Cambridge Judge Business School

The 7th Annual Risk Summit

The Changing Risk Culture of UK Banks: A Historical Perspective

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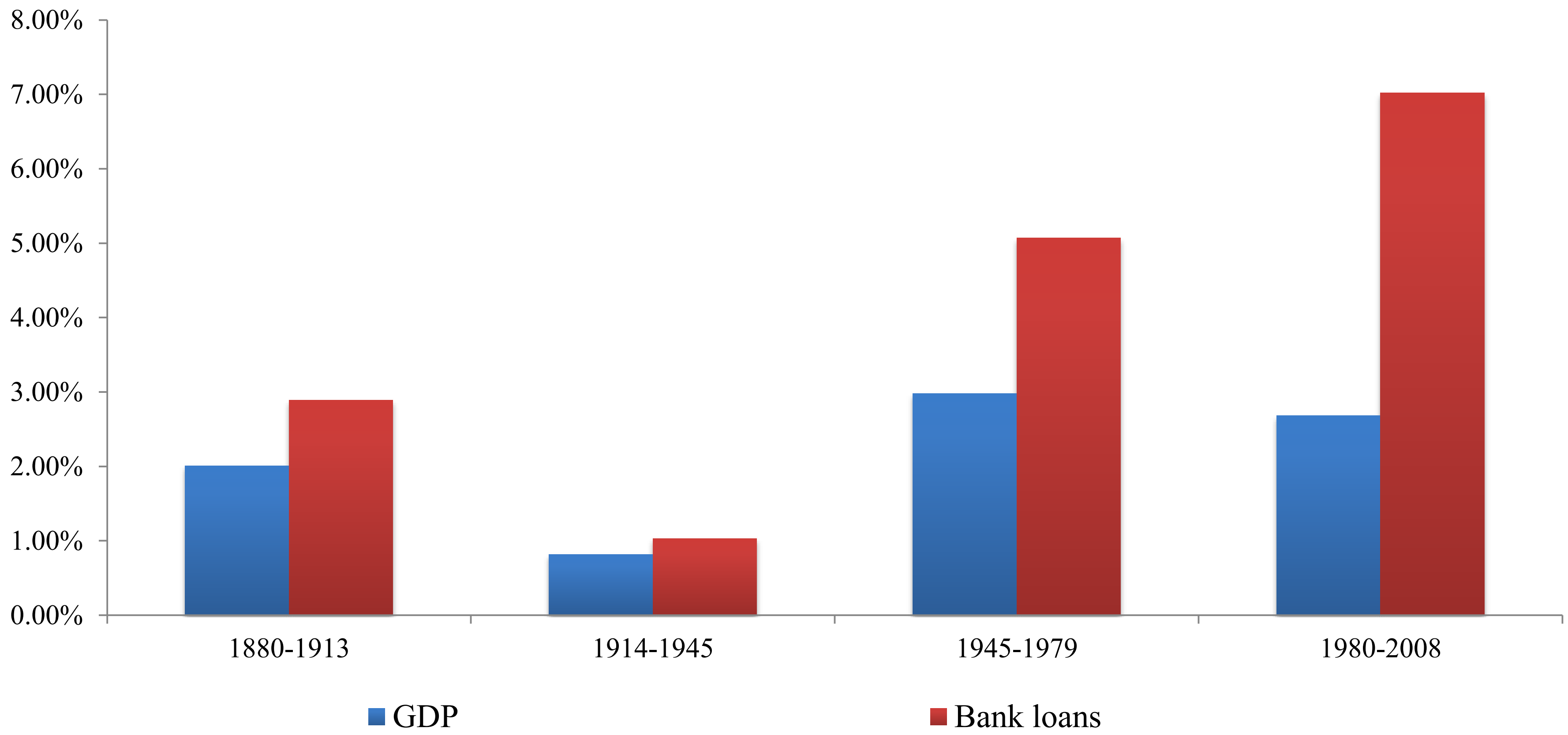
CJBS 25

UK annual real GDP and bank loan growth
‘a credit cycle on steroids’



Source: Aikman *et al*, 2014, p. 1076.

Agenda

- What banks are for (in theory)
  - ‘to facilitate the allocation of resources, across space and time, in an uncertain environment’, Merton and Brodie, 1995, p. 12.
- What British banks used to do (in practice)
  - and what they used *not* to do
- What British banks do now
  - and why this changed

Key terms

- Matching
  - ‘The banker deals in “short money” on both sides. He is essentially a broker whose business is to link up money needing temporary investment with borrowers needing temporary loans’, W. Leaf, 1943, p. 97.
- Mismatching
  - ‘demand deposits are a vehicle through which banks fulfill their role of turning illiquid assets into liquid assets’, Diamond and Dybvig, 1983, p. 405.

Recent literature

- A.C. Hotson, *Respectable banking: the search for stability in London's currency and credit markets since the great currency crisis of 1695* (Cambridge, forthcoming).

- Ò. Jordà, M. Schularick and A.M. Taylor, 'The Great Mortgaging: housing finance, crises and business cycles', *Working Paper 20501*, National Bureau of Economic Research, 2014.

- A. Offer, 'Narrow banking, real estate, and financial stability in the UK, *c.* 1870-2010; in A.C. Hotson and N.M. Dimsdale, *British financial crises since 1825* (Oxford, 2014).

- J.A. Turner, *Between debt and the devil: money, credit, and fixing global finance* (Princeton, 2016)

What banks are for: the theory

- Facilitate the trading, hedging, diversifying and pooling of risk
- Allocate resources
- Monitor managers and exert corporate control
- Mobilize savings
- Facilitate the exchange of goods and services

What British banks used to do

- Clearing banks
  - Payment and overdraft facilities
- Discount Houses
  - Money markets (bills of exchange)
- Accepting Houses
  - Merchant banks
- Finance Houses
  - Consumer credit, hire purchase, industrial credit

What British banks used *not* to do

'It is contrary to all sound principles of banking for a banker to advance money in the form of permanent loans', J.W. Gilbart, 1907, p. 149.

'The Bank [of England]'s opposition to mortgage lending by banks had longstanding antecedents, eighteenth-century experience giving it a "dislike of real property or mortgages as a bankers' security", A.C. Hotson (forthcoming) quoting J.H. Clapham, *The Bank of England* (1944), pp. 249-50.

'House or shop property, even of a superior class, is not a desirable security…on the grounds of its uncertainty of sale', G. Rae, *The Country Banker* (1885), p. 105.

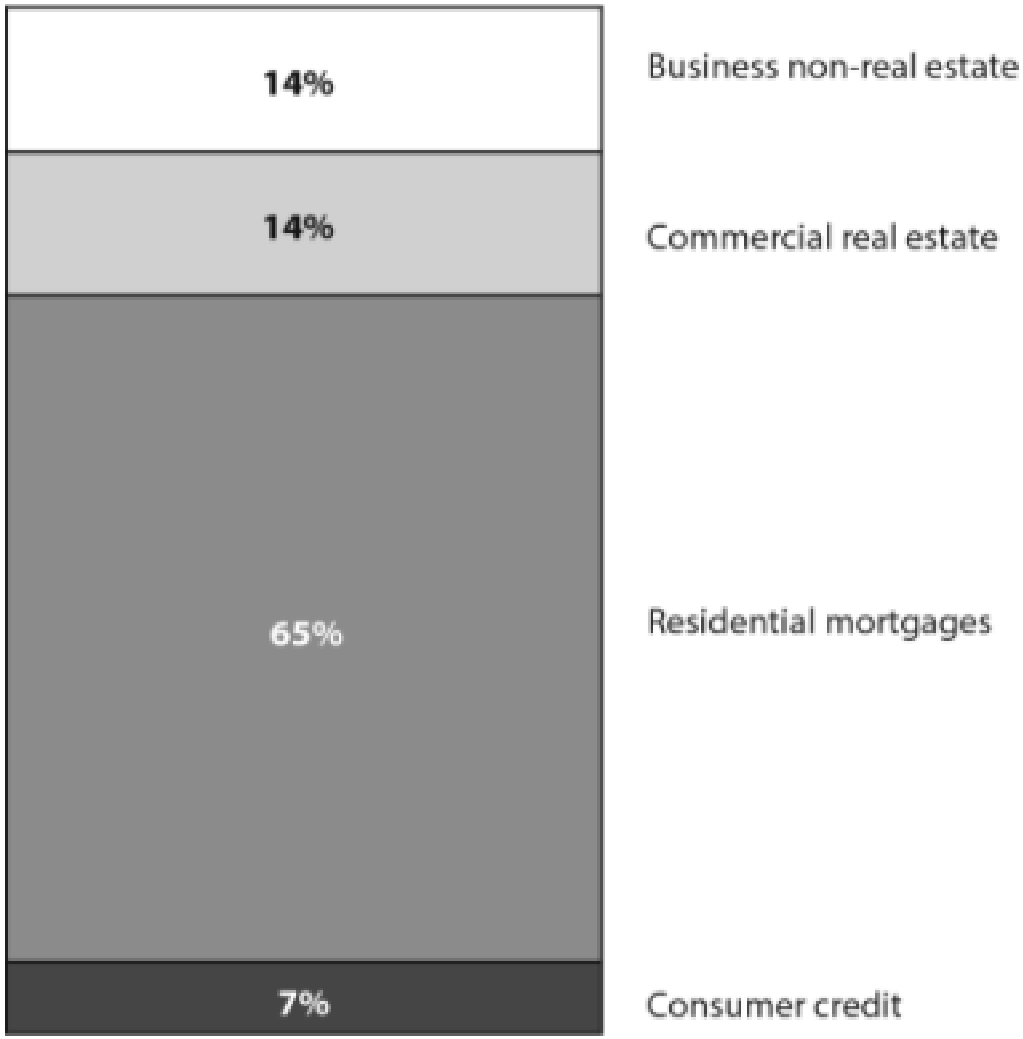
Building Societies

- 2,795 local, regional and national Building Societies in 1890
  - Amalgamations reduced to 1,026 by 1930
- Mutuals
  - Lower cost of capital
- Post-WW2 cartel
  - Competed on deposit rate *not* lending rate
- Building Societies cannot ‘create money’
  - Mortgages ‘rationed’ to longstanding customers with savings record. Lending driven by deposits.

What British banks do now

‘In 2007 banks in most countries had turned primarily into real estate lenders…the intermediation of household savings for productive investment in the business sector – the standard textbook role of the financial sector – constitutes on a minor share of banking today’ Jordà, Schularick and Taylor, 2014, p. 2 and p. 10.

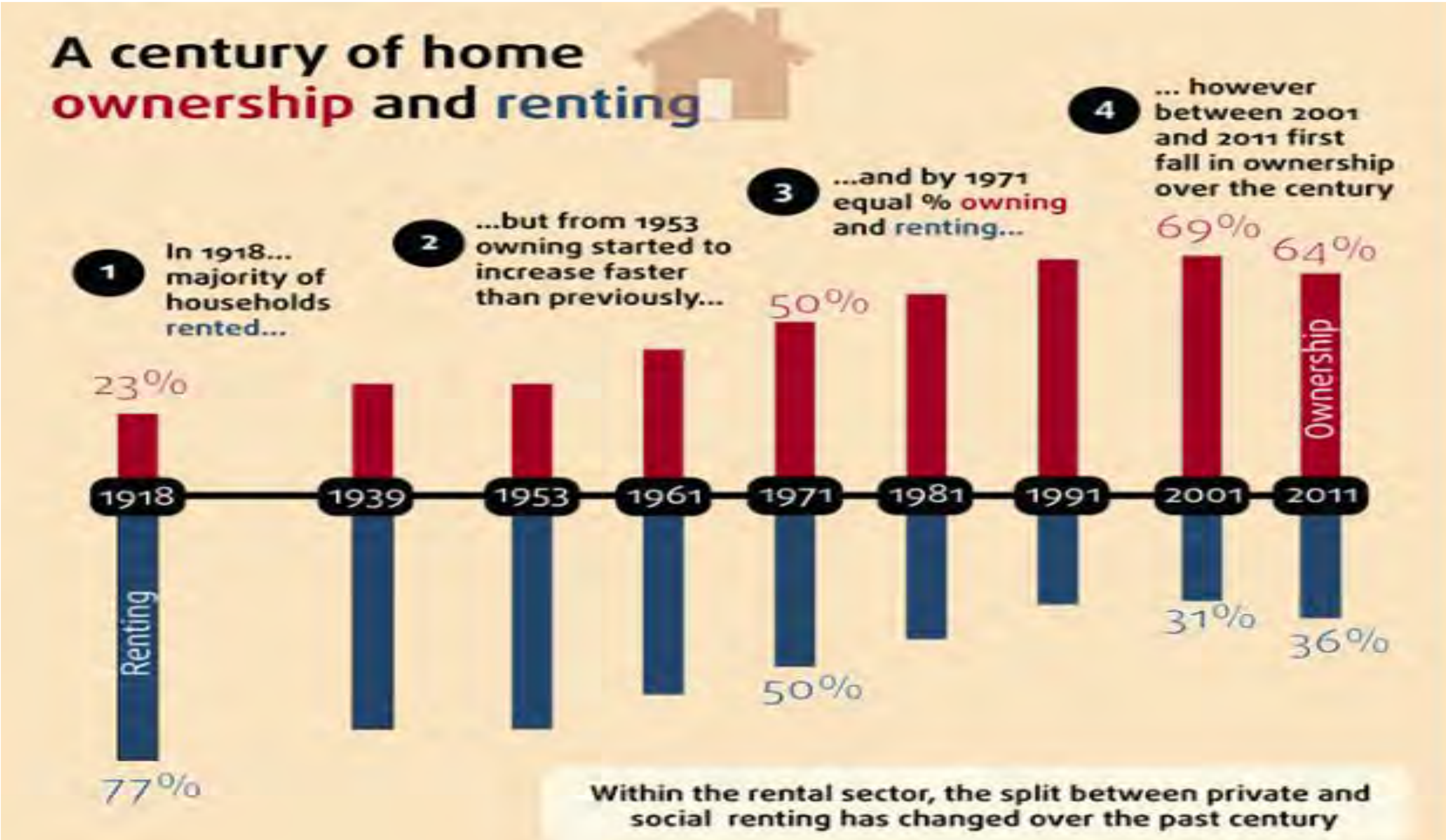
Banks' balance sheets



Why did this happen?

- Macroeconomic change
  - Affluence, property as inflation-hedged store of wealth
- Disintermediation
  - Euro markets, secondary banks
- Deregulation
  - End of ‘gentleman’s agreement’ on mortgages
- Securitization
  - Originate and distribute
- Basel
  - Capital requirements not liquidity requirements

Home ownership



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Source: National Archives (2011 census)

The problem

'the attributes of real estate as an asset make it unsuitable as security for the institutions that manage the payments system. The maturities are long, the assets are costly to liquidate, their value can fluctuate enormously, and they are exposed to taxation' A. Offer, 2014, p. 172

The Global Financial Crisis

Conclusions

- Matching is still be important
  - Especially for banks that ‘create money’ and operate the payments system
- Deregulating the Building Societies was ‘our biggest mistake’
  - Lord Griffiths (Goldman Sachs), former head of Mrs Thatcher’s Downing St Policy Unit, 2016.

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