could soften the blow to the clearing banks of ending the Cartel by freeing up much of their liquidity to help them compete with the secondaries. Naturally this led to a sudden expansion of the credit supply.

It was at this time that the Bank first began to look into the rise of second mortgage lending over the previous two years, which was done entirely in the secondary markets. It found that the major factors in its rise were (unsurprisingly) the rise in house prices and the credit squeeze on normal lending from banks. The freedom to use a second mortgage as you desired, rather than on specific items, encouraged their use over, for example, the hire purchase agreements of finance houses (BoE 3A8/7, 7.8.1970). Credit was squeezed in the official, regulated channels, and so was seeping into the economy through unregulated ones. As one money broker put it (quoted in Kynaston 1994, 440):

"Each new attempt at direct control has prompted ingenuity to the creation of new instruments and new markets... [All fringe and secondary banks etc.] have one thing in common: they have all offered back doors to borrowers in whose face the front door has been shut."

C&CC aimed to open the front door again. It was designed to allow the clearing banks to compete on a level playing field with the finance houses and secondary banks by removing lending ceilings. The idea was that the greater respectability of the clearing banks, matched
by their greater size and relations with the commercial sector, would allow them to take back the market share they had been losing to newer banking institutions. This was to be desired as a means of control: the hope was that if the majority of bank lending was done by a few clearing banks with good relations to the Bank of England, the Bank would be able to influence credit conditions informally through general guidance without the need of ceilings. If a situation requiring emergency action arose, calling special deposits was supposed to immediately reduce credit in the economy by forcing banks to place extra deposits in the central bank. It was believed in the Treasury (and would later turn out to be the case) that special deposits were not all that powerful a tool (BoE 3A8/7, 20.8.1970).

The Bank openly wished for three things at this period (and had one hidden aim):

1. To remove prolonged credit restraints, which were an embarrassment to the Bank's credibility, an uncompetitive obligation for the clearing banks, and a check on the government's desire for rapid expansion backed by an easing of bank lending.

2. A level playing field between the clearing and non-clearing banks to help the regulated clearing banks innovate and compete, while removing an unfair advantage from the unregulated non-clearing banks.

3. A single method of control over a unified banking sector, which would allow the authorities greater ability to influence market outcomes. (Kynaston 1994, 437)

4. As the Bank later admitted (in its submission to the Wilson Committee in 1978), it had a hidden fourth aim: to try to kill off the secondary sector for good.

As we have seen, the Bank was not alone in feeling that the time was ripe for a fundamental rethink of banking policy. The Chancellor, Anthony Barber, noted in the House of Commons that the Cartel might of its own accord fall apart (reported in Times 16.12.1970, 4), there
were complaints from the regulated banking sector about how they were being managed by the Bank, while the unregulated banks ignored Bank directives. In the last two months of 1970, Jonathon Fforde, the Bank’s chief economist, wrote up a personal note that was sent to the governor at the end of the year on how the desired change should come about. This is the final basis for C&CC, which was released to the Treasury in March and to the banking community for comments in May of 1971. A Bank memo early in the new year noted that Douglas Allen (in the Treasury) had remarked that that year “might be a better opportunity for a more radical move on this front than he had heretofore thought” (BoE 3A8/10, 13.1.1971). The Bank was beginning to take notice the political environment around it, and decided to speed up the Fforde timetable to “preserve the momentum and avoid the risk of being caught on an ebb tide.” The note decided that the risk of change was now lower than the risk to the Bank’s economic credibility and goodwill in the sector of no change (BoE 3A8/11, 5.2.1971). The Bank therefore decided to kill many birds with one stone, quickly, and use C&CC to (BoE 3A8/11, 18.2.1971):

1. End the cartel;
2. Remove “problematic” ceilings;
3. Create more flexible short-term interest rates;
4. Improve the management of gilt-edged markets through the dismantling of the discount house cartel;
5. Smooth over EEC entry, “if and when” the UK joined.

In achieving these aims the Bank would manage to improve its relations with the major banks and, it hoped, remove the secondary banking market, all while improving market competition and innovation. According to the Bank the “overriding imperative” of the change was that “any new system of credit control must be so presented to overseas observers... that it carries the conviction that it will be effective” (BoE 3A8/12, 12.3.1971).
Just as with Sterling devaluation in 1967 (an event which the *Times* (11.9.1971) argued started the whole debate for monetary reform), it was the worry of international loss of confidence in London as a financial center which caused the UK authorities to act as they did. In March the document was sent to the Treasury under the new name C&CC, and in May, following the government’s ‘Barber boom’ expansionary Budget (Tait 1972, 489-509), the final version of the ‘Bank consultative document’ (not a Government proposal) was published and sent to the banks: “the first time in the Bank's 250 years it had ever consulted anyone,” according to one (apparently exaggerating) market participant (Capie 2010). The Bank had used the Tory government’s desire for competition to push its own ends (Reid 1982).

*Summation*

C&CC was an attempt by the Bank of England to achieve a number of things at the same time: to rationalize the UK banking system, restore its control over credit conditions, loosen the conventional prudential requirements on clearing banks, and create institutional space between itself and the Treasury in financial markets. Its net effect was to loosen monetary conditions greatly and allow any institution to undertake any banking activity. It ended up boosting the entities it was meant to restrain, to lose Bank control over the banking system, and forced the government to end, once and for all, the Bank and banking sector’s freedom from legislation. It was, in short, an unmitigated failure. We now turn to the market reaction to C&CC to see why.

*How the market reacted to C&CC: mania*

The major outcome of C&CC was a market boom (Goodhart 2014). Largely this is because C&CC was launched into a slack economy. Despite the worries during the late 1960s as the
policy was being developed, there was no squeeze on bank lending in the summer of 1971. As the Wilson Committee (1980) later put it when investigating this era, the reason for the lack of credit advances to industry at this time was not because of a lack of credit in the economy but because of a lack of investment opportunity in productive sectors: manufacturing and industry. The Bank went ahead with the policy change because it saw a political opportunity under the Tory government to achieve its aims (Reid 1982). For this it was applauded, e.g. by the Financial Times (15.5.1971) and the Times (17.5.1971) who argued that C&CC would increase competition and innovation within banks, possibly at the expense of finance houses. The Economist (22.5.1971) called it “at last, a revolution in the City,” although it quoted one dissenting banker as saying “mark my words, in ten years’ time Britain will have as many banking laws and regulations as America,” in which he was absolutely correct in terms of direction, if not exactly in terms of amount. This banker understood that as soon as the principle of a rational, new policy for banking was allowed, there would be no obvious point at which to stop future policy innovation. The Times disagreed: the new regime’s minor provision on extra information gathering from banks “is not regarded, even by cynics, as a back door means of restricting the creation of credit” (Morison, Times 13.10.1971), and as Capie argues (598) “CCC was about credit control not surveillance” anyway. It even praised the Bank for removing the “Byzantine non-system” which preceded C&CC (Times 11.9.1971). In short, commentators applauded the Bank.

Supply-side reforms in credit did have some effect on credit conditions, even in a slack economy. The immediate reductions of 12-15% prudential ratios (Economist, 22.5.1971) for clearing banks, along with their new ability to compete with other banking institutions in parallel markets led to a massive expansion in the money supply and in credit lent (Wilson, 70). Bank lending to the private sector increased from £1.9 billion in 1971 to £6.4 billion in 1972 (Ibid., 7). In November 1971 bank rate fell to 4.5%, where it would stay until it
jumped up to 6% in June 1972 (Gowland 2013). Far from the interest rate being deliberately raised to stem credit creation, it fell to persistent lows (Moran 1986). This shows an oversupply of money in the economy – not surprisingly when restraints were thrown off and the clearing banks’ excess liquidity from their previous prudential ratios could suddenly flood into the market.

The UK economy suffered major unemployment in 1971-1972, so a number of stimulatory steps were taken (Wilson, 7). This was part of the Conservative government’s ‘dash-for-growth’ strategy (Tait 1972, 489-509). The removal of restrictions unleashed pent-up demand in the economy and led to a boom of lending. On both the fiscal and monetary side there was a lack of control. The government’s hope was that ‘one last heave’ would push the UK onto a permanently higher level of productivity (a higher productivity ‘plateau’) which would then in itself justify the expansionary measures (Conservative Party Manifesto, ‘A better tomorrow’, 1970).

With cheap, abundant credit, an expansionary political approach to the economy, a new focus on competition and market-adjustment for previously rationed and controlled sectors of the economy (the abolishment, along with lending ceilings, of preferential sectors for credit advances), credit was free to flow – domestically – to whichever sectors would give it best returns. From September 1971, when the final elements of C&CC were put in place, to December 1973 at the start of the secondary banking crisis, the money supply (M3) rose cumulatively by 73% (Kynaston 1994, 442). Industry and manufacturing did not need this credit, so it flowed to two sectors that had previously been under-lent: property and personal finance. Sterling lending to UK borrowers – primarily to the property sector – rose 148% (Kynaston 1994, 451). Unsurprisingly, against such a booming backdrop, the FT Index peaked in May 1972, at a level it would not reach again for several years (Reid 1982). This was the creation of a ‘consumer society’ (Economist 23.9.1972).
C&CC therefore ended up not so much killing off the secondary sector as enabling it, because of the sectoral effects of the credit boom more than the boom itself. It helped the secondary sector unduly because it was more focused on property and personal lending than the clearing banks (by definition, as well as tradition and prudence) and because – as smaller, newer entities – they were more able to fill in a niche role in the developing financial economy. At this stage of transition, the clearing banks’ potential universalism of services was a hindrance not a help as they sought to claim market share back from the secondary sector (Economist 23.9.1972).

One contributing factor in this dynamic was that a large proportion of secondary banks were clearing bank subsidiaries. The clearing banks tended not to engage directly in the secondary market, which meant that even when they were successful in claiming business (through their subsidiaries) they did not claim back market share to the regulated sector. This perhaps pedantic point matters because it alters how the Bank of England could conduct its supervisory role. The more activities that were engaged at arms-length by the clearing banks, the less it helped the governor of the Bank of England to call in clearing bank chairmen when he wanted to change market conditions. Competing in the secondary market changed the clearing banks’ operating culture to that of secondary banks, rather than making the secondary marker more ‘responsible’ like the primary one.

The outcome of C&CC’s market effects was rapidly rising money aggregates in the economy: in the words of one Labour MP writing in the Financial Times years later: “there was more competition than credit control” (Jay, Financial Times, 17.10.1975). There was also a rebalancing of the financial sector, as capital moved from previously privileged sectors to those that had been starved of capital. But as Gowland (2013, 27) insists, even if demand had previously been frustrated, when it is satisfied it still counts as a net increase to aggregate demand. It is new and should not be discounted as a contributing factor to the
credit boom, as the Bank of England tended to do. Indeed, this 'releasing of pent-up demand' was one of the aims of C&CC. Competition within and between banking sectors, a growth of demand for and supply of credit, a market-led rebalancing of where credit went through the price mechanism: this was the explicit objective of C&CC. It is therefore disingenuous of the Bank to say in its submission to the Wilson Committee (1978) that these outcomes were due to an unfortunate confluence of events between the macro-economy and the monetary situation (an argument also used internally in a review of the ‘new approach’ at the time, BoE 3A8/25 13.4.1973). The Bank got what it wanted, it just turned out to want the wrong thing.

**Analysis of C&CC’s failure**

Two things, specifically, were negative for the Bank’s aims in the way C&CC turned out. Firstly, the secondary banking sector did not contract, as the Bank had hoped, but boomed. Secondly, there was no control on growth in credit conditions. Together these led to uncontrolled growth in the money supply (which led to inflation) and in property prices. Both these outcomes were also affected by the government’s expansionary fiscal policy. C&CC had led to competition which the wrong people won and no credit control. It therefore failed on its own terms. The deputy governor of the Bank, Jasper Hollom, denied this analysis in a speech of October 1972, one year on from C&CC’s introduction: volatility was the point of C&CC, so the authorities would just have to get used to being flexible with uncontrolled surges in bank lending (text reported in *Financial Times*, 20.10.1972). The question is how convincing that argument is.

The failure of credit control is easy to explain. Credit control relied on interest rates to control credit growth. The mechanism for raising interest rates was supposed to be the Bank’s calling Special Deposits – despite the fact that research during C&CC’s development showed this would be ineffectual. It proved to be. But more than relying on a powerless...
instrument of control – perhaps enough on its own – the Bank was constrained in its use, because it had to be a creature of the government since its nationalization in 1946 (even if it had significant levels of operational independence). It therefore was not able to deploy its interest-rate weapon to hold back credit growth, as it increasingly wanted to, because the government was worried about the effects on balance of payments and on unemployment (Zawadzki 1981). In classic establishment Keynesian fashion, the government thought it could eke out a little more GDP and a little less unemployment by allowing slightly greater inflation in the economy. This tactic led to stop-go policies in the 1960s, and was no more effective in 1971-73. The politics of credit control, unsurprisingly, trumped its economics. Indeed, when market interest rates started rising of their own accord in 1972/1973, the government – specifically the Prime Minister himself against the wishes of his Chancellor and the Treasury – intervened directly to ‘subsidize’ a politically-necessary less-than-10% interest rate for homeowners, by giving a grant to building societies to keep them at 9.5% (Kynaston 1994). This ‘subsidy’ lasted until C&CC itself was terminated in the autumn of 1973. Once again, the politics of credit allocation was allowed to undermine the intended free-market operation of the price mechanism to distribute economic resources. The authorities changed Bank Rate into Minimum Lending Rate (MLR) in October 1972 in an attempt to make themselves more able to manage the market rate (Reid 1982); it was in a way a fig-leaf for ending the C&CC experiment with market-based interest rates for control (Moran 1986).

The salient point here is that this political interest in Bank policy now moved from the purely monetary and macroeconomic aspect, into the area of banking policy specifically: which had always been, and was intended to remain, an area of Bank expertise outside politicians’ remit. By linking together banking supervision and credit policy through C&CC, the Bank had unwittingly opened bank supervision up to the same political interference as
monetary policy. During his speech one year on, deputy governor Hollom directly blamed the interaction of interest rates with political economic concerns: unemployment and inflation. In essence he blamed the government: “the Government's expressed policy is to encourage by all means the expansion of activity... there is no monetary policy which will simultaneously stimulate expansion and moderate inflation” (*Financial Times*, 20.10.1973).

Around this time the first public attacks on C&CC came, arguing against the theory of the policy itself in that free competition with “oligopolistic” larger banks would not of itself guarantee appropriate credit allocation (reported in *Times*, 6.12.1972). This hints at the failure of the ‘competition’ part of C&CC as well.

The failure of the competition aspect of C&CC is perhaps more interesting than that of CC. As we have seen, in fact it did not fail. It performed exactly as intended, indeed as expected. It was just this was an outcome the Bank of England did not like (BoE 3A8/25, 15.1.1973).

Interestingly, the Treasury was less worried than the Bank about the success of secondary banks which it saw as proof of an entrepreneurial capitalism in the UK that highlighted the success of its economic policies. This is because the Bank assumed C&CC would benefit the clearing banks at the expense of secondary banks, and in so doing allow the Bank’s informal relationship with the clearing banks to resume management of the banking system: both in terms of supervision and credit control. C&CC was a pro-clearing bank policy. This was for reasons of prudence, intellectual coherence, and also convention and control. For the Bank, the clearing banks were easier to control informally, because they were used to it, there were fewer of them, and they should have been grateful for having their uncompetitive restrictions eased with C&CC. Therefore, by helping the clearing banks outcompete secondary banks and gain predominant positions in the banking sector, the Bank hoped it would be able to exert greater control over the banking sector through its usual informal, personal contacts with the clearing banks. Credit control was meant to happen through
competition, as well as to restrain its effects. Therefore when competition did not have the
outcome it was intended to, the credit control aspect of C&CC was shown to be dramatically
underpowered as well.

**Conclusions on C&CC’s failure**

C&CC was the response to failure and the cause of failure in bank supervision. It was a
failure because it failed on its own term. Even where it was successful, in promoting
competition, it did not have the desired outcome. But C&CC was also a response to the
failures of the previous cartel and ceilings system. It is true there had not been a banking
crisis in the UK for over 70 years before C&CC, but that system was complicated, irrational,
uncompetitive and, at times, a restraint on UK economic growth. The previous system had
sacrificed growth in financial services – both in quantity and innovation – for stability. The
growth happened in the end because of unregulated international markets based in London.
This made the old system untenable. C&CC, unwittingly, in turn sacrificed stability for
growth. It was the simple failure of an intellectually rational plan to adequately encompass
the complexity of the real world. It is hardly alone in that.

Ironically, in C&CC’s failure it achieved one of its main aims: of killing off the secondary
banking sector and replacing it with regulated banks. Equally ironically, the rescue was
achieved through no semblance of the free-market thinking that characterized the move to
C&CC, but through the epitome of the old, informal way of doing things: locking the
principal bankers up in the Bank of England and giving them ultimata until they agreed to
supporting the secondary sector in the way the Bank wanted. The informal system
managed to rescue the informal system from the crisis it had itself caused. No wonder when
the crisis was over that politicians took one look at this informal, free-market hybrid and
decided to end it for good. The *Economist* called this trend in 1973, just before the crisis
struck: “It has never been easy for the Bank to be both the City’s spokesman for capitalism
and an official watchdog of the City’s operations. The Bank almost certainly does wear too many hats... Today, the ultimate political sovereignty of governments over central banks is not in doubt” (Economist 30.6.1973).

The key to understanding the policy of C&CC is to see it as a way of affirming the Bank’s traditional way of doing things in a modern market: Bank autonomy in the banking sector against the Treasury and individual banks. It failed, simply, because this ideal (and idealized) informal way of conducting banking policy was not suited to the modern, larger, heterogenous, internationalizing financial market. It failed for the same reason that the pre-C&CC world failed. The Bank, on its own, without statutory powers or clear guidelines (e.g. on licensing banks), could not manage to oversee the whole banking sector: due to its lack of resources as an outcome of the informal approach to supervision, and because it did not recognize a single banking sector. Interestingly, this was foreshadowed in comments on the very first draft of the ‘New Approach’ that would become C&CC, which stressed the need to work out the failures of the current system and to make sure that they were overcome in the new one. Somehow this was superseded as the various political and pragmatic aims of C&CC took over. Capie (525) argues similarly with different terms that C&CC’s failure ultimately came down a problem of the formal and informal recognition of ‘banks’.

The Bank’s original diagnosis was that this was because the ‘real’ clearing banks were unable to compete against other financial institutions because of ceilings and the old messy form of bank regulation. So these constraints were removed with C&CC. The C&CC regime itself then failed because the Bank still did not recognize that it would have to supervise and smooth out both sets of banking institutions directly. It argued that secondary banks were under the jurisdiction of the Companies Act 1967 and therefore the Board of Trade and Treasury, though no one else bought the argument (Kynaston 1994, 462). The credit control
parts of C&CC were not, on their own, enough to ensure stable growth in financial markets. An April 1974 paper inside the Bank on fringe banks found that:

“Over thirty institutions which take deposits (amounting in aggregate to more than £550 million) and give credit have been identified as operating on a scale which would warrant their inclusion in the arrangements for control of credit. They are not at present covered by either the bank or finance house schemes” (BoE 3A8/25, 6.4.1973).

This allowed a massive inflationary property boom to take place in an unregulated side of the banking sector, without prudential or governance supervision: simply because the Bank did not think these institutions were ‘really’ banks. That is, its political definition of a bank took precedence over any economic definition. The Bank still called institutions ‘banks’ according to its opinion of the individual institution, rather than according to what that institution did in the economy. This is against the explicit aim of C&CC to create a homogenous banking system. The problem of C&CC, pace contemporary attacks, was with both competition and credit control.

The secondary banking crisis and the Bank’s success in failure

The secondary banking crisis was a text-book story of Minsky’s financial instability hypothesis (Minsky 2011). Easy credit conditions led to an increase of investment in increasingly crowded market sectors that relied on unending asset price rises to make a profit. When market sentiment changed for exogenous economic reasons – in our case labor unrest, the end of Bretton Woods, the Yom Kippur war and OPEC’s oil price hike – the inability to roll over debt led to some failures and the start of a self-fulfilling panic and market rout. This threatened banks, small depositors and bank lending to the real economy.
Fraud and poor governance were uncovered and regulatory laxity blamed. This account is standard and completely correct.

What is interesting about the secondary banking crisis was the authorities’ response. Firstly it was entirely the Bank that responded, almost without the Treasury knowing the crisis was unfolding. Secondly, it was informal, idiosyncratic and immediate. Thirdly, it was collective at the level of the rescuing banks, but individual for the institutions being rescued. These three aspects took shape almost instinctively, and reveal the benefits of a system that had just led to the same crisis itself: it was quick, comprehensive, and cheap. Nonetheless, as a system of bank recovery and resolution, hoping and relying on every institution to happen to act correctly and in concert is not very convincing. Despite its success in the secondary banking crisis, therefore, this informal Bank-led system was dismantled straight afterwards and in its place was built something more formal, explicit and organized.

In June 1972 there was a Sterling crisis, the pound floated and bank rate began to rise consistently for another year, until it steadied and dipped in mid-1973. It then jumped to hit 13% in December 1973 when the falsity of this stability was revealed (Gowland 2013). From mid-1972, the Bank was increasingly called on to stem credit expansion (Wilson, 71), and the governor asked banks not to lend so much to property companies (Times 9.8.1972). This was the first time since C&CC that the Bank had used its powers to ‘guide’ banks, and signals that the price method of credit control was not working as intended. The UK joined the European Economic Community on 1 January 1973, but any consequences of this were far off (Wilson, 15).

The government’s most aggressively expansionary budget yet in March 1973 overheated the market and the Prime Minister asked for a reappraisal of C&CC from the Bank due to monetary (i.e. sterling) turmoil (BoE 3A8/25 23.3.1973). He was willing to see monetary
policy change again, but not his fiscal policy. The importance of monetary policy had not yet been learnt. By June 1973, there were worries the market was turning. Secondary bank share prices fell below peaks, and some well-known secondaries saw their share prices fall 40-50% (Reid 1982). Some examples of poor financial decisions came to light – for example the inability of any branch of government to regulate or supervise the Crown Agents, which made property investments for Commonwealth governments, as well as problems with the Scottish Cooperative (Capie 2010). UK investors became jittery and looked for ways to park their money. Eventually investors simply fled the secondary market - unregulated, unsecured and without a lender of last resort – for the primary banks. The Economist was reduced to asking “what should be done with the City?” just over a year after praising the ‘revolution in the City’ (Economist 9.6.173). As they wrote: "Labour wants to nationalise it, the Conservatives want to rationalise it, the think-tank wants to cartelise it. They're all wrong." It saw the competitive forces unleashed by C&CC as permanent and argued that competitive universal banking was the way forward: for the Economist C&CC should not have been aborted so early. It was one of the few bodies that thought so.

As the summer of 1973 ended, a weakening market was slowing down but not yet in panic. Kynaston (1994, 478-480) quotes the Economist as saying that Britain was “two-thirds of the way to an economic miracle” and that Rothschild’s think-tank (IBRO) thought the City needed even more competition. Towards the end of the year the City suddenly lost confidence. Bankers and commentators began to complain about the very rules in C&CC they had welcomed two years earlier (Times 7.9.1973), with most complaints going against low interest rates not restraining credit expansion. In November MLR hit 13%, while the stock market fell 29% from November to December; property values similarly fell 30-40% (Reid 1982). In November also a prominent secondary bank (because of its political connections with the leader of the Liberal party), London and County Securities, found itself
in liquidity problems (*Guardian* 13.11.1973). The Bank had to organize its rescue two days later (Kynaston 1994, 484).

At this time, due to a sense of catastrophe in the wider economy from a state of emergency being imposed to deal with the miners’ strike and the worsening international situation (OPEC and the October Yom Kippur War), the government executed an abrupt U-turn and introduced a harsh mini-Budget on 17 December 1973 (Reid 1982). This cut government spending, raised a surtax of 10%, taxed property development profits and curbed bank lending with the ‘Corset’. This marks the end of the C&CC experiment with the free market (Moran 1986). This political volatility hit property and bank lending markets precisely at the time they needed to be shored up (Kynaston 1994, 484). A run started on secondary banks. This turned into a concrete problem on 19 December 1973 when Cedar holdings found itself needing a bail out (Gordon 1993).

Cedar was a large and generally respected secondary bank that had, during the course of 1972-73, become increasingly involved in the property market and was part owned by a property company (which was itself owned by the family that had set up Cedar). This heavy exposure to property led to a run on Cedar when property values fell. This time the Bank acted instantly, and called Cedar’s institutional backers to a meeting at the Bank, which ended up lasting until early the next morning. By the time the institutions, Barclays (as Cedar’s ‘relationship bank’), the Bank of England and Cedar’s management left, the basic outline of how the Bank would rescue the secondary banking sector was established. The institutions (shareholders) and Barclays (bank finance) would agree to underwrite Cedar’s debts and at the same time take over management of the firm (Gordon 1993). For this to work, the assumption that the secondary banks were fundamentally solvent and merely illiquid had to be correct (Kynaston 1994, 287).
A week later on 28 December 1973, this system was formalized in the ‘lifeboat committee’ which became a permanent committee of all the major clearing banks, housed in the Bank of England. This committee took requests from secondary banks whose liquidity had fled into the primary sector and agreed to recycle clearing banks’ deposits back into the individual institutions until the prospect of a bank run abated. By mid-January over £200 million had been lent to over 20 secondary banks in total (Kynaston 1994, 486-9). There was some pride that “only in Britain” could this system work because of the authority of the Bank and the willingness to cooperate between rival banks (Reid 1982). This system was in daily operation until 1975, when the worst of the operation had passed, but took many more years before the clearing banks’ positions in the secondary sector were eventually unwound.

After initial success over the Christmas period in stopping a run on the secondary banks, and a knock-on run on the clearing banks, worsening industrial action removed the growing hope that the crisis was over (Economist 5.1.1974: ‘How the City was saved’): the UK went to a 3-day working week, miners and rail-workers went on strike and the City continued to feel “miserable” (Kynaston 1994, 489-491). Such was the confusion of the times that the Times main City correspondent, Ian Morison, wrote a two-part article entitled ‘What is a bank?’ There was no clear answer under the contemporary British system (8-9.1.1974). It became clear under continued stress that a number of secondary banks were fundamentally insolvent. These were ultimately bought out and wound down by the lifeboat committee, which accepted much of the left-over loss.

In February of that year, the Prime Minister, Edward Heath, fought an election asking the question ‘Who governs Britain: the government or the miners’ and lost. The government was replaced by Harold Wilson’s Labour (and pro-miner) party. The new government started raising taxes, and reached an accommodation with workers to stop labor unrest.
The interesting aspect of this new government is that it started making contacts directly with City bankers rather than going through the Bank as had been the case (Kynaston 1994, 496). The old dilemma the *Economist* had noted for the Bank cheerleading and disciplining the City was beginning to be resolved one way or the other. The idea of bank reform gained currency, with the *Times*, *Economist* and the *Financial Times* in February all devoting articles to how banks could be licensed, operated and supervised in the international, European and domestic settings. By mid-1974 it seemed the crisis had abated, due to the Bank’s prompt actions, for which it was widely praised (e.g. two articles in the *Financial Times* 5.2.1974). It was this that allowed commentators to think more widely about how to stop this happening again in the future. The Bank of England in July took the opportunity finally to reorganize its supervision department, removing the Discount Office and creating a separate, better-staffed, dedicated bank supervision team (Kynaston 1994, 503). The new department, however, was still meant to have friendly and informal relations with the banks it was supervising (*Times* 19.6.1974).

Unfortunately the crisis was not yet over, and life-boat liabilities kept rising (Reid 1982). At this point the major fear was international contagion, and the euromarkets drying up (Kynaston 1994, 496). In June the German bank Herstatt failed and closed down before markets closed in the US, resulting in failed clearing. This caused problems in international markets, and the first plank of an international supervision regime was laid when the governor of the Bank of England convinced his counterparts that ‘parental responsibility’ over branches and subsidiaries was the most effective way forward (Kynaston 1994, 502).

The lifeboat committee, again, managed to contain the ripple-effects of the internationalization of the crisis, but its level of commitments was ever rising. In August the clearing banks capped their contributions at £1,200 million, above which the Bank would have to provide the money. The final tally was £1,295 million with the Bank accepting the
extra £95 million. To balance this, bankers later began to accept the need for more regulation (Financial Times 3.8.1975). The Economist even argued that British banking was “behind the times” and its supervision needed to be sharpened and the banks to think a little harder about how they should be structured (Economist, 9.8.1975). In September 1974 the last of the secondary banks joined the lifeboat while in October a second general election of the year confirmed the Labour party’s majority. The crisis was beginning to pass.

In November, however, National Westminster’s chairman was forced into declaring that the bank was not itself receiving report from the Bank as its shares fell to 88p. The protracted crisis was beginning to move into the banking sector proper.

To calm the City, the Labour chancellor, now with a confirmed parliamentary majority and with good contacts among the banks, ‘moved right’ which led to a surge in equity prices (Kynaston 1994, 516). The last acts of emergency support took place in December 1974, with government bail-outs of the quasi-state Crown Agents, and the Bank bail-out of Burmah Oil (a major oil company and institutional investor). As Kynaston puts it (516): “The UK was beginning to look like Italy” in terms of state-guided financial markets. The FT index hit a low on 6 January 1975, and then rallied solidly for the rest of the month. As suddenly as the market had worsened in 1973, it turned at the beginning of 1975. This did not mean that all emergency operations were finished, however. In March of 1975 London & County, the secondary that had started the crisis, was allowed finally to fail (Kynaston 1994, 518), while other secondaries that had been used as lifeboat vehicles were now themselves having to be rescued – showing to some the Bank’s folly in supporting them to start with (Capie 2010).

Unbeknownst to market participants, the Bank started directly funding some property companies in 1975 to stop them failing. From before the crisis when the Bank did not even want to recognize secondary banks as banking institutions, it was now directly engaging
with property developers and other non-financial companies to stem stresses on the primary and secondary banking systems (Economist, 20.9.1975). By the end of December 1975 financial markets were calm, the lifeboat commitments were back down to £900 million and the sense of crisis in the economy was over. Most importantly for the authorities, no British institution had defaulted in the euromarkets (Reid, 192). As the Times put it: “It was the year of survival by expedient” (Times, 29.12.1975). Not exactly strong praise, but perhaps not that surprising given the Bank’s informal and pragmatic approach.

Remarks on the secondary banking crisis

As the story of a financial crisis, there is little shocking here. A credit boom led to euphoria, sentiment soured, turned into a panic, and bank lending dried up leading to successive financial failures that required systemic intervention by the lender of last resort, even for financial firms it did not recognize as within its remit. There were no ‘proper banks’ in a crisis. The lifeboat solution is interesting because it was a last gasp success of the Bank’s informal method of control. The Bank showed instinctive leadership, barely informed the Treasury to start with, and used its clout with the clearing banks to force them to a collective position guaranteeing the overall banking system.

The decision for the lifeboat committee to provide funding on an institution-by-institution basis is remarkable (Capie 586-7): it goes against the Bank’s own tradition of lending as last resort on a market-wide basis (Bagehot 1873). The solution to this riddle can be found in two places: firstly, it was not clear to start with how many and what kind of secondary banks would need support, so it might have seemed that only a few specific banks had problems. Secondly, it came from the new competitive clearing banks which did not want to be on the hook to bail out secondary banks who had close relationships with their competitors (and which were themselves competitors). For all that they were operating
collectively, this was no return to the chumminess of the cartel. The bank-by-bank solution forced the ‘relationship bank’ to pick up the lion’s share of the secondary bank’s loss, and so in some way they had to pay for their own decisions leading up to the crisis. It may have come about through clearing bank squabbling while setting up the lifeboat system – rather than as a deliberate Bank policy – but it went someway to reducing moral hazard in the clean-up operation.

By the end of this episode, the free-market approach to monetary policy was over, the financial system was market-oriented in theory but still relied on decisive guidance by the authorities, and the secondary banking sector had taken a severe beating from which it would not recover in anything like the same form. The secondary banks also took much of the official blame for the crisis and from the clearing banks – as we have seen, this is at best disingenuous. The Bank, somehow, had managed to emerge from the crisis with its authority enhanced, even though its own policy had directly and singly led to it. London remained a pre-eminent financial sector. The lifeboat was a successful venture, but a lot of this narrative looks like luck.

As this self-inflicted story of a policy-induced crisis came to an end, the questions facing policy-makers looked the same as in 1969: what is a bank and how do you supervise it? To the second question the answer had become clear: more formally and explicitly. To the first question, they still had no answer other than ‘people we like’. This lays the groundwork for the 1979 Banking Act which formalized this approach; and which had a similar outcome to the Bank's previous attempt to regulate the banking sector through the concept of ‘respectability’ rather than function.
Conclusion: Interpreting the C&CC-secondary banking crisis episode

The banking situation before C&CC was a confusing mess. Its stability was due to a lack of systemic links between the various forms of ‘banks’ and financial institutions. It is easy not to have a crisis in the banking system if you do not have a single banking system. C&CC was an attempt to rationalize the various forms of banking in the UK into one homogenous market. It did this. But it did it in a way that increased systemic linkages without guaranteeing their robustness. C&CC can therefore be seen as having created a single banking system, rather than having stabilized one that already existed. This is the thrust of the ‘more competition than credit control’ argument.

The question is why this is the case. No-one in the Bank of England, and certainly no-one in the Treasury, thought of their job as creating a banking market. Rather they thought they were making life easier for clearing banks – in so doing making life easier for themselves as supervisors – and establishing an intellectually coherent basis for their supervisory role. But this highlights the salient point: with such a close focus on the elements of a system they liked most and took most for granted, the authorities lost track of the system itself. For reasons of history, society, and intellectual familiarity, no-one questioned the role of clearing banks in a banking system, and whether these institutions – as they were then – were the suitable basis for a rationalized banking regime in the City. It turns out they were not, as we have seen. It also turns out that the Bank in its form then was also not a suitable supervisor: it had “too many hats” and too few resources. By prioritizing favored institutions within the system, policy-makers made the system unstable. The Bank had acted politically but not financially. That is, the Bank’s C&CC policy appeased various stakeholders – the Bank itself, clearing banks, the government – but did not take into account the financial functions of the institutions it had created and was trying to monitor.
The reason the Bank then succeeded in containing the secondary banking crisis is because it ditched the idea of a rational economic model for banking supervision and did what it needed to do: “survival by expedience.” The Bank worked out how to use the resources in front of it, rather than relying on assumed types. The Bank’s support for property companies at the end of the crisis shows that it had got over its obsession with ‘proper’ banks, and come to accept that its role in guaranteeing systemic stability required it to accept the system as it is, not as the Bank thought it should be.

The C&CC and secondary banking crisis fiasco, above all else, shows the importance of thinking through the actual basis of the elements of a policy-change, rather than relying on previous, familiar categories. This is the failure of a rational plan to encompass the complexity of reality.

The next case study, on the introduction of the first statutory banking regulation in the UK – the Banking Act 1979 – shows that this revelation was short-lived, however. The Bank went back to its old ways of trying to decide what was a ‘proper’ bank, and how it could support them. This led to another crisis, also entirely of the Bank’s own design: the Johnson Matthey Bankers affair of 1984.
Introduction

The Banking Act 1979 was the first statutory banking law in the UK. It marks a fundamental change in the approach to banking regulation and supervision. Despite this, there was little controversy when it was introduced. Most market participants and public officials accepted the need for a law. This was in large part because of the supervisory failures that led up to the secondary banking crisis. Two questions arise with the Banking Act, however: why did it take more than five years to get into law after the fringe crisis, and why did it take the two-tier form that it did?

The answer to both questions lies in the political process; that is, the relative influence between the interests of different institutional actors. As events caused different actors to gain or lose influence, they became more or less able to advance their interests in creating a bank law. The Banking Act 1979 reflects the final outcome of this round of contestation. It represents a compromise whereby the government managed to force a statutory banking law onto the Bank of England, ‘compensated’ by legal backing for the Bank of England’s authority over banks and the Bank’s ability officially to separate ‘proper’ banks from other non-bank financial institutions (called ‘licensed deposit takers’). Similarly to the outcome of the 1946 nationalization of the Bank of England, the Bank formally accepted a subordinated role to the government while insisting on its operational independence.

As a short-term strategy the law favored the status quo in the Bank’s interest, but created longer-term tensions. In the case of the Banking Act 1979, these emerged in 1984 with the ‘Johnson Matthey Bankers affair’. This ‘affair’ revealed significant short-comings in the Bank’s approach to bank supervision, laying bare a fundamental problem with the two-tier banking system. This would lead to a redrawing of the law in 1987 as an add-on to the City’s
deregulation in 'Big Bang' and to the UK's third banking regime in less than eight years. The JMB crisis also highlighted tensions between the Bank of England and the government which undermined one of its two sources of legitimacy. This de-legitimation of the Bank would not ultimately be resolved until Tony Blair made the Bank independent in 1997. The 1987 and 1997 policy changes are the material for the third and fourth case studies respectively.

Reasons for the Act

The 1979 Act was an attempt by the Bank to undo the effects of a banking law even as it was being introduced. The Bank sought to gain legal backing for its authority without being constrained by the same law that conferred it. In a sense the Bank hoped to legislate the status quo and its own privileged place within it. This status quo, however, was a situation in flux following the secondary banking crisis and not suitable to be 'locked in' by law. Many of the fundamental changes that led to the crisis remained: such as a bifurcated banking system, and the increasing internationalisation of the City of London. The two tiers of the Banking Act did nothing to solve the basic question supervisors posed themselves: what is the difference between a bank and a non-bank if they both perform the same activities? The 1979 Act was an attempt to answer it in a social sense, through traditional and social ties. That is, the Bank assumed it knew what a 'proper' bank was, and just had to find the right formula in law to legislate it. This assumed that the category of 'bank' was clear-cut and stable – despite clear evidence from the secondary banking crisis that this was not the case. The Bank’s supervisory approach was not to think widely about what the banking (or financial) system as a whole needed, but to work out how to categorize approved counterparties. It continued to think institutionally and historically rather than prudentially or through economic theory.
There is one further reason for the Banking Act, which points to the shrinkingly domestic nature of UK banking and its regulation: the UK’s membership of the European Economic Community (EEC). The UK acceded in 1973 and at that time a banking bill was working its way through the Community. The aim of this bill was to harmonize banking regulation within the EEC. Not least thanks to the UK’s objections, this draft was rejected by the member states, but a new, looser draft Directive was eventually negotiated and entered into force in 1977. This required all EEC members to have a banking law which gave prior approval to deposit-taking institutions. The UK did not have any single law which did this, and through debate across the 1970s the UK authorities decided that a single Banking Act would be the easiest way to comply with the Directive. The fact that there was domestic pressure to create a banking law made this an easy choice. Therefore it would not be correct to say that the Banking Act 1979 came about because of an EEC requirement, but rather that domestic and international factors both came together to make the creation of a banking statute the best option for resolving multiple issues. This is one of those times when everything comes together to point in one direction of travel.

Although the need for a banking act of some type was accepted by 1979, the form it took was far from inevitable. The core aspect of the Act was to create two tiers of banks: ‘accepted banks’ and ‘licensed deposit takers’ (LDTs). To be approved as an accepted bank, the institution had to offer a wide range of services, highly specialized services, and have good standing in the banking community. Institutions which failed in these criteria – as determined by the Bank with minimal right of appeal – were classed as LDTs. Note that even in the preamble of the Act and its drafting the law answered the old question ‘what is a bank’ very simply: an institution which takes deposits.17 This law regulated who could take

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17 It starts: “An Act to regulate the acceptance of deposits in the course of a business;...”
deposits, not who could lend out on credit (even though this was one of the ‘range of services’ that would be taken into account when approval was being sought). The Bank was keen to stress that no idea of respectability or reliability should be imputed to being a ‘tier one’ or ‘tier two’ bank, but that it was merely a question of what kind of services were offered. No-one believed this, eventually the Bank stopped insisting on it, and the legal punishment for LDTs which used the word ‘bank’ or similar in any of their names or literature would argue against the point. As everyone in the financial press came to look at it, the law was used for ‘sorting the sheep from the goats’. This law gave legal power to the Bank’s obsession – evidenced from C&CC at the start of the decade – with keeping ‘real’ banks and other bank-like institutions at arms-length from each other. One final element of this law was that LDTs would be placed under far closer scrutiny than approved banks, who would have little supervision beyond their regular statistical returns. The Bank trusted the management of banks to know what they were doing and to tell the truth. This trust proved misplaced.

This idiosyncratic form had nothing to do with the EEC. The two-tier system was created by the Bank, with the more-or-less indifference of the government of the time, for the Bank’s own reasons. Both the Bank and Treasury wrote internal reports on the banking systems of other EEC member states and of the rest of the world, but what they showed up is the extreme heterogeneity of banking systems at this time. There is far from a ‘template’ of good banking or of accepted banking regulation at this point. So far as there was any international regulation it rested on the principle of ‘parental responsibility’ for branches and subsidiaries in other jurisdictions. The 1979 Banking Act, therefore, was a UK response to a UK situation.
Failure of the Banking Act

The story of the Banking Act represents a regulatory failure to get to grips with market change. The Bank for its own reasons created legal constraints on the development of the banking market and in so doing distorted it. The Bank attempted to force a form onto a market it no longer understood and which was out of its control. This, it could be argued, was also the case of C&CC at the start of the 1970s, except this time the Bank had legal backing for its authority. The Bank could not argue that its failure any more was due to lack of market reaction to its decisions, but rather had to accept that its decisions themselves were the cause of the problem. This becomes clear in the story of the failure of Johnson Matthey Bankers (JMB).

JMB was a subsidiary of Johnson Matthey PLC, a gold dealer, which had been created in the 1960s to carry out its bullion trade. JMB was one of the five members of the London gold market – a cartel arrangement between five leading banks which together formed one of the most important gold markets in the world. When the Banking Act came into force JMB was accepted immediately as a tier-one bank. In the early 1980s it expanded its commercial loan book dramatically in the search for profits. Due to poor management, it ended up with very large, separate exposures to two foreign businessmen: around 30-40% each of the bank’s capital base. As the loans to these businesses began to turn bad the bank decided to continue lending to help them trade out of crisis, rather than precipitate their bankruptcy. The bank did not report all their exposure to the Bank of England and their auditors were not allowed legally to notify the banking supervisors because of client confidentiality. In September 1984 the Bank was finally alerted to the fact that JMB was alarmingly overexposed and that the parent group Johnson Matthey PLC would not be able to stand behind all its bad loans. The Bank acted on its own immediately and bought JMB for £1. It argued that it had to do this to avoid a systemic crisis because of JMB’s position in the gold
cartel. JMB itself was a minor bank, but if 1/5th of the gold market failed this would do
immediate reputational damage to one of the City’s major markets, and would put stress on
the other banks in the cartel, potentially forcing them to require liquidity support. This, the
Bank argued, could have easily migrated into the wider banking sector and caused a
systemic banking crisis like the secondary banking crisis.

The Bank succeeded in averting a systemic crisis, but it did so by causing many to cast
doubts on its judgement, supervisory ability, and claim to legitimacy. The initial £1 cost to
the Bank soon turned into £100 million liabilities for the Bank. Thus while it was literally
true that the Bank rescue of JMB had not cost the Exchequer anything, the government was
now on the hook for a large amount of money in a transaction it had only been informed of –
and not involved in – at the very last minute. The Chancellor faced strong pressure in
Parliament from Labour MPs angered that so much money could be found to save a failing
bank at precisely the time the government was closing down mines and industry for not
being profitable. Following bad advice from the Bank he ended up unwittingly misleading
Parliament, which caused political problems for the government. Relations between the
Treasury and Bank deteriorated, and the government ultimately decided to redo the
Banking Act 1979 with another one in 1987 which removed the two-tier structure, and
brought UK banks in line with the post-Big Bang (1986) financial landscape. The Bank never
recovered its autonomy in banking supervision.

The Bank therefore created the environment for the JMB affair through its poor supervision
and poor drafting of the 1979 law, even though it did manage to prevent a systemic crisis.
This is a story of two supervisory regimes: an attempt to create an open, legal one, and the
previous one of ‘club rules’ and unspoken authority. The Bank failed to manage the
transition to the new regime because it sought the legitimacy of the new while not giving up
its autonomy under the old. In the end the government had to step in to fundamentally
reshape the banking market, the Bank’s relationship to this market, and the Bank’s relationship to the government and public. At this point, banking regulation becomes fully political and no longer in the purview of the Bank of England, for all that it remained the government’s agent in the City of London. This is the logical outcome of the 1979 Banking Act, and it could be argued is also the natural end-point of the Bank’s nationalization in 1946.

Implications of this story
The real question of this whole story is: why did the Act take the shape it did? This gets to the crux of the Bank’s regulatory failure, its loss of status in the banking world, and to the wider issue. The Act took the very strange shape that it did for reasons to do with the political process rather than those of the financial activities being regulated. That is, bank regulation was proven to be a political rather than prudential issue. This means that the Banking Act 1979 took the form it did because of the relative ability of different actors (essentially the Bank and Treasury, also to an extent private market participants) to achieve their institutional aims through the legislative process: determining the need for a law, setting the terms of debate, negotiating them, and implementing them. The prudential regulation of banking was the content of this law, but it was not what the contesting actors were concerned with. The government wanted a banking law to say that it had removed the possibility of another systemic crisis like the secondary banking crisis, and also to comply with the EEC. Because of its failures in the 1970s, the Bank was unable to resist this demand. It then decided, however, to make any new law one which would most suit the Bank and leave it least constrained. Because the government by this time (1977-1979) was in the middle of industrial turmoil, losing its parliamentary majority, and otherwise preoccupied with a sterling crisis, it was in no great position to argue when the Bank
presented it with a draft law. The shifting influence of the two institutions explain why the UK ended up with a law, and a law in this shape.

The trouble with the political cause of a banking law, however, was its implementation in the market. Even a perfectly-crafted law to manage a system would have some difficulty adapting itself to reality. A law designed in a way to create a banking system imposed on market activity has a double job: to force reality into its mold and then to manage it effectively. The Banking Act 1979 was not up to the task precisely because of the distortions it caused. In the simplest terms, the Act caused the potential for a systemic crisis which the Bank was so keen to avoid when JMB failed. Had the Bank not created a 'top tier' of banks (leaving aside the question of appropriate supervision for one moment), a minor market-player subsidiary of a mining group would not have been able to threaten a systemic banking crisis. By accepting JMB as 'a bank', the Bank caused reputational risk when it failed. By creating a rigid categorization around 'banks' and what they could and could not do, the Bank encouraged small institutions to 'improve' their reputation in the banking market by gaining the top classification and then forced these different institutions into one regulatory framework which then increased the risk of contagion. On top of this, the Bank then essentially ceased supervising 'real banks' because they could be trusted (though it is probably correct that the situation of the early 1970s where clearing banks were supervised and controlled closely while all other financial institutions were allowed a free-for-all was perhaps even stranger (Economist 22.9.1979)).

The 1979 Act was a half-hearted attempt to move banking regulation on to a more 'modern' footing: explicit and legal. The Act itself had its flaws, as did the Bank’s implementation of it, but the crucial fault-line that cracked in 1984 with JMB was this ‘modern’ banking system’s interaction with an old closed market, the gold cartel. The worry with JMB was that its poor commercial loans would lead it to fail, which would then undermine the cartel, which would
then undermine the wider banking sector. The systemic linkage came precisely through the politically-protected, 'strategic' market of a cartel arrangement which the Bank refused to be allowed to fail. In responding to this the Bank created moral hazard by making it look like no bank, however small, would be allowed to fail. (This worry has essentially been proven correct.) The JMB affair is a case of poor regulatory design interacting systemically with closed markets, and fear of the international loss of confidence in the City. Three themes, all in state of flux at this point, interact:

- The regulatory design of banking;
- Club versus open governance regimes; and
- The international exposure of domestic finance.

The links between these three policy choices are what threatened a systemic crisis from the failure of JMB, a very minor bank. In this light it is perhaps quite impressive the Bank managed to resolve JMB so successfully (without systemic crisis), albeit for £100 million.

The epilogue to this affair, however, is its political ramification: how it sullied relations between the Bank and the government, how the Bank lost prestige simply from its failure leading up to JMB, the anger of the Chancellor and his ‘punishment’ of the Bank, the politicisation of the Bank in Parliament and questions over its legitimacy to act. The politics of this are largely a side-show in terms of how it impacted banking regulation, but are crucial for understanding how the supervisory architecture has developed in the UK since. The question ends up: what is the legitimacy of an autonomous government agent and how can it commit a democratic government without prior approval? These questions go back to the heart of the debate around the 1979 Banking Act and the Bank’s rescue of JMB.
Measures after the secondary banking crisis and EEC

The 1979 Banking Act has its roots in the secondary banking crisis. Despite this there are nearly five years from the end of the crisis until the Act is given royal assent. What explains this delay and what else happened in this period? Banking supervision was not static, and even during the crisis itself a number of measures were taken.

The first major change was the Bank of England’s abolishing of its ‘Discount Office’ which (among other things) had been its equivalent of a department of bank supervision (Kynaston 1994, 503). In July 1974 this was turned into a Banking and Money Market Supervision Division, with more staff (around 70) and better funding. This also formalized the Bank’s relationship with banks to some degree, although they maintained the need for informal contacts (Times 19.7.1974). As well as this, the failure of Bankhaus Herstatt in 1974 forced international regulators to come up with some form of guideline of how to divide responsibilities between jurisdictions (Schenk 2014). Even without major change in policy, therefore, the Bank was beginning to come to grips with a need for improved supervision domestically and internationally.

The international dimension had a second aspect: Europeanization. The UK joined the EEC in 1973, just before the start of the secondary banking crisis. At this time the EEC was trying to implement a Europe-wide banking bill to harmonize banking practices and regulation across the Community (BoE 8A48/4). The EEC member states at this time had highly divergent laws, reflecting the different development paths of banking in their countries, different aims from legislation and poor communication. Even when discussing similar laws, there was a difference in opinion on what the terms meant (e.g. the definition of ‘management’ in a law: is it de facto as the Bank of England argued or does it need to be a named person as the Italians and Germans argued (NA T520/111, 29.3.1973)?). At the day-
to-day level, the Bank of England, at least, showed a poor grasp of how the EEC worked and how to advance its aims there, even to the extent of not knowing what some of the acronyms it was reading meant or the titles and roles of officials who were visiting (BoE 8A48/4). Perhaps not surprisingly, the 1972-3 attempt at an EEC banking bill failed.

Nevertheless, the problems of the international harmonization of banking regulation were real. There were concerns from bankers (NatWest) that the British authorities were not keeping them informed of progress in Brussels (BoE 8A48/4, 3.8.1972), while the Bank continued to try to advance its aims in negotiations (e.g. by trying to alter the legal basis for discussions to require unanimity rather than majority voting, BoE 8A48/4, 19.1.1973). At the same time as trying to fend off an unwelcome bank harmonization law in Europe, the Bank was trying to keep control of banking in the UK (BoE 8A48/4, 29.1.1973). One problem of the confused state of banking legislation in the UK before the 1979 Act is that no one institution or department had ‘ownership’ of the relevant rules. Thus the Department of Trade and Industry wanted to repeal the Moneylenders’ Act, but in so doing would have undermined Bank attempts to rely on this as a licensing system under the proposed EEC law. The Bank was simultaneously in charge of banks but did not have the power to define them in law.

Straight after the end of the secondary banking crisis (1975) the government thought of ways of licensing deposit-taking institutions. This is because, even though the EEC draft had gone for the time being, it was clear that there would be some sort of banking Directive in the future; this also rested on the prevailing understanding of the secondary banking crisis. This idea was that one major cause for credit build-up in ‘irresponsible’ firms was that the public could not easily tell what was a bank and what was not (BoE G14/348, 22.7.76). Banking terminology was wide-spread in secondaries’ advertising and names, but many institutions were not conducting what the Bank would consider ‘banking’. The assumption
was that if the public knew what was ‘really’ a ‘bank’, people would be able to choose where to put their deposits and take loans more carefully and thus avoid the confusion that prevailed in the build-up to the crisis. It saw the crisis of banking regulation before the 1973 panic as one that tricked consumers, not one which confused supervisors themselves. The Labour government thus introduced a White Paper (the first step to a bill) to license deposit-taking in 1976, though accepted it would probably take until the next parliament to finish it (parliaments at this time were of no fixed length, though a maximum of five years). The wider Labour party, however, had a much simpler answer to the problem of banking – albeit one which did not gain much support – nationalize the major banks and have the Bank of England give its money to the government for national investment (BoE G14/348, 9.9.1976). This call largely undermined the Labour’s party’s appeal in the City. Two years later, the Governor of the Bank of England spoke about the draft bill then in Parliament as an extension of the White Paper, and praised it for allowing the Bank statutory authority while not “prejudic[ing] the close and informal relationship with the banks” that was so successful for UK supervision. He wanted the authority of an Act without the limitations of one, and the two classifications of bank were his way of achieving this (BoE G14/348, 19.7.1978). Nonetheless, he still managed to complain about the Bill’s complexity and length.

For these reasons - the secondary banking crisis, the EEC requirements, and the need for clarity in UK law over banking authority - the government introduced a banking bill (Times, 24.11.1978), which finally completed its progress through Parliament on the last day of the parliamentary term before breaking up for the General Election which would bring Thatcher to power (Financial Times, 16.2.1979) – indeed the same minister was responsible both for the Banking Bill and EEC harmonization negotiations. The reason for the delay in the law was the difficult political situation of the late 1970s. The Labour government, which
enjoyed good relations with the Bank of England (Financial Times, 21.5.1979), had lost its majority over the course of the parliament and was relying on ad hoc support from minor parties to get its laws through (Fay 1987). At the end of the process there was a delaying tactic by some Conservative Lords who sat on the boards of banks and who effectively held the bill hostage until it was written in that banks would not have to disclose interest rates on statements to customers. This had been a bone of contention for banks for a long time, and something which the Bank had conspicuously failed to achieve on behalf of the banks it in theory represented to government (Fay 1987). This unwillingness or incapacity to help was noted by banks which now sought more direct contact with politicians, thus undermining one of the Bank’s two traditional roles (representing the City to government; the other being representing government to the City).

Despite this, the Bank worried that the incoming Conservative government in May 1979 might be more difficult to deal with because of their greater links with the City, and because Conservative MPs might have their own policy views (BoE 6A50/29, 3.4.1979). It also worried about the legacy of C&CC and the secondary banking crisis (which took place under the previous Conservative government) and the party’s preference for private sector housing which might have effects on the role of building societies and secondary mortgages. In short, by the end of the 1970s, the Bank saw potential threats in the government, the EEC, and international markets. About its only ‘safe’ allies were the domestic banks which still looked to it for protection, even if they were beginning to have doubts about its effectiveness. The Bank’s solution was to carve out a legal role for itself through the Banking Act which would clarify its two major sets of relations: to the government and to the market.
The Banking Act 1979: explanation, justification, and significance

By current banking legislation standards, the Banking Act 1979 is neither very long nor complex, but the system it created was unique (The Banking Act 1979). Its principle feature was to create two tiers of authorization: recognition as a bank, or as a licensed deposit-taker. Only recognized banks could use the word 'bank' without restriction. The mechanism of authorization was to make it an offence to take deposits from the public unless authorized into one of those two categories by the Bank. Authorization as a bank would be given to those of “high reputation and standing in the financial community” providing “a wide range of banking services or a highly specialized banking service”. Licensing would go to other institutions seeking to receive deposits so long as they were “competently and prudently managed” (Andersen & Co. 1979). On top of this, there was to be a deposit protection scheme for deposits with authorized institutions up to 75% of the first £10,000, which would be funded with contributions from institutions of both tiers. The Act clearly has as its primary aim to protect consumers rather than create prudential rules, which reflects the priorities of the Labour government (Fay 1987).

The ‘wide range’ of activities had to include current/deposit accounts and financing in the form of loans or overdrafts. Beyond this it was up to the Bank to decide whether a bank carried out enough of the following (Andersen & Co. 1979): “foreign exchange services for domestic and foreign customers; finance through bills of exchange and promissory notes, with finance for foreign trade; financial advice for the public or corporations, or investment management services and facilities for securities purchasing and sales.” The ‘specialized services’ aspect was included to allow Discount Houses into the top tier.

There were certain “demanding” management requirements as well (Financial Times, 21.9.1979): the institution could not have all its assets owned by a single individual and at
least two people had to effectively run the business. There was more detail for the soundness of management for LDTs than for banks, reflecting (supposedly) the more stringent process. On top of this there were certain capital requirements. Most basically businesses had to maintain net assets “commensurate with the scale of their operation”, including a minimum net assets of £5,000,000 for an institution providing a wide range of services or of £250,000 for highly specialized banking services, while LDTs had to have net assets of at least £250,000 as well. The Bank stressed that the point of capital adequacy was not to keep an absolute minimum but to keep something appropriate to the “state of the institution’s balance sheet.” As with the law itself, the Bank was trying to have formal authority to keep a flexible approach. In terms of foreign banks, the Bank took into account the supervision of the home authority and did not require each individual branch to fulfil these requirements “in isolation” (Andersen & Co. 1979). Finally, the Bank had power to revoke recognition and the only appeal was directly to the Chancellor.

The Bank continually justified the Act, starting with the former governor Leslie O’Brien, who dedicated a speech to it just after it came into effect (O’Brien of Lothbury, Leslie, Kenneth O. 1979). Largely his speech was given over to explaining why the Act would not lead to an increase in regulation for banks: firstly because non-statutory regulation had not meant no regulation beforehand, and because this Act leaves the Bank free to act as it would wish. As an unabashedly pro-banking central banker (against other forms of finance) he finally (and for the first time) let the cat out of the bag that C&CC had been designed to reverse disintermediation (that is, bring financial activity back to the banks), and that this Act would solve some of the problems the secondary banking crisis had uncovered. He also, alone, argued that this Act was directly because of the EEC directive. While, as we have seen, it would have been required anyway, there were strong domestic reasons for wanting a bank law: not least the mess made under O’Brien’s watch of the C&CC-secondary banking
fiasco. His insistence on the role of the EEC here is not hard to reason out. As an institutional voice of the Bank of England he also nicely makes the point that since a bank law was coming, this version is the best the Bank (and implicitly he argues therefore all banks) could hope for because it leaves the Bank's powers substantially unconstrained. His is a bullish account of the law, and the Bank's public reaction to it.

We gain a slightly different understanding of the official attitudes to the law by looking at its and the government's internal papers. One point that could be stressed more is that the Act not only set the Bank over other banks but also for the first time gave it formal powers over other deposit-taking institutions. In the Treasury's words, "the short point is that the Act not only placed the Bank's responsibilities on a statutory footing, but also widened their scope" (NA T520/111, 15.2.1984). This is the formalization of the emergency actions the Bank had to take during the fringe crisis, when it de facto accepted responsibility for all the secondary banks as a systemic precaution. After the Act, the Bank has had its scope widened and, whether it realized it in these terms or not, it had become more of a financial supervisor than simply a gate-keeper to privileged status for banks. As experts from the IBRO put it when discussing the Act: “Despite the title of the Act, many of its provisions are of chief concern to persons who would never think of themselves as bankers at all” (Morison, Tillett, and Welch 1979). The Bank, as whole, was happy with the Act (BoE G14/348, 5.4.1979: “it provides a framework within which we shall be able to operate flexibly and without prejudice to our close relationship with the banks that has contributed so much to the effectiveness of our existing supervisory arrangements.”) but the Treasury was unsure. An internal note between Treasury officials from a bit later on shows how they felt the need to support the Act in public, whatever they privately (openly) thought of it (NA T443/66, 23.8.1982); the reason given for the Act is the ease of legislating a range of policy changes and updates in one single act rather than piecemeal over time. An argument of
legislative efficiency, while the Treasury's view of the two tiers is that it came out of the policy on regulating the term 'bank' and nothing more (certainly nothing prudential), which seems a rather naïve view of the Treasury if not an outright lie. Whatever the public expressions of the authorities on the Act, then, it never secured total support, and Treasury-Bank relations were wary even as it was introduced. This would only increase as time went on.

The fundamental question with this Act is how much it really created a new system in banking, and how much it just legislated the status quo or “smartened up” after the crisis (Financial Times, 3.9.1979). The IBRO experts complained that it left open a number of loose ends (Morison, Tillett, and Welch 1979) although it did finally provide an “all-purpose” definition of a bank, and Moran argued that it began to end ‘club government’ in banking regulation but did not finish the job (Moran 2003): that would not come until the mid-1990s and the Barings crisis. Both highlight the tension in giving the Bank powers which it 'will not need' because it will maintain friendly and informal ties with banks. The excitement of the UK's first banking act papered over many of these problems in the short-term, as people adopted a 'wait and see' attitude. But nearly as soon as the law was implemented, it was condemned by nearly all: officials, the press, bankers (and people refused the title bankers), and even within the Bank for the misguided effort that went in to making this system work. It quickly became clear, the Act had not really changed anything but had given the illusion of change: while this may have been the Bank's intention all along, it had poor consequences for banking supervision in the UK.
Immediate disapproval of all: officials, press, and sheep and goats

The Bank’s authority has traditionally rested on two sources of legitimacy: its close relationship to the commercial banks in the City and its close relations with the government. These were put under strain in the 1970s and the Banking Act was designed to clarify these two relationships, while almost incidentally improving the prudential situation of the UK’s banks. The reaction to the Act, however, meant that this was impossible. The City felt that the Bank had failed to promote its interests, while the government remained wary of the Bank’s autonomy. Taken together, these issues led to the JMB bank failure which forced the government to restart the political process for a new bank law. This section traces how the UK got from the introduction of its first Banking Act to the failure of JMB.

No sooner was the Act in place when people started attacking it, not least the two-tier structure. Indeed, many banks and other institutions seem to have found it difficult either to understand or take seriously given how many of them missed the deadline to register (Times, 7.2.1980) or else did it on the last day (BoE G14/348, 3.4.1980). While people acknowledged that the UK now finally had a legal definition of a bank (Financial Times, 27.9.1982), this in itself caused problems. Those recognized as ‘banks’ expected greater protection by the Bank, while those ‘relegated’ to being LDTs were offended by the lack of respect of their management and trustworthiness they thought this implied. There were worries too that because the Act only related to deposit-taken for the authorization-process, any entity which did not seek licensing and did not take deposits but still acted ‘like a bank’ in terms of credit creation would slip through the cracks and not be supervised at all (NA T438/49, 24.2.1983).

Problems with the categorization continued throughout the 1979 regime, especially when it came to licensing foreign banks, which was in theory done in a non-discriminatory way with
due regard given to the home-nation supervision. This caused frequent disputes with the Foreign and Commonwealth Office which was anxious that non-recognition should not be seen as an insult to the home nation (e.g. with Iranian banks, including BCCI: Times, 24.6.1980). There were domestic embarrassments as well; for example, after the Bank and Treasury had actively encouraged the new European Investment Bank (EIB) to open an office in London (the Chancellor was publically at its office’s opening celebrations), the Bank found under the Act that it was unable to authorize it as a ‘bank’ and would have to call it an LDT (NA T443/66, 5.10.1981), until they wrote an exemption. Similarly there were constant problems with the supervision of foreign representative banks, which in theory did not undertake any banking activities, but occasionally collected deposits for their foreign branches (BoE 8A118/2, 15.4.1980). The Bank continually tried to discourage these banks from undertaking any activities but worried that under the law it did not have the power explicitly to forbid it. Even the Bank began to think that a change in the law might be necessary (BoE 8A118/2, 14.1.1981). The logic of statutory regulation now demanded that any clarifications to bank regulation go through the parliamentary process, rather than a simple communication by the Bank. This increased the cost of change and made it slower and less likely, meaning that the distortions caused by poor drafting would have longer to effect the market.

Although those not recognized as banks complained (including Finance Houses and Building Societies, Times, 22.5.1980), even the authorized banks had cause to complain after the Act. When the government introduced wind-fall taxes on banks in the 1981 budget, the banks felt that the Bank of England had not played its role in defending them to government and began to wonder why they granted it so much influence over their decisions (BoE G14/348, 12.3.1981). On top of this, the Act required the Bank to introduce guidelines in due course on banks’ liquidity, capital and loan controls which seemed like unwarranted
intrusion in management’s affairs (Financial Times, 21.3.1980). The constant drip of legally-mandated new requirements the Bank had to impose on the banks increasingly annoyed banks’ management and made them less inclined to treat the Bank as a trusted friend – as previously – and began to see it as a bureaucratic department that was making their life difficult (Times, 9.5.1980).

The Bank of England also had to ward off attempts by other departments to take control of government bank policy. This was not so much the Treasury – which anyway was in charge of the Bank – but the Department for Trade and Industry, which was anxious to promote trade and competition in the UK economy and did not like the Bank’s protection of top-tier banks (this is the beginning of the Big Bang ‘City revolution’ of 1986), and, surprisingly, the Foreign and Commonwealth office who was anxious about the UK’s role in promoting global free trade and therefore wanted foreign banks to have the same status in the City as domestic banks (Times, 20.11.1981). There were concerns that other departments were using the Bank’s definition of a bank for their own legislative purposes, which would undermine the clarity of the Act and the Bank’s authority over this designation in a way analogous to the confusion of the pre-C&CC era of banking regulation (NA T443/66, 18.08.1982). The Treasury’s response to this was to make sure to amend any drafts with the word ‘definition’ in relation to the word ‘bank’ and replace it with the word ‘expression’. They also demanded that other departments should inform them if they intended to use the word ‘bank’ in any new proposed legislation. Civil servants were ever cautious and possessive.

The twin threads of the politicisation and internationalisation of bank regulation intertwine with the case of the proposed buy-out of the Royal Bank of Scotland Group by HSBC (then a Hong Kong-based banking group – i.e. foreign). The Bank’s basic assumption was that it did not want to see major banks (essentially the London and Scottish clearing banks) fall into
foreign control. Their argument was that the clearers had, through accepting the Bank’s authority and following its informal rules, shown themselves sensitive to the national interest (BoE G14/348, 15.4.1981). Note how the Bank uncritically identified its supervision with the national interest. As well as the simple desire to keep UK control over something approaching a ‘strategic asset’ there was a more specific worry with a Hong Kong-based group about the future status of the colony, which was due to revert to China in 1997 (Ibid.). Thus when Standard Chartered’s bid for RBS was counter-bid by HSBC, the Bank strongly discouraged the possible foreign take-over. In times past and to a City bank, this would have been enough to stop the proposed bid. HSBC, however, following the letter of the law more closely than its spirit, went ahead anyway. This was seen as a direct challenge to the Bank of England’s conventional authority (Kynaston 1994, 593). The governor, who was due to retire and had poor relations with the Thatcher government (see below), decided to make this his final battle and exerted his every influence to stop the bid and promote the Standard Chartered bid. Practically this meant that the Bank sent the proposed bids to the Monopolies Commission, which eventually rejected both of them. This was taken as a sort-of win for the governor, but was not a ringing endorsement of the Bank’s authority over the City of London. Despite the Act, under the very economic reform-minded Thatcher government (about to unleash massive financial liberalization under Big Bang) banking regulation and supervision became more and more a political (and national) concern, rather than something which could just be left up to the Bank.

Despite the 1979 Act in theory giving the Bank clear authority over well-defined ‘banks’ in the City of London, it found its authority contested by the increasingly-international market which did not accept ‘guidelines’ and informal supervision like the old British banks, and the government which did not want to leave the Bank to its own affairs. As the strap line of

There was a further cause to the loss of the Bank’s legitimacy. Immediately after taking office, and with no warning, the Thatcher government abolished exchange control after 40 years. This disconcerted the Bank, led (as under C&CC) to large volatility in the credit market, and to worries over the role of sterling (NA G14.348, BoE 11A80/1). Not least it led to a severe deterioration of relations between the Bank and the Treasury at a time when the new statutory nature of banking regulation should require them to work closer together for the good of banking supervision. The government blamed the Bank for undermining its monetary policy and causing a sharp recession, while the Bank thought the government was behaving recklessly and simply had no idea how to respond (BoE 8A243/2 and BoE 6A395/9). Thatcher decided that the problem was the governor and when his term expired, refused to reappoint him and placed someone relatively unknown who was seen as a puppet in charge instead (Kynaston, 588).

It was at this time that the government began to work out how it hoped to reform finance in the UK, which would eventually become the Big Bang or ‘City Revolution’ of the 1986 Act. The Wilson committee - set up in the 1970s by a Labour government trying not to split over the issue of nationalizing the bank after the secondary banking crisis – finally reported in 1980 (*Times*, 26.6.1980), leading to major speculation over the future of the City, which was widely seen to be failing (*Economist*, 28.6.1980). The UK was seen to have a problem of underbanking which was caused by restrictive regulation across the City as a whole and not just from the Banking Act (*Financial Times*, 1.9.1980), while some commentators worried that the City was becoming more not less ‘clubbish’ as a response to the stresses of recession and foreign competition. The tension between the free-market Conservatism of Thatcher and the established Conservatism of the City became marked (*Economist*, 17.10.1981).
2.7.1983), as did the problems of the Bank's dual role as autonomous guardian of the City and agent of the government (Times, 26.1.1984).

The period from the implementation of the Act in 1980 to the failure of JMB in 1984 was marked by the increasingly obvious flaws in the Act, the decreased authority of the Bank of England in terms of bank supervision, and increasing political interest in how (and for whose benefit) the City of London should be run. When the JMB affair broke due to the Bank's poor record of supervision and the inadequacy of the 1979 Act, the government seized the opportunity to reform the legislation to bring it in line with its wider objectives of Big Bang. That is the story of the next case study; now we trace out who JMB was, why it failed, and what this said about UK banking supervision in the early 1980s.

**JMB: who they are, how they got into crisis, role of the Banking Act 1979**

The best initial source of information on Johnson Matthey Bankers, their crisis and rescue is the Bank of England's own account which was submitted to Parliament and then published in their Annual Report (Bank of England 1985). This will form the basis of this section, as modified by other sources. It explains how a minor bank, itself a branch of a wider non-banking group, so threatened a systemic collapse of the UK banking market that the Bank of England ended up supporting it to nearly the same cost as the entire lifeboat operation of the secondary banking crisis, while the governor and Chancellor of the Exchequer narrowly fought off calls to resign. This crisis – more in the machinery of government than in banking markets – then lays the groundwork for the redrawing of banking authority in the UK which forms the next case study.
**JMB – who they were**

As the Bank report explains, JMB were set up in 1965 to conduct the banking and bullion business of the parent company Johnson Matthey PLC. As such it was authorized under the Exchange Control Act of 1967 to undertake foreign exchange transactions and so was supervised by the Bank of England before the enactment of the 1979 Act. This meant that it was immediately granted recognition as a tier-one bank in the first round of decisions under the new Act in April 1980. It largely dealt in foreign exchange and the bullion trade and had a very small commercial banking division. Table 1, below, shows how its loan portfolio grew in the early 1980s as it sought out greater profits off the back of declining revenues from its gold business. These loans tended to relate to the Middle East, Pakistan and Nigeria, JMB’s traditional regions. As the table shows, total assets more than doubled in the four years from 1980 to 1984, as did its bullion business, but its commercial business exploded nearly ten-fold – it was still far smaller in aggregate than its bullion business, however, roughly 25% of its size. For all that its commercial banking business was rapidly growing, it still remained primarily a bullion-trading outfit, not a commercial bank.

**Table 1: JMB assets 1980-1984**

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<tr>
<td>Loans and Overdrafts</td>
<td>34</td>
<td>78</td>
<td>135</td>
<td>184</td>
<td>309</td>
</tr>
<tr>
<td>Holdings of bullion and customers’ bullion-related accounts</td>
<td>678</td>
<td>786</td>
<td>804</td>
<td>1,226</td>
<td>1,359</td>
</tr>
<tr>
<td>Total Assets</td>
<td>874</td>
<td>1,040</td>
<td>1,183</td>
<td>1,735</td>
<td>2,089</td>
</tr>
</tbody>
</table>

*Source: Bank of England 1985, p33*
Because of its traditional and large role in the bullion markets, JMB was part of the London gold fixing. This was a semi-official cartel which set the price of gold each day through negotiation between its five members. This gave JMB an institutional importance which it would not necessarily have had simply on the back of its business activities. It also meant it interacted daily with some other well-established and trusted banks, most of which were owned by the large UK clearing banks.

_Failures as bankers – failure in the Bank_

As table one suggests through the rapid increase of one of its business divisions, JMB was not able to control its commercial lending growth. This happened because it had entered into a number of large individual exposures, which the Bank blamed on poor commercial banking practices. The largest two of these exposures were to two separate foreign business groups. “By June 1983 the sizes of the exposures to these debtors were equivalent to 26% and 17% of JMB’s capital base, respectively” (Bank of England 1985, 34). These continued to grow over the course of the year to 51% and 25%. There were also problems with other loans, a number of which were in US dollars which, as the dollar-sterling exchange rate slid in 1983-1984, increased total sterling lending for the bank. The loan-book thus grew very rapidly without adequate provisioning.

The bank’s problems began in 1984 with the two large exposures: “JMB was faced with a familiar banker’s dilemma of deciding whether to lend more to help a customer trade out of its problems or to refuse further credit and bring about the customer’s failure. JMB chose the former course” (Ibid.). The Bank firmly puts the blame on the failure of internal controls inside JMB and poor prudential management of the bank: failure to demand security for loans, the rapid build-up and concentration of risk in the bank, and poor provisioning for bad debts.
It is no surprise the Bank of England puts such blame on the internal management of the bank, because many others saw the failure as the Bank's own failure of supervision (NA T520/122, 2.10.1984). The Bank devotes a long section of its report to show how it supervised JMB adequately in this period, and in the same way as it did all the other recognized banks. That is, trusting its annual reports and relying on the bank's auditors for confirmation. The auditors, however, were legally bound to respect their client's confidentiality and were not able to flag up any concerns to the supervisors in the Bank. As if it were a mitigating factor, the Bank said that it had raised concerns about JMB's accounts in the summer of 1983 and then earlier in 1984, but JMB kept pushing back its meeting with the Bank to explain itself. This does not show very severe or strenuous supervision. When they finally did meet in August 1984, the Bank expressed concerns over the size of the two large exposures and asked the auditors to look at them again (they subsequently found misreporting even on the already large exposures). This finally caused JMB's management to realize they had under-provisioned the loans, and that to build this up would severely undermine the Bank's net worth and make it insolvent (NA T520/122, 1.10.1984). It was at this point that the Bank stepped in to buy JMB for £1. All this shows the laxity of the supervisory gaze, its reliance on accurate and trustworthy reporting by management and auditors, and the powerlessness of the Bank to enforce prudential measures onto recognized banks.

Role of the Banking Act 1979

These failures – supervisory and market - clearly have their origin in the Banking Act itself. Although it gave the Bank statutory authority, it removed the need for the Bank to supervise banks themselves and told it to focus on supervising the 'less responsible' LDTs. JMB had not been mentioned before the crisis in any prudential review meeting, or to the Treasury by the Bank, and Bank officials thought this excusable because the press had not mentioned
problems in the bank either (NA T520/122, 2.10.1984). This suggests that the Bank did not think it should have more detailed information than that published by the press: not a very strict form of supervision. Some inside the Bank also thought that the Act's requirement for banks to provide a 'wide range of services' was actively harmful because it encouraged banks to get involved in new areas of banking activity of which they had little experience (NA T520/122, 2.10.1984) – a situation that is clear from JMB’s business growth in the period 1980-1984 as shown in table 1.

Taken together, the Act was shown through the failure of JMB to encourage lax supervision of expansionary banks, simply because they could be trusted having gone through a more rigorous approval process for banking recognition than LDTs. As we have seen though, JMB was accepted as a bank simply because it had always been treated as a bank for purely exchange control reasons prior to the 1979 Act, and as a member of the London gold fixing it was accepted as in good standing with the London banking community. There was almost no scrutiny of its actual business activities, and even less so on an ongoing basis yearly when it had been granted banking status. This is the statutory laundering of an unchanged club-system of banking governance, or in the words of one Bank official: the two-tier system was their “fig-leaf” (Fay 1987).

The rescue of JMB: Bank success/Treasury ignorance - immediate victory/long-term questions

Nevertheless, and as with the secondary banking crisis a decade earlier, the Bank managed to make up in resolution where it had failed in supervision (Times, 3.10.1984). At least that is how it seemed initially. It acted quickly and decisively to avert a systemic panic, seemingly with little cost to the public. As time wore on and the situation became politicised, however, the Bank found itself increasingly unable to defend its actions. It was
this failure of political skill which ultimately led to the 1987 Banking Act. On top of the
domestic implications of the JMB affair, it also brought the international dimension to light
again: how should supervisors treat a bank within a wider business group and a domestic
branch as part of an international group (Financial Times, 3.10.1984)? The JMB affair
showed the risks to London’s international standing as a financial center from its domestic
supervisory arrangements. The rescue was the Bank’s attempt to hide this development.

The rescue

The rescue was simple enough. After attempting, a little half-heartedly, to find a private-
sector rescuer for JMB, the Bank agreed to buy it for £1. The governor and chancellor met
on the 1 October 1984 to discuss the situation for the first time, with the governor
explaining who the bank was, what difficulties it was in and how the only solution was for
the Bank to buy it (NA T520/122, 1.10.1984). Not surprisingly Lawson, the chancellor, was
annoyed to have been kept in the dark until there were no options left, and the governor
argued that the bank could not be allowed to fail – despite its small size – because of its
systemic importance to the gold market. The worry was that if JMB was allowed to fall,
there would be a run on the other members of the gold fixing which would weaken
confidence in their parent clearing banks and potentially cause a run on the UK banking
market and destroy the London bullion market (Ibid.). The chancellor agreed to the Bank’s
actions on the explicit understanding that no public money would be spent and that the
Treasury would not give any guarantee. The Treasury privately assumed that a rescue
would greatly increase moral hazard because it showed that no bank, however minor,
would be allowed to fail because of potential systemic effects (NA T520/122, 4.10.1984).
This worry was reinforced by the US’s recent example of bailing out Continental Illinois. The
press was quick to see in this failure and rescue the end of ‘gentlemanly banking’ and the
failure of the Bank’s methods of informal supervision, which would in the future require
“more form-filling, closer scrutiny... and a new string of regulation” (*Financial Times*, 22.6.1985). The same article quoted one senior banking saying it was “a sad day, but necessary.” The JMB affair severely dented the Bank’s authority as a competent supervisor, undermined any lingering respect for the 1979 Banking Act, and infuriated the Treasury for being kept in the dark by the Bank. No surprise that it was assumed a new regime would have to come.

**Calming the Treasury**

The key to calming the Treasury down was that no public money should be spent on the rescue. This meant that the Bank’s money (which was not classified as public) would be, along with some private involvement. This, not surprisingly, angered the clearing banks who did not see why they should be forced to pay for a competitor’s rescue. The Bank’s ability to corral the clearing banks into a deal was seen as a test of its moral authority over the City (*Times*, 12.1.1984). In the end they agreed, but at the cost of further bad blood between the banks and the Bank, which reduced its ability to get them to act in the ‘national interest’ as it had before. It showed the weakness of the Bank’s supervisory approach (*Economist*, 10.11.1984), and led it – essentially for the first time – to be publically attacked by politicians and bankers as incompetent (*Financial Times*, 6.2.1985). Also for the first time, the Treasury did not defend the Bank but allowed it to take the flak for its own decisions – it made clear that the price of autonomy was isolation. Unfortunately for both the Bank and the Treasury, the cost of the rescue was put at £245 million, an outrageously large sum for such a small bank, though it was stressed that this would be borne by the Bank and not the government (*Financial Times*, 14.5.1985). About the only solace Lawson could grab from this situation was that he could blame the two-tier system on the previous Labour government (*Times*, 21.6.1985). The best the governor could do in a speech to the bankers of the City of London was to say that despite all the difficulties, at least it was a
collective rescue operation and the bank did not fail (Leigh-Pemberton, BoE 7A371/4, 18.10.1984). Quite why it is a good thing a failed bank was not allowed to fail was not explained. His deputy the next week was reduced to saying that it was good for the private banks to join in the rescue because they all benefitted from systemic stability (McMahon, BoE 7A371/4, 23.10.1984). Bankers which had just been handed a wind-fall tax and told to comply with more regulations were understandably a little confused as to why systemic stability was still at risk. Obviously, the Bank wanted private funding so it could stand by its commitment to the government that public funds would not be used. Under the post-1979, politicised banking regime, it understood which group between the government and banks was more important to keep on side.

**Political repercussions**

The affair raised political questions about the government’s professed aim of not allowing failing enterprises to be rescued (*Times*, 3.10.1984), especially at a time when it was closing unprofitable mines and industry down across the rest of the country (*Times*, 18.10.1984). The rescue of JMB was beginning to look politically indefensible and the affair dragged on because of parliamentary scrutiny. The Bank and government were to realize that a banking law not only gave supervisors legal authority, but also put them into a system of political contestation. As Fay (1987) put it, the Bank would have got away with the rescue if it was not for probing in parliament by a Labour opposition angry over the government’s perceived double standards on industry rescues. This opposition took up a lot of the Treasury’s time, mainly because it forced them to look into the Bank’s actions in much greater detail than they were already doing (NA T520/122). In demanding the Bank explain itself, launching their own research into the situation, and responding to the Labour MPs, the Treasury realized that the Bank’s actions – which had been presented as inevitable and
autonomous – were in fact likely to result in the government having to use public money for
the rescue and came from the Bank’s uncritical assumption that JMB should not be allowed
to fail (NA T520/122, 9.10.1986). The Treasury’s aim became to distance itself from the
specific decision while still assert its responsibility over the banking sector.

In its correspondence with and about the Bank, the Treasury was privately very critical. It
called the Bank’s confidential reports on the JMB affair “feeble” and “like an apologia”, and
attacked them for failing their supervisory duty (NA T520/123, 7.11.1984 and 15.11.1984).
Lawson’s repeated question to the Bank was why they felt they had to rescue JMB at all,
more than the mechanism they then used to do so (NA T520/124, 26.11.1984). The Bank, as
always, focused on JMB’s role in the gold market. Lawson bought this but still thought that
most of the problem came because the Bank had no time to act because its supervisory
failures meant it was uninformed. The Treasury therefore decided to use this opportunity to
“put the Bank on notice” before stripping it, potentially, of its supervisory powers (NA
T520/123, 21.11.1984). The government’s problem was that in public and in parliament it
had to defend the Bank’s actions. It therefore demanded that in the future the Treasury and
Bank write a new memorandum of understanding about when the Bank would have to
notify the Treasury that it was using its own funds (as an indicative limit they set £50
million – NA T520/124, 2.11.1984). Internally, as well, the Treasury drew up a tentative list
of banks which should not be allowed to fail: essentially the clearing banks, discount houses
and accepting houses, and they built up a file of best-practice from this and previous crises
(NA T520/124, 7.12.1984). The Treasury was determined to be better prepared in any
future crisis, so that this issue of lack of time for a reasoned response should not arise again.

The government’s solution to this political problem was to launch a review of the Banking
Act (Financial Times, 30.10.1984) to remove the two-tier structure but, also, more
fundamentally to alter the architecture of supervision. Thatcher wanted the Bank to give up
all its supervisory roles but her chancellor, Lawson, convinced her to allow it to keep them subject to a board of banking supervision’s control (Kynaston, 666). His argument was that a Bank without any supervisory role would not know what was happening in the City, would lose the respect of the market, and from that would lose significance in the City and internationally in its other macroeconomic roles, monetary policy execution and as one of the major world central banks. The outcome of the JMB affair was that structure of UK banking supervision was altered precisely because of action in parliament and the animus of the prime minister not for prudential reasons of systemic stability. The failure of JMB was the pretext, not the cause.

The deeper problem from this affair was the rift it caused between the Bank and Treasury (Economist, 27.7.1985), and the attack on its legitimacy that came from all sides – especially on its capacity to act on its own (Financial Times, 12.8.1985). The concern was that within banking the Bank had sweeping powers and, it turned out, could end up committing public money without government or democratic oversight (if in no other way than through reducing its dividend payment to the Treasury because its own profits had been hit by the rescue, BoE 5A19/6). The Bank reorganized itself internally (Times, 26.9.1985), while the government’s approach to banking supervision shifted (Financial Times, 2.10.1985). The fact remained, however, that through its supervisory failure with JMB but even more so through its political aftermath, the Bank lost its position of unquestioned dominance in the City, both in the opinion of the government and of the market (Financial Times, 16.12.1985; Economist, 21.12.1985).
Conclusion

The story of the 1979 Banking Act and JMB's failure can be summed up as the attempt to enshrine the old ways of club governance in an 'open government' way, and the failure of this. It was the attempt by the Bank to keep supervision informal and under its control, while appearing to bow to the need for greater transparency. It failed and as a result of this, the Bank took a beating politically. This led to a new round of the political process which altered, for the third time in eight years, the form, purpose, and method of UK banking regulation. As during the secondary banking crisis, the failure of the Bank in leading to crisis was followed by its success in resolving it, because of the speed and independence of its action. By this time, however, it had lost the goodwill of the banks and the government and so it was not praised for its successful resolution but in a way punished by being exposed to parliamentary and press scrutiny. Having been granted legal authority under the 1979 act, it now had to face political opposition. This dented its legitimacy and made the current system of banking regulation untenable. The Bank had lost the respect of the markets around the forming of the Act – both because of the Act's necessity and because the Bank did not seem able to defend banks' interests as well as it had in the past – and then the Bank lost the respect of the government by not fulfilling its new role as a supervisor and political body around the JMB affair. Bank supervision through the Bank of England was now delegitimised.

Once again, as with the secondary banking crisis, we can trace this story as an arc of political-regulatory change leading to market failure which then required new political-regulatory change. Crucially, the failure of JMB can be directly attributed to the form of the policy change in the Banking Act 1979: the two-tier structure of banking and supervision, the Bank's new political role as a legally-sanctioned body, and the Bank's legitimacy for autonomous action. These were all issues the Act was designed to resolve, but the solution
it gave – because of its peculiar form – was unsuitable. The reason the Act had this unusual form was because of the attempt by the Bank to appear to change with the times without wishing to concede anything of its previous methods.

This case has told the story of how the UK got its first banking law, why this law had a unique shape, how this shape then led to a bank failure, and this failure then forced the government to introduce a new bank law. The next case will look at the negotiations around this new law and how this then led to two institutional failures as well. For the first time, the international dimension will predominate.
Introduction

The City changed drastically under Thatcher. This was not the result of a deliberate programme of reform by the new government, but rather came about through a series of unintended consequences, opportunistic moves, and pressure from the private sector. In so far as the outcomes of these processes were coherent with each other, this is because they all reflected Thatcherite principles even if they were not Thatcherite policies. The City at the end of the so-called ‘City Revolution’ was more open internationally and less restricted internally. It had become a highly competitive engine of private-sector growth which, taken together with Thatcher’s wider industrial policy, fundamentally reshaped the UK economy. The result was the dominance of capital markets in the UK backed by strong state authority (Story and Walter 1997). This led to the current political economic set-up of mitigated neo-liberalism and broke away from the post-war consensus of the Keynesian welfare state.

Such a strong outcome is surprising given that to start with Thatcher essentially had no financial policy to speak of. What little she had was an after-thought of her attachment to Monetarism. In attempting to make Monetarism work so as to curb inflation, Thatcher abolished exchange controls in 1979. This, almost unintentionally, opened UK banks up to international competition for which they were ill-prepared. This was the first move in the ‘City Revolution’ - albeit unintended as part of a wider programme of liberalization - which forced future changes in the organization of the City.

Simultaneously, the UK Office of Fair Trading (OFT) was investigating the Stock Exchange for fraud and uncompetitive practices. This began a process of legally-derived private-sector reform in equities markets with which the government only became involved towards the end of the process. This 1986 reform became known as ‘Big Bang’ and is perhaps Thatcher’s most famous and iconic financial policy. Nonetheless, it was not a
deliberate government policy designed to reform equities markets, but rather was the
government’s attempt to regain the initiative in an ongoing, non-state process and force it to
a conclusion which fit the government’s priorities.

The general incoherence of the City at this period, relating to but not solely to the two
developments above, led the government to introduce the Financial Services Act of 1986.
This was a separate process to Big Bang and the later Banking Act. Only with the FSA, eight
years into Thatcher’s premiership, can we talk of a deliberate financial policy as such and it
was as much an attempt to make the status quo coherent as it was to reshape markets. It
followed from the tensions introduced into financial markets by the abolishing of exchange
controls, and sought to bring Big Bang into a wider financial framework; but the FSA was a
wider attempt to recreate the City in Thatcher’s image: competitive, anti-establishment, and
rational.

These three elements – exchange controls, Big Bang, the FSA – radically altered the
regulatory environment of the City, and hence the market environment, but they did not
directly involve banking regulation. The tensions this led to with the existing 1979 Banking
Act, coupled with this Act’s obvious failure over JMB, encouraged the government to update
it with a new Banking Act in 1987. This reform is the focus of the next case study. In this
brief chapter we will fill in the background to the 1987 Banking Act by looking at each of the
three steps of the City Revolution in turn.

Abolition of exchange controls 1979

Abolishing exchange controls can be considered as the most radical – in the sense of
aggressive, profound, and drastic – change of all Thatcher’s policies in her 11 years in office.
Certainly this is true of her financial policies. It is all the more remarkable, then, that this
action was undertaken with almost no foreshadowing, very little internal and external discussion, and seemingly was done off-hand. Perhaps its ultimate significance was not well-understood at the time and has only become clear with hindsight. This act was the trigger which, single-handedly, set in motion the whole train of events that led, ultimately, to the modern UK’s financial economy of a hyper-open, competitive, and dominant financial market in the City at the expense of other industries and social equality.

There were two reasons for the abolishing of exchange controls: as an ideological blitz to shock the economy into liberalization (Lawson 2011), and as a means of avoiding ‘Dutch disease’ with the discovery of North Sea oil (Plender and Wallace 1985). It allowed all UK banks to trade in all currencies without restriction, after exactly 40 years of quantitative limits. Different ministers had different reasons for their decision to back abolition: some for reasons of political freedom, some to boost European integration, some for economic liberalization, and some for party political reasons (Ikemoto March 2016).

As Plender and Wallace argue, however, the decision still came as a shock to market participants and commentators since it had not been flagged up publically or expected (p. 20). In this sense it was an early example of Thatcher’s radicalism, what they call her ‘fundamentalism’: sudden, bold moves that in one step change the fundamentals of the economic situation; and from which it is very hard to roll back. Big Bang will be another such fundamental move, although it came about for different reasons.

Lawson (triumphalistically) sees the abolition of exchange controls as an example of the death of bipartisanship in UK economic policy (the post-war consensus) which he sees as a “blow for freedom” that is both political as well as economic (p. 39). Through such partisan moves he argues that Thatcher managed to move the consensus in politics and not just defy it. Abolishing exchange controls was as much a political as a financial policy therefore. Blair
(and Brown’s) decision to grant the Bank of England immediate independence, with almost no public discussion beforehand, is a later example of the politically signaling effect of a bold move in financial regulation (see final case study).

Hall (1987) and Kynaston (1994) agree that abolishing exchange controls, and in such a decisive fashion, led to the future changes in the City. Kynaston quotes Nicholas Goodison, the chairman of the Stock Exchange at this time, that “the real cause” of Big Bang was the “abolition of exchange controls in 1979, because that completely freed international capital markets as far as London was concerned.” At a stroke it removed the barrier between “the two Cities” – the domestic and international markets – which showed up how uncompetitive the domestic banks had become ((Plender and Wallace 1985)).

It is in this aspect that the decision impacts most closely on banking regulation. By exposing UK banks to international competition at home – they were already able to compete in international wholesale markets – it exposed the low capital base they had to work with and the lack of coherence of the structure of UK banking (Lawson 2011). In short, removing the protection of exchange controls made UK banks internationally uncompetitive. It also led the members of the Stock Exchange to worry about their own competitiveness. Until the Stock Exchange itself was reformed and liberalized this was no major worry – although the Exchange and UK equities markets along with it had stagnated in international terms – but as the investigation into the Exchange’s practices gathered pace, it became clear that the Stock Exchange would itself have to become more competitive (Kynaston, 616).

The abolition of exchange controls forced UK banks to compete internationally by removing the distinction between domestic and international capital markets. The restricted equities market in the Stock Exchange severely hampered their ability to raise money, given the UK’s historic ‘under-banking’ in terms of its deposit base. It is no surprise therefore that the Bank
of England championed the liberalization of the Stock Exchange and to a great extent managed the process (Plender and Wallace 1985). The abolition of exchange controls therefore had a directly liberalizing effects on UK banks through allowing them to deal currency freely and an indirect one on the Stock Exchange which realized it would have to reform if it were to compete internationally (Kynaston, 616).

**Big Bang 1986**

Big Bang is Thatcher’s most famous policy – certainly as regards the City – yet it was not, in any real sense, her government’s policy at all. It came about because of an investigation by the Office of Fair Trading (OFT) into the Stock Exchange’s long-standing anticompetitive practices. The Thatcherite outcome happened because the ‘new’ pro-competitive, rather than pro-elites, Conservative government supported the OFT over the City establishment. This was a result of Thatcher’s ethos for breaking up closed markets and ‘un-meritocratic’ groups wherever she found them – coal mine or boardroom equally. Eventually the government played a brokering role between the OFT and the Exchange to ensure the City’s international reputation. A non-governmental decision about the rules of the equities market ended up causing the largest single shift in UK banking practices in its history. How a single, independent investigation led to the shake-up of the City is an instructive story for seeing how the informal and formal regulation of the City coexisted at this point; and led to the supremacy of the state over the market in terms of regulation.

The reform of the Stock Exchange began in some ways with the Gower report on financial services (Gower report 1985), which was commissioned to look into the whole system of how the City worked and for whom. It came about because a series of frauds had reduced public and political confidence in the City, while the Wilson Committee’s report which
finally was published in 1980 was largely seen as inadequate as a basis for future action, albeit useful as a base-line description of UK financial markets at that time. While investigating investor and consumer protection in financial services, however, Gower’s report began to grow into an investigation of the Stock Exchange and City more widely. Essentially it attacked the “complex and arbitrary” rules in the City; the system of informal self-regulation was breaking down (Kynaston, 595).

At the same time the OFT had opened a case against the Stock Exchange for uncompetitive behavior regarding what was known as ‘single capacity’: that is, the obligatory division of labour in the Stock Exchange between jobbers and brokers (jobbers being market-makers on their own account, and brokers trading on behalf of clients). As part of this system of single capacity there were also minimum commissions which guaranteed stock-market participants profit at the expense of their clients (Kynaston, 616). This case ran until 1983 when the government involved itself, through the Secretary of State for Trade and Industry, to resolve the issue with minimal public relations damage to the City and to try to force coherence on the legally-necessary reform of the Stock Exchange with Thatcher’s increasing desire to reform the City as a whole: to break open the cosy club of the City (Kynaston, 585, 618).

One development which undermined the Stock Exchange’s defense of uniqueness and need for special rules (i.e. which would allow it to be exempted from the Restrictive Practices Act) was the establishment in 1983 of LIFFE, the London International Financial Futures Exchange (Kynaston, 622). This Exchange allowed dual capacity and did not set minimum commissions, was introduced by the Bank of England, and seemed to work well in creating a futures market without any of the traditional and idiosyncratic rules of the Stock Exchange. As the OFT’s investigation into the Stock Exchange continued, the Exchange’s special pleading began to look increasingly like a call for market protection. There was a clear
tension between the Restrictive Practices Act’s requirement that competitors should not have non-market agreements among themselves – so as to protect consumers – and the self-regulation of a club in the Stock Exchange which did precisely that (Plender and Wallace 1985). The restrictions on foreign membership or ownership of members of the Stock Exchange was also increasingly at odds with the internationalisation and liberalization of the City that Thatcher was pushing, and which was anyway coming about from the abolition of exchange controls.

In 1983 a deal was agreed to reform the Stock Exchange by removing minimum commissions but allowing single capacity. This was seen as a sell-out to the City by the Conservative Party (Plender and Wallace, 2). This might have been the end of the story had it not been for the many different interactions between the Gower report, the OFT investigation, the market changes brought about by ending exchange controls, technological change, and the gradual realization in the government (or perhaps the increasing intransigence of the Prime Minister) that partial reform of the City would not work (Kynaston, 629): the old system either had to be protected fully or reformed fully (NA PREM 19/1718, 6 June 1986). Big Bang came out of merging together of all these different strands of market change and political response. Change would not have come on its own, but came about as a result of the government’s response to foreign pressure: to the fear that London would lose out as a financial center to New York and Tokyo if its securities markets did not become more competitive (Kynaston 634, Plender and Wallace, 42-48). One reason for this was the international trend away from bank intermediation towards securities trading for raising capital.

From the Stock Exchange’s point of view, one problem with this international shift in market patterns was that the number of jobbers had shrunk significantly from 104 to 13 between the 1950s and 1970s (Plender and Wallace, 84). This reduced liquidity in the
system, thus driving up prices for consumers: all of which had the effect of reducing the Stock Exchange’s business and, with the removal of exchange controls, driving consumers to foreign securities markets. Because banks were major clients of the Stock Exchange, and looking to become increasingly involved as financial markets liberalized and internationalized, the Bank of England naturally worried that the lack of reform of the Stock Exchange was driving banking business out of London and reducing London’s importance to world financial markets. The Bank has always had two remits (usually at odds): to ensure the stability of the UK banking system and to promote London as a banking center. At this time the Bank decided that improving the London Stock Exchange was the most important way of ensuring London’s international competitiveness (Plender and Wallace, 91).

Thus in 1983 the Stock Exchange - faced with a legal investigation into its practices, Bank of England involvement in an area traditionally outside its remit, government pressure, loss of business to international competitors, a reduction in the number of its own members, and a successful counter-example, semi-competitor in LIFFE – agreed to reform itself over the next three years (Plender and Wallace, 91). This was to become known as Big Bang due to the instant and fundamental change in practices it would lead to. Before Big Bang actually happened, however, every Stock Exchange member firm had been bought out or taken part in a merger (Plender and Wallace, 111). The market pressures at this time were as important in the changing of traditional market practice as regulatory change (formal or informal). It is in this sense that Goodison could say that Big Bang would never have happened without the abolition of exchange controls.

The actual reforms did not, in fact, happen all at once: there was a ‘little bang’ in March of 1986 which allowed outside firms to buy above the traditional 29.9% ownership limit of Stock Exchange members (Times, 3.3.1986). This allowed both members and outside firms some time to get used to each other before Big Bang itself happened in October of 1986: the
ending of single capacity and the removal of minimum commissions (*Times*, 20.1.1986). Both government and commentators knew this would be a signal moment in the City’s development and both sides also wondered whether it would work. A Number 10 Policy Unit note to the Prime Minister in the run-up to Big Bang was stark (NA PREM 19/1718, 3 June 1986):

“If Big Bang goes off successfully, it will be seen as a showpiece for Government policy on deregulation and increased competition; if it leads to scandals and liquidations, it will be labelled the unacceptable face of unpopular capitalism.”

Early technical problems after Big Bang seemed to confirm some commentators’ fears (*Times*, 30.10.1986): “From Big Bang to Big Flop in three days” which was blamed on the fact that the Stock Exchange “had been forced” to reform rather than come to it willingly. In a telling point, Galletly and Ritchie argue that the government too was forced to intervene in the stock market and more widely in financial market reform, precisely because of market-based change rather than to cause this change: “Government regulatory intervention into the marketplace is often not the cause of change: it is the consequence of it. Frequently, government trails behind changes that have happened and legislates retrospectively to tidy up a fait accompli” (Galletly and Ritchie 1986).

Big Bang was much more than a tidying-up exercise, but their identification of the direction of causality is quite right. The abolition of exchange controls, as part of the liberalization of the UK economy, led to market changes which were at odds with the traditional and uncompetitive practices of the Stock Exchange. These became intolerable economically – as shown by London’s loss of international competitiveness – and politically. The government took the opportunity, when reform was inevitable, radically to change the way the Stock Exchange worked. At the same time it used the reform of the Stock Exchange as an
opportunity to reform the working of the City as a whole. This came in the Financial Services Act which passed in 1986.

Financial Services Act 1986

As a result of the market-based changes to the City that came about as a reaction to the abolition of exchange controls, and with one eye on the situation of the Stock Exchange, the government decided to reorganize how the various parts of the City worked all together. This was an attempt to create coherence once and for all between the various markets in the City, and also to ensure a level-playing field between individual types of financial institutions as well as with international competitors. The aim of this Act was to make the City competitive internally and internationally, to ensure (or recreate) its dominance in world financial markets. This reflected long-standing UK economic policy, Thatcherite economic principles, and an opportunistic bid for advantage at the expense of the US. As a financial-industrial policy the FSA was supremely successful on its own terms, although considered inelegant as a piece of legislation (Economist, 15.11.1986). Whether it was desirable for the UK economy and society as a whole is a matter of personal political opinion. The development and success of the FSA highlights the government’s concerns of the time and its attempts to compromise with the traditional character of the City.

The Gower report more directly led to the FSA than to Big Bang. Its remit for investor protection in the City as a whole led it think about how best to manage financial regulation when the traditional informal regulatory system seemed to be creaking (Rider, Chaikin, and Abrams 1987). As banks moved more into securities dealing and bank intermediation declined as a way of raising capital, a wide-ranging look at how best to regulate these industries became necessary. Wedgwood et al. (1987) quite simply call it the “regulation of
the investment business” in all its forms, and see it as the most comprehensive attempt at financial regulation in UK history.

The basic principle of the FSA was “self-regulation within a statutory framework” (Ibid.). This meant that each industry would have a ‘Self-Regulatory Organisation’ (SRO) as its regulator, which was made up of industry practitioners (rather than public servants), yet given statutory powers to enforce their decisions: the authority for these would ‘flow down’ from the Secretary of State for Trade. As even one of the Act’s architects, Nigel Lawson, accepted, however, the term ‘self-regulation’ is complicated, (Lawson 2011):

“[Self-regulation is] a misleading term for a statutory system: but rules [were] made by Self-Regulatory Organisations (SROs) set up under the Act and manned by practitioners not bureaucrats, under the aegis of the Securities and Investments Board (SIB) on which practitioners were also represented. The system had been greatly influenced by the Gower report on investor protection of 1984: supervision should not ‘seek to achieve the impossible task of preventing fools from their own folly... but should be no greater than is necessary to protect reasonable people from being made fools of’.”

Thus self-regulation did not mean that, as in the ‘old’ City, industry clubs or bodies could do what they like, but rather came to mean ‘practitioner-led’ regulation, in as much as the officials of the self-regulatory organizations (more below) were practitioners in their fields. This was designed to encourage industry buy-in to regulation, so as to improve compliance, as well as to ensure that it did not become too bureaucratic and invasive. But as Lawson (p. 244) later regretted, it had the unfortunate effect that “most of the ablest practitioners [were] too busy making money to be able to devote adequate time to the task of regulation.”
Moran (2003) argues that in fact the Act was a bit of a fudge, an attempt to keep the image of club government so as to “defend markets against democratic control” while nonetheless empowering them in a statutory framework (p. 160). This is similar to the Bank of England’s attempt with the 1979 Bank Act to keep its independence from government while availing itself of statutory powers. Both Acts led to conceptual problems of how to give private bodies public authority. Even within Number 10 there were concerns over this (NA PREM 19/1718, 26 April 1986), and astonishingly given the public face of the Act as being completely ‘self-regulatory’ the government’s attorney general argued that in fact SROs (here discussing the overarching Securities and Investment Board specifically) should be considered (ibid.):

“really a public body on most of the normal tests, exercising functions delegated to it by the Secretary of State and responsible to him and to Parliament. The real difference between it and other Quangos [quasi-autonomous non-governmental organizations] is that the Government has been careful to avoid exercising any control over its expenditure and particularly its salaries (whose levels Ministers would find hard to defend if they were responsible) [...] despite ministerial control over appointments and powers, and its clear role in performing a public policy function, it is still to be asserted that SIB is in the “private sector”.”

That is, City fears that the SROs were in fact Trojan horses for state involvement in financial markets were entirely correct. This point is made forcefully in Vogel’s *Freer Markets, More Rules* (1996) whose argument is in the title. Far from the FSA, Big Bang, and Thatcherite financial liberalization heralding ‘deregulation’ it actually consisted of ‘reregulation’. That is, the replacement of old rules with new ones, and the merging together of different markets. This led to the growth of the regulatory framework, even as it created space for more financial activity by individual firms (Ibid., 2-3). In other words, there was no trade-off
between regulation and financial sector growth, but rather between different forms of
regulation: “Reregulation [is] the reorganisation of government control” (Ibid., 16).

The Secretary of State for Trade, Leon Brittan, argued as much to his ministerial colleagues
before the introduction of the Act, saying that the “Bill builds on the tradition of self-
regulation, it ensures that self-regulation has the teeth and the statutory backing it needs to
be effective” (NA PREM 19/1717, December 1985). Self-regulation was chosen because it
was believed it would lead to more effective regulation, which is why regulatory agencies
needed to be close to the markets they supervised (i.e. practitioner-led) so they were not
left behind by market innovation. This was meant to be a protection against the SROs
becoming like the US Securities and Exchange Commission – seen as the nightmare scenario
in the UK for its legalistic, invasive, and bureaucratic management of financial markets
(Vogel, 108).

After being presented as practitioner-led regulation, practitioners were themselves
disappointed when they realized that in fact the public power they were handed down – as
if through apostolic succession – from Secretary of State through the SIB to individual SROs
was in fact at heart a “highly bureaucratic and legalistic system” done with minimal public
expense (Reid 1988). As with banking regulation after 1979, no sooner had the government
created a statutory framework for financial regulation than it found itself unable to resist
the urge to use it for its own aims: to issue direction to the ‘self-regulatory’ bodies, tinker
with the rules, and use its powers to try to advance its political aims (Vogel 1996).

The FSA fundamentally reformed the regulation of finance in the City but tried to do so
within the traditional framework. This fudge was as untenable in the long-run as the Bank
of England’s attempt to do the same in 1979, and just as the 1979 Act had to be reformed, so
did the 1986 FSA have to be turned into FSMA in 2000. The FSA came about as the
government’s reaction to the changing international financial market structure of the early 1980s and its attempt to open London up to international trade so as to ensure its competitiveness as a global financial center. As Moran (2003) notes, the government was “triumphantly vindicated” in this decision by the growth of London’s economy from the 1980s-2000s, but the ease with which Thatcher’s government managed to legislate open markets was not managed by its ability to control them afterwards. The FSA, following Big Bang and the abolition of exchange controls, was an attempt to regulate how the new, more open, markets worked, but subsequent financial failures, the need for a new Banking Act, and ongoing regulatory change show that this was less successful than its market-opening sister policies.

Conclusion

These three steps form the ‘City Revolution’ which transformed the UK economic landscape and world financial markets. The City took on the appearance of being the world ‘best practice’ along with similar reforms in the US before and afterwards: the success of this Thatcherite financial model in reshaping the City and seeming to lead to a UK economic boom seemed to validated the policy of financial liberalization. This eventually led to its introduction, with regional variation, more or less across the globe. This would become the global norm holding at the start of the final case study in the 2000s.

What this quick background has shown, however, is how contingent on the UK historical situation these reforms were. While they all to a greater or lesser extent reflected Thatcherite principles of competition, open-access, and the removal of cartel-like elites (relying on a paradoxical strengthening of the state to strengthen independent markets), these reforms were not born out of a coherent plan to reform the City and financial markets.
The City Revolution was made up of unintended consequences forcing further policy-change, opportunistic power grabs by the government against non-state organizations, and the relentless prioritization of the market over other elements of the political-economic system. No wonder that a bank law introduced in 1979 as the last gasp of the previous government, whose aim was consumer protection more than increasing competition, formed in a City fundamentally different to Thatcher’s new regime, should fail and need reform. This reform happened in 1987 and is the start of the next case study.

The Thatcher government took a decision not to try to fight globalization but to embrace it. This was signaled through the abolition of exchange controls. This act, however, led to a knock-on of unintended – even if not all unwelcome – consequences, which required first the reform of the weakest part of the City – the Stock Exchange – and then the interactions of the rest of the City through the FSA. The cause of the last two policies was market-based – the regulation was to reform for the City to be able to compete internationally – but the cause of sudden globalization, while probably inevitable, was the political shock therapy of instant liberalization of exchange controls. Just like in Eastern Europe after 1989 this had political as well as economic reasons. The Times (27.10.1986) explained the self-driving aspect of Thatcher’s financial reforms clearly:

“As in all political revolutions, change has acquired its own momentum, drawing in other related strands – such as changes in investor protection – and shifting its objectives in ways that could have been imagined only by the most farsighted when the process started. Greater competition, requiring more efficiency in dealing with stocks and shares and raising capital for government and industry, remains central to the changes. The focus of that drive has, however, shifted from competition between members of the old club to the need to compete with and adjust to other
financial markets and other financial centres which have been brought together by the simultaneous revolution in communications and information technology.”

Similarly the Spectator (quoted in Kynaston, 696) argued that Big Bang itself was exaggerated (a “sideshow”) “compared to the 'bigger bang' of what has been going on over the past 25 years.” That is, the massive growth of euromarkets; or in other words, the financial globalization caused by the collapse of Bretton Woods and liberalization of exchange rates (and hence capital flows) across the world and offshore regulatory arbitrage caused by strict US financial regulation and the recycling of petrodollars. Abolishing exchange controls, Big Bang, and the FSA should be seen as the Thatcherite attempt to harness this secular trend towards international liberalization in finance (and the related move away from bank intermediation towards securities trading to raise capital) so as to ensure and promote London’s role as a global financial center. But as Reid (1988, 23) argues, this happened in “a largely unplanned way,” while Plender and Wallace (1986, preface) explain that “there was little in [Thatcher’s] manifesto to suggest that the City of London was to become the focus of sweeping reforms.”

The City Revolution was unplanned and unexpected, and it swept everything before it. Now it was the turn for specific banking regulatory reform: to fit banking’s statutory and supervisory frameworks for this new City.
Introduction

The 1987 Banking Act came about because of the obvious failure in the 1979 Banking Act with the JMB fiasco. The government took the opportunity of the Act, however, to fit banking into its ‘new-look’ City post Big Bang and the FSA of the previous year. This meant that banking regulation had to be fit into the SRO framework. In practice this was an almost negligible, invisible, change since the Bank of England both beforehand and afterwards was in charge of banking supervision under its own statutory authorization. As such it was on a par with the SIB as an overarching regulator, rather than under the SIB’s jurisdiction as one of its component SROs. This matters to our story because it shows how banking, even under the ‘new’ liberalized City, was kept apart as a separate area of financial activity away from securities trading or other parts of the investment business. This is telling because it shows how banks, and bankers, through the influence of the Bank of England as a political institution within the British political framework, managed to keep banking as a privileged and protected area of financial activity. It had always been so, and remains so today, but once one stops thinking of this as a ‘natural’ fact, it is clearly at odds with the rest of the Thatcherite liberalization of the City which broke down divisions between different areas of financial, ‘investment’, activity. Banking had used its traditional, institutional influence to protect itself from major regulatory change.

In reality, the Act itself was fairly minor. It was not a major overhaul of banking, it did not open up vast new swathes of legitimate activity for banks, nor did it herald a new regime of bank supervision or regulation. If ever there was a ‘tiding-up exercise’ to juridify the status quo (cf. preceding background chapter) this was it. Its major innovation was to do away with the two-tier system of bank recognition to create one category of ‘bank’ for any institution, above a certain size, that conducted deposit-taking and loan-making activities. All these institutions would then be under the jurisdiction of the Bank of England, and by
statute be compelled to comply with its rulings; gone for good was the idea of supervision through ‘nods and winks’ and ‘suggestions’ over tea for the large, established banks. Against the Bank’s wishes, to ensure the suitability of the Bank’s supervision a Board of Banking Supervision was set up to monitor how it managed banking supervision. In theory the Board was independent, with two thirds of its members appointed by the Chancellor. However its chairman was *ex officio* the Governor of the Bank of England and the remaining third of the Board were Bank staff.

The other main part to the law was a prudential change to the exposure-limit a bank was allowed to have to a single investor. This was clearly a late attempt to undo the causes of the JMB affair. What is interesting about this change – the only one tied up with financial stability itself rather than with the definition and defining of a bank and its scope – is that had the banking supervisors done (or been able to do) their job properly it would not have been necessary. Bank regulation is being used to correct failures in bank supervision: you do not need to legislate something like that if supervisors are empowered and involved enough to resolve similar problems on their own. As a further back-stop, the Act introduced a deposit protection scheme to protect investors. Again, adequate supervision and well-formed (i.e. regulated) markets should allow market discipline and timely intervention to remove the need for deposit protection. This Act seems of two-minds as to how successful supervision can really be considered. Rightly so, as events would turn up.

On the domestic level, and assuming everything else equal, the simplicity of this new regime – that if you take and then lend deposits you will be considered a bank and treated as such – seems to have worked. Where it failed was internationally, as we shall see with BCCI and Barings. This international failure is despite the introduction of Basel which was designed to create prudential equivalence between jurisdictions. Again, what these cases show is a failure of *supervision* not (necessarily) one of the rules that the supervisors were attempting
to implement. The policy responses to the two failures are telling; there was no major revision of bank regulation but there were moves to achieve greater clarity over international supervisory responsibility both within the Basel/BIS framework and within the EU with the post-BCCI directive.\textsuperscript{18}

To simplify greatly, the argument of this chapter is that the 1987 Banking Act essentially resolved the UK's long-standing problem with defining a bank and its scope.\textsuperscript{19} It did this by saying, simply, that above a certain level of activity you were a bank if you took deposits and lend them out again; and, further, that if you were a bank you had to accept, by law, the authority of the Bank of England. What this Act did not do is change or resolve how the Bank of England itself conducted banking supervision. This is ironic given that the failure of JMB and the impetus for a new bank law was almost entirely due to the Bank's supervisory failure. The Act also did not – probably could not – deal with the newly expanded international dimension of banking. Poor supervision and the extra-jurisdictional activities of BCCI and Barings led to their spectacular – almost theatrical – failures. The policy response to these failures was to change supervisory arrangements (domestically and where possible internationally) rather than banking regulation.\textsuperscript{20} That is, for the first time in our cases, the implicit question being answered by a policy response to bank failure was not what is a bank and what can it do but was rather how do you control this bank. In this sense we can say that UK financial policy has moved onto being primarily motivated by prudential concerns of financial stability rather than by 'political' aims – ‘political’ in the sense of being

\textsuperscript{18} There was an interesting foretaste of this situation with the collapse of Banco Ambrosiano leading to Basel in 1983 where Italian fraud was channeled through Luxembourg to avoid detection (Truell and Gurwin 1992).
\textsuperscript{19} Which has essentially been the story of the previous two case studies.
\textsuperscript{20} Basel II came about much later than these failures, was not directly caused by them, and led in a direction away from tightening rules on banks as one would have expected if it had been induced by a bank failure rather than by a push for global liberalization.
concerned with legal resource allocation within the UK’s political economic context and about appeasing various vested interests and variously influential domestic factions.

That response (the removal of bank supervisory powers from the Bank of England and related legislation such as FSMA) will be the subject matter of the next and final case study. Here we shall look at the process that led to the introduction of the 1987 Banking Act (much of which we have already seen in the preceding two chapters), what this meant for UK financial markets, and how Basel fit this into the global context. Then we shall look at the two dramatic failures of BCCI and Barings, which showed that yet further change was needed for financial stability, albeit this time on the supervisory more than the regulatory side.

**Banking Act 1987**

The Banking Act 1987 was a direct effect of the regulatory failure associated with JMB. As we have already seen, the introduction of ‘two-tier’ banking led to poor regulatory oversight of recognized banks, and did not allow the Bank of England adequate supervisory information (*Times*, 26.9.1985). Broadly speaking, the 1979 Act was written to protect investors rather than to provide prudential stability (Lawson 2011). At the end of 1984, therefore, Lawson, as Chancellor, set up a committee to look at how the UK banking supervisory system could be improved (248-9), and especially how he could empower the Bank of England internally so that the bank supervision department did not remain “something of a backwater” compared to the monetary policy side (250).

Lawson set up an internal inquiry into improving bank supervision so as not to demoralize the Bank any more (248), termed the Leigh-Pemberton committee after the Governor who chaired it. His main recommendation was to remove the distinction between the two tiers
so as to allow supervisors to treat all institutions the same. At a stroke, when implemented, this opened up the field of UK banking to all institutions which took deposits ‘as a business’ (Banking Act 1987, 13). That is, which made a profit off deposit-taking. The traditional City division into ‘real’ banks and other banking institutions, which had seemed so important to defend throughout the 1970s, disappeared in the face of supervisory and market failure. As Lawson put it in his memoirs (251): “It was significant that JMB was recognized as a bank.”

One other benefit that was seen from removing the distinction between the two categories of banks – on top of improved supervision – was the worry that UK banking was suffering internationally from the inability of large parts of the domestic banking sector from calling themselves ‘banks’. This hindered their ability to market themselves and grow, while international banks (under the 1979 Act) could call themselves banks (Lawson, 251). The Chancellor namechecks BCCI specifically as one of the overseas ‘banks’ which the Bank of England would not like to have been called a ‘bank’ but as a foreign-registered entity could not block.

Two other major features of the 1987 Act were the implementation of a ‘regular dialogue’ between auditors and supervisors, removing the strict confidentiality which was seen to have contributed to the Johnson Matthey Affair (Banking Act 1987, 71), and the setting up of the Board of Banking Supervision (Lawson, 252). The first was included in the Leigh-Pemberton report while the second was not: perhaps unsurprisingly for an internal Bank inquiry. This Board was to be an independent assessor of the Bank’s ability to supervise the UK banking system, although it was chaired by the Governor with one third of the board from Bank staff. The other two thirds were appointed by the Chancellor. The Board had no ability to force the Bank to supervise in a certain way, but if the Bank decided to ignore the Board it would have to inform the Chancellor in writing why so (Banking Act 1987). This
was felt by the Bank to be an intrusion into its affairs, but in fact looks like a pretty lenient compromise compared to the total removal of Bank supervisory authority which some, including Thatcher, wanted (Lawson, 252). This shows us that the Bank’s problems with supervision were already felt, and the compromise of an ‘independent’ Board of Banking Supervision was meant to make the Bank take its responsibilities in this area more seriously. The failures of the early 1990s led to its loss of these powers under New Labour.

Lawson identifies two areas of weakness in his own new law: that the Bank of England did not manage to “come to terms” with its role as a public agent under the statutory framework, meaning the Bank was too worried about being taken to court with its actions (Lawson, 253) – fearing that if it lost a case it would then lose all market influence. The second problem was the fragmentation of the different parts of financial supervision (Ibid.). This made supervision harder, and consequently fraud more likely. Lawson argues powerfully that fraud is an inevitable consequence of inadequate supervision (253-55), to which the only solution is joined-up supervision between the different financial and criminal agencies: bank regulators, supervisors, national anti-fraud squads, the police, and international counterparts. He was writing with the benefit of hindsight, post-BCCI and Barings, but it is hard not to agree with him.

With the 1987 Banking Act, Lawson removed the causes of the JMB affairs – slamming the door after the horse had bolted – and rationalized the UK banking market, by saying that any entity which took deposits for profit should be considered a bank. This ended the ages-old problem of working out how to define a bank. Having worked out a bank definition, the Act then reasonably said that all banks should be under the statutory supervision of the Bank of England and Board of Banking Supervision, and provided some basic prudential rules as to limiting exposures to individuals ((Reid 1988); Bank Act 1987, Schedule 3). As with the 1979 Act, the 1987 Act as a whole was less about prudential regulation (creating
specific rules to ensure financial stability) than about creating a framework for the banking market and its supervision. The Act was successful in creating the broader, de-regulated, market, but was less successful in ensuring adequate supervision (*Times*, 10.12.1986). As Lawson admits (368), “a financially deregulated economy [such as the UK post-1987], while more efficient and dynamic, is also probably less stable, by virtue of an amplified credit cycle.” His solution was to pass the buck and argue that borrowers therefore had to exercise more self-discipline (Lawson, 368).

The alternative response, however, is also possible: that supervisors need more power and to be more willing to use that power to ensure discipline in the market. The 1987 Act succeeded in rationalizing and removing some of the traditional, problematic, distinctions within UK banking (*Financial Times*, 2.1.1988, 1). But it did not succeed in creating a satisfactory supervisory framework for this new, de-regulated, banking market. Having opened up banking domestically and internationally, the Act did not then succeed in controlling it. The supervisory failures around BCCI and Barings within the next 8 years showed this up.


Before those failures would be exposed, however, the UK experienced a stock-market crash, an economic boom, and then its worst recession since 1930. These were related, though not in a particularly clear way. The international financial regulatory community also got together to try to work out how to regulate finance in the new era of deregulated, globalized financial markets. Again, the story of the first Basel Accord is not straightforward.21

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21 And will only be discussed in so far as it is relevant to our narrative of UK bank regulation. See Goodhart (2011) for an in-depth look.
The key point to note about banking from the late 1980s is the change in culture in the City (Kynaston, 720). This had been a perennial worry since the end of the 1960s, but with the 1987 Act the form of banking (deregulated and undifferentiated) finally allowed the new culture to flourish (cf. the preceding chapter for details of the City revolution). The supervisory failure of the old system of ‘nods and winks’ led to and was reinforced by the move to statutory banking under the 1979 Act. This led to the increased formality of supervision. The 1987 Act removed the distinction between respectable recognized banks and other deposit-taking institutions, and led to the equivalence of all forms of institutions which undertook banking. Together with the changes from Big Bang and the FSA, which removed historic protections for other forms of financiers (e.g. in the stock market), and which put all financial activity into a statutory framework, the stage was set for a legalistic approach to finance in the City (Vogel, 108). That is, it was no longer enough to appeal to ‘the done thing’ or to ‘gentlemanly behaviour’ for City practices, but – along the US lines – if something was not banned explicitly it was permitted, and if there was a way to make a profit from an activity it should be undertaken. This is the ‘innovation’ and ‘competition’ which successive governments and the Bank of England continuously tried to promote.

When it came, however, it was continuously decried: partly for reasons of prudence and a dislike of legalism, but partly for reasons that can only be called snobbism.

The ‘Lawson boom’ of the late 1980s started with a credit boom from 1986 (Lawson, 373). This was caused by financial liberalization and a change in animal spirits in the economy caused by the government’s insistence that it had ‘transformed’ the economy. Reduction in interest rates over the early-to-mid 1980s along with increased long-term expectations contributed to a boost in consumer demand (Cobham 1997, 76). The immediate outcome of

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22 And frankly it would be hard to think of a more patronizing term than ‘licensed deposit taker’ to show the Bank’s displeasure at these ‘new’ ‘banks’.

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this boom was a rise in house prices. Together with the increase in consumer spending and the rise in house prices itself, inflation picked up reaching nearly 10% by the end of the decade. This was essentially the same as the inflation rate when Thatcher came to power against which she set her governments and their stern monetarism (figure 1).

**Figure 1: UK inflation under Thatcher, 1979-1990**

![Graph of RPI All Items: Percentage change over 12 months: Jan 1987=100](source)

Because of the government’s supply-side reforms of the early 1980s (largely labour market and trade union reforms), they felt that the UK economy could handle growth of around 4% without overheating. Therefore during this boom Lawson cut tax rates in the ‘giveaway budget’ of 1988: the basic rate of income tax fell from 29% to 25% and the higher rate fell to 40%. This constituted a fiscal stimulus which led to a growth of output along with higher inflation. The global fall of oil prices in 1985-86 caused the pound to devalue, which was allowed by the government (still in charge of interest rates at this point) so as to stimulate
the non-oil sectors of the economy (Cobham, 83). The flash-crash of ‘Black Monday’ in 1987 (spreading from Hong Kong through London to New York, (Carlson 2007)) worried the government that a turn-around in the economy was about to happen, so they cut interest rates to stimulate an already overheating economy. In short, we argue, following Cobham, that the excessive depreciation of the pound from 1986 led to the Lawson boom when coupled with financial liberalization.

Following this boom, the bust came in response to attempts by the government to rein in inflation. This was a significant rise in interest rates (from 7.4% in 1988 to 14.9% in October 1989: Bank of England Statistical Interactive Database), as well as using interest rates to try to keep the Pound in the right zone to shadow the Deutschmark as part of the Exchange Rate Mechanism (ERM) (Bank of England 1991). This led to a collapse of house prices (leading to ‘negative equity’ for many home-owners), which itself led to a consumption shock (Cato and Ramaswamy 1996). The economy did not recover its position for three years until 1993. On ‘Black Wednesday’ in 1992 the pound crashed out of the ERM, at great expense to the Bank of England, and restored monetary policy independence to the UK (from following the Bundesbank). Despite the damage done to monetary policy-makers, the shock of expulsion from the ERM in fact led to falling unemployment, inflation and economic growth for the UK due to lower interest rates and lower exchange rates (Budd 2005). Nonetheless, it was a major failure of Tory economic policy, and left the Treasury looking incompetent for dealing with monetary policy (Kynaston, 752). In time this will lead to monetary independence for the Bank of England (see final case study). This quick section has given an economic background to the two bank failures we will discuss.

On top of the economic background here, we should discuss a little the international attempts to regulate and supervise global banks which started with the Cooke committee at the Bank of International Settlements (BIS) in 1987 (Reid, 259). This was to turn into the
first Basel Accord of 1988. It started with a bilateral pact between the UK and US and then grew to include all the Group of 10 countries. As much as to promote a level-playing field among international banks and to ease supervision in all regulations, however, this was also an attempt by US and UK regulators to ‘protect’ their banks from Japanese competition, since Japanese banks had to hold much less regulatory capital than their Anglo-Saxon counterparts (Reid, 259). Lord Bingham (1992) in the preface to his inquiry into BCCI gives a good account of the development of Basel from 1975 to 1992. He explains how the responsibility for supervision was to be divided between host and home supervisors according to the branch/subsidiary distinction, facilitated by a free-flow of information (4). This ‘Concordat’ of 1975 gradually turned into the first accord of 1988, which introduced prudential requirements for global banks (including, relevantly for our cases, money laundering – Financial Times, 14.11.1989, 28). That is, the focus of international financial policy moved in the opposite direction from that of UK policy – from supervision to regulation. The internationalisation of regulation and supervision was supplemented in the European Economic Community by the adoption of the Second Banking Coordination Directive (26) which introduced the idea of ‘passporting’: that is, of being registered in one European Member State and using recognition there to be allowed to practice in others. This is a brief look at the international supervisory-regulatory background to the collapses of BCCI and Barings.

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23 The UK/Bank of England was still considered to have a lead role in finance and its supervision (Economist, 11.6.1988, 21)
Spies, frauds and corruption: BCCI's collapse (1991)

Frankly, the story of BCCI should probably not be included in a history of UK banking regulation. But it is too good to leave out. It is the story of massive corruption, international fraud, money laundering, drugs cartels, Afghani mujahedeen and Western spy agencies. On closer examination (by the authorities at the time and of researchers now) BCCI was not even a bank. But it does tell us something about international bank supervision in the early 1990s. This is because the bank used the disorganized, ad hoc, and in a sense still 'gentlemanly' system of supervisory cooperation to carry out its scam. In a contest between the Bank of England and the CIA it would be foolhardy to bet on the bankers. But a properly coordinated and communicating system of international supervision could, at the very least, have closed BCCI earlier or, perhaps, even have stopped it in its tracks as it grew.

BCCI pretended to be a bank to attract deposits from small-business owners and households in the West, and then used that money to fund an international Ponzi-scheme. The senior members of the bank made use of the money through insider loans, used it to buy political favors around the world, and 'paid back' deposits by attracting new customers through its image as the bank for immigrants and Muslims in the West. In terms of regulation its aim was to be "offshore everywhere," (Adams and Frantz 1992) that is to be subject to no overarching jurisdiction which could unveil its activities. In that sense it was legally headquartered in Luxembourg, had most of its activity go through the London office, had most of its deposits raised through the fraudulent holding of an American bank, while

24 Among its more interesting roles was the direct financing of terrorism and drug cartels, funding the Pakistani atomic bomb, and operating as a front for CIA payments around the world. Less amusingly it was also reported to have used murder and rape as methods of silencing potential trouble-makers (Long 1993; Beaty and Gwynne 2004). Tariq Ali, who started anonymously covering BCCI for the New Statesman from the 1980s, wrote a fairly odd screenplay about BCCI (Ali 2008), but this is one of those times when fact is more amazing than fiction. Somehow his fantasy does not manage to do justice to just how corrupt and fraudulent BCCI was.
having its shares majority held in the Gulf. Its internal operations were un-hierarchical and run through committees which had no seniority in them; and the founder acted, spoke, and was treated more as a prophet than an entrepreneur or banker.

People knew, however, that there was something not right about the bank. Traders in London were forbidden by management to deal with BCCI because no one was sure where it was getting its money from (one banker of the time said that it was common knowledge in the pubs in the City that the bank was fraudulent (Times 13.7.1991, 1), which reported that brokers had been forbidden from dealing with BCCI), while already by the late 1980s the Bank of England and the Fed had forced BCCI to slow down its expansion. In 1988 the Bank of England and six other regulators took the first step in what would develop into a joint form of supervision in creating a ‘college’ of supervisors for BCCI. This came after the bank had already been busted for money laundering a Colombian drug cartel. The interesting question is, then, not so much how did BCCI get away with its scheme for so long – the answer to which is largely known as a combination of duplicity and bribery – but why did bank supervisors find it so difficult to close it down, and how did they manage it when they did. Firstly we will have a quick run-through of the bank’s development, its public and then actual modus operandi; then secondly we will look at the supervisors’ delayed and then successful response to the ‘bank’.

BCCI was formed by Agha Hasan Abedi in 1972 and was conceived, at least publically, as a ‘third-world bank’. That is, a bank from the third world, which could service its unique customers, sometimes in an Islamic way, and better than western banks which were seen to have underprovided for this sector. The development of the bank was closely bound up with

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25 This historical account is formed from three books: Beaty & Gwynne 1992, Adams & Frantz 1992, and Truell & Gurwin 1992. Where there is a specific point under discussion it will be referenced, otherwise it is a point in agreement from some or all of these books.
the geo-politics of South Asia in the early post-war years from 1945 to about 1970. This is not because it was a government initiative but because of the career and movements of Abedi.

Without going too specifically into the details of his life, it is enough to say that he got his first job in banking in Bombay/Mumbai through personal connections. Following Partition he moved to Pakistan in 1947, aged 25, worked as a banker and then founded a bank, United Bank Ltd (UBL) in 1959. It became the second largest bank in Pakistan based on his professionalism and innovation, using technology to promote itself as a ‘modern’ bank for the masses. He also focused attention on overseas banking and profited from the development of the oil industry in the Persian Gulf, particularly with the UAE. UBL was nationalized under the Pakistani/Bhutto nationalization programme that started in 1971. Abedi was placed under house arrest in 1972 for his connections with the outside world, for being a financier, and for alleged CIA links. In 1972 Abedi founded BCCI.

Because of his experience with nationalization, Abedi decided that he wanted a bank that was “located everywhere and regulated nowhere” (Adams and Frantz 1992). To this end he registered the bank in Luxembourg – which then as now was known to have lax and compliant regulators – and set up his operation in London. BCCI was 75% set up with funding from the ruler of Abu Dhabi – who knew and supported Abedi from his previous banking work – and 25% from the Bank of America, which Abedi considered necessary to gain international legitimacy. BCCI grew rapidly across the world, opening up into Africa, Asia and across the Middle East, and split itself into range of different holding companies which were ultimately held by two organizations, one Luxembourg and one in the Cayman Islands. Each division reported directly to Abedi, as President, and his CEO, with no internal controls or management structure. The holding structure of BCCI Group is given in figure 2 below. Because of this internal failure of management the bank was not allowed to own an
American bank, and in 1980 Bank of America sold its stake out of worries about how BCCI was financing itself and being run. BCCI created ICIC which was owned by wealthy Middle Easterners using ‘nominees’ to remain anonymous, and also, in theory, many of its shares were owned by BCCI’s workers who were encouraged to consider themselves owners of the bank and ‘part of the family’.

Through lying to the Fed, OCC and other American authorities, BCCI managed to buy First American bank in 1982, and made Clark Clifford, a respected DC lobbyist and advisor, chairman of a board made up of other ‘respectable’ Americans. There is also suspicion that the CIA helped cover BCCI during this period to allow it secretly to hold First American (Truell & Gurwin, 429). Through this acquisition, Abedi managed to control a much larger slice of US and international banking than it seemed through BCCI alone: it was in fact called a “bank within a bank” (Adams & Frantz, 317).
Even without knowing about this fraud, regulators across the world were concerned by BCCI. Abedi and his supporters put this down to ongoing western colonial attitudes. Beyond even banking regulation, the Bank of England was so unimpressed by BCCI’s respectability that in 1980 it told some property developers not to allow BCCI to let a prestigious site on Cornhill, next to the Bank. The developers complied (Kynaston, 592). Despite this, BCCI was still allowed to operate in the UK. It is hard to see what the Bank of England was doing here except attempt to maintain its club atmosphere in a physical sense, even if not in the market itself. In 1988 a drugs raid in Tampa, Florida let to the uncovering of BCCI’s involvement in laundering drug money from the Medellin cartel (and from Central American dictators such as Noriega). At this point, people’s suspicions about BCCI came into the open (Long, 72); it still took three years for the regulators (primarily the Bank of England) to close it down.
Nonetheless, before exploring how the bank was finally brought down, it is worth noting that its ostensible business operations were basically simple retail banking, supplemented with fees for additional services. Its public mission was to get as many deposits as possible, and lend them out to underserved parts of the population, notably in the UK immigrant businesses and households. It also developed a worldwide remittance service, for a fee. BCCI grew so rapidly in the UK in the 1970s that the Bank of England capped its number of branches at 45 in 1978 (Economist, 27.1.1990, 96). There were also worries about its unstable capital base, with so much coming from the Sheikh of Abu Dhabi alone (Block 2013). By the time BCCI was closed in 1991, it had millions of depositors in 69 countries (Long, 104) – these were the people who lost out from its closing. But instead of using these deposits to make loans and invest, as a retail bank should, it seems that BCCI and Abedi simply used the money to fund more overseas expansion to gain new deposits, and gave the money out in unpayable loans and to cronies. In this sense it operated identically to a Ponzi scheme (Adams & Frantz, 278).26

So the question then moves on to how the Bank of England finally shut down BCCI and why then, seeing as the governor, Leigh-Pemberton, acknowledged in the House of Commons that they had known of problems with the bank since 1990 (Long, 70)? As the Times reported, the Bank had known for years that BCCI was doing wrong, but thought it was all separate (Times, 20.7.1991.4). It only came to light when a whistleblower (a fired executive) got in touch with the Bank and showed them some undeclared deposits that had been funneled through the 'bank within the bank'. Then the Bank decided to take action, called its fellow supervisors and over 4th July weekend coordinated an instant shut down of nearly all

26 It later came out that the bank owned 56% of itself (Times, 5.8.1991) in a bid to trick supervisors that it was solvent.
BCCI’s activities in its major markets across the world. The Bank took a long time to act, but when it finally did it was effective (Times, 8.7.1991, 15).

There are three potential reasons for the delay and failure of banking supervision and regulation with BCCI:

1. Supervisory failures of the Bank of England: be it for incapacity or complacency;

2. Failure of cooperation internationally between jurisdictions and domestically between agencies and auditors; and

3. Deliberate fraud and political/diplomatic protection by governments or their intelligence agencies; this would include bribery and corruption of public officials and banking supervisory officials.27

Taking the issues in turn it seems clear that one problem the Bank of England had was its lack of ability to supervise effectively in the ‘new’ City. As Block (5) puts it, the Thatcherite reforms of the 1980s had left the Bank without its “eyes and ears” in the City. That is to say, the increasing legalism of bank supervision and the turning of the Bank of England more and more into a form of public agency had left it unable to pick up market sentiment and market rumor. This would explain, for example, why the Bank of America had immediately walked away from BCCI when it realized what kind of bank it was, while the authorities in the UK (and US) found themselves unable to gain desired information from the private bank (Adams & Frantz, 42). The Bank justified itself by saying that it could only act when it had “solid evidence” of fraud (Truell & Gurwin, 317). The Governor even suggested that banking fraud was endemic: “If we closed down a bank every time we had a fraud, we would have rather fewer banks than we have” (Adams & Frantz, 295). The Bank also, quite rightly,

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27 Of course, there is no reason that the ‘answer’ as to why it took so long to uncover is not a combination of the three.
worried about the market effects of shutting down a large, globally interconnected bank. At the time of closure, PWC, the bank’s auditors, claimed BCCI would need $1.78 billion new funding to continue (Adams & Frantz, 293). Even avoiding a bail-out, under the UK new deposit protection scheme around $100 million would have been needed to compensate depositors; money which would have had to come from BCCI’s competitors who had refused to deal with the bank because it was so untrustworthy - indeed, not creditworthy (Adams & Frantz, 293). In this “reverse Robin Hood” situation, the honest depositors would feel the pain of the closure and disciplined market participants would have to rescue the market (Adams & Frantz, 7).

But more to the point, commentators at the time (Financial Times, 23.1.1993, 5) and afterwards seem to think that regulators were simply clueless (Truell & Gurwin, 351): they did not question the information they were given and did not manage to put it all together. Of particular problem for the Bank of England was the fact that, following the 1987 Act, it had all the power it needed to shut down BCCI: that is, the Bank could revoke its license if it felt BCCI was not being managed by a fit and proper person (Financial Times, 18.11.1991, 18): “Even without the benefit of hindsight it is hard to see how BCCI escaped closure much earlier.” As we have seen, since 1988 it was clear (and public) the bank was engaging in criminal activities on a large scale: the Bank’s incapacity to shut down BCCI then is not clear. It had the legal powers and it had the information needed. This means that the reason must be because the Bank did not want to shut down BCCI: either because it was worried about the effects, or because it did not think that it was a UK jurisdictional problem. This leads us to the second set of reasons for the failure to supervise BCCI adequately (or close it down earlier): international and domestic lack of cooperation.

The problem of international regulation was deliberate. BCCI was designed so as not to have one overarching ‘home’ regulator that could monitor all its activities. This meant that the
Bank passed the buck to the Luxembourg regulators (where BCCI was legally registered) and accepted their judgement that BCCI was fit to practice in London (where it conducted most of its activity). According to the 1987 law, the Bank had the right but not obligation to accept a foreign regulators’ judgment. As we have seen, the market in London and even the Bank itself on some level knew that BCCI was not an ordinary, or responsible bank, yet it was happy to accept Luxembourg’s decision that the bank was fit to operate. It is hard not to agree with the Financial Times’ judgement (18.11.1991): “ultimately, responsibility rests with the Bank.” The BCCI affair primarily reflected badly on the Bank as a supervisor (Times, 8.7.1991), and did damage to London’s reputation as an international financial center; exactly the outcome the Bank was hoping to avoid by not shutting BCCI down precipitously. The problem, then was one as much as international coordination as of communication. The Bank knew about BCCI but did not feel it was its responsibility to deal with (Block, 165). This is despite the creation of the informal college of regulators that was set up in 1988, post-Tampa bust, between the UK, Switzerland, Luxembourg and Spain (and later the Cayman Islands) to monitor BCCI (Adams & Frantz, 277). This college came in useful when the Bank decided to pull the plug on BCCI, but until the Bank of England finally accepted its ultimate responsibility over the bank – as a matter of fact given BCCI’s operations – the regulatory college was as impotent as the Bank itself. Again, the problem was not one of information communication but of accepting responsibility: a problem of agency not competence, internationally and domestically.

This is also the case domestically, between auditors and supervisors. Unlike in the JMB affair, auditors now had legal protection to pass information on to supervisors. The hard wall between the two was removed. In the autumn of 1988, after the drugs bust, the supervisors requested PWC audit BCCI in Luxembourg and the Cayman Islands (Adams & Frantz, 278). This revealed evidence of “poor banking” but nothing more untoward
(Financial Times, 24.7.1991). Nonetheless, the Bank had received ten audits on BCCI between 1988 and its closure in 1991 from PWC (Ibid.). Until March 1991, none of them showed the Bank anything it would consider “concrete evidence” of malpractice. The March audit, however, had uncovered the ‘bank within a bank’ and many of BCCI’s illicit operations: it showed BCCI owned at least 60% of CCAH, illegally, secretly, and against the Fed’s permission (Adams & Frantz, 291). What had changed in the meantime was a whistleblower coming forward, having been fired amid widespread disgruntlement at the bank that employees’ shares had turned out not to exist (Adams & Frantz, 298). All this came about because Abedi had suffered a heart attack in 1988 and his successors fought for control and generally lacked his grip (Adams & Frantz, 278). Thus the ultimate downfall of BCCI came because it fell apart internally, not because of any external pressure from the authorities acting on information gained by auditors: this is surely the largest failure of them all. The saving grace for international cooperation was the operation to close down the bank itself: this was coordinated in secrecy by the Bank of England, with cooperation of the Fed and other central banks, to ensure that all BCCI’s major operations were closed simultaneously across the world with minimal market effect. This was so successful that many observers thought that the Bank had overreacted and acted too soon in closing down the bank (Adams & Frantz, 320). Nonetheless, as Lord Bingham’s inquiry firmly put it: “The Bank did not pursue the truth about BCCI with the rigor which BCCI’s market reputation justified” (Financial Times, 23.10.1992). He concluded: “It is the Bank, not the auditor, which is the supervisor.” Whatever failures of intelligence domestically and cooperation internationally, under the 1987 Act the Bank of England had clear responsibility to supervise banks in the UK and if necessary to revoke their licenses. It did not succeed in doing this.
The other cause is in many ways much simpler, and begins to spin away from the scope of this thesis again: corruption, bribery, and fraud. There is evidence that PWC in Luxembourg colluded with BCCI to aid it in its fraudulent activities (Block, 43), while the links between the CIA and BCCI have already been discussed, and became much clearer in Senator Kerry’s investigation of the bank after the crash and in the New York attorney’s case against it (Kerry and Brown 2011). There are also widespread claims of the bribery of public officials in different countries, which for some explains why banking supervisors and law-enforcers did not want to intervene (Beaty & Gwynne, 1992): they had themselves been corrupted (Financial Times, 9.11.1991). Furthermore, even when the Bank did have enough information to worry about the bank and think of intervening, the bank’s geopolitical links and reputation as a ‘third world bank’ - that stood up to a ‘colonial attitude’ of western banks and regulators (Adams & Frantz, 323) – prevented it from taking action. There were long discussions with the Sultan of Abu Dhabi (as the major shareholder) if he would shore up the bank, and then when he would not there were worries about damaging UK-Abu Dhabi relations (Beaty & Gwynne 1992). In fact in the end there was a diplomatic spat between the two countries about the Bank’s unilateral action in closing BCCI without informing the sovereign whom the Bank did not trust to keep quiet about the operation (Times, 7.17.1991). In fact it is quite hard not to have some sympathy with the Bank in these cases: it is not its job to detect criminal activity, nor to assume everyone they speak to is a crook (Economist, 13.7.1991), nor to go toe-to-toe with the rulers of foreign countries (Truell & Gurwin, 356). If the “whole thing was a front” by the CIA (Ibid, 432) then it was even less the Bank’s job to unravel the mess. The political cover given to the bank by having

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28 There is even an interesting, if probably insignificant link, with JMB because one of the key customers to whom JMB lent recklessly was part of BCCI’s circle of corruption (Block, 29).
former Prime Minister Jim Callaghan and former President Carter as advisors just made it that little bit harder for regulators to step in (Financial Times, 23.10.1991).

Nonetheless, the way BCCI managed to operate – the methods it used and international environment it took advantage of – enabled the crimes. The fact that, despite the college of supervisors, international bank regulation was patchy was a "systemic and structural problem" not simply idiosyncratic (Block 2013). As Leigh-Pemberton admitted above, fraud is not uncommon in banks: what is uncommon is the lack of responsibility felt and unwillingness to supervise a bank, or to close it down when the fraud was uncovered.

To conclude on BCCI, and leaving aside (if we can) the blatantly criminal aspects of its conduct, the case still tells us of the failure of banking regulation and supervision in the UK in the early 1990s. That is, it was specifically a failure of supervision. The Financial Times put it very clearly at the time (12.10.1992 – emphasis added):

The BCCI affair probably does not point to serious flaws in the law relating to bank supervision. It is the implementation of the law which appears unsatisfactory. The main purpose of banking supervision is to protect depositors. At the heart of the 1987 Banking Act is the requirement that no one should take deposits from the public without being authorized by the Bank of England... What the BCCI episode indicates is the need for cultural change at the Bank.

The Bank had the powers under law it needed to control BCCI, and it had very clear regulations for how to consider the bank and regulate its activities, but it did not do so. This, as we have argued above, is because it did not take responsibility for the bank because it was 'offshore', because it was an 'odd case' (i.e. in many ways not operating like a bank –
hence why the market refused to deal with it),\textsuperscript{29} and because it ignored many of the warning signs. So long as there was no risk to the UK financial market place the Bank was happy to leave things alone and not cause a fuss. In this is fulfilled one part of its remit as the City's supervisor: to promote London as a place of business. However it failed terribly in its other remit: to protect the stakeholders of a bank (depositors and investors). As Adams & Frantz (7) touchingly put it: "the failure of a bank is not gauged by financial markets alone. It must be measured in human terms as well." This ‘reverse Robin Hood’ hurt the people it was pretending to help: the immigrant small-business owners and households who had been underserved by traditional banks (\textit{Times}, 11.7.1991). Beyond they betrayal of trust, BCCI directly defrauded them in a form of Ponzi scheme. It absolutely was in the Bank’s remit and job description to protect and support these small depositors. They fact that it did not do so for reasons of 'high' international politics and financial policy shows the problems with the fundamental tension between the Bank’s two roles as promoter of the City’s international position and protector of banks’ customers. Or in other words of promoting competition and promoting financial stability. In this case, as in most other cases, the Bank as supervisor opted for protecting the City's reputation over protecting banks' financially unsophisticated customers.\textsuperscript{30} As ever, the Bank blamed its supervisory failure on external problems and did not look at reform itself or its attitude to supervision (Truell & Gurwin, 434). This would come back to bite it in a few short years.

\textsuperscript{29} Oddly the poor market reputation of BCCI seems to have led the Bank to write it off and therefore treat it less strictly (maybe because ‘market discipline’ was already systemically isolating the bank?) rather than look into closing it down.

\textsuperscript{30} Often allowing the government to help or support these people after the fact. Cf. 2008 crisis.

If the BCCI affair was complicated by non-banking issues and broader criminality, the next banking scandal to hit the Bank of England had no such complications. Barings’ collapse was a purely financial affair, caused by a ‘rogue trader’, poor management within the bank, and grossly inadequate supervision. Many of the same themes as BCCI of poor communication between authorities domestically, lack of international responsibility, and a certain supervisory complacency are present, but without the additional complication of spies, fraudsters, and Middle-Eastern potentates. In timescale and geography, as well, instead of the problems being built up over decades around the world, Barings’ collapse happened in one department of one well-known bank over the course of a year or two at most. None of the ‘mitigating’ factors of BCCI were present. Quite simply, the Bank had not learnt its lesson.

The Barings story is an easy one to summarize. Barings bank - the oldest merchant bank in the City and famously ‘banker to the Queen’ (Times, 27.2.1995.3) – developed a securities business in the 1980s. The old managers did not understand securities trading. A young trader went to the Singapore office with almost no oversight, did not hedge his positions, and started trading from a fraudulent, hidden account (the so called ‘88888’ or ‘five-eights’ account) to hide his increasing losses. At no point did auditors, management in London, or UK or Singaporese supervisors notice anything was amiss.31 After the Kobe earthquake and the collapse of the Nikkei, Leeson’s positions became catastrophic. He started being asked for repeated margin calls from SIMEX, for which he requested money from London. Over £800 million was sent over without checks. Eventually people in London and Singapore began to look more closely at his accounts, realized they did not make sense, and Leeson

31 Indeed the chairman of Barings, a Baring, even said that “it does not in fact seem to be that difficult to make money in the securities business” off the back of Leeson’s trading (Leeson 2015).
fled before he could be exposed. While he was in hiding a Barings team in Singapore found his records and began to piece together what had happened. Barings immediately went to the Bank of England for advice and protection, but a private buyer could not be found (because Leeson’s positions remained open and his liabilities increasing massively by the minute, *Times* 27.2.1995.1), the Bank refused to use public money to bail out the bank (and privately welcomed the lesson in moral hazard this would teach the City), and the bank went bust. The action of one unsupervised securities trader in Singapore brought down London’s most respected bank.32

But if the story is easy to tell, working out how it all went wrong – and seemingly so quickly – is less easy. Any analysis must hinge on a number of factors:

- Poor management within Barings and the problems of combining a bank with a securities trading firm;
- Poor supervision from the Bank of England and poor cooperation between London and Singapore;
- Culture change in the City after the Thatcher reforms; and
- Financial innovation outpacing regulatory innovation (and management’s understanding).

That is, the analyses involve market design, the prudential system, the human factor, and the nature of financial competition itself. The first two levels of analysis are controlled by policy,33 while the latter two are only tangentially controllable. They can all be examined, however. Any final answer given for Baring’s collapse must involve them all.

32 There are a number of very good accounts of Barings’ collapse. This narrative is taken from Leeson (2015), admittedly a self-serving account originally published in 1996, Drummond (2008), Fay (1996), Gapper & Denton (1996) and Rawnsley (1996).
33 Indeed the tensions between these two levels are the focus of this thesis: policy to open up markets versus policy to control them.
**Management failure**

Leeson brought down Barings. But it is not right to think that he did so ‘on his own’.\(^{34}\) This is not to say that he had ‘co-conspirators’ in his fraud, as Barings’ chairman suggested at the time (Kynaston, 764). But the scale and success of his deception relied on significant failures in his oversight and Barings’ management more generally. Leeson did not, like some genius, identify a minor weakness in an otherwise robust system which he then exploited. The system was itself weak. You could say that the weakness of the system created Leeson, rather than Leeson created the weaknesses in the system. This is another way of saying that, without significant change, something like Leeson’s fraud was more likely to happen than not, given Barings’ poor management structure.\(^{35}\) As a banker quoted in Kynaston (764) put it: “Fingering Leeson alone is like blaming a lance-corporal for the outcome of the First World War.”

The question, then, has to be what caused this management failure. Short of simply saying that Barings was uniquely unreformed and traditionalist among merchant banks – which does not help anyone very much – there were two ‘causes’ of Barings’ management failure: its attempts to navigate the larger, more open, City post-Thatcher’s reforms (*Economist*, 4.3.1995, 11); and its related attempt to merge a securities firm with its traditional banking practice (*Financial Times*, 4.3.1995, 8). Both of these issues brought tensions to the bank which were never resolved (except by the bank’s collapse).

In 1984 Barings Brothers (a merchant bank) bought a former City broker firm and turned it into Barings Securities with the aim of merging the two into a US-style investment bank (Gapper and Denton 1997). From the late 1980s globally, and especially in the UK since Big

\(^{34}\) Fay (1996) is particularly keen that Leeson should not escape censure. He calls his book “the case for the prosecution” (3).

\(^{35}\) Obviously this is not to say that the form, scale, and longevity of Leeson’s fraud was inevitable; much less to deny Leeson responsibility for his criminal behavior.
Bang and the FSA, there was a turn towards securities trading rather than bank intermediation. Barings Brothers, with declining banking profits, hoped to join this trend. As a business strategy this made decent sense, but the management styles and cultures of the two firms were very different: the bank was cautious, risk-averse and traditionalist while the securities firm represented the modern city, profit-hungry, swaggering and scornful of regulatory brakes (Tickell 1996). The two sides never managed to gel their cultures or management practices, with the Barings top management (the bankers) seeing the securities side as a cash-cow, and the securities team having thinly-veiled contempt for the bankers (cf. Leeson’s interview on the BBC). As the securities firm made profits and grew it became “a series of regional fiefdoms”, especially geographically, without a strong grip from the center that could exert controls (Gapper & Denton, 6). Thus when Leeson was sent to Singapore, it was no difficulty for him to play off his local managers with his managers in London, all of whom assumed he was being supervised by someone else.

The reasons for Leeson’s move to Singapore should also reflect badly on Barings. Having moved to Barings in a back-office function, he applied for a trading license but lied on a form saying he had no criminal record (he had been fined by a local court. (Drummond 2008)). Instead of firing him or at least keeping an eye on him, Barings moved him over to Singapore in what Hogan (1996) calls the “old imperial tradition of sending the younger son to govern Bengal,” or of sending criminals to the colonies. As he explains though, advances in telecommunications meant that that was no longer a risk-free option. In short, Leeson could do as much damage to Barings in Singapore as he could in London (and evidently he did). To compound this error of judgement, Barings then allowed Leeson to have both a back and front office role: that is he would trade in the mornings, and then in the afternoons.

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do the settlement for his own and the rest of the team’s trading. This is a fundamental error of management and cause of conflict of interest. It meant there were no internal controls or checks on Leeson’s trading except when he had to request margin for his trades from London. The reason this should have been acceptable is because Leeson was initially only allowed to arbitrage between the SIMEX and Osaka Nikkei 225 futures markets, which is risk-free (Gapper & Denton, 11). This seemed to be risk-free profit-making, Leeson was good at it, and started engaging in the more “cheeky” but not illegal practice of ‘switching’ between the two, which was to buy in Osaka, fulfill the order in Singapore’s smaller market to move the price, and then sell the remainder at a profit in Osaka (Gapper & Denton, 12). After a while market rumors hit London that Leeson was doing something odd and he was asked to tame his switching. Management in London got confused by some of the numbers coming out of Singapore and when investigated could not find some money that Leeson had reported. Reports came from Singapore that Leeson was confused, rude, and increasingly drunk, but still central management did not think it urgent to examine what was happening in Singapore (Gapper & Denton, 14-20). As a ‘star trader’ Baring’s treasurer was intimidated by Leeson because he did not really understand how his trading worked, or why he had to keep on asking for so many margin calls (which was, in reality, his request for more money to shore up his 88888 account). London kept sending the money (around £900 million by the end) without asking any questions (Hogan, 12).

Only after Leeson cracked and fled did Barings’ management realize what had happened. No managers had actually seen Leeson’s accounts or the SIMEX reports of his trading, and just

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37 The arbitrage was between the cash markets (shares and bonds) and futures markets, which in theory should move together, but sometimes one or the other was underpriced and so could be used for a risk-free instant, small, profit. There was no betting on future value but exploiting the difference between an agreed future value and current price. The only downside of the differential is the time-wait between paying now in the cash market and collecting in the futures market in the future. Arbitrageurs were not taking a view on markets but exploiting current opportunities/inefficiencies (Gapper & Denton, 9).
relied on him to tell them what he was doing (Gapper & Denton, 21). Furthermore, all the accounts in Osaka which in theory for his trading had to match Singapore were not matched at all, he was just long on the Nikkei: he had not hedged at all. He had also traded from Barings’ own account not on behalf of a client as he was meant to (Gapper & Denton, 24-26).

In short “the daily reports [Barings] had received from [Leeson] had been a complete fiction” (Gapper & Denton, 29). And yet there was no one in the bank, in London or Singapore, who thought it their job to look closely at what he was doing, even as a routine part of their job (Financial Times, 8.7.1995, 1). He simply was left to get on with it, to the point that at one time before the collapse a drunk Leeson had boasted that his SIMEX positions were larger than Barings’ entire capital (Fay, 147).

For Hogan there is no doubt, Barings’ collapse was due to fraudulent trading abetted by management failure (Hogan, 27): “Ultimate responsibility for the collapse of Barings Plc lay with its board and management” (ibid., 42). One of the worst indictments of Barings’ management must surely be that they did not even realize there was a problem they were ignoring or incapable of dealing with (Financial Times, 27.2.1995, 17). They simply did not know what their own bank was doing (Drummond, 4).

Supervisory failure

Barings’ failure of management is convincing. But banks do not operate in a vacuum. The risk of bank failure, which may entail counter-party risk, is supposed to be managed by bank supervision and prudential regulation. Why did the supervisors not fulfil their duty and uncover fraud and the risk of Barings’ failure? At heart it is because of the final end of Moran’s club government of the City (Moran 2003, 173), and the Bank’s assumption that Barings could be trusted because it was an old institution (Kynaston, 766).

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38 Indeed Drummond reports that “Leeson’s losses eventually totaled over £900 million – double the bank’s capital base of about £480 million” (Drummond 2008, 2).
The Bank, against even its own newly written-rules (Drummond, 104), allowed Barings an ‘informal concession’ to allow Barings to move as much money as it wanted to Singapore for margin payments (Kynaston, 766).\footnote{As Moran (175) argued:}

> “The Bank regarded the controls in Barings as informal but effective. It had confidence in Barings’ senior management, many of whom were longstanding Barings’ employees. Accordingly, it placed greater reliance on statements made to it by management than it would have done had this degree of confidence not existed. In short: it believed what Barings told it, without checking, and this at the high tide of the regulatory state. In other words, even after two decades of financial failure and institutional reform, a central value of the club world in banking regulation – that there existed a small category of elite institutions who could be trusted with light touch, informal regulation – still persisted.”

This error of supervision – the persistence of club government – was compounded by the international aspect of finance in the 1990s (Tickell, 15): even if the Bank had wanted to supervise Barings, without an international regulatory authority it was powerless to do anything in Singapore, while the Singaporese authority assumed Barings was under the Bank’s control. It is as if the world had learnt nothing from BCCI about the importance of international cooperation between supervisors (Rawnsley 1996). Tickell convincingly argues that this represents the “importance of place” for supervision even in a globalized financial world (20). The consequences of the revelation of the Bank’s weakness at supervision, powerlessness to force a rescue, and international impotence led it its eventual

\footnote{And tried to argue that it was just one official who operated on his own (Times, 21.7.1995, 23). There are parallels with Barings trying to blame Leeson alone. Both organizations created the environment in which an individual was able to operate beyond his competence, however (Drummond 2008).}
loss of supervisory powers (Tickell, 21, 43). The fact that the Bank encouraged the Media to spin the story as one – like BCCI – of ‘unsuitable’ characters (foreigners, working class from Watford) bringing down a ‘proper’ institution shows how reliant it remained on its old way of doing things even in the statutory, ‘regulatory’ era (Tickell, 25).

In mitigation of the Bank, supervision had become much harder since it first gained this statutory role in 1979 (Gapper & Denton, 337). From simple, traditional banking carrying out usual transactions, Barings, and the City as a whole had expanded into a web of different financial activities and institutions with global operations. As the FT put it: “The City whose good name has been so dreadfully traduced no longer exists” (Financial Times, 1.3.1995, 1). Increasingly foreign banks took over the majority of trading in the UK market and the traditional distinction between investment – i.e. equity and securities trading – and banking proper had broken down (Ibid.). Coupled with the difficulty of international supervisory cooperation (Financial Times, 6.4.1995) it is perhaps not surprising that the Bank was happy to allow a ’known quantity’ like Barings to operate on trust, especially given its reputation for 100 years of being risk-averse and almost staid (Times, 1.3.1995, 27).

Nonetheless, the Bank had responsibility for financial supervision, difficult or not, so should have done its job – or learnt to do so (Fay 1996, 185). Indeed, it argued that it had (a senior official quoted in Fay, 250):

“After BCCI we’ve been moving away from the cup-of-tea-type approach. We have a manual which sets out management guidelines, and says who is responsible for what. Contrast that with Barings: you could not find an organization chart there. Nobody was responsible for Leeson. In our way of doing things, everything is absolutely clear. Circumstances in which you refer up the line are clear; delegated authority is spelled out. That’s been in place since 1993. I presided over that. Every conversation we have with a bank is minuted; every interview is recorded; every
telephone call is logged. We’re a very different institution than we were. We’re moving in a more intrusive direction, and we will go on doing so.”

And yet, as the ‘informal concession’ shows and despite trying to pass the buck back onto Barings, clearly the Bank had not managed actually to use its new ‘professional’ regulatory practices successfully. Fay argues it was for reasons of propriety: the Bank did not want to seem too ‘intrusive’ to Barings (251). Once again, the old ‘club’ did not want to look too harshly or behave too rigorously against one of its own. No surprise, then, that the first calls for reform after the crisis were for the Bank to be stripped of supervisory responsibility (Financial Times, ‘Labour urges removal of Bank’s supervisory role’, 18.7.1995, 18).\(^{40}\) Even the supporters of the City and of the Bank saw that the failure was not one of complex finance but of poor internal control and external supervision (Financial Times, 19.7.1995, 15). The Bank’s spectacular failure opened it up to political attack in a manner reminiscent of the JMB affair (Financial Times, James Blitz, ‘MPs hit at Bank of England’s handling of Barings’, 17.12.1996).

Culture change

A deep reason for both the management and supervisory failures could be called culture change. The City had changed over the 1970s and 1980s from the cozy, club, protected cartel-like banking system to one that was aggressively open, international and competitive (Kynaston 1994). This manifested itself in a number of ways. Firstly, at the aggregate level, ‘the City’ lost its brand domestically as being responsible and trustworthy and became the City as we know it today: venal, aggressive, hard-working and responsible to nothing other than its profits (Kynaston, 768). Secondly, at the class level, there was significant griping

\(^{40}\) Which indeed is exactly what happened under the next Labour government. See next chapter.
about the 'lower class' nature of the new City – otherwise called meritocratic. This upset old-school bankers, supervisors and the media which contributed to the City's loss of reputation (Kynaston, 763). We have seen how this played out with Leeson in Barings: the Bank not paying much attention to the bank because it was 'high class', and then management and Bank trying to blame ‘the oik’ Leeson for bringing it down (Kynaston, 765).

The third culture clash is probably more important than just English people having to get over themselves: the culture clash between banking and security trading and especially between their different time horizons (Fay, 32). Banking’s need for long-term prudence is fundamentally at odds with security trading’s focus on rapid and short-term changes in price (Fay, 16). This remains concerning because – perhaps until ring-fencing came in vogue after the 2008 crisis – the trend in banking over time has been towards liberalization. That is, increasingly allowing any financial institution to undertake any financial activity.\footnote{How this interacts with bank regulation, which has the effect of protecting banking institutions, is, of course, the focus of this dissertation.} Moran points out that the move from club to regulatory government (and concomitant culture change) was a “revolution from above” (180), against many of the wishes of market participants at the time. This explains why old attitudes persisted within organizations – banks or the Bank – even as they took advantage of the new freedoms to increase their range of activities. In short, it explains why Barings was so gung-ho moving into the securities business without changing their management system or even really learning what it was about (Tickell 1995).
Financial innovation

One other aspect of the collapse of Barings which was much commented on at the time was the role of derivatives trading (Moran 2003, 175). This was a relatively new practice at the time, and was blamed for being overly complex and risky. Financial innovation has always been a convenient scapegoat for disrupted competitors and flat-footed supervisors. However, as Zhang (1995) argues, it is not the product that should be blamed but its use. Leeson after all sank Barings because he was out and out betting in the markets rather than engaging in any financial, risk-based speculation (that is, he had not hedged like he was meant to. Zhang, 134). In the end, calls at the time to ban derivatives trading in London or to hamper it severely were ignored (Times, ‘Baring losses’, 27.2.1995, 19), not least because something, once invented, cannot be un-invented (Financial Times, John Plender, ‘The box that can never be shut’, 28.2.1995, 19). As the FT argued in the above-cited article, attempts to blame derivatives for Barings’ failure are just to distract attention from the management and supervisory failures that really led to it.42

The end of Barings

Barings’ failure is perhaps overdetermined, but it can be traced back to a combination of the four analyses above. Financial innovation and culture change in the City, coupled with a staid business strategy on the part of Barings, which led to management failure which was allowed to persist through poor supervision. Eventually, a ‘rogue trader’ came along who exploited all these facts. With this situation it is hard not to agree with Fay’s conclusion

42 Though it is true the article does call for some form of ring-fencing for derivatives trading.
(298): "Will an event like the collapse of Barings happen again? Of course it will. Somewhere, it – or something like it – is happening now."

Nonetheless, as with JMB and indeed the secondary banking crisis, where the Bank of England failed in supervision, it succeeded in its rescue strategy; which in Barings’ case was not to rescue it. The Bank was largely praised for allowing it to fail when no buyer or lifeboat looked possible (Moran, 12), and especially for not throwing public money behind the bank since they did not think there was any systemic risk. As Moran argues this was a fundamental signal to the world that the City of London had changed and there would be no special treatment for anyone, not even the oldest, most prestigious merchant bank (Moran, 13). The failure of the lifeboat plan (because the losses were too large and Barings seemed so unrepentant) showed the limits of the City's clout in new international financial markets (Gapper & Danton, 48-54).

**Conclusion**

Barings’ collapse shows perfectly how the City had changed from 1970 to 1995. As its markets had been opened up first internationally and then functionally through a change in regulation, its supervisory arrangements had not kept pace. This explains the series of frauds and scandals that hit the City in the 1990s (along with monetary turmoil from shadowing the Deutschmark and then from Sterling's time in the ERM). By pointing the blame at Leeson alone, the Bank and its supporters in the City hoped to emerge unscathed from the failure (Tickell, 6). At this point, however, the Bank had run out of reputation to trade on, political clout to rely on, or luck to hope on: it lost its role as a supervisor as soon as New Labour came to power in 1997.
The Conservative governments opened up the scope of 'banking' by removing most of the
distinction between banking and finance. It did this through removing restrictions on the
stock exchange (Big Bang), placing all financial institutions under the same regulatory
framework (FSA), and by removing any 'traditionalist' distinctions between different forms
of banking itself (with the Banking Act 1987). It also expanded the geographical reach of the
UK’s financial market by essentially removing any limits on where and how much financial
institutions could operate (exchange controls and the reforms above). However the
government did not update its supervisory arrangements. The Bank of England, despite JMB
and later BCCI, still managed to cling on to its privileged role in the City as a semi-public
agency through its political ties and international reputation (this is why Lawson in the end
did not want to strip the Bank of its supervisory powers after JMB. Lawson, 2002). With
Barings’ failure the Bank lost both those attributes. The fact that this collapse happened at a
time when traditional institutions in the UK were looking discredited, worn out and ‘sleazy’
exacerbated the Bank’s reputational loss.

Nevertheless, there was some satisfaction that Baring’s failure showed the new City was
governed by ‘market efficiency’ and ‘impartiality’ and the Governor, for one, was happy that
it would instill market discipline through moral hazard. The City as a market-place in some
ways gained from Baring’s failure, and some of the contemporary worries that Barings’
collapse would sink the City were unfounded. Barings unleashed the ‘Wimbledonization’ of
the City (Kynaston 1994). The Bank, however, had not shown it was up to the task to
manage this new City.

The government had opened up new markets, but had failed to control them. The attempt to
do so would have to come from New Labour. It seemed successful at first, but the new
system’s failure in 2008 showed that the new regime was just as unable to control financial
markets as the old one.
Introduction

Labour's first action when it came to office in 1997 was to grant the Bank of England independence. Why did it do this and what did it mean?

There are a number of reasons for the decision, ranging from the personal ambitions of the Chancellor, Gordon Brown, and the political symbolism at the heart of the ‘New Labour Project’ through to academic fashions and the inexorable power of global finance. Ironies abounded, too: it was a Labour government that made the move although a former Labour government had nationalized the Bank in the first place; the Tories had been dreaming of granting the Bank independence while Labour had barely mentioned it; and the Bank seemed to be rewarded for its egregious failures of the 1990s.

Nonetheless, although the bolt might have been unexpected, it did not come out of a clear blue sky.

This chapter will first trace how and why the decision to grant the Bank of England operational independence for monetary policy was taken, and why this led to the creation of the Financial Services Authority (FSA). The second half of this chapter will look at how this new, ‘international best-practice’ supervisory regime allowed the build-up of unrecognized risks in UK financial markets, channeled the global financial crisis into the country, and led to the conditions for the first bank run in the UK since Victorian times.

The final irony is that a period starting with the removal of a quasi-state department from the public sector ended with the world’s largest private bank being quasi-nationalized. What went wrong?
Part 1: Regulatory change

The debate in the 1990s: Central Bank independence and the institutional structure of bank supervision

Nigel Lawson had wanted to give the Bank of England independence in the 1980s (Lawson 2011). Margaret Thatcher had not, and so nothing happened (cf. previous case study). For all the idea may have followed logically from her commitment to monetarism, it was violently at odds with her method of governance and obsession with control. Economics lost out to politics. In the early 1990s under Major there were sporadic calls for Bank independence, which grew after the ERM debacle (Kynaston 1994, vol 4). Lamont as Chancellor is credited with putting the Bank on the path to independence by introducing inflation targeting and monthly meetings between the Chancellor and Bank Governor (House of Commons Treasury Committee 2011). This brought inflation under control and reintroduced the Bank to monetary policy-making, albeit in a subordinate role. Nonetheless, it was not inevitable that the Bank would be granted its independence, and its failures of supervision with BCCI and Barings reduced trust in the institution. The politics of central bank independence lost out to the economic failures of the Bank's supervision. Finally when Blair and Brown came to power, the two were aligned.

The call for central bank independence reflected a major change in academic, professional and policy thought over the 1990s though it was not sudden. Table 2 below, taken from Patel’s multi-level analysis of Bank of England policy-change, shows there were eight attempts from the late 1980s to grant the Bank independence before Brown’s decision (Patel 2009, 333-346).
<table>
<thead>
<tr>
<th>Date</th>
<th>Actor</th>
<th>Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>September 1988</td>
<td>Nigel Lawson</td>
<td>Conservative Government</td>
</tr>
<tr>
<td>March 1991</td>
<td>Norman Lamont</td>
<td>Conservative Government</td>
</tr>
<tr>
<td>June 1992</td>
<td>Norman Lamont</td>
<td>Conservative Government</td>
</tr>
<tr>
<td>December 1992</td>
<td>Edward Balls</td>
<td>Fabian Society</td>
</tr>
<tr>
<td>January 1993</td>
<td>Norman Lamont</td>
<td>Conservative Government</td>
</tr>
<tr>
<td>November 1993</td>
<td>Eric Roll</td>
<td>Centre for Economic Policy</td>
</tr>
<tr>
<td>December 1993</td>
<td>Giles Radice</td>
<td>Treasury Select Committee</td>
</tr>
<tr>
<td>January 1994</td>
<td>Nicholas Budgen</td>
<td>Private Member's Bill</td>
</tr>
<tr>
<td>May 1997</td>
<td>Gordon Brown</td>
<td>Labour Government</td>
</tr>
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Table 2: Proposals for an independent Bank of England

Source: Patel 2009

From the mid-1990s onwards (Goodhart and Schoenmaker 1995, 539), there was the increasing policy assumption in the UK that Bank of England independence was the best way to fight inflation: still the major macroeconomic policy of the government. This was part of an international trend towards central bank independence (Tager 2007, 359-366). The indices of central independence jumped in the 1990s across the world, and especially in the EU (Lijphart 2012, 234-235). This is not the place for a close look at the arguments for and against central bank monetary independence, globally or in the UK, but it needs to be said that gradually over the decade and academic consensus and increasingly a political consensus formed that central bank independence was desirable in itself (see, e.g. (Chadha, Macmillian, and Nolan 2007, 311-327) and (Eijffinger and Haan 1996)). This was especially true since it was one of the Maastricht criteria for joining the Single Currency (European
Union 1992). The question for the UK came to be how to reconcile this with parliamentary sovereignty and democratic legitimacy (Briault, Haldane, and King 1996).43

This constitutional question interacted with other, more operational, issues.44 These were how best to ensure the desired outcomes of monetary policy, how a government could best ‘signal’ its openness to business and trustworthiness with the economy (Tager 2007, 359-366), the eternal British fight between the needs of the City and of industry, financial competitiveness versus stability, and the struggle for financial supremacy between London and New York (McKinsey 2008). The possible accession of the UK to the Euro also added a unique twist to the debate: Euro-accession required central bank independence (European Union 1992). Despite the academic, economic, consensus that had formed about the desirability of an independent central bank, therefore, there were still significant questions as to what that meant, how best to achieve it, and how this could affect subsidiary issues.

Bank of England independence was not a done deal.

What finally tipped the scales in favor of Bank independence was that the ‘New Labour’ government wanted to do something new in economic policy which would signal a decisive break not just from the preceding Conservative government but also from previous Labour party policy (Financial Times, 'Freedom balanced by Scrutiny', London, 1.4.1997: 22).45 As part of its overall rhetoric of removing a ‘sleazy’, out-dated, and out-of-touch Conservative...
government, Labour wanted to show itself as modern, internationalist, meritocratic and technocratic (Labour Party 1997; Walsh 1997), also (Campbell 2007). As part of this Labour political drive for Bank independence, we should also note that it was Brown, as Chancellor of the Exchequer, who made the announcement and made the decision. Partly this is what we would expect, since the Chancellor is in charge of economic policy and had always been the minister responsible for the Bank of England. Equally within the Blair-Brown duumvirate of Labour’s first term in power, Brown was given almost total control over domestic policy (Rawnsley 2010). Nonetheless, in terms of the constant power struggle between the two architects of New Labour, Brown clearly used the opportunity of a sudden, unexpected, drastic and fundamental change – which was uniquely within his gift – to lay bare his own ‘New Labour’ credentials alongside Blair, at a time when, following the landslide electoral victory and the start of Blair’s messiah complex, the Prime Minister had all the public limelight (Campbell 2007). Brown was anxious not to be cast as the ‘old Labour’ part of the pairing, or as a roadblock to modernization (Coates and Lawler 2000). Labour’s most major change in its entire first term (Economist, ‘Britain: Labour’s coup’, London, 5.5.2001) would be his achievement alone. As ever with New Labour, spin and substance were the same thing.

Having granted the Bank operational independence for monetary policy – for personal, political, economic, and geopolitical reasons – what is interesting is what Brown chose to do next: hive off one of the Bank’s traditional roles (indeed under nationalization one of its only direct roles) as bank supervisor and create a new, dedicated financial services authority. The reason for this was based, again, on developing academic doctrine: that of the

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46 Ironically given his later attempt as Prime Minister to distance himself from Blair’s legacy (Seldon 2011).
separation of monetary and financial supervisory policy which is best discussed in Goodhart and Schoenmaker’s paper (Goodhart and Schoenmaker 1995, 539).

The argument for the separation of supervision from central banks was that there was an inherent conflict in interest between the need to control inflation through use of the interest rate, and what banks needed to stay healthy (Briault 1999). That is, bank stability might be threatened by economy-wide necessary interest rate changes. A central bank which had both remits might therefore compromise on its inflation targeting so as to support its financial stability role. Interestingly, Goodhart and Schoenmaker argue that there is no clear evidence this is the case, note that about half of the economies they survey had the roles separated and about half joint, but make the point that separation may be beneficial, in some cases, since central banks were finding it harder to persuade banks to finance rescues, and therefore a more political entity with access to public funds might be beneficial. Nevertheless, even this tentative, qualified endorsement was given the proviso that in any case a central bank and financial authority would have to work incredibly closely together because of the central banks enduring, and inevitable, role of lender of last resort.47

Due to politicians’ understanding of the dominant intellectual paradigm for financial markets of the Efficient Market Hypothesis (EMH), the separation doctrine gained political backing (The Times, City editor, ‘Regulators back in the melting pot’, London, 21.5.1997: 31), and it seemed to fit the macroeconomic environment given the success at tempering inflation and the start of a long period of smooth growth: “the end of boom and bust” (Brown, Gordon, Pre-Budget Report, Parliament, 9.11.1999). There was a rationale for financial regulation (Llewellyn 1999) and a single institution to oversee it seemed

47 Additionally there was a ‘twin peak’ theory (Taylor 1995), which said that there should be a separation of prudential and conduct of business supervision since they were fundamentally different activities. This idea finally had its moment in the sun when the FSA was disbanded following the financial crisis back into the Bank, with the Financial Conduct Authority (FCA) hived off into a separate agency.
preferable (Briault 1999). To international eyes, as well, the separation would allow the
government and City to show to the world that the UK was at home with the international,
meritocratic, globalized form of banking, without national preference (The Times, ‘Brown's
Bill must offer safety to savers and a stick for City sinners’, London, 22.5.1997). The Barings
episode had underlined this (to the upset of many, cf The Times, William Rees-Mogg, ‘How a
great bank was brought low’, 27.2.1995, 18), but with banking supervision under the
control of the Bank and the Bank under the control of the government, the City's level
playing field would always be in doubt and contingent on the good-will of the government.
An autonomous central bank with a separate bank supervisor would solve two time-
inconsistency policies for macro-financial policy. On a more pragmatic note, with the
increasing blurring of the lines between bank and non-bank finance from Big Bang onwards,
it struck many as strange that a central bank should have control over such large parts of
non-bank finance (e.g. capital markets and insurance) (Sinclair 2000) and (Goodhart 2002,
1-32). There were also calls, for example from the Cruickshank report into bank
competition, that this new agency should have a role actively promoting competition in the
City (Cruickshank 2000).

Politically, as well, the separation of supervision and monetary policy seemed to be a way to
solve the problem of increasing the Bank of England’s powers (by making it independent)
while still not ‘rewarding’ it for its public failures of supervision in the 1990s. The idea of
granting the Bank independence of monetary policy (where with ERM the government had
spectacularly failed) but taking away its role as banking supervisor (where with Barings at
least the Bank had spectacularly failed) seemed to square the circle. At the same time, it
would allow the new Labour government the opportunity to create a new ‘constitution’ for
banking and financial services in the UK through its creation of a new financial services
This would allow Labour to promote its ‘pro-business’ credentials, mark a clean beginning from the Tories’ “sleazy” relations with the City (Campbell 2007), and let the new government leave its stamp on the most prestigious sector of the UK economy. By overtaking Thatcher’s liberalizing reforms in the City, Labour was signaling that it was overtaking Thatcher’s government and by association becoming the ‘natural party of government’. The separation of roles was a political as well as an economic policy.

Developing a separated system of single financial supervision, allied to an independent central bank, seemed to solve a lot of political, financial and economic issues in one fell swoop (Dale and Wolfe 2003, 200-224). The fact that the Bank was only too happy to get rid of what it considered, at this time, an inferior part of its practice – bank supervision – in favor of the academically, internationally, and publically more ‘glamorous’ role of monetary authority, meant that there were few complaints from the Bank that it was to lose one of its original and most specific roles (Dan Conaghan 2012).

Within a few weeks of taking office, Blair and Brown had transformed the supervision of UK finance and the conduct of monetary policy. This was a remarkable, and unforeseen, change (even the Economist was alarmed at the way the decision was made, although it welcomed it: Economist, ‘Labour’s good start’, London, 10.5.1997: 14): in its scope, thoroughness and fundamental nature, it was a match for Thatcher’s ‘City Revolution’. But it was one thing to decide on the changes, quite another to steer them into reality.

Separation in practice: getting from FSA to FSMA

The process of developing the supervisory regime was not easy (Jackson 2015). This suggests that the initial idea of separating monetary policy from financial supervision - and

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48 Cf. Mandelson’s being “intensely relaxed” about people becoming “filthy rich.”
49 Something else again for that reality to be what was wished for (see part 2 of this chapter).
splitting responsibility for financial supervision into three unequal parts but creating a single financial supervisory institution - was not as simple and obvious as was assumed. In the end it took four years to 2001 before the whole process was over: the entire first term of the Labour government. Not bad going for something which was announced as the first major policy action after its election.

On the parliamentary side of the process, the bill was so long it required a new institutional form of scrutiny (a joint House committee - Economist, ‘Dangerous watchdog’, London, 23.1.1999: 67), and was long and messy (The Times, ‘Drawing the monster’s teeth’, London, 16.3.2000: 29). The final Act (Financial Services and Markets Act (FSMA) 2000) barely satisfied anyone who had championed its birth. So what went wrong, or why was the process so complicated?

Initially, the process of creating what would become the FSA was simple enough. Ten days after announcing the independence of the Bank of England, Brown announced the FSA (Economist, ‘Labour turns to the City’, London, 24.5.1997: 14). This took the form of his announcing its name in a speech (The Times, ‘One watchdog to monitor all City dealings’, London, 21.5.1997: 1). Under his current powers, he took the Securities and Investments Board (SIB), moved the powers of the other Self-Regulatory Organisations (SROs) into the SIB, appointed a new head who was seen as a market disciplinarian (The Times, ‘Banker charged with making the watchdogs bark to a single tune’, London, 31.7.1997: 27), and initiated the Financial Services and Markets bill (which when it became an act would be known as FSMA). This bill would confer statutory powers on the new, augmented SIB, renamed the FSA. Hopes were high both in markets and in the commentariat (Financial Times, ‘Watchdog with bigger teeth’, London, 29.10.1997: 17) and the moves were widely praised. Indeed with this basis, the FSA managed to get to work straight away, well before it
received the statutory powers that in theory underpinned its authority (The Times, 'FSA sets out tough but ‘flexible’ rules for City', London, 8.9.1998: 28).

In this period the FSA could even be claimed to be successful (Economist, ‘New Labour’s report card’, London, 10.6.2000: 59). Inflation was low and there were no financial scandals. We cannot say that this financial growth and stability was because of the FSA, but given what was happening in the US at the time with the dotcom boom and bust, Enron, and 9/11, London clearly thrived in this period (McKinsey 2008). We can at least say that the FSA did not cause any problems for the City, and its operations compare favorably with previous UK regimes (cf. the preceding case studies). We cannot confirm that the FSA helped but we can securely say it did not hinder.

Throughout this period, however, the FSM bill was making slow and complicated progress through Parliament. Firstly the sheer size of the bill meant the government decided to invent a new form of joint House committee, so that it could be scrutinized more quickly (Ferran 2003) (this innovation was considered a success (Coates and Lawler 2000)), but even this efficiency still meant only certain aspects could be looked at in committee a limited number of times. There was simply too much material to get through (The Times, 'A new regime is born, but the City will wait and see,' London, 15.6.2000). Because of this, also, the process of debating, consulting, and amending the bill meant that the legislative process took far longer than other bills (Financial Times, ‘Tremors in the City’, London, 7.4.2000: 20), despite the fact that the controversies and compromises required were in general far less, and less contentious, than with the comparable 1986 Financial Services Act which FSMA was designed to supersede (Financial Times, ‘Nice architecture, shame about the fine detailing’, London, 8.4.2000: 17). Through aggressive legislative timetabling, in the end the bill was passed into law in 2000, to come into effect in 2001, but it was messy and the FSA itself felt pressure to bear its teeth at the market to assert itself (Economist, ‘Too big for its
suits? The Financial Services Authority’, London, 17.11.2001: 67). It was being tugged in all
directions by its “risk-based approach” to supervision (which gradually shaded into “light-
touch”), its desire to assert itself, its limitations by statute, and public understanding as to
its role. The FSA had to be all things to all people (Financial Times, ‘A watchdog that is

What this confusion, legislative and functional, shows, however, is the fact that it is not easy
to legislate modern, international financial markets in a clear and comprehensive manner.
This is not simply a matter of special pleading, captured regulators, or political
compromise,50 but the nature of financial innovation, interconnection, and
institutionalization. There are many moving parts which require a flexibility and sensitivity
of treatment that is hard to come by in statute.

To add to this inherent complexity is the fact that, like all previous financial authorities we
have looked at in this dissertation, Blair and Brown had two aims with the law: to increase
both financial stability and competition (FSMA 2000, Art. 2.2-3). These were not seen at the
time as contradictory aims: following on from the Efficient Market Hypothesis (EMH), which
states that markets are perfectly rational (assuming perfect information) and therefore
financial stability can be guaranteed through the free market. If only there had been some
history in the UK of unbridled financial competition leading to financial instability.51
Although separated supervision could, in some readings, have solved this issue by granting
one objective (financial stability) to one institution and the other (competition) to another,
in reality the two aims were each to be achieved by one institution, the FSA, but be the
responsibility (on some level) of three separate institutions: the Bank of England, the FSA,
and the Treasury. Each, in their own way and according to their own powers, was to

50 Though of course it could also be that (Calomiris and Haber 2014).
51 Cf. Cases 1 through 3 above.
promote the City and simultaneously control it. To coordinate themselves, they wrote a Memorandum of Understanding (MoU) (HMT 1997) which said that the Bank should oversee the stability of the financial system “as a whole” (as well as stability of the monetary and payments systems), the FSA was responsible for the supervision of financial institutions individually, and conduct of business, and the Treasury for overall framework of financial legislation and regulation, and hold any political responsibility (and indeed, more responsibility than was generally recognized (Williams 2000, 14-17)). As a statement of principles this was fine enough, but it turned out not to be the handbook for coordinated action that it was assumed to be and which was needed when the crisis struck (House of Commons Treasury Committee 2011). There is also a clear set of reasons why all three of the organizations ended up promoting financial growth at the expense of stability:

- The Bank of England finally considered itself free of banking supervision with the creation of the FSA, and was determined to make a success of its monetary policy (Dan Conaghan 2012). This meant low and stable inflation with minimal interest rate shocks. This was the ideal environment for financial growth, and the Bank interpreted its role as guaranteeing the banking system as a whole to mean just this: that it had to enable steady financial growth. It simply was not thinking about the build-up of risk in the system (Darling 2011).

- The FSA, as the newest and in some ways least prestigious of the organizations, was keen to establish itself as a respected player in the City. This meant that it had to bare its teeth somewhat in the early years (The Times, 'FSA sets out tough but 'flexible' rules for City', London, 8.9.1998: 28), but that if it picked too many fights with banks they would complain over its head directly to government and the FSA would be seen as ‘problematic’ which would further erode its authority - as for example happened with HBOS, see below (Parliamentary Commission on Banking
Standards 2013). It had the opposite problem to the Bank: by only focusing on the minitiae of bank supervision in a ‘silo’ approach (i.e. non-systemic), it allowed the rapid growth of banking activities without thinking through how this could later affect bank stability (Thain 2009, 434-449).

- The Treasury was just interested in economic growth and its tax receipts (Darling 2011). As the most political of the organizations, it was quite happy not to look too closely at this goose that continued to lay ever larger golden eggs.

The MoU divided up responsibilities for bank stability but all actors shirked theirs. Promoting financial growth was more rewarding (in every sense) for individuals and institutions than limiting it in favor of stability. In this sense, following Minsky, we can say that ‘stability is destabilizing.’

Nevertheless, the new regime was not a disaster. It represented the best approach of the time, based on the assumptions people held about financial markets (and post-communist capitalism in general). It also represented a ‘rationalized’ and well-praised form of institutional set-up for bank supervision. It was, however, highly contingent and peculiar to the UK case. Had the pound sterling not performed as it did in the 1990s, had new Labour not come to power and wanted such a total break from the past in all things, had Blair and Brown not feuded so constantly, had the Bank of England not had the specific history and reputation it did at the end of the 1990s, the FSA/FSMA regime would not have happened in anything like the way it did. It existed because of the political needs of the current government, as conditioned by public opinion and contemporary academic thought. The FSA may have become a model for other jurisdictions, and been praised for being a clear response to contemporary theoretical positions, but it was built out of the rubble of ancient and modern UK political economic history.
This regime achieved its aim of improving London’s competitiveness and helping its banks compete internationally. Fantastically so: RBS became the world’s largest bank (by assets, Financial Times, ‘RBS et mon droit: HM deficits’, 19.1.2009), the City became the world’s foremost financial center (by some standards, (McKinsey 2008)), it gained the euro forex trade from the euro-zone (Daripa, Kapur, and Wright 2013, 71-94), represented the largest single aspect of UK tax revenue (Darling 2011), and for a period it even seemed to offer financial stability. The new regime seemed to work (Hall and Henry 2000, 5-11).

But while it ‘worked’ it also had unintended consequences: made all the worse by being hidden and ignored as they built up. One overlooked consequence of the separation of bank supervision from the Bank of England was that liquidity provision for stressed banks (Lender of Last Resort) was now separated from the supervisory authority (as warned about at the very beginning of this theoretical period (Goodhart and Schoenmaker 1995, 539)). This was not a problem while liquidity was cheap and plentiful, but it was a common theme of the reports on the bank failures from 2007 onwards. Separate but related to this is the fact discussed above that responsibility for systemic stability fell through the gap between the three MoU institutions. In schematic terms ‘what went wrong’ with the regulatory-supervisory system is that systemic stability concerns lost out to narrower institutional concerns: monetary stability for the Bank and financial conduct for the FSA, pro-market stances for both. This is perhaps to be expected during a long period of growth and prosperity – “The Great Moderation” – but the very point of creating a new authority for financial supervision was supposed to be to avoid these conflicts of interest. In this sense the new regime clearly failed, and indeed its failure was baked-in to its original design. It would only be exposed, however, with the shock of the crisis.

That is the story of the second half of this chapter. We shall move on to a very quick outline sketch of the crisis – which is the standard telling – to set the context, and then move on to
look at the three major UK bank failures. Each was different but there were significant overlaps: Northern Rock, HBOS, and RBS. Investigating these cases (each of which was the subject of official inquiries) will explain how the FSA/FSMA framework, having allowed the build-up of hidden risk in the system, then channeled the international financial crisis into the UK banking system, forcing them to fail and be rescued at great expense to the taxpayer.

More viscerally, the flaws of this regime led to the first bank run in the UK for 150 years: the system did not ‘work’.

**Part 2: Market collapse**

*Global Financial Crisis*

The causes of the global financial crisis are well understood – overdetermined even – and it is certainly not the aim of this dissertation to up-end the prevailing consensus. But it is worth setting out our understanding and chronology of the crisis quickly to create a background and context for the stories of UK bank failure which we are more interested in. The crisis is a global story originating in the US, blowing through the UK and Europe on its way around the world. It was a major shock for every economy, of course, but it had different routes-in everywhere and different effects. That is, the same shock interacted idiosyncratically with national specificities. That is an obvious point, but one worth bearing in mind for our discussion of the ‘UK global’ financial crisis. The financial crisis was indeed particularly severe in the UK because of the nature of its banking system and its regulatory regime. Following this outline sketch of the global crisis we will then dig down into each UK major bank failure: Northern Rock, HBOS, and RBS.

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52 For good, clear accounts see, among many others, (Tett 2009), (Rajan 2010) and (Sorkin 2009).
The world economy in 2007 was imbalanced, with large current account surpluses in some developing nations, and Japan, and corresponding large deficits in the US, UK and other developed nations. Interest rates in developed nations fell to historically low levels (see figure 2).

![UK real interest rates](source: "Turner Review" FSA 2009)

The financial crisis had its origins with the search for yield in these markets; in the end yield was found in US subprime housing debt (FSA 2009, 13). This was transformed through financial innovation into supposedly safe, risk-differentiated products that were bought around the world by institutions desperate for risk-free returns (FSA 2009, 14). Much of the debt was also swapped between the same buyer-and-seller firms in insurance-like products called Credit Default Swaps (CDS) (Tett 2009). These were intended to operate as risk mitigators. This financial system was overseen, such as it was, by the Basel II capital adequacy framework which allowed market participants to assess their own credit risk levels and determine their own risk-control policies (Bank for International Settlements 2004). The rationale behind this was that market participants had better information and
reacted more ‘efficiently’ than regulators, and therefore their own risk management would be simultaneously more effective and less distortive (and cheaper) than public-sector regulation (Tarullo 2008). The situation at the start of the crisis, therefore was: risky debt, packaged as risk-free and spread around the global system, guaranteeing itself, essentially unregulated by the public sector. Credit growth was also very high, as was bank leverage (figures 3 and 4 below).

Figure 3: UK debt as a % of GDP  
Source: “Turner Review” FSA 2009
This situation continued happily enough until early 2007 when interest rates rose from Fed action to curb anticipated inflation, which led to increasing default rates among subprime borrowers and consequently falling house prices (Darling 2011). Since the securitized assets chain was largely built on mortgage loans and rising house prices, this caused increasing losses on these products. Because of their own balance sheet weakness and uncertainty as to other institutions’ credit-worthiness, financial institutions essentially stopped lending to each other (Lewis 2010).

This by definition caused an instant contraction of liquidity in the system (the ‘credit crunch’) which soon became acute for the most exposed (and usually worst managed) institutions: across the world (Financial Times, ‘BNP Paribas investment funds hit by volatility’, London, 9.8.2007).

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53 Problems with the way Credit Reference Agencies (CRAs) operated in the system exacerbated this situation.
54 As we will see, Northern Rock was one such institution.
managed firms went bust – indeed it is a core plank of EMH so that market discipline can operate – but in a system that had grown so interconnected, and so unclear in its connections, even the failure of minor and weak firms added stress to already stressed major firms. That is, implicitly, every financial institution was ‘too interconnected to fail’ (Markose et al. 2010). This was not well appreciated to start with.

Exactly these worries led to government bail-outs and forced restructurings of Fannie Mae and Freddie Mac (Financial Crisis Inquiry Commission 2011), but for whatever reason you accept, the US government decided to allow Lehman Brothers to collapse in September 2008 (McDonald and Robinson 2009). This was the moment of sharpest systemic shock which forced all market participants to reevaluate their balance sheets and assumptions about how markets, and the government-in-market, worked (FSA 2009). Only coordinated government intervention could prop up the financial system. Crucially, as Brown (now UK prime minister) realized, this intervention had to be a massive, coordinated, international recapitalization and not just ad hoc institutional liquidity provisioning (Seldon 2011). That is, the crisis of lending and in financial product innovation had revealed that the problem was on both sides of the balance sheet: not just difficulties in repaying liabilities, but the risk-free liquid assets institutions held against these liabilities were shown to be in fact almost valueless and highly illiquid (FSA 2009). The answer, mutatis mutandis, was for governments to recapitalize failing institutions, often in the process taking them over, removing or guaranteeing their toxic debts, then gingerly selling them back to the market. The world is still in the middle of this process.

So, schematically, the story of the crisis is this: poor loans (debts) spread through a system that had too little liquidity and capital, and which was under-regulated. As banks could not

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And indeed the world’s largest insurer AIG.
maintain their payments and their assets could not be sold on, the market value of these assets decreased effectively to zero (through the uncertainty effect described above as well as fire sale dynamics). Governments were therefore forced to step in to recapitalize, reorganize and reregulate banking.\textsuperscript{56} There were also a geographic retreat to home countries: both market-based during the crisis and due to regulatory jurisdictions from the public sector response. This was a brief sketch of the global financial crisis. Now we shall look at the cases of the specific UK bank failures: Northern Rock, HBOS, and RBS.

\textit{Northern Rock – A crack in the Rock} \textsuperscript{57}

Northern Rock was a nineteenth-century founded building society which demutualized into a bank in 1997 and listed itself on the stock market (Shin 2009, 101-119). Its total assets grew in the period 1998-2007 from £17.4 billion to £113.5 (House of Commons Treasury Committee 2008). Its assets were concentrated in residential mortgages, primarily in its home region of the north of England. It also gained a significant amount of its short-term funding from the international wholesale markets. It created an on-balance sheet vehicle called Granite (based off-shore, in Jersey) which it used for its securitization business. Shin argues convincingly, however, that, unlike with some other banks especially in the US, this SPV was not the major factor in Northern Rock’s collapse.

If we look at the graphs below (figures 5 and 6), we can see that on the eve of the crisis Northern Rock’s balance sheet was mainly made up of wholesale-funded retail loans (residential mortgages) and securitized bonds. The level of covered bonds actually grew during the crisis, but its securitized notes and wholesale funding operations collapsed, needing to be propped up by a special Bank of England loan. As the parliamentary

\textsuperscript{56} The fact that they had to do so much ‘rethinking’ about banking suggests on its own that government had not been doing its job overseeing the sector properly to start with.

\textsuperscript{57} The substance of this case comes from the Parliamentary inquiry \textit{The run on the Rock (House of Commons Treasury Committee 2008)}. Unless otherwise noted, this is the source for this section.
commission into Northern Rock showed, the bank was overleveraged, overly reliant on certain sectors of funding, and did not have appropriate internal or external controls in place. When the first winds of the financial hurricane blew over the Atlantic, Northern Rock’s house seemed more to be built of straw than stone.

**Figure 5: Composition of Northern Rock’s balance sheet**  
Source: Northern Rock Annual Report and Accounts 2006
From the timing of the run on Northern Rock, it becomes clear that the run itself was not the cause of the bank’s problems, but rather an (exacerbating) symptom (Shin 2009, 101-119). First Northern Rock lost access to wholesale funding because of the decline of its balance sheet following the closing down of liquidity in US markets, then it asked for Bank of England support (FSA 2009). When this leaked out (through a BBC journalist’s blog) the news caused a panic and a bank run. Northern Rock was already in difficulty before its retail deposits were drawn down – ironically they were, in the main, healthy, assets (House of Commons Treasury Committee 2008). They were though being used to prop up a bank that was highly leveraged and the old maturity-transformation problem of banking came back: mortgages and personal loans are long-term while the bank's liabilities were short-term.

Quite simply, although it had some solid assets, these were not nearly enough to cover its
liabilities when easy funding ran out and the market to sell the assets on seized up: in short, the bank proved to be insolvent in the new market conditions (FSA 2009).

When this was realized, the government and Bank of England tried, over the course of a weekend, to find a buyer for Northern Rock (Darling 2011). They nearly succeeded but in the end the size and, again, uncertainty of Northern Rock’s liabilities precluded this (Seldon 2011). The government allowed a support facility for Northern Rock and guaranteed its deposits to stop a run (House of Commons Treasury Committee 2008). There were legal considerations which constrained their government’s actions (Darling 2011), which showed that the Memorandum of Understanding framework (HMT 1997, 60) was not suitable for this level of rescue operation. Failing to find a private buyer – after state support – Northern Rock was taken into public ownership, split into a good and a bad bank (called Northern Rock Asset Management). Virgin Money bought the good bank in 2012 and phased out the Northern Rock brand, while the government still owns the bad bank.

What went wrong with Northern Rock has been subject to intense scrutiny – rightly – but it seems clear that the basic business model failure was an overreliance on wholesale funding to cover its immediate funding needs, and on international capital markets for the selling on of its securitized mortgages (House of Commons Treasury Committee 2008). There are three dimensions to this:

- Borrowing on international money markets and then trying to sell on the loans that were extended with this funding (“originate to distribute”) made the bank highly reliant on international market conditions. When funding dried up the bank was not able to meet its growth (lending) needs and it became undercapitalized. Then when the bank could not sell on its securitized mortgages it was left with low-return
assets that could not cover its liabilities (House of Commons Treasury Committee 2008).

- Its second problem was that the bank was not as diversified or safe as it thought it was. For all its geographic reach and boasting (Northern Rock plc 2007), at this point geographic diversification was less useful than funding-source diversification.

- Finally, at root of all these problems was poor management and poor supervision (House of Commons Treasury Committee 2008). This reflected the unproven and lazy assumptions of the EMH era: markets would always be liquid, asset values would always rise, markets could effectively regulate themselves. These assumptions proved to be wrong, and the bank failed.

Northern Rock was the canary in the mine (Darling 2011). On its own, its run would have been a dramatic event, an embarrassment for the government and its economic policies, and – worst of all – painful to the many savers and mortgage-holders of the bank. But it could not have caused a financial crisis of this scale, or, had it been isolated, would it have necessarily had major systemic effects in the UK. Unfortunately Northern Rock was simply the first, most sensitive (because of the riskiness of its business model) financial institution in the UK to be hit by the cooling-down of international financial markets. Northern Rock, though, was not the only bank to suffer, and the FSA did not get much better, even after this severe example, at reassessing other institutions’ strength or weakness. Although - in a way - total systemic collapse was avoided, individual, large, institutions still failed.58 In any case, the financial crisis began in the UK with Northern Rock. It did not end there.

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58 Which is ironic given the FSA previously had managed to supervise institutions but ignore the system.
HBOS – False Security\textsuperscript{59}

HBOS’s situation was similar to Northern Rock’s – though its failure was based in its corporate division rather than its mortgage and personal loans divisions - but rested on a much more worrying situation. The bank’s managers did not know what they were doing, nor did they what the bank itself was doing. In 2004 HBOS was told by its group finance director that it was “an accident waiting to happen,”\textsuperscript{60} and the FSA raised concerns over its prudential operations (Parliamentary Commission on Banking Standards 2013). And yet by 2007 any worries internally and externally had ceased, to the point that it was given a waiver for some Basel II requirements (FCA 2015) by the FSA just months before its failure. At the heart of the story of HBOS is one of a false sense of security: the managers thought they were uniquely capable, they thought they were running a conservative operation when in fact they were running a risky one, and supervisors were confident that they had nipped its ‘growing pains’ in the bud (Parliamentary Commission on Banking Standards 2013). The benign macroeconomic environment, which led to rapid and easy growth, certainly had something to do with this. In a sense we can see HBOS as a microcosm of Minsky’s financial instability cycle and the story of changing ‘animal spirits’. Its growth and death was one big behavioral bias.

This is a shame because to start with HBOS had some real advantages (Perman 2012). It was founded in 2001 by the merger of a former building society – Halifax – with the second largest Scottish retail bank, the Bank of Scotland.\textsuperscript{61} This merger was synergistic since Halifax had, over a century, become the largest building society in England; after it

\textsuperscript{59} This case is mainly based on the FCA’s and Parliament’s investigations into HBOS’s failure, and the one detailed account of its crisis: (FCA 2015), (Parliamentary Commission on Banking Standards 2013) and (Perman 2012)
\textsuperscript{60} Hence the title of the Parliamentary report into HBOS’s failure.
\textsuperscript{61} ‘On the rebound’ following BoS’s failed bid for NatWest (Perman 2012).
demutualized in 1997 it became the fifth largest UK bank. Bank of Scotland had a strong branch network and commercial lending business (Parliamentary Commission on Banking Standards 2013) but was looking to expand into a larger economy (UK versus Scotland). Both organizations were considered responsible, while regulators as well as the market were happy for the merger to happen (FCA 2015), although Halifax was Bank of Scotland’s second choice after NatWest. The Bank of Scotland had been called the “most boring bank in Britain” and was famously cautious and responsible as a community/national bank (Perman 2012).

The new banking group – HBOS – had a very different culture: one of aggressively going after sales to grow market share, almost regardless of the revenue they brought in (Perman 2012). Internally, the management of the banking group was duplicated and run ‘federally’ with little internal hierarchy or merging of management functions (Parliamentary Commission on Banking Standards 2013). The new bank’s aim was to break ingot the ‘big 4’ UK banks (RBS, Barclays, Lloyds, HSBC) to turn it into the ‘big 5’. Its corporate strategy therefore was to gain a 15-20% market share in each sector it operated in (FCA 2015). As the crisis began to strike, management relied increasingly on the corporate division to build revenue, which led to increasingly risk deals being made (FCA 2015).

Nonetheless, there were warning signs that its growth model was more risky than the bank’s managers realized. As mentioned, in 2004 HBOS was warned that its business model – raising large amounts of loans on international money markets to fund its retail loan growth - was risky rather than inspired, leaving the bank highly leveraged and dependent on the goodwill and trust of foreign banks. In the initial stages of the crisis, however, this was not realized and HBOS remained well regarded by the markets and it saw retail inflows from people looking for risk-off positions (FCA 2015).
As the ripples form the US spread across the Atlantic, and following Northern Rock’s failure in September 2007, HBOS initiated it contingency funding programme. At this stage everyone, including internally, thought that HBOS was a safe bet. As the FCA/PRA report notes, HBOS remained a ‘buy’ for all of 2007, although its share price had fallen 26% in the year (FCA 2015). In the new year, however, market rumor had it that HBOS was badly affected by Bear Stearns’ collapse of March 2008, which led to its finding it more difficult to access international money markets (FCA 2015). A weak reputation in the markets persisted adding to HBOS’s funding weakness in early 2008. Along with the generalized deteriorating market environment, this forced HBOS to switch its funding strategy from long-term to short-term covered bonds (Parliamentary Commission on Banking Standards 2013). HBOS was reluctant to be seen to pay for longer-term funding options lest this be perceived as a further weakness (FCA 2015). Increasingly, HBOS came to rely on the Bank of England’s Special Liquidity Scheme for its funding, swapping assets for Treasury bills. By September 2008 this SLS was HBOS’s primary new funding source. On the asset-side, HBOS was constrained in its attempts to draw down its balance sheet because it had an in-house ethos – a legacy of its Scottish retail banking days of which it was very proud - of ‘leaning against the wind’ which meant to continue lending through the cycle (Parliamentary Commission on Banking Standards 2013). All this did during the crisis was exacerbate HBOS’s funding problems, since it continued to lend and then had to find the funds to balance this out.

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62 The Bank of England’s own explanation of the scheme is as follows: “The Special Liquidity Scheme (SLS) was introduced in April 2008 to improve the liquidity position of the banking system by allowing banks and building societies to swap their high quality mortgage-backed and other securities for UK Treasury Bills for up to three years. The Scheme was designed to finance part of the overhang of illiquid assets on banks’ balance sheets by exchanging them temporarily for more easily tradable assets. Although the drawdown period for the SLS closed on 30 January 2009, the scheme remained in place for a further three years.” Bank of England Website, found at: http://www.bankofengland.co.uk/markets/Pages/sls/default.aspx
When Lehman Brothers fell in September 2008, and interbank liquidity dried up, HBOS was left extremely exposed. It had used up all its sources of funding: wholesale markets were gone, it had used up most of its collateral on the SLS funding, and to make matters worse it saw an unexpected outflow of customer deposits (FCA 2015). This put extra pressure on the bank but, like Northern Rock, it was at most a proximate cause of failure. Two days after Lehman Brothers failed, HBOS confirmed it was in talks with Lloyds and the next day (18 September 2008) the takeover was announced. This gave clear and immediate short-term relief to the bank (FCA 2015).

The proximate cause of HBOS’s failure was the market situation after Lehman Brothers’ collapse, but just as Gavrilo Princip did not cause the First World War, nor did this failure kill off HBOS. As the FCA/PRA and Parliamentary reports makes clear, HBOS had much deeper and longer lasting problems, which go back to its poor management structure, aggressive business strategy and contempt for external supervision (Parliamentary Commission on Banking Standards 2013). The reliance on wholesale funding meant that the Bank had little flexibility for maneuver when it came under acute pressure (FCA 2015). The failure was not that the bank got into unforeseen difficulties – which can happen to anyone – but to have left itself with no options for when this happened. This was not a problem of risky investment banking but just old-fashioned poor management of a retail bank (Perman 2012). In the words of the Parliamentary report, it became a “model for bad banking”.

The poor management, while responsible itself, was exacerbated by a lax, subservient and complacent regulatory environment which was keen to see the signs of financial strength, yet weak to insist on its stability remit in the face of banks’ criticism (Parliamentary Commission on Banking Standards 2013). Regulators were scared of displeasing political masters lest they be by-passed in the future: HBOS at one point wrote back to the FSA
criticizing it for trying to impose regulatory requirements (Parliamentary Commission on Banking Standards 2013, 28).

HBOS was created and died entirely within one regulatory framework, and should be seen as the creature and inevitable fruit of that particular supervisory tree. The fault for the failure was HBOS’s management; the fault for HBOS (and its management) was the FSA/FSMA regime.

**RBS: World’s biggest bank, world’s biggest failure**

RBS was the big one: the major failure of a major bank, nearly complete nationalization at vast public expense. The rest of the crisis in the UK can with hindsight be seen to have been leading up to this. This was the one failure that regulators and politicians were striving to avoid. And yet, they could not. Why not? Why, in the end, was there a huge, and repeated, government bail out? Why, in the birthplace of financial capitalism, did a free-market government find itself having to nationalize the financial system? What happened that made this the best option available?

RBS moved into the general UK market, from Scotland, when it bought NatWest in 2000 (Fraser 2014). At the time NatWest was three times RBS’s size. Bank of Scotland had originally attempted to take over NatWest, but was outbid by RBS. This aggressive deal to move up to a larger stage (the UK market rather than the Scottish one), set the scene for the next eight years. The deputy CEO, Fred Goodwin, led the NatWest deal (Fraser 2014). As a consequence of this success, he was made CEO the next year and he continued with his aggressive international acquisition growth strategy (Martin 2013) – not just in banking but across a range of unrelated areas (e.g. buying out UK insurers Churchill and Direct Line). He was so aggressive that in 2006 he was forced by shareholders to promise not to make more
acquisitions since RBS’s balance sheet was being stretched by his “megalomania” (Fraser 2014). To continue RBS’s growth without acquisitions, Goodwin relied on RBS’s investment banking arm, Global Banking and Markets (GBM), to expand massively, increasing its assets in the two years 2006-2008 from £500 billion to £830 billion (Telegraph, ‘Royal Bank of Scotland Investigation’, London, 5.3.2011).

Nonetheless, when in 2007 ABN AMRO put itself up for sale, Goodwin organized a consortium with Santander and Fortis to buy it out for, in the end, $98 billion. RBS performed almost no due diligence on the bank because they assumed it had been done already by the market (BBC Documentary, ‘RBS: Inside the bank that ran out of money’, BBC 2, 5.12.2011). The bank was to be split up three ways, with RBS gaining La Salle, ABN AMRO’s US business, and its wholesale business (Fraser 2014). This deal was finally completed at the end of 2007 when worldwide liquidity was already becoming scarce. The warning signs should have been there that this was a deal too far. This acquisition greatly strained RBS’s resources, and was a material cause of its failure in 2008 (£16 billion of the £24 billion capital shortfall it required from the government was in some way related to this acquisition (FSA 2011)).

RBS at that point, briefly, was the world’s largest bank. But for well before this time it spent money lavishly, almost comically extravagantly. It built a new headquarters for £350 million just outside Edinburgh which was opened by the Queen and Prince Phillip; Goodwin traveled on a private jet; they planned a $500 million new headquarters in the USA; and spent £200 million on corporate sporting sponsorship deals (Martin 2013). The bank had lost any sense of money, and had moved well away from the Scottish reputation for being cautious with money (Fraser 2014).
Worsening liquidity provisioning in 2008, increasing write-downs on the value of its assets due to falling prices, and high exposure to Collateralized Debt Obligations (CDOs) took a toll on RBS’s balance sheet (FSA 2011), which was already stretched by the ABN AMRO deal. At this point the bank urgently needed a capital injection if it was to stay afloat (Darling 2011). The Chairman of the bank reportedly called the Chancellor on 7 October 2008 and said “RBS is going to fail this afternoon. What are you going to do about it?”, while Goodwin left his emergency meeting with the Treasury walking out “like he was playing a game of golf” (Darling 2011): moral hazard seemed to have been personified. This was literally a case of ‘too big to fail’, on a global basis. The UK government found itself forced to recapitalize the bank and in so doing took 58% of its shares (Seldon 2011). This share would continue to grow over the following months. The Labour government had just nationalized the world’s largest bank, though, in practice, the apocalyptically socialist language of much of the commentariat did not translate into government action. It was as a temporary, crisis, measure to restructure the bank, but the irony and embarrassment was lost on no one (Darling 2011).

This action certainly avoided the worst nightmare of a total collapse of the UK banking system, but at the expense of any pretense of a free and functioning banking system, or basic human (or political) fairness. It is not hard to see why UK population bayed for Goodwin’s humiliation (and clawing back of his immense pension (Darling 2011)), threw bricks at his house and car, and forced the government to have the Queen revoke his knighthood (which had been given, not at all ironically, “for services to banking”).

The three proximate and mid-range causes of RBS’s failure were (FSA 2011):

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63 It is clear that RBS knew it was too big to fail and so complacently, having run the bank into the ground, just chucked the problem over to the public sector (Darling 2011).
• ABN AMRO and the strains this placed on the bank;
• Its deep involvement in the CDO market;
• An overly leveraged balance sheet, caused by an over-reliance on aggressive growth.

Much of this is very similar to HBOS’s situation, but it was made worse by the size, scale, and range of activities RBS carried out. RBS was active, and significantly so, in nearly every market sector and in every major geography (FSA 2011).

The ultimate reason for why the government had to step in was because there was no other actor large enough to be able to – RBS’s balance sheet was at the time £1.9 trillion, while UK GDP was £1.5 trillion (Darling 2011). Despite its global activities it was still a UK bank; that is, it was under the UK’s jurisdiction. This was good enough for the UK Treasury when it could boast about ‘having’ the world’s largest bank paying it taxes. But it meant that the UK had to bail it out when it failed. Never was the Bank of England Governor’s statement more true: “banks are global in life, but national in death.” This is the second half of the problem of jurisdictional mismatch which we have seen throughout this dissertation: not just a lack of control over banks while they are growing globally, but an ultimate responsibility for banking activities that took place elsewhere when the bank fails.\footnote{There is an interesting parallel with banks’ ultimate responsibility for their off-balance sheet vehicles when they fail, even if in theory they should be able to keep them separate.}

As with HBOS, the FSA has some of the blame here too. It was happy to see a UK bank take on the world, and to give UK banking abroad some of the status it enjoyed with the City of London (reverse Wimbledonization, in effect). RBS’s growth reflected well on the FSA. But, as ever, this pro-market stance was at odds with the FSA’s pro-stability remit too (FSMA 2000). Beyond just the usual problem of conflicting aims, the FSA allowed RBS to turn into an uncontrollable beast. If the FSA could not even control Northern Rock or HBOS, it had not
chance with RBS: the world’s largest bank, incomparably well-resourced for public relations and political lobbying, with the patronage of the Queen, and the senior, economist-led, echelon of government being led by Scots (not for nothing was it called the ‘Scottish Raj’: Telegraph, ‘Britain run by Scottish Raj, claims Paxman’, London, 14.3.2005). There was no way a new agency in London, led by senior but not overwhelming authoritative public servants, stand up to that level of personal, cultural, political, financial and global influence.

This points to a fundamental problem of the UK political-economic set-up of the time: it was literally inconceivable that the FSA could tame this beast. But this is because of the strange hybrid at the time between the old system in the UK of personal-traditional ‘club’ relations between political and economic elites (‘the establishment’ albeit with a different make-up from before), and the new world of global financial mobility and massive wealth where the club had been killed off by Thatcher. On all three axes – international/domestic, rich/poor, new/established – the FSA found itself completely outgunned. RBS was the perfect embodiment of the UK’s financial constitution of the time: and it failed spectacularly. This is because, ultimately, its growth was based on taking on excessive risk with excessive leverage. As the UK in general, so RBS in terms of banking: it was ‘punching above its weight’ which was impressive until it got floored. In its fall it brought down the rest of the UK economy.

**Conclusion: bank failures and governance failures**

The three cases of bank failure above were all different but had similarities: an over-reliance on wholesale funding, which was quick and cheap; a desire to grow rapidly; and a supervisory regime that held a pro-market stance despite its stability remit. Monetary stability was the focus of the Bank of England, financial conduct of the FSA, and all the
institutions let financial stability policy fall by the way-side. All this was baked in to the original FSA/FSMA and MoU framework.

If we look for a reductive ‘cardinal sin’ it would have to be the dual mandate given to the FSA compounded by the division of responsibilities to the three separate banking authorities. That is, the institutional framework (of a single financial regulator but three ‘responsible’ institutions) was fundamentally flawed. This was masked during the good decade 1997-2007, but exposed by the crisis. The market behavior of the three banks examined here was channeled and conditioned by this regulatory framework, encouraged by the FSA and government eager to grow the UK financial sector, which then led to entities too big to fail, to censure, to control. They built a monster but could not keep it chained. This is because of the nature of international markets and bank leverage. It was also a product of the post-Cold War ideological dominance of free-market capitalism.

The FSA/FSMA regime did not cause the financial crisis. But it arranged the scenery for when it hit the UK stage, and it weakened regulators’ handing for when they tried to react. Ironically, perhaps, and similarly to previous crises, the UK managed to respond relatively effectively when the crisis did hit ((Seldon 2011) and (Thain 2009, 434-449)). The same informality and reliance on personal relations with lack of checks on executive action (and weak agencies) allowed the UK state to respond forcefully and pragmatically (non-ideologically) to the crisis both at home and abroad (even if it was a slight exaggeration for Brown to say he had “saved the world”: Hansard, House of Commons, 10.12.2008).

The FSA/FSMA regime was created out of a contingent set of circumstances relating to the UK political history of the 1990s and justified according to new theories that were welcomed if never tested. This regime encouraged the rapid expansion of UK financial activity – in an international environment that was highly conducive – but allowed its
financial stability remit to be forgotten in the cracks between three institutions. This left UK banking incredibly exposed when the downturn began, increased the likelihood of systemic collapse through interconnectedness, and meant there was a massive short-fall of the capital needed to withstand losses. The only recourse was public finances and an economic recession.

Finance failed, and financial supervision failed. The former might have largely been a case of the financial cycle as a whole, and certainly it was an international phenomenon; the latter was entirely a choice made by the UK political establishment from the mid-1990s onwards. This choice was made because institution-building was good politics even if it was a lousy way to run a financial system.
Introduction

The global financial crisis was not caused by the regulatory regime put in place in the UK under the Labour government. The way the UK financial sector was affected, however, was due to this. That is the story of the last case study. When the storm hit, the defensive walls of the British financial system had been removed – by opening up finance domestically – and the emergency services were confused and weak – by the 1998 settlement. Although, at some level, a total catastrophe was more or less averted, the 2007 crisis essentially reduced the British financial sector to rubble. Banks were nationalized or failed, credit ceased to flow, and the government was on the hook not only for huge amounts of debt but also for the structure and fate of the financial system. This was not even capitalism, let alone light-touch financial capitalism. The regulatory outcome of all this was an unintentionally widened scope of bank regulation.

There are two stages to the post-crisis regulatory response: Brown’s immediate, emergency action; and the following Conservative-Coalition government’s attempts to restructure banking after the end of the acute crisis.

Labour’s emergency response: primacy of politics

As we have seen in the last case study, the forced mergers and bailouts of the crisis resolution were organized in cooperation between the three Memorandum of Understanding authorities: Treasury, Bank, and FSA. In reality these were decisions were taken through the Treasury and the prime minister’s office (Darling 2011). It was a political operation, acting at a fast pace. While this partly reflects the seriousness of the crisis – requiring a political response to ensure legitimacy – and partly the fact that public money was being used in these recoveries, it nonetheless stands in stark contrast to the previous bank failures, which had been arranged by the Bank of England (House of Lords Select
Committee, 2008). Even in the 1990s the Bank was responsible for crisis management and it was the Bank that had to take the rap for any negative consequences (see case study three). Whether the Bank was arranging new regulation and supervision (such as following BCCI and Barings), or organizing lifeboats for JMB and in the secondary banking crisis (which also involved public money to some extent), it was the Bank in charge, often without informing Downing Street of what they were doing. Now, however, the response to the global financial crisis was firmly a political decision taken in full publicity. This marks a change in the way bank regulation and supervision was taking place – at least at the systemic level, and at least in a crisis. This was not a deliberate, policy-led shift towards the primacy of politics in banking regulation. It occurred almost naturally. But the fact that this was unintentional is probably the point. When a real crisis hit and urgent action was required, the only institution which had the ability to act quickly and decisively was the government.\textsuperscript{65} The elaborate architecture and reputation-saving measures of the previous sixty years of bank supervision and regulation had been shown to be either window-dressing, or merely administrative delegation. Responsibility, capacity, and influence over banking at this point rested in Downing Street. This showed the hollowness of the 1998 settlement.

What Downing Street did with this power was perhaps simple: instantly widen out the scope of bank regulation and therefore protection to all and sundry. It bailed-out banks that needed it (often forcing them into a bad bank or into a merger), it guaranteed deposits in an effort to stop capital flowing abroad, it coordinated with international bodies to make sure that the crisis would not spread and also to make sure one jurisdiction did not gain a competitive advantage (this time through stability and protection), and it leant on the Bank

\textsuperscript{65} Compare this with the Eurozone crisis, where the only institution which had the capacity and in some sense legitimacy to act was the ECB.
of England to lower interest rates and then start Quantitative Easing (QE) in a bid to provide liquidity to the UK financial system (Seldon 2011).

The crisis's regulatory outcome was, therefore, a sudden shift (or sudden recognition of the reality) of the locus of bank regulatory power firmly into the political sphere. This was coupled with the sudden expansion of what was considered financial to almost any business that dealt with money as an object (e.g. shadow banking in broad terms). The financial system found itself under state control: if not intentionally, nor permanently, nor maliciously, nonetheless undeniably. Seen from the 1946 perspective of Bank nationalization this might look like a natural progression; from the 1979/1986/1998 perspective of progressive liberalization this is a shocking outcome.

It was never intended as a permanent change in regulatory stance. Everyone – government, opposition, regulators and markets - accepted that fundamental reform of the banking system was needed. What was still up for grabs was what shape this reform would take. At this point (May 2010) an election took place and the Conservatives won the largest share of the vote, largely by blaming the crisis on Brown. They did not manage to form a majority government and went into Coalition with the Liberal Democrats who broadly accepted the Conservative narrative of the crisis and of the necessary policy response: austerity, monetary easing and bank reform.

**Austerity and unconventional monetary policy**

The Coalition's primary aim was austerity. Every other economic decision the government made depends on that fact. The Conservatives had argued that Brown’s emergency response to the crisis had led to unsustainable public debt levels which threatened the UK’s credit rating (and thus ability to refinance its debt). They made cutting the public debt and reducing the government deficit to zero their defining objective. This was sold as a response
to the crisis and to “Labour’s profligacy” which, the Conservatives argued, led to the crisis. It was also a political ideological decision to cut down the size of the state in the economy (d’Ancona 2013). Matthijs and McNamara (2015, 229-245) argue that the victory of austerity politics in the Eurozone following the euro crisis was due to the ‘theory effect’, essentially that the way the problem was narratively constructed determined neoliberal (austerity) outcomes. The same framing could usefully be applied to the Coalition’s decision to impose austerity at all costs in the UK.

To balance out the government’s fiscal austerity, the Bank of England undertook extreme monetary support. This started with reducing interest rates to essentially zero to stimulate demand. When this did not have a very large effect, the Bank – along with Fed – developed a range of ‘unconventional monetary policy’. This started with Quantitative Easing (QE) which tried to directly increase the quantity of money in the economy (rather than indirectly through altering its price with the interest rate), and also included forward guidance (an attempt to tell markets precisely what would happen in the future), specific support for home-buyers, and a Targeted Funding Scheme (TFS) to support bank lending directly. Taken with fiscal policy this, eventually, led to steady and increasing economic growth but with continued stress in the financial sector.

The financial crisis had terrified the UK government. It saw that what had appeared a golden ticket in the form of the City’s financial dominance actually left the UK as a whole on the hook for large parts of the world’s financial system. Parts of this dynamic have been traced out theoretically by Martin and Taddei (2013, 441-452). Without having a reserve currency like the dollar which could finance this responsibility, the UK faced the prospect of public bankruptcy if another financial crisis (however minor) hit any time soon. This explains the economically-disputed focus on austerity. Having already bet the future economic direction of the country on finance decades previously, the government now had
to do everything it could to protect this industry and protect the rest of the country from this industry. Austerity was never an economic policy, far less a fiscal one, it was a financial one. The trouble is, the financial aim had fiscal means and economic effects.

With a strong policy of fiscal austerity and the Bank supporting this through very loose monetary policy, the Coalition therefore moved its attention to banking sector reform.

**Banking policy: ring-fencing and macroprudential policy**

The outcome of the emergency reaction to the crisis was a sudden expansion of regulatory and political authority in the financial sphere. The new regulatory policy framework, therefore, was one which tried to reduce interlinkages within the financial sector and the necessity of political involvement. Practically this meant the separation of ‘risky’ banking from ‘necessary’ banking (that is, investment banking from retail) and the attempt to massage the financial cycle through policy. This shift towards structural divisions in banking - away from the previous policy of universal liberalization - probably owes a little to the new government, and a lot to the desire simply to reverse the changes that were seen to have led to the catastrophe. Interestingly, there had been no political call for new statutory legislation of banking per se before the election (House of Lords Select Committee, 2008-9), but rather for a change in the way existing legislation was interpreted and implemented. Clearly the new Coalition government saw an opportunity to leave its stamp on the City.

Partly, therefore, for political reasons – to differentiate itself from New Labour and to disassociate itself from the financial crisis – partly for ideological reasons – to reintroduce free markets to finance – and partly for fiscal reasons – to get the public sector out from behind the financial system following the crisis – the new Coalition government undertook a significant reorganization of financial supervision and regulation. It also began to
restructure UK financial markets to a level that had not been seen since Big Bang. In some ways these Coalition reforms were a way (softly and silently) to undo the principles of Big Bang. The overall aim of these reforms was to cut down the scope of the financial sector in the UK by changing the internal structure of banking groups, forcing them to ring-fence retail operations from more speculative activity (Edmonds 2013).

As has become a political habit after any form of bank crisis, the government also changed the role of the Bank of England. This time, however, it was given more powers (or rather, its old powers back), following on from what was considered the egregious failure of the FSA to supervise the banking system, and the equally poor attempt by politicians to save it. The Bank of England therefore for once, and ironically due to its decreased influence under the Labour government, was seen not only as not to blame for the crisis but even came out ahead of other actors for its role in and following the crisis. In 2012 it was put back in charge of financial supervision and a Financial Policy Committee (FPC) was created to mirror its Monetary Policy Committee (MPC) that sets interest rates. A Prudential Regulatory Authority (PRA) was also created, but clearly subordinated to the Bank of England, as was the much reduced FSA turned into a Financial Conduct Authority (FCA). There is now no doubt that responsibility and capability to act on financial stability rests once again with the Bank.

*International coordination*

Due to the unfortunate truth spelled out by Mervyn King that “banks are global in life and national in death,” there is another dimension to this: the international one. Short of a global regulatory regime coming into existence, the only way to avoid the national-global dichotomy is to reduce financial markets back to national boundaries. There has been an attempt to create a global regulatory environment ‘lite’ through international cooperation
in processes like Basel and bodies like the FSB, but this has been at best a way around the deficiencies of national jurisdiction rather than a cure for it. Indeed, short of an international fiscal capacity to back up the putative international financial regulatory system it would still ultimately rest on national finances to bail out any future financial system in crisis. Regulatory cooperation is a good thing, therefore, but unlikely ever seriously to change the game when it comes to systemic stability.

European harmonization was a similar but more intense (because legally binding) attempt to do the same thing at the regional level. EU legislation on capital requirements (which implements Basel III), deposit guarantees, and bank recovery and resolution, were all in line with what the UK is already doing, and did not entail a change of UK supervision, just a change of the basis of the laws which are being supervised. It also provided an enhanced framework for supervisory cooperation between member state agencies. The British domestic solution to the crisis under the Coalition government was to attempt to limit ‘domestic’ risk to financial activity as best it can through structural reforms, and to coordinate internationally. The fundamental problem of the national-international mismatch has not been addressed.

The ‘new’ form of UK bank regulation, therefore, will look very much like the old one (pre-1979). Monetary and financial supervision will be back in the same house, the Bank of England firmly in charge of bank supervision and regulation, UK banking groups functionally separated (albeit in a light way via ring-fencing - from 2019 - rather than in the strict way as before C&CC), and an implicit political preference for a national-sized banking system rather than a global or European one. Somehow all this looks like a reversal of the trends of the years since 1979.
There are differences, however, and while the above certainly look convincing, in some ways they are a mere appearance of a return to the past. The Bank of England now relies for its power and influence on statute and the goodwill of the government. Its independence is conditional on its success and popularity in the government. Ringfencing is a very soft version of functional separation, and already banking groups have found ways around it in the domestic context, let alone as part of pan-European groups. Finally nothing has been done, or is likely to be done, to reverse the globalization of financial markets. The new enhanced cooperation of international bodies is not fundamentally different from the Basel process that started in the 1970s or in fact the personal cooperation between the central bank governors of the interwar gold standard years. We must expect that, in another crisis, the reforms of the past five to seven years will not save the UK banking system. In terms of regulation, the Bank of England has been given more powers, and has a governor who seems willing to use them and to assert its independence. As long as the Bank's authority rests on statute, and public money in a democratic age is used to rescue banks, however, the ultimate source of British bank regulatory authority will remain in Downing Street.

**State of play: End of Coalition and Brexit**

The unresolved problems of the UK financial sector have become all the more clear, unfortunately, since the end of the Coalition in May 2015. The Conservatives under David Cameron managed to win a slender majority and form a party government. Government fiscal and financial policy remained the same and the Bank of England continued to support the economy with an easy monetary stance. The UK economic data looked relatively good for its peers – albeit hardly booming – and especially its joblessness rates. The process of bank reform had largely come to an end, although with low bank profitability and continued worries about the health of the financial system. The new bank regulatory dispensation had
not yet been properly resolved, but interest in the sector was waning with increasing economic stability.

That was the state of play at the start of the Conservative government in May 2015. Then Cameron called a referendum on Britain's membership of the European Union. He thought he would win and the UK would remain a member state. He did not and it will not. Britain voted to exit the EU ('Brexit'). This has enormous implications across the British polity. It caused Cameron's immediate resignation, the loss of government for two weeks, and paralysis in the Civil Service. At the same time those who won the referendum to leave the EU also resigned and did not feel they had any duty to try to steer the future direction of the country. It is no exaggeration to say the country was leaderless and without a government for a full fortnight. This had effects not just on the political parties (all of which came out of the episode looking bad) but also on society (with a marked rise in hate crimes and abuse on the streets) and of course on the economy. The pound immediately fell in value by about 11 per cent, and while economic output has not fallen as much as had been warned this is almost certainly because Brexit has not actually happened yet. The UK's status and economic regime is currently unchanged from the before the vote. It is therefore not surprising that after the shock currency response there has been no further economic reaction. Markets will need to see what kind of Brexit the government wants, what it is likely to get, and the final agreement between the UK and EU before they will be able to react.

Where this fits into our narrative of banking regulation is precisely in what was discussed in the previous section: the UK's financial openness to the outside world. No-one in the UK wants London to lose its pre-eminence as a financial center. In fact most positive Brexit scenarios rely on the fact that London is so naturally and obviously the world's foremost financial center that the UK's status regarding the outside world cannot affect it. This seems
delusional, but people also said the same thing about London thriving outside the Eurozone – which it has done – and at other times in its history. There is a path for London’s ongoing financial importance outside the EU. This largely relies on low corporate taxation rates, an easing of financial regulation and a willingness to accept high levels of senior expats. This is the ‘UK as Singapore’ scenario. The trouble with this – beyond the obvious difference between a nation-state of 70 million people and a city-state of 5 million – is that those three policy prescriptions are almost totally at odds with the populist rhetoric during and after the referendum. This wants an end to all immigration, wants ‘punishment’ for the banks and elites to pay ‘their fair share’. Equally, the best way to maintain London’s status as a financial center is to keep close links with the EU Single Market. Practically speaking this means to keep EU ‘passporting’ rights for the City which allows banks registered in London to operate in the EU and vice versa. Maintaining this right seems unlikely for post-referendum domestic political reasons. London will have to take a hit from Brexit whatever form it takes.66

Not just because of the financial crisis, therefore, but also because of this political crisis, the narrative of ever greater domestic and international financial integration which has been traced out in this dissertation seems to be stalling in the UK. The future is not clear; political leadership could still form a consensus and lead the UK and its banks to a better a future. Unfortunately political leadership is precisely what has been lacking since the financial crisis and during the ongoing Brexit fiasco. There may be a bright day ahead, but first the UK will have to live through a very stormy night.

66 Indeed hitting ‘London’ seems to have been one of the main aims of voting to leave the EU.
Part 3: Results and Conclusion
Chapter 10: Conclusion
This chapter starts with a discussion of the case studies and then concludes the dissertation.

**Part 1: Discussion**

There is no need to go through the detail of each case here: that would run the risk of testing the reader's patience. However we need at least a schematic understanding of how to characterize these cases, and then to pull out the commonalities and differences between them. At that point we will be able to see how they support or refute the propositions derived in the first part of this dissertation. This is best done by highlighting the main themes and trends which run through the cases. There are four:

- The relationship between international and domestic finance
- The secular shift from ‘club’ to ‘open’ governance (Moran 2003) – the corresponding irrelevance of partisan politics and the contingency of policy change
- The relationship between fiscal policy, monetary policy and the banking sector
- The domestic scope of finance – the internal, functional separation of banking activity

First, however, an overview of the cases.

**Case overview**

These cases start off with the introduction of the policy of competition and credit control (C&CC) by the Bank of England in 1971. This initiated the cycle of policy change and market reaction which this dissertation uncovers, because it fundamentally shifted the operation of the state control of banking (what we call ‘regulation’ in this dissertation) from one based on hierarchy, influence, and moral suasion (which we have characterized as ‘political’ institutions in this dissertation) to one based on the market mechanisms of price-signaling.
and competition (which we have characterized as ‘private’ institutions in this dissertation).
As the brief background in chapter three shows, this was done because the previous
dispensation was considered unfair to the major banks, constrictive of domestic credit (and
hence harmful to industry), and theoretically unjustifiable. That is, it had lost favor on the
institutional, interests, and ideas levels. It will therefore be no surprise to political scientists
that this banking regime changed. C&CC aimed to resolve all three problems: by helping the
clearing banks to out-compete the secondary banks, by allowing the price mechanism to
allocate credit in the economy rather than quantitative restrictions, and by accepting a more
or less free-market mentality in banking.  

C&CC did not fulfill its aims. It turned out that the supply of credit had not been the problem
for the British economy but rather its demand. Cheap and easy credit found its way via
specialized and more competitive secondary institutions into areas that offered easy
returns, rather than to industry. This boosted secondary banks and lead to a property boom.
Coupled with a fiscal expansion C&CC led to a credit boom, inflation, and the general
overheating of the economy (uncoupled to any obvious productivity gains). The control
mechanisms built in to the policy were not used for political reasons. All this led to an
expansion of secondary banking at the expense of the major banks. Ideologically, the partial
introduction of free-market thinking into financial policy only highlighted where the policy
had not been reformed, leading to theoretical contradictions and implementational
complexities. Finally, when the international economic environment suddenly turned
negative, the boom of the early 1970s turned into a major bust both financially – with the
secondary banking crisis – and economically, which it would remain in for the rest of the
decade. This ‘stagflation’ happened to all major western economies, it is true, but only the

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67 This had always been the theoretical policy stance of the government and Bank of England, but it had
been belied by post-War practice.
UK had to go to the IMF for help. UK fiscal, monetary, and financial policy is to blame. C&CC was a failure from start to end – however well-meant and theoretically plausible it was – and led directly to the secondary banking crisis.

This policy failure and crisis led to the introduction of the first statutory banking law in UK history. The government, seeing what the Bank of England had done on its own initiative with C&CC, decided to place banking regulation under ultimate political control. Because of the political confusion and economic turmoil of the end of the 1970s, however, the Bank was given wide rein to draft the bill. It ended up with the Bank confirmed in its role as bank supervisor, with its preference for separating ‘real banks’ from other ones codified in law, and its power backed up with legal force. Not for the first or last time the Bank of England had managed to gain powers through its failure. What this 1979 Act did do, however, was to confirm that the Bank now had authority over all forms of banking – however it split it up – and not just over the banks it had been in daily contact with over the previous centuries. That is, it forced the Bank to accept responsibility for the whole banking system, one way or the other.

Legal change did not lead to change in the way the Bank worked. This is not surprising if we think about the way bureaucracies work: through individuals working according to established patterns. The JMB affair of 1983 came four years after the passing of the Act. This is not a long time for established practice to change. Therefore when faced with a prospective banking crisis – which through various established and new channels it thought might become systemic – the Bank operated as it was used to: unilaterally, closed and precipitously. This may have stopped JMB becoming a systemic affair (and outside the Bank no one in the world really thought it would) but it was fundamentally at odds with the spirit

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68 Admittedly the Bank’s supervision department had already undergone some major change in the late 1970s, following the secondary banking crisis but before the passing of the 1979 Act.
of the Bank's new statutory role and the political (governmental) oversight of banking. The specific spat between the Treasury and Bank took place over the cost to the public purse (inevitably) but more deeply it represented a form of power-struggle – or at least struggle for influence – over the City of London. This is where the 1979 Act fundamentally undermined the Bank’s role. The Bank had given up the principle of autonomy in favor of its autonomous action. When its action was seen, by its own admission, to have failed (by allowing the JMB affair to happen), it had no basis to fall back on to justify its independence.

The point is that the JMB problem was precisely caused by the 1979 law. Primarily because of the way it separated banks into two tiers, and then secondarily because of how this division interacted with Bank supervision – that is, the top tier banks received basically none. The failure of a top-tier bank (which is what JMB was) would have undermined the whole basis of the UK bank regulatory framework, quite apart from its potentially systemic effects on the rest of the banking system. In this sense, despite the fact that JMB was ‘resolved’ or rather that its failure was controlled, the damage was already done to the Bank of England’s 1979 framework. The poor relations between the Bank and Treasury caused by the saga only meant that the government was eager to use the opportunity to leave its mark on the City.

It did this through a host of reforms, as described in chapter six, which came to be called the City revolution including the abolishing of exchange controls, Big Bang and the 1986 Financial Services Act (FSA). This then moved into the banking sector with the 1987 Banking Act which undid its 1979 predecessor. Practically speaking, this new Act worked, in as much as it solved the ideological problem described at the beginning of this section. The Thatcherite reforms of the City, including the 1987 Act, finally resolved the contradictions of previous piece-meal change to the financial framework. Now any institution that did ‘banking’ would be a bank and under the Bank of England’s supervision. This supervision
would itself be within the wider City framework of Self-Regulatory Organisations (SROs).

This was an intellectually and policy-wise coherent approach to banking regulation, albeit one with a strong political-economic stance built into it: the triumph of the free-market, otherwise known as neo-liberalism. The problem of the bank regulatory framework had essentially been solved, through the usual Thatcherite non-acceptance of nuance, complexity, or traditional sensibilities.

Where this framework fell down was in its interaction with the international scope of banking. While this system may have worked in the UK context, the difference in regulatory stances and supervisory capabilities across the world gave great opportunities for banks to engage in regulatory arbitrage, both between jurisdictions and within them. This could happen fraudulently, as with BCCI, or prudentially as with Barings. In both cases, the incapacity of the Bank of England to carry out its duties internationally led it to fail its duties domestically. This was not, as previously, a problem with the law or framework, but one of supervisory capabilities.

To that end, the Bank was stripped of its supervisory role in 1997, which was given to the newly created FSA. This is the final policy change of our case studies. This was partly a ‘punishment’ for the Bank’s history of bank supervisory failure, partly due to the state of academic thought on the separation of banking and monetary authority (given the newly established monetary independence of the Bank of England), and partly for ‘New’ Labour’s political desire to sweep away the ‘old’ Britain. The decision won plaudits and seemed to work for ten years. This was coupled with a more or less benign international environment, and domestic growth based on sound public expenditure and fiscal policy.69

69 Though the financial turmoil and weak growth, at different times, of both the US and some major European economies means we should not totally disparage New Labour’s, the Bank’s and the FSA’s
However, this financial framework allowed the hidden build-up of significant systemic risk in the UK banking system. The financial crisis was of course not caused by this framework. It was caused by very many things. But this framework is what allowed it to grow unchecked in the UK, while other European systems managed to mitigate it, and caused it to have such a devastating effect on the UK banking system and economy. Three major banks failed outright and were nationalized, others needed significant support, government liabilities to the banking sector exploded and the recession was the worst since the Great Depression (when, it is worth remembering, there was no UK financial crisis). Only the financial equivalent of brute governmental force stopped the total collapse of the UK financial system and economy. The framework failed.

Themes and trends

That was a schematic, sketch, overview of how banking regulation developed between 1970 and 2010. It shows how well-meaning policy change led to perverse and pernicious market reaction which led to further policy change. This happened four times in the period under review. This is the major finding of this dissertation: this continuous loop between the policy and market sides of banking. But, as mentioned above, there are four themes which also recur in this narrative which are worth highlighting.

- **International vs domestic finance**

   In a sense this issue is not a surprise. Finance will tend to be global unless it is constrained. Money is fungible and it does not care where it goes so long as it makes a financial return for the investor. What stops this perfect global market is national laws and national strategy. However it is particularly clear in the UK context how difficult it has been to manage cross-border flows of capital. This is for peculiar historical reasons related to the record from 1997 until the crisis. If, indeed, it is possible to abstract the following crisis from its preceding growth.

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UK’s changing role in the world from empire (and foremost industrial and financial power) to something approaching a small, open economy at the end of our period. But this led to the strange situation in London up to the end of the 1970s where there were two ‘Cities’, the international, off-shore, Eurodollar markets, and the domestic markets. Very little interaction was allowed between them. What this meant practically was that British banks could not really compete internationally and therefore they tended to stagnate against their international competition both in terms of innovation and market share. As various governments tried to improve the sector’s health, through gradual loosening of restrictions, they merely allowed foreign institutions to nibble away further at the UK domestic sector. Finally the 1980s City Revolution removed all restrictions but by that time the overwhelming number of UK financial institutions could not compete and disappeared. Those that survived – the big banks – had to become extremely aggressive and international. This set the scene for the 2007 crisis. This dimension has a corresponding part to play in the problem of supervision: as UK banks became more international, and as international banks moved into the UK domestic market, the UK supervisors (especially the Bank) had to update their supervisory methods: both through increased collaboration with their foreign counterparts and through more explicit rules for foreign banks in London. Both these trends necessitated a more rules-based, explicit and legalistic approach to bank supervision. The old ‘nods and winks’ between people who knew each other socially (the old Bank practice) was not just inappropriate but unworkable. As Story and Walter explain, the larger a market becomes, the harder it becomes to regulate informally (Story and Walter 1997).

- **Club governance, party neutrality, and policy contingency**

This merges into the second theme, the end of club governance. Largely due to the reasons outlined above, and allied to a sense of elite failure, the UK underwent a political
transformation which in cultural terms was called “the end of deference.” This, in the popular imagination, was linked to a number of lurid and highly entertaining political and aristocratic scandals. However it also led to a crisis of governance in the 1970s. This was eventually resolved through the introduction of a ‘regulatory state’ under Thatcher which did away with traditional, social, forms of governance (or perhaps more correctly stopped trying to support these forms) and replaced it with ‘meritocratic’, technocratic attempts to promote economic growth and individual freedom. Those two things together would theoretically lead to the best outcomes for individuals. This is (almost a pastiche of) neo-liberalism. What is striking is that both in terms of political failure and in neo-liberal reassertion this was not a party political issue. Both Tories and Labour had old-guard governments which failed (Heath, Wilson) and both had new-wave governments which promoted the new idea (Thatcher, Blair). Both also had fag-end governments of political opportunism and inertia (Major, Brown). This shows that, political sound and fury apart, governments of all kinds were attempting to deal with the situation in front of them, largely apart from their party ideologies. Policy, especially banking policy, was essentially contingent. We can see this in our narrative how both in 1979 and 1987 Labour and Tory governments followed the same path of constraining the City by law, rather than allowing the Bank’s autonomy, and how both in 1986 and 2001 Tory and Labour governments sought to open up the financial sector rather than to ‘control’ it. Banking policy is contingent upon forces greater than party politics.

70 For example the scandals of Lord Lucan, Profumo, and Thorpe.
71 This explains why party membership and backbenchers increasingly grew dissatisfied over the course of long Premierships and either caused the leaders’ resignations or electoral defeats. For a government the problems in front of the country clearly come before party obsessions.
• **Fiscal, monetary, and financial policies**

Where these party policies did clearly have an influence on banking regulation was through fiscal and monetary policy. These policy areas delineated the area of operation of banking policy. This means that banking regulation was constrained by the operation of fiscal and monetary policy. This is most clear in the first case study where the ‘dash for growth’ of the Barber boom clearly undermined the Bank’s C&CC policy, leading to massive inflation and eventual bust. Similarly in the 2000s, the Bank’s monetary regime of a strong pound, low interest rates and low inflation led to the build-up of asset bubbles that, again, took the form of a property and (securitized) debt boom which then blew up into the 2007 financial crisis. Banking policy was not robust enough to counteract these much more powerful forces of fiscal and monetary policy. What is not clear is whether this is inevitably the case – banking policy in itself could be a weak form of regulation of financial markets – or whether it was just because it was not a priority. The answer is probably somewhere in the middle. But the point stands that these cases show that it is impossible to look at banking policy and regulation outside of broader economic policy and strategy. The fiscal and monetary regimes in place fundamentally determine the scope, strength and direction of financial policy and bank regulation.

• **The scope of bank regulation**

The final theme offers an almost rebuttal to the previous point: through the strict institutional control over banking, regulators (government or prudential) can to an extent determine how this financial regime will be directed. That is, the state (broadly speaking) can allow its fiscal and monetary policy to interact with finance either more or less openly. This is lesson from the UK in the 1960s and 2000s. The ‘closed’ banking era from 1945-1970 had a number of negative effects for the City and the UK economy – that is why it ultimately was killed off – but these negative effects were different ones from the ultra-open
era of the 1990s-2000s. That is, the functional separation of banking activities in the
dered period determined who had access to what kind of finance. This naturally limited
the way in which international or domestic financial or monetary policy affected the City. As
the club system of government made way for the open system of today, this strict rationing
and dependence on deference became intolerable. Banking regulation was opened up, and
the international and domestic monetary and fiscal policies affected banking in a different
way – the way we all know well from the 2000s and the crisis. One way is not better than
the other. There are different trade-offs which need to be determined democratically one
way or the other. But the control mechanism of institutional, functional separation allows
regulators some say over how these other forces will affect banking. The scope of regulation
– determining which institutions are allowed to undertake which activities – becomes the
crucial variable in understanding the development, operation, and function of a national
banking system.

Revisiting our propositions

At this point we can revisit the propositions from part one. The detailed cases, our
schematic narrative above, and the four broad themes and trends which have emerged will
allow us to decide whether the propositions hold or not.

• First proposition: Banking regulation is a public institution. Therefore it is made,
  maintained, and altered according to a political process involving competing vested
  interests wielding different ideas.

We have seen that this proposition holds but it does not go far enough. C&CC was made, as
explained above, for institutional (clearing banks), interest-based (economic growth), and
ideological reasons (free-market). The 1979 Act was made for institutional (government
and Bank), and interest-based (banking stability) reasons. The 1987 Act was made for the
same institutional and interest-based reasons as well as for the ideological reasoning of what may as well be called neo-liberalism: a coherent open financial framework. The 1997 decisions were made again for the exact same institutional, interest-based and ideological reasons as 1987, albeit to update the City for the fundamental change of a monetarily independent central bank. So banking regulation has been shown to operate as a public institution as defined above. Where this proposition does not go far enough is in the knock-on effects: that is, the path dependence of these decisions. This dissertation has shown how one decision necessarily leads on to others, in order to make it work. This is the logic of functionalism and spill-over effects (Mitrany 1975). This proposition also leaves out how public institutions also rely on private institutions for support, but that is somewhat mitigated by the third proposition below.

- **Second proposition**: Bank activity consists of private institutions. Therefore it operates according to market logic, which means the institutional aim is to maximize its own profits.

This proposition holds. Banks and bank activity as a whole obviously try to maximize their profits, and where regulation gets in the way of this they will try to find a way to arbitrage or innovate outside regulation. This could take the form of undertaking activity outside the regulatory boundary (e.g. the secondary banks in the first case), by moving activity abroad (as for example in the third case), by trying to gain a license which allows the greatest amount of activity for the least amount of supervision (e.g. the second case and JMB) and by off-balance sheet activities (the securitization of the fourth case study). Banking activity, finding itself limited in one area, will simply move to another. So far as it is limited it seems to be only by the availability of credit in an economy. Which in an internationally open economy (that is not the size of the USA or perhaps China) is essentially unlimited.
• **Third proposition:** *Banking regulation and banking activity interact in a systemic way. This means that both institutional forms – public and private – operate on one plane.*

This has been shown. The narrative of these cases shows that banking regulation is not an exogenous imposition on banking activity but derives from it endogenously. That is, the market attempt to avoid regulation leads to new regulation, either due to crisis (which is the mechanism shown in these cases) or through an attempt by regulators to ‘catch up’ with market innovation (this has not been shown or indeed seen in these cases). These cases clearly show the cycle of banking and regulation (of the working of public and private institutions). They clearly show how banking and regulation spin off each other – that is they operate in a cycle – and how this cycle has a tendency (in systemic terms a ‘purpose’ or ‘function’) which is towards ever greater liberalization and loosening of constrictions on market activity. Where this proposition could be expanded is by looking at the idea posited in part one of the change of regulation from being a public to a private institution. This change explains the increasing opening of banking markets, because it shows how the attempt was made to control banking first through public institutions. When that failed, from the 1960s, the state tried to exert control through private institutions, initially through the price mechanism. In practical terms this took the form of prudential regulation which in essence imposes higher costs on larger balance sheets. Once started on this path, ‘private’ regulation has only intensified. Once again, we see the path dependence of initial choices.

• **Fourth proposition:** *Banking regulation does not lead to bank stability because it is developed for political reasons not for financial (market) reasons.*

This answer to our original puzzle holds up in the face of our cases. Banking regulation may have bank stability as its content – and even that not always or only, as we have seen (cases one and two especially) – but the final compromise that enters into the market is based on
the political process of influence, interest and ideas, rather than on any sense of the technocratic requirements of the financial sector. Each of these cases has shown clearly how, while responding to the market environment (which is what makes it a cycle), the actual regulation forms according to political imperatives. We will expand this point in the conclusion below, because it is worth thinking about the case that finance cannot be a technical area but itself embodies a political preference.

Therefore these cases uphold our argument and answer: banking regulation is the outcome of a political process even as it is part of a financial cycle. This, more than anything, explains how we get from Minsky’s endogenous financial cycle to one which includes regulation within it. Finance relies on politics. The more the attempt is made to free finance from politics (the disembedding of finance according to our Polanyian interpretation) the greater the threat to financial stability. That is, by not recognizing finance as something politically constructed, we destabilize it by loosening regulatory control. Polanyi’s broad argument fits our cases well, and furthermore shows us our next steps: to re-embed finance into society. Or phrased the other way round, to recognize the political content of finance.

*Closing the discussion*

What we have shown in these cases, therefore, is that there is a pattern of behavior between bank regulation and activity. This allows us to be confident we have found a real system to analyze. Regulation is an integral part of financial activity. So having shown this cycle and supported (and expanded) our initial propositions, we can be confident in our research answer. Banking regulation (and regulatory change) does not lead to bank stability because it is a political outcome for a financial cycle. A public institution in a private space. The regulatory questions posed and answers given are in different languages.
The final part concludes this dissertation by expanding this answer, questioning what implications it has, and looking at further avenues for research. In so doing it will turn this study from one step on from the literature that came before, to the next slab in the path towards an understanding of banking regulation and its place in political economy.

Part 2: Conclusion

Research findings and analysis

This dissertation has tried to understand the relationship between bank regulation and stability. To that end it has looked at the UK’s experience since 1970 when financial instability reared its head again for the first time in 150 years.

This dissertation has, at the simplest level, shown that a relationship between bank regulation and stability does exists. This adds to Minsky’s financial instability hypothesis, which theorizes that financial instability can be explained purely through the actions of financial players. This dissertation shows, however, that banking regulation is an integral part of market activity and not a separate imposition onto it. In different language, banking regulation is endogenous to the financial cycle; it could better be called a ‘financial-regulatory’ cycle. This a strong, albeit not surprising, finding. Attempts to ‘naturalize’ finance as an activity outside the political process act to disembod it from a social framework and leads to instability, in the Polanyian sense.

Furthermore, this study has found that regulation works precisely in a cycle with finance. That is, in a feedback loop. Change in regulation causes change in market activity, which itself causes further change in regulation to accommodate it. This loop is self-reinforcing: it exhibits positive gains. In this sense it is a cycle because it causes itself cumulatively, in Myrdal’s language.
We have seen also that this cumulative change, in the period under investigation (1970-2010), has a tendency. Inevitably if change is cumulative it must go in a direction even if it does not lead to an end point: this is not a teleological argument. In this period we have seen that this change has tended towards the liberalization of banking markets domestically and globally. This means that domestic barriers to bank activity have been stripped – the functional restrictions on bank institutional activity have been removed – while geographical barriers to activity have also been removed. This is globalization. It is too soon to see whether the policy response to the financial crisis will fundamentally break this cycle or just represents one more turn of the screw. It seems more likely to be the latter, since the framework of global, unrestricted banking does not appear to have been changed, but rather strengthened just with greater burdens placed on these global, unrestricted banks. Rightly or wrongly (and this is what we cannot yet say from the market reaction), there has been no imaginative regulatory response to the financial crisis. The scope of banking regulation has not changed, just its intensity.

These findings matter on a theoretical level. They add to the literature on the political economy of financial regulation by taking it out of the binary approach of the dominance of market over state or vice versa, to making it one endogenous financial-regulatory system. This allows us to trace policy change onto market change and back again. This result is useful not because it can explain all financial systems and their political contexts: it patently cannot. Nor should we expect it to. The peculiarity of national financial systems is one of their clearest aspects (Story and Walter 1997). This study has shown how highly idiosyncratic the British financial system is. We should expect all financial systems to exhibit the same level of idiosyncrasy. As globalization continues (and the poor ‘embeddedness’ of financial globalization continues around the world) we need precisely to be aware of how local, strangely, finance is.
This dissertation does create a framework for financial idiosyncrasy, however. The mechanism or process of the financial-regulatory cycle we can expect to be similar around the world. All the details might, indeed almost certainly will, change. But the process of regulatory change, market reaction, and regulatory response allows us to trace out the various diverse systems around the world and across time. The process should be the same even if the details are different. This allows us to use a general framework to discuss financial-regulatory idiosyncrasy. This is a useful contribution to the literature. We have, surprisingly, found idiosyncrasy and contingency in the operation of financial markets due to diverse regulatory activity – as we would now expect from our use of Polanyi’s double movement to look at modern banking markets – but we now have a framework which allows us to examine the causes and implications of specific regulatory and market actions. Simply put, any ‘datum’ of a regulatory policy or piece of market activity can now be examined in light of this financial-regulatory cycle to see how its effects then ripple out through the rest of the financial-regulatory system. Precisely by putting an action into a system – a cumulative cycle – there is now a theoretical basis for making assumptions as to what effect it should have.

**Future research**

This idea of a financial-regulatory cycle may not be theoretically ground-breaking, but it is conceptually useful for anyone interested in studying the political economy of finance. So the recommendation for further research is clear: how does this mechanism work in other countries? Now we have our ‘priors’ from the UK we can test them in other times and places. Do they hold and if not why not?

On a policy-level the financial-regulatory cycle suggests a practical approach to bank regulation. As mentioned above, change within the cycle will not stop this endless round of financial boom, bust and regulatory response. The current cycle, as shown in the UK cases,
continues regardless of a tightening or loosening of certain rules. Either attempts must be 
made to break the financial-regulatory cycle, or it must be accepted as inevitable. If it is 
inevitable, then political efforts must be made to dampen the cycle and to compensate those 
who lose out from it (or at least mitigate its effects). This is essentially what the policy 
response to the financial crisis involves: macroprudential policy to dampen the financial 
cycle, greater capital requirements for banks to slow their growth and provide a cushion in 
bad times, and enhanced (and better funded) deposit protection schemes to limit the effect 
on the end consumer of banking (otherwise known as citizens). Some more industry- 
focused nations have thought to create state investment banks to ensure some productive, 
industrial lending even in the face of a new credit crunch.

The cycle, though, does not have to be thought of as inevitable. The fact that the current 
cyclical system only started in 1970 in the UK, and is different in different countries, shows 
that it is not always and everywhere the same. As discussed above, the financial-regulatory 
cycle exhibits cumulative causation. That is why it is a cycle. But the direction and tendency 
of this cycle is not fixed. Like Newton’s first law of motion, it will continue until it is stopped. 
But it can be stopped, through political choice. Then a new financial-regulatory cycle will 
appear, and continue until it is stopped. The financial-regulatory framework continues - 
finance is always and everywhere a political phenomenon\textsuperscript{72} – but what goes on within that 
framework can change. That is the usefulness of this framework. Practically, therefore, we 
need to research how else finance can work outside the ratcheting effect of globalization. 
How can finance be controlled while still enabled? UK history would suggest that the 
answer lies in institutional form: strong breaks between what institutions are allowed to do, 
but competition within each sector. This would mean something more and stricter than the

\textsuperscript{72} Or if you prefer to paraphrase Clausewitz rather than the Monetarists: Finance is politics by other 
means.
current ring-fencing proposals. Alternatively, the old ‘free banking’ idea could be developed: anything goes, with some strong consumer and deposit protection. Either way, the research agenda must be in the realm of the scope of banking regulation, rather than its intensity. What is an institution allowed to do, rather than the how much which is currently regulated?

The dissertation has not quantified any of the relationships between regulation and banking that it has shown. It does not even attempt to show pure causality. It has traced the process of change and come to generalizable conclusions. For the remit of the research this is acceptable. It is more important to build on the literature to get the theoretical framework right first, and discover the workings of the politics of regulation and financial activity. But at some point it will be necessary to test specific regulatory actions to decide what their actual effects are. That is a next step, and can be done both qualitatively and quantitatively.

**Implications of the research agenda**

There is a further research agenda for the future that would be fruitful: what changed in 1970 in the UK to start off this current cycle? That is, why did financial instability restart in the UK at this time? This dissertation shows it came with the Bank of England’s attempt to rationalize banking regulation and credit control with the C&CC policy due to ideational pressure and sectoral interests (rational markets and supporting clearing banks). This leaves open the question as to what happened leading up to 1970 to harden support for ‘market-based’ banking and to require clearing banks to seek institutional support. Clearly the answer has something to do with ‘globalization’, that is with the increased flow of capital around the world. But on its own this answer tells us little. The different national responses to globalizing financial markets are precisely the issue in question (Story and Walter 1997). In the UK context this relates to the changing role of sterling in the international monetary system: the end of the formal (quasi-imperial) sterling area, the devaluation of sterling in 1967 which symbolized this, and the corresponding attempt to
grow London’s offshore markets as a competitive national industry. The UK has managed to ‘co-opt’ these markets.

This story is well-known and well analyzed, especially by Kynaston, Strange, and Story and Walter (Kynaston 1994; Strange 1971; Story and Walter 1997). But by putting it together with the finding of a financial-regulatory cycle we gain an insight: there are different regimes in the City of London, which consist not just of bank regulation, institutional form, and financial relations domestically and globally but also to British monetary policy, national industrial-economic strategy, and geopolitics. That is, the governance of the City is bound up with the highest level of domestic and international politics. Again, this is no major surprise on a common-sensical level, but it is an avenue which could do with more academic investigation; not least because it does not appear to be bound up in a coherent or at least planned way. As this dissertation has shown, changes in the City come about messily through political compromises and unexpected changes to the market. There is no sense of real government control. And yet it follows closely the changing role of the UK in the world and to some extent changes the role of the UK in the world. This merits further attention.

Looking at the UK since 1945 through this lens of ‘City regimes’ (or in other worlds the financial-regulatory cycle in the broader geopolitical context) we come to a surprising finding. The major break comes, as we have argued, with the change from the previous financial-regulatory cycle of 1945-1970 and not, as may be expected, in 1986 with the Thatcherite re-organization of the City which, as we have seen, was a built-in policy response to market changes. The turns of the cycle which in this dissertation have formed the four case studies (roughly one a decade from 1970 onwards) are shown to be encased in broader cycles (or regimes) from 1945-1970 and 1970-2010 – if indeed the policy response to the financial crisis ends up forming a new City regime. This dissertation has argued that on the bank-regulatory level this assumption of change is not warranted: current change is
little and within the existing financial economic framework. But if we look at it in terms of a City regime – the nexus of bank regulation, economic policy, and national geopolitics – it may be: the UK’s leaving the EU (assuming it happens and assuming it is a hard exit), with its corresponding monetary effects, changing of bank regulation, and national geo-strategy, are precisely the kinds of things which have shifted the ‘City regime’ in the past, comparable to the end of empire around 1945, and the end of what could be called ‘colonial’ Keynesianism around 1970. We should expect to see fundamental change in the role of the City post-Brexit, not just in the individual bank rules enforced, or EU passporting rights as is discussed at the political and daily level, but fundamentally in a way comparable to the growth of Eurodollar markets in the 1960s, and liberalized finance in the 1980s. Naturally this dissertation cannot foresee what this may be. It is unlikely to be anything that is currently being touted (e.g. ‘fintech’ does need not be the ‘next big thing’ for the City): just as Eurodollars were not expected or foreseen in 1945 or Big Bang in 1970. But we should, following on from the idea of financial-regulatory markets and of City regimes – expect it to correspond with however the UK attempts to position itself in the post-Brexit (and perhaps less open) world.

All of this is to say that banking regulation and the control of finance (which is how we have defined banking regulation in this dissertation) is a political decision of the highest order. Regulation and finance feed off each other in the cycle we have shown, but they are both a political decision. There is nothing ‘technocratic’ about it. Attempts to turn regulation into some form of almost mechanical exercise are themselves an attempt to embed a political preference into the financial-regulatory framework. Looking at this cycle as a system helps. As Meadows says (Meadows and Wright 2008): look at the repeated outcomes of a system to see what its purpose really is. A financial-regulatory system which repeatedly crashes yet continues to enrich financiers and governments would seem to have as its systemic purpose
– regardless of what the individual actors may think they are doing – the enrichment of
governments and financial market actors.

The financial-regulatory cycle is a political cycle and it will only change when the dominant
stakeholders of this cycle feel they no longer benefit from it. This dissertation has developed
a way at looking at this statement which would suggest that after the crisis these
stakeholders may no longer feel they benefit from the previous City regime, and that the
UK’s exit from the EU will be the means of change from one system to the next – whatever
form it may take. The dissertation also suggests that the form it will take shall not be
‘decided’ but will come about haphazardly through the diverse reactions of different actors.

Once more, it will be a political process of relative influence, competing ideas, and
institutional persistence and change. The more this political process is out in the open –
recognized, legitimized and debated – the greater the chance that open, capitalist,
democratic governance will thrive.

Final word

Banking is formed by regulation and run on regulation. Regulation is based on political
decisions. The more these distinctions are hidden the less well a financial system functions.

Nothing is inevitable or ‘natural’ in a nation's banking system. Banking and regulation
operate in a financial-regulatory cycle. This cycle is politically contested. Therefore all
banking crises are political crises. Banking is politics.
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Curriculum Vitae

Andrew Whitworth was born on 9 October 1986 in Houston, Texas. He grew up in England and completed an undergraduate degree in Classics and Modern Languages (Russian) at Exeter College, Oxford. Following this he took an M.A. in International Relations and International Economics at the Johns Hopkins University's School of Advanced International Studies (SAIS) in Bologna and Washington, D.C., where he was part of the European Studies department. After his studies, Andrew worked for a number of years in Brussels initially with the European Commission and then in private consulting, primarily on financial affairs. He decided to move back into academia to understand better the relationship between financial and political systems, and rejoined SAIS under Erik Jones in order to complete a Ph.D. During his doctoral studies Andrew has published on European financial resilience, the effect of economic sanctions on Russia, transatlantic trade, and the political processes of the UK’s decision to leave the E.U; he has taught classes on risk in the world economy, European financial markets, and on European history. Andrew currently lives in Italy and continues to research how finance and politics interact in the context of international integration.