

CHAPTER III

THE ENGLISH BANKING SYSTEM

THE Bank of England is the centre not only of the national finance, as the sole bank of issue and controlling the currency in partnership with the Treasury, but is also the centre of the general deposit banking system of the country, by its position as the banker of the banks, in which capacity it holds the ultimate reserve of the whole system of joint-stock banking. It has not only to keep the gold which serves as a backing to the note circulation of the land, but it also has to keep in hand the cash, in the form of notes and gold coin, which may be needed by the other banks to meet their liabilities in case of need. How it fulfils this function we have already seen in our discussion of the crisis of July–August 1914.

It is curious to us, as we look back, to see how reluctantly, and almost unconsciously, the Bank of England took up the rôle of the

bankers' bank, and how unwilling it was to recognise the responsibility which the position involved. Only little more than fifty years have passed since the publication of Walter Bagehot's *Lombard Street*. In 1873 Bagehot had to call attention to two things, first that "the Directors of the Bank are in fact, if not in name, trustees for the public, to keep a banking reserve on their behalf," and second that "so far from there being a distinct undertaking on the part of the Bank Directors to perform this duty, many of them scarcely acknowledge it, and some altogether deny it."

The opinion held by an important party among the Directors was that the Bank of England was simply a competing bank among other banks, and should be conducted as a dividend-earning business for the profit of its stockholders. For this purpose, it was said, no more money should be kept idle, in the form of a cash reserve, than the same proportion as that held by any competing bank. - And indeed it was evident that it was on this proportion of reserve that the profits of the Bank mainly depended. Bagehot pointed out with irresistible logic that the smaller banks, by holding their reserves in

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the form of a balance payable on demand with the Bank of England, could throw the onus of any sudden demand upon the Bank; and that unless the Bank kept itself invariably protected by a very large reserve in cash, the whole fabric of British credit rested on a foundation of the most precarious nature. He pointed out that the position of the Bank of England was wholly artificial. The natural development of banking would have led to the same outcome that had been reached in Scotland, where joint-stock banking had free scope since 1716, and where there had grown up side by side a number of banks of approximately equal power and great stability. In England the privilege given to the Bank of England by the prohibition of joint-stock banking had led to the concentration of all banking capital on the large scale into the hands of the Bank of England; the private banks were kept comparatively weak by the limitation of the number of their partners, and were therefore driven to rely entirely upon their great competitor in times of stress. Bagehot insisted that this special privilege imposed a corresponding duty which could not be shirked; and that the duty of the Directors of the Bank to the protection of

the national credit must take precedence of the rate of dividend to be paid on Bank stock. His masterly essay convinced public opinion; and since its appearance there has been no further question. The Bank has loyally shouldered the responsibility placed upon it, and has maintained its reserves at a point which enabled it to face without any recourse to Government help the various emergencies which threatened the national credit from 1866 to 1914.

It is noteworthy that there appeared at about the same time another outstanding essay which pointed out the manner in which the Bank should maintain its reserves of gold. Goschen's *Theory of the Foreign Exchanges* appeared in 1860, and indicated the power which the Bank had of attracting gold from abroad by means of the bank rate. In particular Goschen pointed out, what had never before been recognised in practice, that when it was desired to affect the foreign exchanges it was necessary that the bank rate should be altered by steps of 1%, and not $\frac{1}{2}$ % as had previously been the practice. These two remarkable books, in fact, between them have been taken, ever since their appearance, as the foundation of the policy of the Bank of

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England in its dealings on the banking side of its business.

The position of the Bank in our system is thus essentially two-sided. On the one hand it represents the national interests. It is the Government Bank, it holds the Government balances, it makes advances to the Government from time to time, it issues Government loans and maintains the service of them, keeping the registers of stocks and paying the interest. The Governor is in constant touch with the Chancellor of the Exchequer, and is the medium by which the financial policy of the Government is conveyed to the City for execution. Under the existing system of issue (if it can be called a system) the Governor is responsible for maintaining a certain amount of gold backing for the Treasury note issue, while at the same time he has to maintain also an adequate reserve in his Banking Department for any calls that may be made upon him by the market in times of stringency. Roughly speaking these are the duties of the Bank to the public.

On the other hand the Governor and Directors of the Bank owe a duty to their stockholders, for whose account they carry on the business of a deposit bank. They

accept from the public deposits payable on demand by cheque—our definition of a banker; they lend money to their customers and on the money market by the discount of bills or by loans against approved securities, and they render most of the small services for which people now look to their bankers. And on this they make a profit which is at least sufficient to pay a steady dividend on Bank stock. The Bank of England paid in dividend 9% from 1904 to 1913; 10% from 1914-15 to 1920-1; 11½% in 1921-2 and 12% from 1922-3 to 1924-5. What the real profits of the Bank are is a secret which is never revealed. No Profit and Loss Account is ever published; the minimum limit of the "Rest" or undivided profit stands at the same figure, £3,000,000, as it did in 1844, and additions are made to it week by week at a rate which will, at the end of the half-year, allow of the payment of the dividend without any drop below the fixed minimum. The only glimpse the public have had into the question of real profits was in the announcement that the Bank had decided to present to the Government a sum representing the extra profits made on the conduct of the Government account during the war. It may

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safely be guessed that "hidden reserves" provide a handsome item to be included among the "Other Deposits."

On the banking side, the Bank of England does no doubt to some extent compete with the joint-stock banks, and it has sometimes formed a source of complaint that their balances should thus be used in competition with them. But for this there is little or no ground. A large part of the bankers' balances is, in fact, not used at all; it is kept idle, earning nothing, in order that it may be at the disposal of the bankers when wanted. And the service which the Bank thus renders far outweighs any loss of business—not considerable in any case—which may be attracted to the Bank of England from the other bankers.

Experience too has taught the joint-stock banks to accept willingly the leadership of the Bank of England wherever national interests are concerned. At one time indeed the relation was not that of willing co-operation. Up to the war the Bank of England was very much disposed to stand on its dignity, and to keep the clearing banks at arm's length. During the first eventful days of the outbreak of war, in the Bank Holidays of August 1914, the clearing banks found

themselves in a difficult position because, while anxious to co-operate with the Bank of England and the Government, they were excluded from all knowledge of the lines on which public policy was being shaped, and the Bank declined to send any representative to attend and instruct the joint meetings of the clearing and country banks which were being held every day. But the necessities of the case, and an enlightened control at the Bank, soon remedied this awkward state of things. On the one hand, a "Treasury Committee" of the bankers was formed, and kept in touch with the Chancellor of the Exchequer; on the other, the Governor of the Bank made it his practice to maintain constant relations with the Clearing House Committee. These relations are still kept up, and, though the clearing bankers are of course never consulted on such matters as the alteration of the bank rate of discount, conferences on many matters of common interest still take place at frequent intervals, and the "Treasury Committee" is still the official channel of communication between the bankers and the Chancellor.

Another change due to the war is the fact that the Bank of England has for some time

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been the custodian of the bulk of the gold in the country, the other banks having agreed to hand over to it, at the request of the Treasury, all the gold coin that comes into their possession. The Bank is thus better equipped than it was before the war to protect the gold reserves, because it knows just where and what they are. Until the war, the amount of gold in the country was a matter of guess-work; and it was only the appeal made during the war to all who had gold in their possession to exchange it for Treasury notes which enabled the banks to take stock of the real position. It should, however, be added that quite recently, in the spring of 1926, there have been some signs of a departure from this practice. The joint-stock banks have not been called upon for some time to hand over the coin which still dribbles in to them from the country, and there have been cases in which gold has been bought by one at least of them in the open market.

It must be noticed that, while the Bank of England competes with the joint-stock banks by keeping current accounts with trading firms and individuals, it makes it a rule not to take deposit accounts for short dates at

interest. It is largely upon the absence of competition in this respect that the London banking system was enabled to establish itself by the side of the Bank. By offering interest on deposit accounts at seven days' notice the joint-stock banks are enabled to attract large funds which they can safely lend again for short periods. This again will come up for consideration when we are dealing with the money market. One of the most momentous departures from precedent made by the Bank during the war was the allowance of interest to the joint-stock banks for short money. This gave the Government complete command for the time over the money market. It was, however, adopted strictly as a temporary war measure, and was withdrawn shortly after the war, in July 1919.

Grouped round the Bank as a centre stand the large joint-stock banks engaged primarily in the home business. These include not only the London clearing banks, among them the "Big Five," but a group of banks in Manchester who have resisted the tendency to amalgamation with London banks, and form an independent group of their own, though one is affiliated, by the purchase of shares, to a London clearing bank.

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With the nature and functions of the London Clearing House we shall deal later on. Outside the Clearing House system stand the Scottish banks, carrying on their business under Scots law, but, of course, in close touch with London through their offices there. In some cases the shares in the Scottish banks also are owned by London banks. The same is the case with some of the Irish banks, though here the attitude is more independent. The Irish banks, like the Scottish, have their own right of issuing notes, which in both countries form the bulk of the currency, though the quality of legal tender conferred on them during the war has since been withdrawn.

With these London and country banks are closely linked the group known as the Overseas banks, under which name they form an Association for the purpose of watching and discussing their common interests. They comprise two main classes: (1) the Colonial banks, some of which have their head offices in London, while others have their head offices in the Colonies with subordinate London offices; (2) the "Exchange banks" dealing chiefly in the financing of trade between Great Britain, on the one hand and India and the extreme East on the other. Here, again,

some have a head office abroad, notably the Hongkong and Shanghai Bank, which has its seat of Government in Hongkong, but a very important office and committee in London. The Overseas banks have joined with the deposit banks, English, Scottish and Irish, to form the British Bankers' Association for common discussion.

Outside the British Bankers' Association are the foreign banks which have London offices. The most important of these are French and American banks, some of whom do a large business and at times lend or borrow considerable sums on the London money market. The first place before the war was taken by the German banks. These were, of course, closed, and their London accounts liquidated during the war; and there has been so far no attempt on their part to return to London. The business which they did has been divided up among London houses in a way which we shall have to mention when discussing foreign banking. These banks naturally do not form part of the British Bankers' Association.

The above classes comprise all the institutions which are generally recognised as banks in London; but the banking system would

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not be complete without the inclusion of at least two other financial groups, which indeed form most essential elements in the highly specialised London money market. New York is at present engaged in introducing them across the Atlantic, recognising that their absence hitherto has been a serious impediment to the growth of that market as a centre of world finance. These two groups are the Accepting Houses and the Discount Houses.

The first group are separated from the banks proper only by a very fine line. They are indeed also known as "Merchant Bankers," a title which closely indicates their functions. On the continent of Europe they would be regarded as typically bankers. In London, however, they have organised themselves as a distinct group with their own association, the "Accepting Houses' Committee." But one of them at least has quite recently absorbed an allied Overseas bank, and now calls itself a bank in its official title. Most of the Accepting Houses are, however, private businesses, working on their own capital, and not "holding out" that they take money on deposit payable on demand by cheque. They make a speciality of the financing of international trade, which is shared by the joint-

stock banks; but in practice their spheres of influence are fairly well marked off, and there is little interference. A special chapter will be devoted to a discussion of their work.

The next group exercise also a highly specialised function. The discount brokers play a very important part in the London market. Here again their particular business, the discounting of bills, might seem to clash with the work of the banks proper; for it has, at all times, been the practice, and indeed an elementary duty, of banks to discount bills, and they do so on a large scale for their own customers. But it is in practice found to be worth their while to depute this work to a very great extent to the specialists, lending them money to be re-lent in the discount of bills. The discount market will again need a fuller discussion later on.

And finally, we must not leave out of sight the Stock Exchange. This is not strictly speaking a part of the banking system; but it is very closely linked with the banks by the custom of making short loans against stocks, generally for a fortnight, "from account to account." This is not only of material assistance to the members of the Stock Exchange, but offers the banks a very

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convenient outlet for money which they do not think it wise to lend out for more than this short period.

We will now, after this brief view of the English banking system, proceed to discuss in greater detail the various members of it.