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NARROW BANKING, REAL ESTATE, AND FINANCIAL STABILITY IN THE UK, C.1870-2010

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Abstract

Banking in the UK was stable for more than a century after 1866. Financial institutions were differentiated according to function. The core banks did not engage in maturity transformation, but in managing a payments system for business. Real estate was a potential source of instability due to high credit elasticity of demand and to long maturities, but credit was successfully rationed by building societies, who relied on the funds that their savers had actually withdrawn from consumption. After 1945, credit rationing came under pressure from consumers and housebuyers. Incremental liberalisations after 1971 released a tide of credit which created a property windfall economy. Borrowers and lenders both prospered until the system collapsed under its own weight in 2007.

1. Introduction.

For more than a century after 1866, the stability of the banking system in Britain was never in question. This period of stability can now be seen as exceptional. During this period, Britain maintained a steady level of economic growth, provided a rising standard of living for the majority of its people, and made a transition from workshop of the world to consumer society. This banking system was different from the one we have today, and appears quite alien to economists trained in modern finance theory. In contrast, the banking system that came into being after 1970s initially seemed to sustain continued prosperity but fell into crisis in 2007, and remains out of control. Economic growth came to a halt, much of the banking system has had to be bailed out, subsidized or nationalized, and there is no agreement on where to go next. The banking system that existed in Britain up to the 1970s may provide some clues as to how financial stability might be restored.

The main attribute of this world we have lost was the functional specialisation of different parts of the banking system. Each activity in the financial system was undertaken by a different set of institutions. This is in contrast with the encompassing 'universal banking' institutions which emerged after the 1970s and which came to dominate. The earlier system kept the risks of different areas of financial business in different compartments, insulated from each. In particular, the special risks arising from the finance of housing and commercial real estate were contained within separate institutions with self-limiting constraints. The financial system operated with self-regulating prudential constraints on liquidity and credit, which kept its expansionist tendencies in check, and allowed liquidity to grow at the same pace as the rest of the economy, and no more. This is the world we have lost, and we might wish to consider how much of it we might want to recapture.

Money has three functions, and in late-Victorian Britain, each one of them was provided by a separate set of institutions. The most immediate use of money is as a medium of exchange. Institutionally, this was embodied in the payments system. On the High Street, the most imposing buildings belonged to the clearing banks, whose main function was to make and receive payments. 'Clearing' was a daily process in which agents of the banks got together to cancel out their mutual liabilities, and to pay over any remaining balances. Another set of institutions, mostly in the City of London, provided credit ('discounting') against short-term commercial paper.

The second function of money is as a store of value. A hierarchy of financial institutions collected savings, and transformed them into investments and loans. At retail street level, there was a class of saving banks; one level higher were insurance companies. In the city of London, investment banks specialised in underwriting bonds and equity issues, while the stock exchange (and other specialised markets) traded in financial and other assets. A special set of institutions, the building societies, accepted deposits, and lent them out on mortgage for house purchase. Insurance companies also lent on mortgage, but other institutions kept clear of the real estate markets.

Money also serves as a unit of account. The Bank Charter act of 1844, made the Bank of England responsible for the value of the currency, the level of prices, and the integrity of the financial system. Despite being a private corporation, the bank understood this function, and on the whole, discharged it well.

2. Payments and Savings.

Economists are used to thinking of banks as performing ‘maturity transformation’, taking short-term deposits, and converting them into long-term loans. It comes as a surprise for them to realise that the core institutions of late-Victorian banking did not engage in this activity. Late-Victorian banks were a kind of urban utility. By the end of the 19th century, the routine everyday business of banking in England and Wales had concentrated in five large institutions based in London, with hundreds of branches each, scattered in every town (Sayers, 1967, ch. 3; Collins, 1988, ch. 3). Like gas and water utilities, their function was to provide liquidity for business wherever required. Legal tender in Britain, either gold coins or Bank of England notes, was limited in quantity by the Bank Charter Act of 1844, and most of the money supply was provided by the clearing banks, in the form of bank deposits and overdrafts. They used this form of liquidity and credit to gradually increase the money supply, more or less in line with economic growth, by operating a sort of 'real-bills doctrine', which accommodated advances to the level of legitimate business requirements (Higonnet, 1957; Goodhart, 1972, 209-210) The judgements that bankers formed on legitimate business were disciplined by the personal risk they took, as bank officers, if advances were not serviced and repaid (Holgate, 1938, 743).[1]

The main function of the 'clearing' banks was to facilitate business payments. They did not lend a great deal, and lent cautiously. Thus Walter Leaf, Chairman of the Westminster Bank,

> The main credit system of the country, the gigantic amount carried by trade in the form of capital or capital debts, is independent of the banker altogether…The banker deals in 'short money' on both sides. He is essentially a broker whose business it is to link up money needing temporary investment with borrowers needing temporary loans (Leaf, 1935, 93, 97).

Credit was advanced in the form of deposit overdrafts or as short advances for a few months, although it was often easy to roll over. In 1909, one expert estimated that nearly three-quarters of bank deposits were created by loans and advances (Withers, 1909, 63), while the scale of outstanding loans was typically no more than about half of the deposits (Goodhart, 1972, 158). Deposits were means of payment: liabilities were discharged by debiting and crediting bank accounts. These accounts either paid no interest, or a low interest rate, and sometimes even incurred a charge. Depositors could obtain their money on demand. This exposure to the volatility of

[1] The 'real-bills' doctrine was applied by the Bank of England to regulate the money supply when convertibility to gold was suspended during the Napoleonic wars (Viner, 1937, 148-9).

business payments made banks averse to risk. They controlled it by keeping a large proportion of liquid assets (such as government bonds and money on call), typically up to a third of their assets; capital ratios of 12-14 percent in the late-Victorian period, and down to about half that level in the inter-war years; and even their own reserves of gold. In 1913 the clearing banks were aiming to accumulate gold reserves comparable to those used by the Bank of England for monetary policy, which they wanted in order to insulate themselves from the effects of that very policy (Offer, 1983, 132-133; Goodhart, 1972, 223-226). Another source of discipline was 'skin in the game', the personal liability of bank shareholders.

From the 1870s and until the Second World War, the Bank of England succeeded in maintaining a stable level of prices. That made money attractive as a store of value. Two types of institutions took money from individuals and locked it away for safekeeping. Saving banks provided a 'store of value' for small savers. Trustee savings banks began early in the 19th century as not-for-profit mutual Associations for saving. The primary consideration was the safety of deposits. The government entered this business with the Post Office savings bank in 1861, which gave a sovereign guarantee for the small accounts of low-earning households. The Post Office also provided a poor man's payment system, in the form of money orders and postal orders (for smaller sums) (Horne, 1947). The funds deposited in these institutions could only be invested in government bonds, and they rose so much that in the years before the First World War, the Post Office savings bank became the most readily available and reliable source for government borrowing (Offer, 1983, 134). By 1938, the total deposits in all Savings Banks was about £775m, or about 3 percent of a net personal wealth of £24,289m. (Sheppard, 1971, Table (A) 3.1; Solomou and Weale, 1997, table 6, 311). Another form of lower-class savings was through self-help. Friendly societies (and ‘industrial assurance’, i.e. burial insurance companies) had £1760m worth of funds in 1938, about 7.2 percent of net personal wealth (Sheppard, 1971, table (A) 2.9).

For the middle classes, a popular form of saving was +-insurance policies sold by Life Offices. Most of these policies were for a fixed term of years, and constituted a form of saving. The life insurance element was attractive at a time when life expectation was volatile at all ages. Only a minority of these policies were converted into annuities, which provided coverage for the risk of living too long. Insurance companies strove to maintain financial claims over the long term, and to control professionally for known actuarial risks. There were scores of firms and the industry was quite competitive. There was a certain amount of concentration at the top, but it would still be interesting to investigate what kept these firms honest. This industry needs to be studied more closely. It is possible that competition kept the reserves relatively low, and so the attraction of steady premium flows was larger than various ways of absconding with the money. It was easier to operate a system of this kind with an expectation of stable prices. Also many of the firms were mutual societies, and their presence in the market would have restrained their joint stock competitors (the Post Office also entered this business). These companies invested for the long-term in bonds, solid equities, and mortgages. They were managed conservatively, and one of their selling points was the sharing of opportunity and risk with the clients (the ‘with- profits’ policies). In a time of poor accounting standards, it is a remarkable that policyholders placed such confidence in the insurance companies, but they did. The scale of insurance company funds in 1938 was £1023m, a smaller proportion of total personal wealth than the funds held by friendly societies, which provided contingency insurance for manual workers and the lower middle class (Sheppard, 1971, table (A) 2.6).

3. Housing

A truism worth restating is that the purpose of saving is to transfer financial claims from one point in time to another. This process is fraught with a variety of risks, and one of the methods of coping with them is to own real estate. Housing is tangible, and provides a flow of shelter regardless of its financial value. Historical experience over the 20th century also shows that housing held its value remarkably well, typically rising in value as fast or faster than GDP, about seven or eight times more than the retail price index, two to three times more than labour earnings (Offer, 2014). Victorian bankers were advised not to take real estate into their portfolios and that they heeded this advice is an important reason for a century of banking stability (Rae, 1885, 94-98, 106-107, 113-116; this was the leading banking handbook of the period). Real estate is poor collateral: its value is uncertain and it is difficult to sell. It is also exposed to taxation. Banks foreclosing on mortgages in recent times typically take a large loss on market value.

In Victorian England, housing was typically owned not for shelter, but for profit. It was provided by small capitalists on the 'buy to let' system. Houses were erected by speculative builders and were sold on to these landlords. House property was subject to large cyclical value swings. The greatest of these swings took place towards the end of the 19th century, when house values rose to a peak in the late 1890s at a time when overseas investment (the other main outlet for savings) was not attractive. In the following years, house values fell sharply, typically declining by more than a third over the Edwardian period, one of the largest house-price collapses recorded (Offer, 1981, ch. 17). At that point the First World War broke out, and within a year, most of the housing in Britain was placed under a regime of rent control which was not fully lifted until the 1980s. Then as now, housing was a very large household asset class (about a fifth before 1914, less than a tenth between the wars, about a third in the last twenty years; Offer, 2014, table 1; also Solomou and Weale, 1997). But these violent fluctuations in its value had little adverse effect on the financial system up to 1939. It actually came out stronger as a consequence. One reason was that rents held up much better than property values, so nominal revenue flows held up as well (Offer, 1981, fig. 17.9, 278). And these assets, on the whole, were not liabilities on anybody's books. When rental flows were capped by regulation, the losses were taken by the owners, and the demise of houses as an investment class cleared the way for owner-occupied housing, financed by mortgage lending. And owner-occupation opened up a new domain for finance.

Building societies had been lending to owner-occupiers since the beginning of the 19th century, but their activities were circumscribed by the dominance of the 'buy to let' rental sector. The introduction of rent control opened a new scope for owner-occupation, and building societies developed the institutional capacity to provide the finance. Their heyday was between the wars, when they financed the great bulk of new construction, and developed new methods to do so. The building societies were not-for-profit mutual societies. They took deposits (mostly from middle-class savers), and lent the money out on mortgage. Their mode of operation had built-in prudential constraints. The loans were funded entirely from time deposits, some of which were classified as 'shares' in the society, whose assets were junior to those of ordinary depositors. The incentive was that shareholders received a higher rate of interest, and might get priority for borrowing. Initially loan-to-value ratios were low, and borrowers had to advance large cash deposits, and to have a good saving record. Mortgages had always provided a rate of return more than twice as high as government bonds. What building societies discovered, was that the borrowers they selected could be relied upon, and that their time depositors were genuine savers, and thus more patient than the businessman depositors and shareholders of the clearing banks. Without needing to maintain stock market value, they could share the mortgage markup with their depositors, and offer them a competitive rate of interest, substantially above the return on government bonds. This attracted a flow of middle-class and even financial industry savings in the 1920s, and even more so after the downwards conversion of interest on government bonds in 1932. On the other hand, they were constrained in the amount that they could lend by the funds deposited in their accounts, together with any reserves they had built up. Unlike the clearing banks, building societies were not able to create money. Their funds were not ledger-book credits, but had been earned by households, and were genuinely withdrawn from consumption. Building society deposits were genuine liabilities, secured only on illiquid housing, and so lending had to be prudent (Cleary, 1965).

Not that it always was prudent: in the 1930s in particular building society managers developed innovative methods of lending high ratios of house value, coming close to 100 percent. Success led to rapid growth, and credit evaluation became less personal. During the 1930s, building societies began to take on greater risk. The managers rose in status as their societies rose in size. They began to compete with each other for market share, and in the process, may have sailed a little close to the wind. Their innovative lending policies largely dispensed with borrowers' equity. Much lending was made directly to developers, who paid insurance to cover the risk of default. Fortunately, the societies were never tested by a substantial downturn, and came out of the Second World War in a stronger position to resume their activities, which continued in the same form up until the 1980s. They rarely, if ever, borrowed money on the financial markets, they built up substantial reserves, and their leverage was low. Their lending was rationed by the savings of their depositors. In consequence, in the interwar years, although demand for housing was buoyant and economic conditions (the middle-class) were good, and although the lending response was ample, it did not overstep prudential limits, and house price levels did not substantially rise between the wars. Although a number of large societies emerged and the sector became more concentrated, the societies did not on the whole pose a systemic risk. Housing finance was insulated from the payments system. The value at risk was only depositors' and shareholders' funds, which were secured amply by the revenue flows that serviced the mortgages (Speight, 2000; Samy, 2010).

These financial innovations helped to build up Britain's large stock of owner occupied housing, much of it eventually transferred from the moribund rental sector. This achievement was remarkable in view of the attributes of housing markets. In Britain and the United States during the 20th century, demand for housing was insatiable: it rose faster than income, if credit was available to feed it. To paraphrase Samuelson on stocks, 'if people buy because they think houses will rise, their act of buying sends up the price of houses… no one apparently loses what the winners gain.' (Samuelson, 1980, 601). This is actually incorrect: once houses rise, the next cohort of people finds it more difficult to buy, and can only be accommodated if credit is expanded. Seen as an asset, for long periods houses appeared to deliver their proverbial safety. The reason, however, was that they have been poor assets economically, the one major commodity which has failed to benefit from economic growth: it did not become any cheaper, either in relative or in absolute terms.

Housing is the main source of financial volatility: As Leamer says, 'Housing *is* the Business Cycle' (Leamer, 2007). Real estate fever is often implicated in financial crashes (Herring and Wachter, 1999): looking back over the last 40 years, there was a commercial property crisis in in the UK in 1973, a large Savings and Loans crisis in the United States in the 1980s. Real estate speculation brought down the Japanese boom of the 1980s, and the economy has never really recovered. Credit loosening in Scandinavian countries in the 1980s was quickly followed by a real estate lending boom and by financial crises and sharp contractions in the early 1990s (Jonung et al., 2009; Honkaphoja, 2009). Imprudent mortgage lending in United States led to a massive crisis in 2007-8 which is still unfolding, especially in the United States, Spain, Ireland, and the UK. Germany, which has a large rental sector, and whose house prices did not escalate, largely escaped a direct financial crisis, and is only affected by the imprudent investment of German banks in overseas mortgages.

The mechanisms of these crises are driven by two factors. Shelter is a necessity, and housing is one of the most visible signals of social status, one that is difficult to make and difficult to fake. Demand for accommodation consequently appears to be quite rigid, and is thus not tightly constrained by income. If house prices rise, consumers will continue to compete as long as they can. This is demonstrated by the long duration of housing 'hot-spots' on the coasts of the United States, and for decades at a stretch in the UK. All the more so, if consumers are provided with credit. In that case, they are merely constrained by their ability to service debt, and can extend the working hours of their households (i.e. with income from two or more adults) in order to service these debts. The uneven increase in house prices across different regions in the USA suggests that it is credit supply which has driven the booms. We now need to consider what factors first constrained and then facilitated the supply of credit after World War Two.

4. Banking c. 1945-1970.

The Second World War ended with a large government debt overhang, and most of the lending capacity of the banks was utilised in rolling over this debt. Commercial lending was restricted. At the same time, a demand for credit opened up. Full employment, rising incomes, and the end of rationing in the early 1950s built up demand for consumption. A housing boom was financed partly from building society sources, and partly by the government. New housing is usually accompanied by the purchase of consumer durables like furniture and carpets. At the same time, a pent-up demand had built up for household appliances, for washing machines, cookers, and refrigerators, and also for motor cars to facilitate commuting from the new outlying suburban locations, and to make use of public investment in highways and motorways. Banks responded by providing, for the first time, loans for consumption purposes, and a system of credit scoring for consumer borrowers. The first credit card came in 1966. The production and sale of consumer goods also needed to be financed and accommodated, generating demand for factories, retail premises and for office space in town centres. The credit required for these purposes required longer maturities than the existing banking system was used to provide. Commercial property required large new sources of mortgage lending. The existing clearing bank system, constrained as it was with lending controls, was not able to respond adequately to these demands, which were met in large part by hire-purchase credit companies and by secondary banks.

The issue was investigated in the Radcliffe committee on the working of the monetary system, which sat between 1957 and 1959. The Bank of England, and the Treasury, who between them managed the monetary system, faced four tasks that were not easily squared. One was to roll over and begin to discharge the large overhang of government debt. A second was to maintain price stability, primarily at this stage in order to maintain the exchange rate. A third was to maintain full employment and the momentum of growth, and a fourth was to accommodate the new demands for credit. The committee dismissed the concept of ‘money’, and instead focused on the larger issue of liquidity, which was determined by the supply of credit overall. This earned it some scorn from contemporary and subsequent commentators of a monetarist bent (Capie, 2010, 134-137), but in my humble view it was right. It identified no magic bullet, and instead recommended a pragmatic mix of administrative, regulatory, fiscal, and monetary controls, involving a good deal of regulatory judgment, to try to keep the lid on credit expansion. This turned out to be messy to manage and not very precise. But the decade that followed only looked bad at the time: in retrospect those were years of prosperity and growth, albeit with upwards inflation creep. By the end of the sixties, however, the regulators had tired of regulating, and the policy mood had changed.

The Radcliffe Committee took evidence painstakingly for two years. It wanted to find out how banking worked, and to improve it by the application of reason and judgment. A decade later, policy-makers had lost their patience. The British economy, bound to a fixed exchange rate, struggled from one apparent crisis to another. From Chicago blew the winds of market efficiency and monetarism, and the drafts penetrated the Bank (Davies, 2012, 5-6). The Central Bankers pushed aside the lessons of practice and judgment, and reached for the convictions of faith. On

Christmas Eve 1970, the chief economist of the Bank of England, John Fforde, wrote in an internal memo to senior colleagues,

> He who argues for fundamental change must to some degree, be preaching a faith. If one does not believe that competition is capable of stimulating efficiency and innovation, then presumably one ought not to object to a permanent system of ceiling controls on banks. But if competition has any virtue, we ought not to have a system that stifles. (Fforde, 1970, 6)

This line of reasoning justified a root and branch reform, known as 'Competition and Credit Control', applied in September 1971 (Bank of England, 1971). It replaced controls on borrowing with competition for credit by means of interest rates. More important for our story is the intention of breaking down functional barriers between the clearing bank cartel and other finance companies in order to create a uniform credit market and allow market forces free rein. That is a good idea, if one believes that the unfettered operation of market forces is benign. At the height of Victorian laisser faire, the Victorians did not hold this belief. And despite the dominance of efficient market doctrines during the last three decades, there is no analytical proof that markets necessarily have such benign outcomes, while the empirical evidence is very mixed.

Shortly afterwards, the Bank of England gave a strong indication that those who took liberties with market freedoms would not be punished. CCC was consistent with Edward Heath's dash for growth. But instead of an industrial investment boom, what followed was a consumer boom, with rising property values and imports. Inflation rose and was followed by widespread industrial unrest. Following the oil shock of 1973, the secondary banks which had largely financed the boom faced the prospect of failure, and were rescued by the Bank of England. Those who took excessive risk were bailed out (Reid, 1982).

In this respect as well, Competition and Credit Control was a genuine turning point. It started a withdrawal from prudence, and an increase in lending which continued unabated for more than three decades, until 2008. The underlying faith in competition and markets was the new policy metaphysics. The unleashing of credit also shook up the city of London. The stock markets revived, overseas banks began to arrive in large numbers, and a large Euro market in dollars developed in London for corporate financing.

5. Credit Liberalization, 1979-2008

The Thatcher government which came into office in 1979 shared the intuitive faith in market efficiency. It followed on CCC with a sequence of moves to deregulate finance. There is no need to go through these shifts in detail. In outline, capital controls were abolished in 1979, deposit insurance was introduced in the same year, ceilings on lending were lifted in 1980, and the 'Big Bang' reform of city of London institutions in 1986 changed the culture of finance, by admitting Wall Street investment firms with their risk-taking bonus culture; eventually they absorbed or crowded out British investment banks. In the course of the 1980s, the separate compartments by function of British finance were finally dismantled.

Housing finance, which was still prudently rationed by the building societies, was also opened up from 1980 onwards. The residue of rent control was abolished, and council houses were offered for sale to their tenants, with councils forbidden to use the money to build new houses. This extended the market for housing finance, although housebuilding actually stagnated. Banks were allowed to enter mortgage lending in 1980, and from 1986 onwards, the building societies began to convert themselves from mutual societies into traded public shareholder companies. Their managers took the opportunity to help themselves to the accumulated reserves built up over several generations. The chief executives increased their pay about threefold (Shiwakoti et al, 2004). The shareholders were given between £135 each (Abbey National) and up to £2,000 (Halifax). Overall, about £36 billion in shares and cash were distributed by 1997. With the exception (among the giants) of the Nationwide, all the large societies (notably the Abbey National and the Halifax) took this route, although some sixty societies remained mutual. The prudence that had built the privatised societies into greatness now deserted them, and none of them managed to survive as an independent private entity. Banks and privatised building societies competed avidly to lend, and drove up house prices rapidly. The rise of house equity made homeowners feel wealthier, and discouraged them from saving.

The challenge for finance from the 1970s onwards was quite different from what it was in the early post-war years. The 1970s were also a transition period into a new type of economy. Labour productivity rose more slowly, and business profits also declined. Exporters were increasingly challenged, and the domestic manufacturing and coal mining sectors went into decline. The cyclical shock of high oil prices was mitigated by the development of North Sea oil fields, whose royalties is also helped to reduce the fiscal burden on government. But the consequent strong pound (pushed up by oil and the high-interest rates of anti-inflation policy) was another burden for manufacturing, which lost ground to competitors in Europe and in East Asia. Instead of British export earnings, City Banks now managed the earnings of exporters *into*

Britain. International capital mobility and floating exchange rates made it easier for large international balances to find their way into London.

Bankers faced a new challenge: how to recycle the large amount of liquidity placed in their hands. Financial deregulation gave them a free hand to lend it out. The problem was to find profitable outlets. Initially, the balances arose from the large surpluses of oil exporting countries. From the 1980s onwards, as domestic and international inequality surged, large domestic funds had to be recycled as well. It is difficult to be more precise. A reform of the presentation of the National Accounts in 1997 means that flow of funds accounts before 1987 are no longer available online, so it is difficult to monitor where the money came from and where it went.

The structural change in finance is dramatic: In the course of somewhat more than three decades, bank lending has risen from less than half of GDP, a level at which it had rested since the 1880s, to ten times as much, i.e. more than five times GDP. Liquidity ratios, which had been firmly regulated, declined from about 30% (on the broadest definition) down to almost nothing by the end of the century. Capital/asset ratios, which were more than ten percent before the First World War, fell down to less than five percent. Banking business, previously a sedate activity delivering between five and seven percent return on capital, acquired the attributes of highly profitable, and by implication, highly risky business, returning between 20 and 30 percent, an order of magnitude higher than the typical 2 to 3 percent of long-term economic growth a year (Haldane, 2009).

These changes transmitted themselves to the structure of the economy. Let us reduce the economy to four sectors: (a) manufacturing and mining, (b) government, health and education, (c) construction utilities and trade, and (d) finance and business services. Taking the gross value added to GDP of each sector, then between 1970 and

2005, sectors (b) and (c) each remained approximately constant. Manufacturing and mining declined from around 37 percent to 16 percent. At the same time finance and business services replaced it almost precisely, rising from less than 20 percent to 36 percent. Movements in employment were similar in magnitude, with manufacturing and mining declining sharply, and finance and business services taking their place. Financial intermediation on its own rose to some 14 percent of GDP value added. (Offer, 2012, fig. 4, 33).

For the financial system, making a profit in this service economy became a problem. This is where housing became so important. Housing is a long-lived commodity, and new construction only adds a tiny fraction in any given year. Supply cannot expand rapidly, but price was responsive to the supply of credit. With public housing declining and stigmatised, with private rental property inferior in quantity and quality, people in work competed for housing by bidding up prices. In doing so, they were supported by the deregulated financial system and by low interest rates. Up to the 1980s, mortgages, despite the large aggregate quantities, were a lacklustre asset almost entirely issued by non-traded mutual societies. The deregulation of mortgage lending, and the privatisation of the building societies, opened up what seemed to be a secure and open-ended supply of assets with a good financial yield. Effectively it allowed financial institutions to capture a rising share of the labour income of the country. For borrowers the deal was mitigated by the prospect of capital gains, as house prices increased much faster than incomes. Financial institutions leveraged their small capital with deposits from overseas, and from selling off the loans and lending the proceeds again, thus creating as much new credit as they dared, with leverage ratios rising up to levels of between 40 and 50 (Independent Commission on Banking, fig. 5.4, 128). On the borrowing side, mortgage borrowing debt rose about fourfold in relation to income between 1975 and 2005, while unsecured debt rose about the same (Fernandez-Corugedo and Muellbauer, 2006, chart 3, 43). By the end of the period, outstanding UK debt amounted to about three times GDP, and about 80 percent of that was secured on housing and commercial real estate (Independent Commission on Banking, fig. 3.4, 51; Lord Turner’s evidence, Great Britain (2009-10), 2 March 2010, Ev83).

The decline of productive investment opportunities also caused finance to turn its attention to the public services, to utilities, transport, infrastructure, education and health, which are mostly financed by the government. It is beyond the scope of this essay to deal with privatisation in its various forms. Suffice it to say here that the privatisations of utilities and other infrastructure provision in education and health and defence, constituted a successful move by finance to convert tax revenues that support these activities into profit streams (Offer, 2012, 30-34). Financial enterprise was not about identifying new productive opportunities, but about capturing a share of the labour income flow, the most reliable and stable revenue source available. It was this revenue source which underpinned the huge profits, salaries and bonuses earned in the financial sector.

6. A Property Windfall Economy

The unshackling of credit in the UK in the 1970s eventually created what might be called a property windfall economy. It continued for more than thirty years, and for a long time had more winners than losers. For that reason, it enjoyed broad popular support. When costs increase, that is a sign of reduced efficiency, but in the property windfall economy, rising property values were taken by the media, in line with popular perceptions, to be a sign of health. Indeed, even four or five years after the crisis, much effort is being expended in restarting the property boom.

Among the winners may be listed, first, the borrowers. If they had to take out larger loans, and if their monthly outlays tended to rise (which they did; Offer, 2008, fig. 4, 551, and unpublished data from CML Research, provided by John Muellbauer), they acquired an appreciating asset. This asset could then be used to rise another step up the housing ladder, to bleed off some equity to finance consumption, to act as a nest egg in a world of unstable values and relentless inflation, and to bequeath to the children. Many of the baby-boom generation, who came of age in the 1960s and 1970s, did well out of the property windfall economy, and were hardly inclined to question it.

For the lenders, the property boom provided an expanding market for their activities. In rolling over increasing quantities of liquidity that accumulated within the system in consequence of global trade imbalances and the rise of domestic inequality, the open-ended housing market provide what seemed to be reliable and safe returns. The lending profits were creamed off by a small elite of lending companies and by their executives, who took a lion's share of the profits, with rest going to shareholders, some of them pension funds, whose managers also paid themselves well. These large payouts to managers exacerbated the inequality that had helped to cause them in the first place.

The 'Great Moderation' of expanding housing, low consumer inflation, and asset price inflation, gave credibility to market efficiency doctrines. They appeared to vindicate the regimes of Thatcher, Reagan, Clinton, Blair and Brown, and their de-regulatory reforms. So much so, that the political left largely embraced these doctrines as well, and indeed went further in implementing them, pushing financial institution de-regulation beyond the boundaries still respected by their conservative predecessors. The Great Moderation also vindicated the exponents of market efficiency within economics.

Voters increased their standards of living, mostly due to cheaper manufactures of rising quality, imported from the Far East. In the 1980s and 1990s, the low cost of liquid energy and gas heating also stimulated motorization, and gas central heating. The transactions economy, with its large profits and large incomes, helped to maintain employment, and provided a strong flow of taxation. In gratitude, governments gave financiers substantial tax breaks, in the form of lower taxation on capital gains and on non-domiciled residents. From the 1990s onwards, governments also drew on the City to finance infrastructure investment through public-private arrangements (PFI) at markups greatly in excess of the cost of public borrowing. In the process, both ministers and civil servants benefited personally through a 'revolving door' system, in which ministers moved on to lucrative directorships, and civil servants moved in and out of the private companies they contracted with (Transparency International, 2011; Kremer 2012). On a fairly crude measure of an annual sample of instances of corruption reported in *Private Eye*, reported corruption rose about tenfold between the 1970s and the 2000s, with private-public deals generating the largest number of instances (author's work in progress with Danyal Arnold).

Who lost? When Old Labour morphed into New Labour, it moved into the centre ground of J.K. Galbraith's 'Economy of Contentment', in which the weak minorities were sacrificed for the benefit of comfortable majorities. As houseowners became increasingly wealthy, newcomers into the housing market were increasingly shut out. After 2001, house prices rose three times more than incomes in ten years (National Housing Federation, 2012). In the more affluent parts of the country, it became impossible for ordinary workers in average types of jobs, even professional jobs, and even working couples, to move from rental into purchase (Offer, 2006, 284-285; Batchelor, 2007). The surpluses accumulated by houseowners and lenders (and speculatively, by some borrowers) were then channelled into providing rented accommodation, much of it of lower quality, for those who could not afford to buy. By 2011, renting families were spending almost half their pay for housing (Rawlinson, 2011). In order to be able to buy many had to put in much longer hours of work, requiring mothers to earn rather than look after children, and to spend what was left over on childcare. The effects on family structure and functioning have yet to be studied.

7. Climax

In 2007-8 the music stopped. Debt could be rolled over no longer. As in Japan and Scandinavia earlier, the housing and commercial property finance boom collapsed. In order to maintain the flow of real estate lending, prudential standards in the USA and in Britain had been lowered, and by 2006, the high levels of property values and debt could no longer be supported out of the incomes of increasingly marginal borrowers. Once default began, it began to spiral downwards, and eventually shook the foundations of the whole financial system, which fell into a crisis that is far from ended (Duca et al., 2010).

A good deal of the debate about the crisis has taken the form of a technical discussion about the structure of financial institutions. In the UK, Competition and Credit Control of 1971 began the dismantling of functional specialisation in British finance, and the unclasping of the credit ‘corset’ in 1980s and mortgage lending by the banks, and the Big Bang in the City of 1986 opened the way for universal ‘one-stop’ global banks, which combined payments, lending, investment, mortgages, and ‘investment banking’, i.e. speculative financial activity for corporate clients, wealthy individuals, and on their own account.

The UK did not have any Glass-Steagall legislation to go back to, of the kind that had separated retail and investment banking in the United States. After the collapse of much of the UK banking system, and its bailout by government at taxpayer expense, many voices advocated the erection of such barriers. The Independent Commission on Banking (the Vickers Commission), which reported in 2011, recommended a porous separation, further diminished by uncertainty and the postponement of its implementation until 2019.

Is that likely to restore stability to the banking system, let alone that kind of stability it had enjoyed for more than ten decades after 1866? What are the fundamental requirements? It seems to me that the core function of the banking system, that public policy needs to safeguard, is the payment systems. In the summer of 2012, the electronic payments system of several banks failed for short periods. That provided a reminder of the importance of this function. Reliable and secure payment is what the great Victorian and inter-war Clearing Banks provided.

The second issue is what to do with Real Estate. If the banking industry is to be broken up by function, then housing loans are not a suitable activity for narrow banks. Real estate provides the collateral backstop for the bloated banking system. 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. The strictures of George Rae, in *The Country Banker*, still hold. The Victorians knew why they kept away. There are several housing finance models available. Housing has been (and to some extent remains) in the public sector. That, in effect, was the nature of public housing. In the United States, no bastion of socialism, housing finance was kept under federal control by means of the FHA, and then of ‘Fannie’ and ‘Freddie’, until they were privatised in 1969, and they continued under semi-official tutelage afterwards, though not a very prudential one. Another option is the mutual/ethical model, like the North American Savings and Loans Societies, which had been regulated strictly until the 1980s, or the British Building Societies, which had built-in constraints on their expansion. The largest mutual institutions in the UK, the Nationwide Building Society, and the Co-operative Bank, survived the crisis unscathed, although the Nationwide did indulge in some wholesale borrowing, and the Co-op has recently come to grief due to an imprudent merger with the Britannia Building Society.

In the Vickers Committee report, there is no consideration of keeping housing and commercial property finance beyond the reach of the ring-fenced banks. After the financial crisis in Sweden in the early 1990s, the Swedish government had sufficient independence and moral capital to deal quite brutally with the banks. No such detachment appeared to be possible for British governments. The Vickers Commission itself, despite being described as ‘Independent’ in its title, had two bankers among its five members. Its ‘ring-fenced’ banks would still be able to provide housing finance. Implicit in this decision (and the decision to place its functional boundaries *within* institutions, and not between them) was an acceptance that financial crises would continue; that the property windfall economy, or some variant of it, would be allowed to operate, at half-cock if necessary; that the immediate cost of preventing crises in the future was greater than their discounted future cost. The City honeypot was too dangerous to tamper with. The economy had changed so much since the 1970s that unwinding finance was too large a task to attempt.

Which leaves the problem still on the table. Finance is a heavy cost on the economy. If I believed in efficient markets, I would say a 'deadweight cost', a large rent levied for the benefit of those who administer the surpluses of Britain's suppliers, and the assets of its rich. Financial stability, it appears to me, is not just a matter of institutional design. It is not only a question of where boundaries will run, and which type of institution will be allowed to generate which type of credit. A return to stability requires a return to that credit rationing that gave so much pain to the bankers of the 1960s. It requires taking the windfall away. It requires pushing credit back into the bottles from which it had escaped. Is that possible? That is not just a banking question, but a social and political one. Its resolution, or the failure to do so, will determine the future course of British economy and society. The stakes are that high.

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