The small bank failures of the early 1990s: another story of boom and bust

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- Prior to the recent global financial crisis, the Bank of England last provided emergency liquidity assistance to banks in the early 1990s. This was intended to prevent contagion from a group of small banks to larger, systemically important financial institutions.
- The Bank of England is now in a better position to guard against many of the vulnerabilities that led to the small banks crisis. History suggests that regulators should continually look for early warning signs of heightened risk in the financial system, such as rapid credit growth, a decline in underwriting standards and large shifts in business models.

Overview

'There are several questions banks should ask themselves. Do they really pay attention to the lessons of history — for example the property crisis of the early 1970s? Did they really monitor the credit criteria which had served them well in the past?' — Robin Leigh-Pemberton, Governor of the Bank of England (1993).[2]

The early 1990s witnessed the failure of a large number of small banks in the United Kingdom. Although these banks were not by themselves systemically important, the episode was serious enough for the Bank of England to provide emergency liquidity assistance to a few of them in order to prevent contagion to larger more systemically important banks.

The origins of the crisis lay in the banking system's response to the deregulation of the UK retail banking system. A combination of rapid growth in lending to households and lower underwriting standards as banks competed aggressively for business left them exposed to heightened risk of loan losses. Losses crystallised after the UK economy experienced a downturn in the early 1990s, exacerbated by tight monetary policy. Banking system credit losses in the United Kingdom in the early 1990s were over three times higher than they were in the recent financial crisis.

As well as being vulnerable to loan losses, many small banks were overly reliant on short-term wholesale funding, in particular from local authorities. This left them exposed to funding risk which materialised once market participants lost confidence in their creditworthiness. Loan losses and funding outflows led to the eventual failure of 25 small banks operating in the United Kingdom at that time.

The Bank of England is now in a better position to guard against the vulnerabilities that manifested themselves almost a quarter of a century ago. There have been improvements in the regulatory framework for banks following the recent financial crisis; for instance, tougher minimum liquidity and funding requirements have been introduced to reduce banks' exposures to an outflow of wholesale funding. Macroprudential oversight can help spot risks, including rapidly increasing credit provision and funding vulnerabilities and the Financial Policy Committee has been given a range of powers to help mitigate those risks.

Nonetheless, history tells us that regulators should remain vigilant. The events leading up to the small banks crisis in the early 1990s are not dissimilar to those that have resulted in many crises before and since. Looking for early warning signs of heightened risk in the system, such as fast credit growth, decline in underwriting standards, and rapid changes in business models, will help the Bank of England protect the financial system against such risks.

(1) The authors would like to thank Ian Bond, Eric Engstrom and Alex Merriman for comments and George Barton and Tiago Dos Santos for their help in producing this article.
(2) Governor's speech to the Chartered Institute of Bankers (1993).

Between 1990 and 1994, 25 small banks operating in the United Kingdom failed in some sense.[1] A concentration on domestic property-related loans, coupled with reliance on wholesale markets for funding, left the small bank sector vulnerable to the recession at the time. Although these banks were very small — even collectively — relative to the aggregate level of UK economic activity — the episode was serious enough for the Bank of England to provide emergency liquidity assistance to a number of them in order to avoid contagion to the wider banking system.

This is one of a series of *Quarterly Bulletin* articles focusing on historical episodes of financial instability in the United Kingdom.[2] The purpose of examining this and other historical episodes is to build a better understanding of the causes of financial crises, and to disseminate this knowledge to a wide audience. This article aims to draw out the lessons from the early 1990s episode that may help the Bank of England to achieve its objective of maintaining financial stability.

The first section of the article explains how a number of factors — the pre-crisis liberalisation of the financial sector, its impact on competition and the overall macrofinancial environment — contributed to the crisis in the small banks sector. The second section then describes how the crisis unfolded, explaining the causes of bank failures, and the Bank of England's response. The last section considers the lessons for avoiding and managing banking crises today.

Origins of the small banks crisis

A raft of measures was implemented in the 1970s–80s aimed at liberalising the UK financial sector. These changes led to an increase in competition in the provision of financial services, which resulted in banks lowering their lending standards and contributed to a boom in credit.

Financial liberalisation and credit expansion

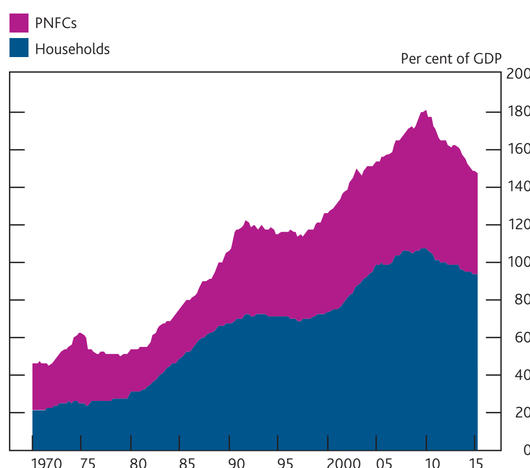
Prior to 1971, the Bank of England determined the maximum amount of credit that banks could extend. In 1971, the authorities introduced a 'new approach to Competition and Control', primarily to promote competition in the highly cartelised banking sector. This new approach aimed at controlling credit supply by setting its price rather than by limiting its quantity. Early teething problems with supervising a more liberalised financial system were witnessed with the Secondary Bank Crisis in the early 1970s. A number of smaller and medium-sized 'fringe' banks had funded themselves from recently deregulated wholesale markets to finance property lending. But many of them failed once the property price boom went into reverse.

Even then, some credit constraints remained, but banks were freed up further to increase credit provision following the removal of the so-called 'corset' in 1980, which allowed banks to increase credit provision. The corset was a mechanism that penalised banks for rapidly expanding their deposits, thus constraining the rate at which banks could increase their domestic lending.[3] But it became less effective after the abolition of capital controls in 1979 that meant credit could be provided directly to UK borrowers from abroad.

Banks responded to the removal of the corset by expanding their domestic mortgage lending — a market which had until then been dominated by building societies and which was seen as profitable and 'low risk'. Banks' share of new mortgage lending consequently increased from around 10% in 1980 to 40% in 1988.

A rapid boom in domestic lending over the decade ensued. The supply of credit, no longer limited, responded to high demand during a housing and commercial real estate (CRE) boom. Mortgage demand was supported by interest rate tax relief and endowment products that at the time appeared attractive. Between 1985 and 1989 residential property prices increased by nearly 80% and CRE prices by almost 90%.[4] Throughout the 1980s, lending to households was strong and overall lending accelerated in the late 1980s as CRE lending increased materially. In aggregate, non-bank private sector debt doubled relative to GDP during the 1980s (**Chart 1**).

Chart 1 Non-financial private sector debt[(a)]



Sources: Bank of England, Office for National Statistics (ONS) and Bank calculations.

(a) ONS data are not available before 1990. Before then, ONS household and private non-financial corporations (PNFCs) debt series are assumed to grow at the same rate as the Bank of England's household and PNFC lending series.

(1) Throughout this article, we define failure as entering administration or liquidation, relying on liquidity support from the Bank of England, or closing down after having authorisation revoked.
(2) Previous articles looked at the failure of the City of Glasgow Bank in 1878 (Button *et al* (2015)) and lessons from Japan's banking crisis in the 1990s (Nelson and Tanaka (2014)).
(3) See McLeay, Radia and Thomas (2014) for a further explanation of how extending credit can increase deposits in the banking system.
(4) See Zhu (2002).

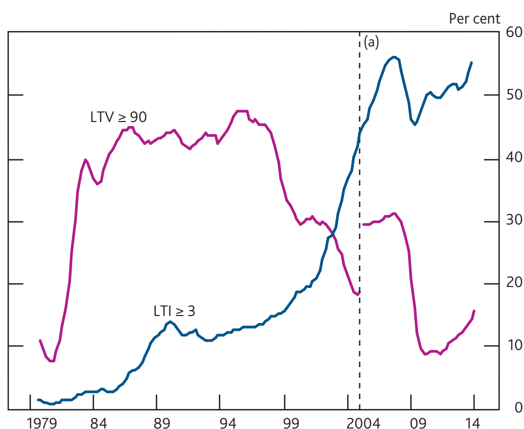
Competition and lending standards

Mortgage lending and retail deposit-taking had traditionally been the preserve of building societies, so increased competition from banks put pressure on their business models. In response, the government decided to allow building societies to broaden their activities to include the provision of non-mortgage loans. They were also allowed to access wholesale funding markets, which were at the time cheaper than retail deposit funds. A number of building societies converted into banks. These changes exposed banks to more competition from building societies, as they became freer to respond to market conditions.

Banks also faced competition from specialist mortgage lenders that relied on low wholesale funding costs.(1) This forced banks to reduce their margins to remain competitive. For example, among other innovations, for the first time in 1985 UK banks offered interest on current accounts. The net interest margins of the four largest clearing banks fell from an average of 5.7% in 1985 to 4.7% in 1989.(2)

As lower margins put pressure on banks' profits, they sought to increase lending by reducing their lending standards. This was evident on two metrics in mortgage lending — the loan to value (LTV) ratio and the loan to income (LTI) ratio, which measure the amount lent as a proportion of the value of the property and of the borrower's income respectively. Both of these ratios rose during the 1980s (**Chart 2**). By the late 1980s, almost half of new mortgages advanced had LTV ratios of over 90%.

Chart 2 New mortgages advanced for house purchase by LTV and LTI



Sources: Council of Mortgage Lenders (CML), Financial Conduct Authority (FCA) Product Sales Data and Bank calculations.

(a) Data from the FCA's Product Sales Database (PSD) are only available since 2005 Q2. Data from 1979 to 2005 Q1 are from the discontinued Survey of Mortgage Lenders (SML), which was operated by the CML. The two data sources are not directly comparable and shares are illustrative prior to 2005 Q2.

Monetary policy in 1990

In October 1990, the United Kingdom joined the Exchange Rate Mechanism (ERM) of the European Monetary System. The Deutsche mark (DM) was the *de facto* anchor currency against which sterling was pegged. In Germany at the time, inflationary pressures following the reunification resulted in the Bundesbank tightening monetary policy. Although there were already signs of a domestic recession, UK interest rates — which had been raised from 1988 in preparation for the ERM — were kept high in order to keep sterling within its exchange rate band against the DM.

This exacerbated the slowdown in the economy. Annual GDP growth fell from over 4% in June 1989 to minus 1% two years later. As growth slowed there was a precipitous fall in property prices — residential and commercial property prices fell by 14% and 27% from peak to trough respectively. Mortgage borrowers faced the twin impact of rising mortgage costs from higher interest rates, and a reduction in the value of their property. The unemployment rate — which even at the peak of the boom was 7% — rose steadily, to 10.5% by 1993.

Against this background, worsening lending standards left banks vulnerable to credit losses from property-related exposures. As the economy slowed and interest rates rose, borrowers struggled to make repayments on their loans. Consequently, banks' write-offs on their mortgage lending increased significantly.

The crisis unfolds

Much of the banking sector's difficulties in the early 1990s reflected the recession at the time, which was shared by a number of advanced economies, following the late 1980s boom. In this fragile environment of high loan losses, the reliance of a number of small banks on short-term wholesale funding left them vulnerable to a liquidity shock (ie banks need to quickly refinance maturing debt at a time when creditors are less willing to lend). When these funds dried up in 1991, the Bank of England intervened to prevent the failure of a number of small banks and potential contagion to the rest of the banking sector. This section sets out these events, starting with a description of the structure of the UK banking system in the early 1990s, and following on with losses on banks' loan portfolios, funding problems and finally the authorities' reaction.

Structure of the banking system in the early 1990s

The UK banking system at that time can be divided into a few broad categories: (i) the large retail and investment banks, (ii) branches of foreign-owned banks, and (iii) small and medium-sized banks. **Table A** shows the number of banks in

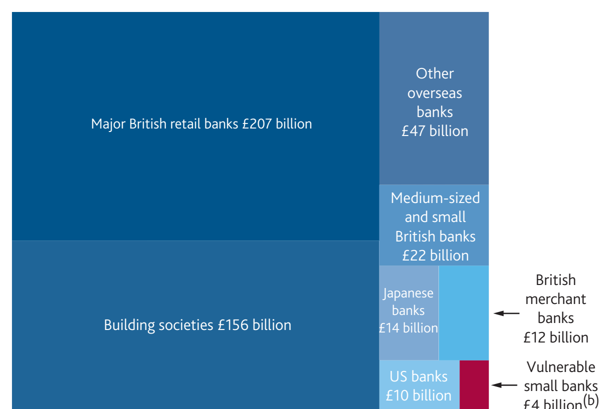
(1) In general, specialist mortgage lenders had access to more funding sources (eg often in the form of residential mortgage-backed securities) than small banks. The specialist mortgage lenders have traditionally focused their attention on one or more specialised markets, such as buy-to-let or self-certified mortgages, or lending to customers with adverse credit histories.
(2) Callen and Lomax (1990).

each category from February 1990 up to February 1994. Of the 540 banks operating in the United Kingdom in 1990, just less than a quarter were small or medium-sized banks.(1) The majority of the lending to UK residents was done by the largest UK retail banks and building societies (**Figure 1**). Building societies had a much larger market share of mortgage lending than they do currently, accounting for around 60% of the stock of mortgage lending. Lending to companies, however, was largely done by banks. The small banks whose solvency was threatened in the early 1990s played a small part in the aggregate provision of credit, accounting for less than 1% of the stock of UK lending to the non-financial private sector.

Table A Number of authorised banks in the United Kingdom

	1990	1991	1992	1993	1994
Commercial and investment banks	75	70	72	73	71
Branches of foreign banks	340	336	328	332	360
Small and medium-sized banks	125	116	111	96	80
Total	**540**	**522**	**511**	**501**	**511**

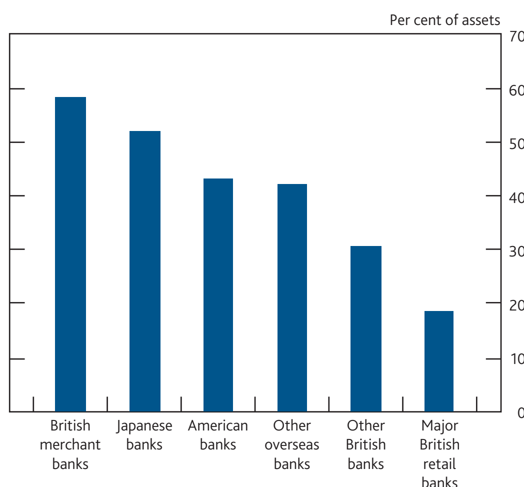
Figure 1 UK lending to households and companies at end-1989(a)



(a) Stock of sterling-denominated loans to UK residents, excluding financial institutions.
(b) Estimate based on data available for the banks on the Bank of England's vulnerable bank watchlist.

As well as doing a considerable amount of lending to the UK private sector, foreign and British investment banks were among the most active in UK money markets. Nearly 60% of investment banks' sterling-denominated loans were made in wholesale markets (**Chart 3**). Japanese banks also lent a substantial amount of money in these markets. At the end of 1989, they had £15 billion of loans outstanding in money markets — marginally less than investment banks, and equivalent to half their lending in the United Kingdom. The weakness of Japanese banks as a result of a domestic downturn in the early 1990s, and their eventual withdrawal from UK markets likely exacerbated the tightening in sterling money market conditions.

Chart 3 Share of sterling-denominated loans in UK wholesale markets in December 1989(a)

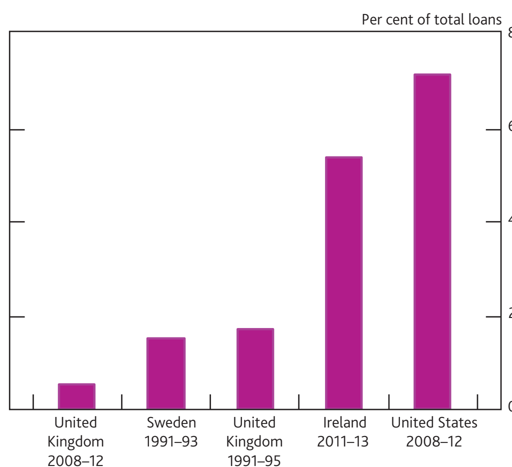


(a) Chart shows major sterling-denominated lenders grouped by type of bank.

Credit losses and problems at small banks

UK banks' aggregate losses on domestic household lending in the early 1990s were high. Cumulative write-offs on residential mortgages between 1991 and 1995 were similar to those in Sweden, which suffered an outright systemic banking crisis with the failure of its largest banks. They amount to over three times the size of credit losses in the recent financial crisis (**Chart 4**).

Chart 4 Banks' cumulative write-offs(a)



Sources: Bank of England, Central Bank of Ireland, Council of Mortgage Lenders, FDIC, Glas Securities, MIAC-Acadametrics, Nordiska Ministerrådet, Prudential Regulation Authority, Statistics Sweden, published accounts and Bank calculations.

(a) For the United Kingdom, 1991–95: banks and building societies and 2008–12: for a sample of the largest mortgage lenders as of end-2007. Swedish losses based on housing credit institutions. Irish losses are from 2011 to mid-2013 and refer to Allied Irish Bank, Bank of Ireland and Permanent TSB. United States losses refer to all FDIC-insured institutions. All losses are scaled to the share of loans outstanding at the beginning of the period.

The larger UK banks had enough capital to absorb these credit losses without threatening their solvency. But problems arose at a number of small banks. The degree of their exposure to

(1) They accounted for less than 5% of UK lenders' total assets.

property-related loans was uncertain but thought to be substantial, which meant credit losses could potentially threaten their solvency. In the autumn of 1990, Authority Bank, a small lender, went into administration as a result of a large exposure to a group of property and leasing companies. In February 1991, Chancery Bank, which also had large exposures to property-related lending, also failed.

The bad debt problems experienced by small banks in late 1990 and early 1991 were well publicised and contributed to growing nervousness in money markets. The failure of Authority Bank closely followed the failure of British and Commonwealth Merchant Bank (BCMB), which went into administration earlier that year due to difficulties faced by its parent company. BCMB was unable to replace funding, including from short-term money markets, as counterparties withdrew due to uncertainty following the failure of the parent company and fears about losses from property-related loans.

Funding problems and contagion

BCMB's reliance on wholesale funding markets was not unique. Perhaps as a result of generalised low interest rates in wholesale funding markets in the late 1980s, many small banks were heavily dependent on these markets, and in particular on larger banks and local authorities who provided nearly half of their funding. Local authorities were attracted by the higher deposit rates that small banks often paid relative to their larger peers. In June 1990, a quarter of local authority funds placed with banks were held at 40 small banks.

Such dependence on funding from local authorities meant that small banks were vulnerable to deposit flights in the event of a confidence shock. A handful of small banks relied on local authorities for more than one fifth of their funding. The failures of three banks — BCMB, Chancery Bank and Edington Bank (a small investment bank that failed in November 1990) — had already served as a warning to local authorities, whose funds at these failed banks had been locked in administration.

The closure of Bank of Credit and Commerce International (BCCI) in July 1991 — due to an instance of fraud — represented a turning point for local authorities. A number of them lost access to funds placed with BCCI. At this point, local authorities began to withdraw virtually all their short-term deposits from some small banks. There was a 'flight to quality', with funds redeposited with larger clearing banks. A timeline representing the crisis is shown in **Chart 5**. The share of small banks' deposits from local authorities fell from 21% in December 1990 to only 6% nine months later in September 1991 (**Chart 6**).

Larger banks, including foreign banks, also began to reappraise their exposure to the small banks' sector during this period. Foreign banks, in particular, retrenched from interbank markets. As a result, UK banks' total wholesale borrowing fell by nearly 15% during 1991 (**Chart 7**). Both US and Japanese banks were experiencing problems in their home markets, which may have exacerbated their reaction to the UK downturn. Within four years, 25 small banks had in some sense, failed.

Chart 5 Timeline of the crisis

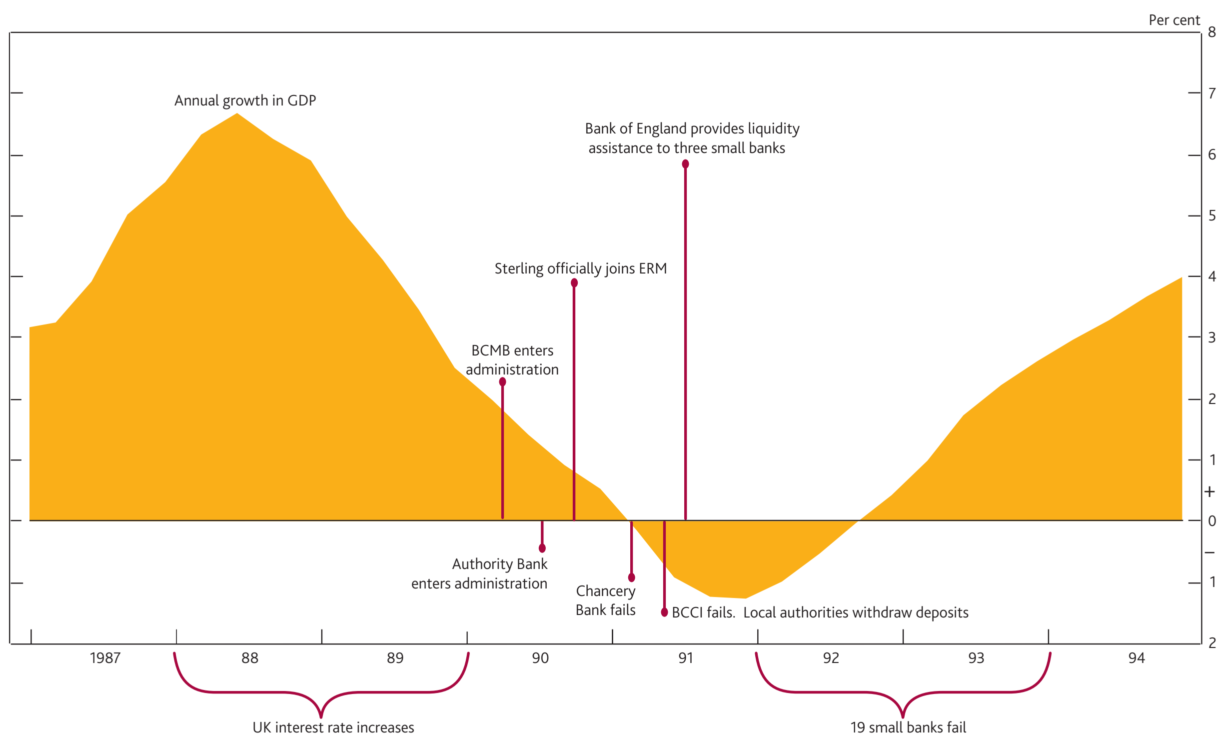


Chart 6 Small banks' deposit funding from local authorities

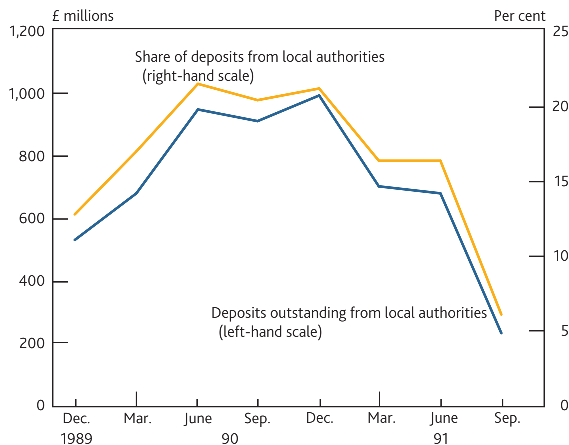
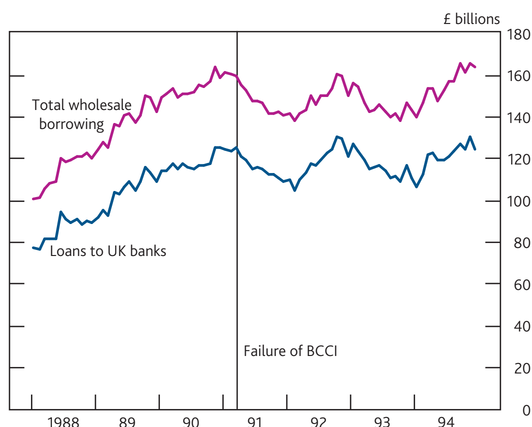


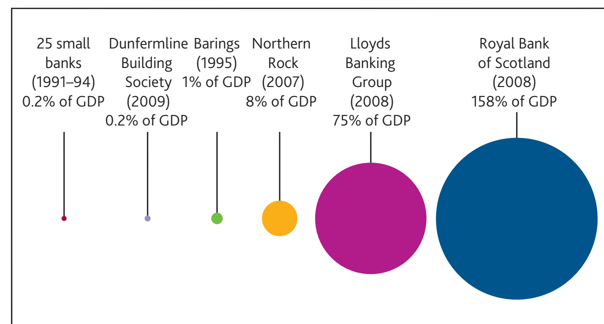
Chart 7 UK banks' sterling-denominated wholesale unsecured lending and borrowing



The succession of small bank failures was not in itself of systemic importance — the very small combined size of the banks that failed meant that the loss of financial services provision in the United Kingdom was negligible. The assets of the small bank sector as a whole were equivalent to only 2.3% of GDP in 1991, about 35 times less than those held by the major British banks. The small banks that failed had total combined assets of only 0.2% of GDP — equivalent to those of Dunfermline Building Society, which failed in 2009. This stands in sharp contrast to big bank failures in 2008 (**Figure 2**). But the actual and prospective failures had led to an environment of uncertainty and fear in wholesale markets, and there was a possibility of contagion to larger, more systemically important banks.

There are both direct and indirect channels of contagion from bank failure. In terms of 'direct' contagion, larger banks' exposures to small banks were generally small in this particular case, and so this channel did not pose a material risk to large banks in 1991.[1]

Figure 2 Size of bank failures in the United Kingdom since 1990 (per cent of GDP)[a]



Sources: Published accounts and Bank calculations.

(a) Bubbles show total assets as a percentage of annual GDP in the year of failure.

However, there was greater evidence of (and potential for) contagion through 'indirect' channels. First, banks can be affected through confidence effects that cause investors to reassess risks from banks, and reduce or cut the funding they provide them with. The environment of uncertainty created in interbank and wholesale funding markets after the closure of BCCI in the summer of 1991 made contagion through this channel a potentially important risk.

Another indirect channel of contagion is that the failure of one or more financial institutions — even if small — can cause liquidity providers to reconsider their lending to bigger financial institutions which they think have a similar business model and/or vulnerability to the same adverse shock (so-called 'information based' contagion).[2] This occurs because collecting information on the creditworthiness of individual banks is costly. The failure of one bank can therefore be sufficient for market participants to draw strong inferences about the viability of other banks — even if those inferences turn out to not be warranted by the underlying financial positions of those other banks. Such contagion was also possible in 1991, as medium-sized banks also relied on local authority and bank funding, although not to the same extent as small banks. There was also some concern that contagion might even spread to one or more of the biggest UK banks.

The UK authorities' reaction

In the weeks following the closure of BCCI, the Bank of England considered that the risk of contagion through these indirect channels had become large enough to have wider implications for financial stability. In particular, the Bank worried that risk aversion in funding markets could spread to larger banks, and may even consequently cause problems at large systemically important banks, if problems in wholesale funding markets were to worsen. As an internal July 1991 Bank report put it: 'the systemic danger of National Home Loans

(1) See Ferrara *et al* (2016).
(2) See Santor (2003).

[a vulnerable small bank] is that it has a substantial £600 million of commercial paper in the market and it has £90 million of funding from quality corporate names'. In other words, the Bank feared that the small banks' problems would spread to a different sector of the funding market, and a sector on which some of the larger banks were heavily reliant.[(1)]

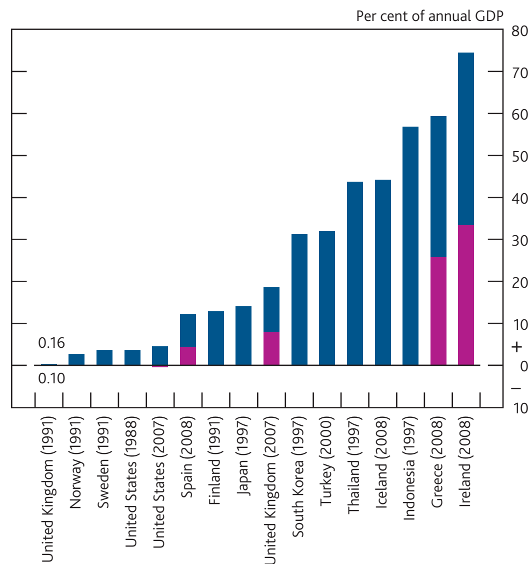
At this point, the Bank of England was already playing a central role in managing the small banks crisis by acting as a mediator between banks, encouraging the larger clearing banks to lend to the small banks' sector. The Bank did this by arranging meetings between the key stakeholders concerned. This approach had been successful during the 1970s Secondary Banking Crisis when the Bank had set up a lifeboat operation — whereby larger clearing banks were asked to continue to provide funding to smaller 'secondary' banks with a liquidity problem to avoid a systemic crisis. Perhaps because of the less systemic nature of the small banks in the early 1990s and the more competitive environment in the banking sector, efforts to facilitate the provision of liquidity from the clearing banks proved unsuccessful.

The Bank decided instead to arrange official liquidity support when three more small banks — National Home Loans (NHL),[(2)] City Merchants Bank,[(3)] and East Trust — ran into severe funding problems. The Bank did this either by providing funding directly to the small banks in trouble, or by guaranteeing credit lines from larger clearing banks. The Bank only disclosed the provision of official support over a year later.

In addition, the Bank kept a further 40 small banks under close supervisory review.[(4)] These banks were generally dependent on wholesale markets for more than one fifth of their funding. The banks were required to provide regular additional information, especially relating to their liquidity and cash flow. The Bank continued to do this even after it had provided liquidity support and conditions in money markets eased. This is in part because small banks continued to close down until 1994. In some cases, the Bank helped institutions to wind down their business in an orderly manner.

The economic cost of the failure of these institutions was small. Together, the small banks that failed had assets of approximately £1 billion — less than 0.2% of GDP in 1991. In contrast to many banking crises around the world, there was no government injection of capital into the banking system, although the Bank of England took a small loss on the credit that it extended (**Chart 8**). In 1993, the Bank disclosed that it had made provisions of £115 million against possible losses.

Chart 8 Fiscal costs of banking crises[(a)(b)]



Sources: Hoggarth and Soussa (2001), International Monetary Fund (2015) and Laeven and Valencia (2012).

(a) United Kingdom (1991): peak of Bank of England provisions.
(b) Other crises: cumulative gross financial outlays of central government on financial sector restructuring. Magenta bars show, where available, costs after recovery.

Lessons for today

There are a number of lessons that can be drawn from the early 1990s small banks crisis. The Bank of England is now better equipped in a number of ways to protect the financial system against the series of events which occurred then — through an improvement in micro and macroprudential regulation as well as a regime to resolve failing banks, among other things. If institutional memory is maintained, regulators' experiences of banking crises should continually improve their understanding of how to reduce their likelihood and impact. Some of the lessons from the early 1990s episode are discussed below.

Rapid change brings challenges for bank managers and their supervisors

As outlined in the first section of this article, the financial liberalisation of the 1970s and 1980s resulted in substantial changes to the structure of the UK banking system. This opened up the banking sector to more competition and innovation, as well as rapid credit growth. It is clear *ex post* from the credit losses during the recession that banks took on too much risk during the boom period.

(1) Bank of England Archives (Reference 9A257/1).
(2) NHL relied heavily on local authority funding, losing much of this in March/April 1991. By mid-May, only one third of the next two months' maturities were expected to roll over. Following BCCI's collapse most of this was lost. The clearers agreed to provide a £200 million facility, but only with an authority's guarantee. By February 1992, the Bank of England was committed to meeting all NHL's liabilities and bought it outright in 1994 for a nominal sum in order to facilitate control over asset realisation.
(3) City Merchants' liquidity difficulties were less severe but client money funding was at risk. The Bank again guaranteed a facility, allowing City Merchants time to run down the business. After discussion with the Bank, NatWest and Lloyds agreed to provide a £30 million facility for two months (with possible extension up to twelve months) provided the Bank of England would cover the risk.
(4) See Bank of England (1993).

Rapid change and innovation may often create challenges for bankers and regulators alike. Bank managers may feel tempted, under competitive pressures, to take on more risks to maintain or increase their returns. Banks can do this by changing their business models, for example to lend in lucrative markets that they are less familiar with. These risks can sometimes be misunderstood or underestimated. In the late 1980s, this risk manifested itself in a rapid expansion of lending and a lowering in lending standards. Ahead of the most recent crisis, rapid innovation came in the form of some types of securitisation that were systematically mispriced.

For supervisors, spotting these risks when they are building up can be difficult, but rapid and large-scale responses to shocks on the part of banks may act as a warning sign that they may be taking on excessive risk. In the United Kingdom, more detailed regulatory data are now collected on a regular basis from banks than in the early 1990s, and the Prudential Regulation Authority (PRA) — the Bank of England's supervisory arm — is better equipped to identify and tackle the build-up of risks in banks' balance sheets.

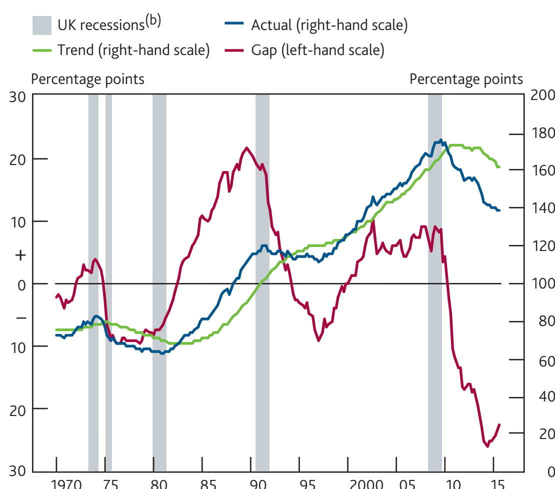
Rapid growth in credit may be a sign of excessive risk-taking

As the 1990s small banks' experience highlighted, rapid lending growth can be an indicator of a decline in lending standards. The pattern of a generalised rapid expansion of credit provision fuelling a property boom, followed by an eventual crash and large credit losses is one that has often repeated itself in banking crises in the past and around the world.[1] It was also a feature of the recent global financial crisis in many countries, including the United Kingdom.

Macroprudential regulation can guard against this risk by developing and monitoring measures of excess aggregate credit growth. In the United Kingdom currently, the Financial Policy Committee (FPC) looks at a number of core indicators of potential excess credit to do this, including the credit to GDP gap.[2] This indicator measures the deviation of aggregate credit to households and non-financial companies relative to GDP from its long-run trend. Interestingly, if the UK authorities had been using the credit to GDP gap indicator in the 1980s, it would have likely been flashing a warning sign of a pending downturn. The level of credit rose to 20% above trend ahead of the recession and associated small banks crisis in the early 1990s compared to 10% in the run-up to the global financial crisis (**Chart 9**). That said, at the current conjuncture, the FPC has indicated that there are a number of drawbacks with the credit gap measure and that there is no simple mechanistic link between this indicator and the FPC's policy.[3]

Even at an individual bank level, rapid credit growth can be a powerful predictor of failure. This was the case in the early 1990s bank failures. On average across the banks that went on to fail, credit growth was 30% at its peak in 1989, almost twice the rate of the banks that survived (**Chart 10**). Of the small banks in the fastest-growing quartile, 40% went on to fail. Unsurprisingly, the banks that failed reduced their lending materially in 1990 as losses started to build up, perhaps in a bid to improve their liquidity positions and their lending portfolios.

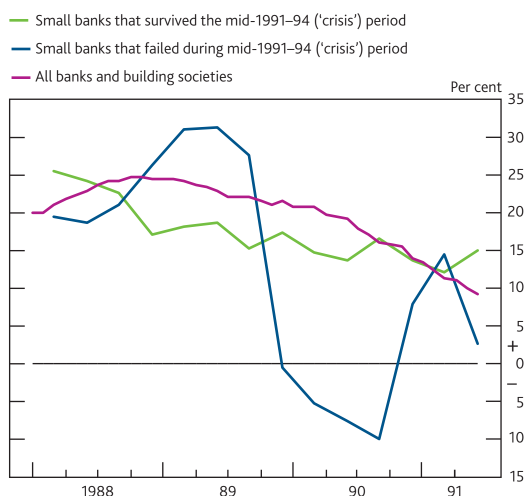
Chart 9 Domestic credit relative to GDP[(a)]



Sources: British Bankers' Association, ONS and Bank calculations.

(a) The credit to GDP gap is calculated as the percentage point difference between the credit to GDP ratio and its long-term trend.
(b) Recessions are defined as two consecutive quarters of negative quarterly real GDP growth.

Chart 10 Annual growth in bank lending to UK non-bank private sector



Source: Logan (2000).

(1) See, for example, Laeven and Valencia (2012).
(2) These core indicators are published in the Bank of England's semi-annual *Financial Stability Report*.
(3) See Bank of England (2015a), page 36.

Undiversified lending and funding can leave banks vulnerable to shocks

A clear lesson from the small banks crisis was that overreliance on a single source of funding can leave banks vulnerable to a withdrawal of funds. When the local authorities withdrew their funds, small banks struggled to find short-term finance to pay out these deposits, and eventually failed or relied on the Bank of England for liquidity support. This risk crystallised in a similar way in the recent crisis: Northern Rock eventually failed in 2007 when it could not repay lenders following its overreliance on funding from short-term wholesale markets.

Two regulatory requirements are being introduced, following the financial crisis of 2008, to guard against vulnerabilities to liquidity runs. First, the Liquidity Coverage Ratio (LCR) requires banks to hold enough liquidity to cover a short-term outflow of funds. Second, the Net Stable Funding Ratio (NSFR) will require them to fund long-term illiquid assets with long-term stable liabilities, and should ensure that banks are less vulnerable to funding shocks in the first place.

Lack of diversification was also a problem in the small banks' lending decisions. Logan (2000) shows that the banks that failed during the 1990s had less diversified lending portfolios than those that survived — the median bank (in terms of size) that failed had nearly half of its assets concentrated among ten counterparties. The banks that ended up failing also had much lower levels of capital, leaving them more vulnerable to a few of their creditors defaulting. The regulatory capital framework now guards against such risks. When setting capital requirements for banks, the PRA assesses risks from the concentration of exposures.(1)

The need to deal with 'too big to fail' issues

While the early 1990s crisis was limited to small UK banks, the Bank of England was concerned at the time that stress in wholesale markets may also affect bigger banks' ability to fund themselves, thereby potentially destabilising them. Indeed, larger UK banks were also hurt by the recession, and three of the major UK banks (Barclays, NatWest and Midland Bank) lost their triple-A credit ratings by end-1991.

In the event, limited contagion in funding markets meant that the UK authorities did not at the time have to grapple with the reality of a large bank failure. The hypothetical question of how to deal with a large bank failure without using taxpayer funds was left unanswered in the aftermath of the crisis. In the recent global financial crisis, some of the largest UK banks were bailed out at enormous public cost.

The Bank is now better placed to resolve bank failures through a framework called the Special Resolution Regime.(2) In the case of a small bank whose failure would have no systemic consequences, the Bank of England would put it into a bank insolvency procedure — ensuring that insured deposits are promptly paid out while winding down the bank. If this course of action could give rise to systemic consequences, other tools are available to the Bank to stabilise the firm. For larger banks, the Bank of England would use its powers to carry out a 'bail-in' to absorb losses and restore solvency using the bank's *own* resources — shareholders and unsecured creditors are written down and/or converted to equity to restore the bank's capital position.(3) Regulatory standards are being introduced internationally to ensure that bail-in resolution strategies can be carried out in the event of a bank failure.(4)

Prompt and covert official liquidity provision can stop contagion through financial markets

It is difficult to measure the success of the Bank of England's intervention in financial markets in 1991. Conditions in the wholesale funding markets did not continue to worsen — but it is difficult to attribute this solely to the Bank's provision of official support. It is likely that the covert nature of the liquidity support helped to calm financial markets without alarming participants about specific firms. However, the failure of the Bank of England's original plan to set up a 'lifeboat' operation slowed down the official response to the crisis — at the cost of worsening conditions in funding markets.

The Bank of England now has a clear framework for providing liquidity insurance facilities. The Bank's Discount Window Facility (DWF) and Contingent Term Repo Facility (CTRF) are both available to banks and building societies that experience a liquidity shock. Firms facing an idiosyncratic or market-wide shock would borrow from the Bank of England via the DWF, while the CTRF would be activated by the Bank in response to actual or prospective market-wide stress of an exceptional nature. In addition, the Indexed Long-Term Repo operation is available to banks to meet predictable liquidity needs. Banks and building societies are able to position collateral with the Bank of England in advance of a shock to facilitate drawing from these facilities in a quick and efficient manner.

Too little and too much competition can both be damaging to financial stability

The early 1990s small banks crisis shows that although competition imposes a welcome and healthy pressure on the banking system which can benefit customers (for example in the form of easier access to credit), competitive pressures can lead to the build-up of risks in the banking system. The lesson for regulators is to monitor banks' lending behaviour to ensure that they do not respond to these pressures in a way that endangers financial stability.

(1) See Bank of England (2015b).
(2) See Bank of England (2014).
(3) Chennells and Wingfield (2015) provide an introduction to the resolution of bank failure through bail-in. An indication of the type of tools that are likely to be used for different types of bank can be found in Table 1 of Bank of England (2015c).
(4) See Financial Stability Board (2015).

Nowadays, the Bank of England should be better equipped to deal with the market failures that may arise from either 'too little' or 'too much' competition. The PRA was given the secondary objective of facilitating 'effective competition', which Dickinson *et al* (2015) define as being achieved when 'market or regulatory failures are either not significant or else have been addressed'. To deal with risks arising from heightened competition, such as the weakening of lending standards seen in the 1990s small banks crisis, the PRA can rely on its judgement-based approach and supervisory powers to identify excessive risk appetite.

Conclusion

The credit boom in the late 1980s proved costly and resulted in a subsequent deep economic downturn in the early 1990s. This, in turn, contributed to the small banks crisis at the time and the need for the Bank of England to provide emergency liquidity assistance to a number of banks. However, the small banks crisis did not have a scarring effect on the United Kingdom's economy. And although the crisis threatened to spread to larger banks, the banks that failed were too small to have any lasting effect on the structure of the banking system. But the lessons from a familiar story of boom and bust in the property market, and a subsequent banking crisis, remain relevant today. It would be impossible and undesirable to make the financial system failure proof, but bearing these lessons in mind — both in spotting risks and vulnerabilities in the banking system, and on dealing with them — should help the Bank of England better safeguard financial stability in the United Kingdom in the future.

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