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Were banks special? Contrasting viewpoints in mid-nineteenth century Britain

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Abstract

In 1853 a Royal Commission was set up to investigate whether laws related to limited liability in Britain needed to be modified. As part of its evidence gathering the commission issued a questionnaire that included a number of questions on whether banks should be subject to the same liability laws as other types of commercial enterprises. This paper analyses the responses to the questions about banks to understand whether banks were seen as a special case. Support for modifying the law to make limited liability more easily available to banks was lower than for enterprises in general. Banks were seen as a special case because of the risk of bank runs and because their creditors were not able to assess accurately the riskiness of banks. But the special nature of banks caused others to favour limited liability because it made banks' capital levels more transparent. These arguments echo wider debates during the nineteenth century and are similar to contemporary theories for why banks are regulated.

Key words: Banking history, liability laws.

JEL classification: N23, G21, G28.

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1 Introduction

Company law, including how it applied to the banking sector, evolved substantially during the nineteenth century. At the beginning of the century commercial entities tended to be partnerships, operating with unlimited liability.[1] Barriers to incorporation as a joint-stock company decreased over the first half of the century. Access to limited liability for shareholders became possible following legislation in the middle of the century. These developments were mirrored in the banking sector, although there was lingering reluctance to move toward limiting liability until later in the century.

This article focuses on the debate about the liability laws for banks which was part of a Royal Commission formed in the 1850s to resolve the issue of whether commercial enterprises should have the freedom to incorporate with limited liability: the 1854 Mercantile Laws Commission. As part of its work, the commission issued a questionnaire that included several questions about whether or not banks should be subject to the same liability laws as enterprises in other sectors. The responses to these questions provide an insight into the extent to which banks were viewed as different or 'special', warranting a stricter set of liability laws for their shareholders, as well as the reasons why some believed unlimited liability should continue in the banking sector even if it no longer did so in other sectors of the economy. The reasons given in favour of unlimited liability in the banking sector show similarities with contemporary theories for why banks should be subject to regulations to ensure their stability.

The paper builds on Turner (2009) who discusses the debates about liability laws for banks during the nineteenth century. It also complements studies of the 1854 Mercantile Laws Commission by Bryer (1997) and Taylor (2006) who discuss the support for changing liability laws for enterprises in general, but do not focus on the arguments made concerning banks specifically.

The article proceeds as follows. Section 2 provides an overview of the development of liability laws in the banking sector in Britain during the nineteenth century. Section 3 discusses the 1854 Mercantile Laws Commission. Sections 4 and 5 compare the arguments for and against limited

[1] Under unlimited liability partners were jointly liable for a partnership's debts, which meant in the event the partnership was dissolved they had to cover any shortfall of assets relative to debts. Similarly for shareholders of an unlimited liability company in the event of the company being liquidated. Under limited liability, the shareholders, say, would not be responsible for covering the shortfall and thus could only lose as much as they had invested.

liability for banks made in the responses to the commission's questionnaire with wider debates during the nineteenth century and contemporary economic theories of banking regulation, respectively. Section 6 discusses the views on limited liability in the insurance sector expressed in the questionnaire responses. Section 7 concludes.

2 Liability arrangements in the banking sector in nineteenth century Britain

Prior to the 1850s the main form of liability arrangement in the banking sector, and in the British economy more widely, was unlimited liability. In England joint-stock banks had been permitted since 1826, with the proviso that a bank operated outside of a 65 mile radius of London (Hunt (1936)).[2] Similar legislation was introduced around the same time in Ireland, and banks in Scotland were in effect joint-stock enterprises under Scottish partnership law (Turner (2009)). But in each of these cases limited liability was not permitted. The only banks with limited liability were those with explicit permission to do so: the Banks of England, Ireland, and Scotland, the British Linen Bank, and the Royal Bank of Scotland. The restrictions on limited liability in the banking sector mirrored restrictions faced by enterprises in other sectors (Hunt (1936)).

Unincorporated companies did try to mimic the effects of limited liability through other means. Freeman et al. (2012) discuss the mechanisms used such as limited liability clauses in their constitutions, even if there was uncertainty about whether those clauses would be legally enforceable. But hardly any banks had such clauses: bank shareholders appeared to rely more on other mechanisms such as special rights to dissolve a bank if losses became too big. Most banks also included clauses specifying that shareholders were only liable in proportion to their shareholding ('pro rata' liability).

An act in 1857 enabled banks to incorporate with limited liability without requiring specific permission. After a further act in 1862, which removed a floor on the minimum denomination of shares, limited liability banking began developing.

[2] A joint-stock company is a company where its members have provided capital in return for shares which are transferable (e.g. by selling them to other investors). A joint-stock bank is a joint-stock company carrying out banking.

While banks were now free to incorporate with limited liability, unlimited liability did not disappear immediately. Between 1862 and the late 1870s unlimited and limited liability banks co-existed. According to Dun (1876), there were 52 limited liability banks and 82 unlimited liability banks in Great Britain and Ireland in 1875. Among the limited liability banks, only seven had converted from unlimited liability, with the rest new entrants since 1862. The perception that unlimited liability protected depositors was reflected in how limited liability banks had significantly higher paid-up capital ratios (Turner (2014)). For instance, based on data reported by Dun, the mean ratio of total capital and reserves to total assets ratio for unlimited liability banks in Great Britain and Ireland was 37.8%, while the mean ratio was 58.7% for limited liability banks. The difference is statistically significant at 1%. The coexistence of the two liability arrangements ended abruptly in 1878 when the City of Glasgow Bank failed. The banks' shareholders incurred large losses which was attributed to the shareholders' unlimited liability, although they also reflected the scale of the losses the bank had incurred on its assets.[3] While unlimited liability fell out of favour, the reluctance to switch to limited liability persisted. The Companies Act 1879 introduced another liability concept, reserve liability, under which a shareholder was liable for a bank's debt up to some multiple of their shareholding.[4] The number of banks with reserve liability grew rapidly after the passing of the Act, while there was a decline in the number of unlimited liability banks (see Acheson et al. (2010)).

3 The 1854 Mercantile Laws Commission report

In 1853 a Royal Commission was formed to investigate whether the elements of the laws of partnership related to limited liability of partners should be modified. It reported in 1854 (Royal Commission on the Mercantile Laws and Amendments to the Law of Partnership (1854)). The conclusion of the report was that no change in the law was necessary, although only five of the eight commissioners put their names to it. These commissioners did not believe they had received evidence pointing to unlimited liability reducing investment and were concerned that greater access

[3] See Button et al. (2015) for an account of the bank's failure.

[4] This was not a totally new idea. Reserve liability was suggested as a possible model for changing the liability laws in several of the responses to the Mercantile Commission's questionnaire; see Section 3.

to limited liability could lead to destabilising speculative behaviour. They did, however, recognise limited liability might have been desirable for enterprises too big for private partnerships to willingly undertake (e.g. docks, railways, and shipping companies) or for enterprises providing social benefits (e.g. baths and wash-houses, lodging houses, and reading rooms), but subject to sanctioning by Parliament or the granting of a charter. The three other commissioners who did not put their names to report all supported a change in the law (Taylor (2006)).

The split of opinion among the commissioners mirrored the differences in opinion among the respondents to a questionnaire the Commission issued as part of its evidence gathering. The commissioners highlighted the conflicting views on whether or not access to limited liability should be liberalised in the questionnaire responses: *'Your Majesty's Commissioners have been embarrassed by the great contrariety of opinion entertained by those who have favoured them with answers to their questions.'*

In the commissioner's report no mention is made of whether other certain types of enterprises required a special set of liability laws. Yet three of the thirty questions in the questionnaire were focused on banks. These questions, along with the first question about whether or not the responsibility of partners for partnership debts should change, are reproduced in Figure 1. The respondents' responses are included in full in an annex to the report. Their answers to the questions, especially to those shown here, provide an insight into whether or not there was support for changing the laws governing the availability of limited liability to firms in general and whether or not there was support for changing the law related to banks (and insurers) specifically. The questionnaire was sent to individuals and chambers of commerce in Great Britain and Ireland, as well as individuals in the United States and Continental Europe.

Bryer (1997) estimates the number of respondents from Britain who were for and against a change in the liability laws. He classifies a respondent having been for a change if they supported limited liability *for* either or both partnerships and joint-stock companies without requiring sanction by an authority and *against* if they were against unlimited liability or an enterprise needed official permission to have it. He concludes that a majority of respondents were in favour of a change in law (43 to 31). Support for a change was strongest among lawyers, academics, and MPs. Taylor

Figure 1: Questions related to banks from the questionnaire issued by the Mercantile Laws Commission of 1854

> 1. If you are of opinion that the responsibility of partners for partnership debts should in no degree be changed or modified, you are requested to state the grounds on which that opinion is rested.
>
> 3. Do you think that the law should be altered or modified as to partnership debts in general, or as to the debts of certain partnerships only?
>
> ⋮
>
> (2) Would you apply it to the partnerships for banking or insurance?
>
> 10. Are not joint stock banks or other companies so situated peculiarly liable to suspend payment at seasons of commercial embarrassment or political distrust? And are you of opinion that the existing law of unlimited liability operates injuriously by deterring prudent person of property from becoming shareholders in such banks or other public companies?
>
> 12. Would you make this distinction in regard to joint stock banking companies, that all such banking companies issuing their own notes should be established on the principle of unlimited liability, and all banks circulating merely Bank of England notes limited liability only? Or would you distinguish between limited and unlimited liability in the case of any public joint stock companies in the case of any public joint stock companies of a special kind such as life assurance societies?

(2006) focuses on views of British respondents regarding joint-stock companies. He concludes that opinion was more balanced: 36 in favour of an extension of limited liability to joint-stock companies by right versus 38 against. But, again, support for limited liability was relatively stronger among lawyers and especially academics and MPs. Support for limited liability was much weaker among merchants, manufacturers, and chambers of commerce, and bankers.

The questionnaire responses indicate a lower support for changing the liability laws for banks specifically. Table 1 shows the numbers for and against a change in the law for banks specifically (or note-issuing banks more narrowly) among the respondents from Britain that answered questions 3(2), 10, and 12.[5] The total number supporting a change in the liability laws for banks was exactly

[5]The number of responses is fewer than the number of respondents to the questionnaire since not all answered the questions related to banks. The proportion of respondents that did not express an opinion about banks varies between the respondent types: of the types where there are over ten such respondents, 29% of bankers, 31% of lawyers, and 44% of merchants, manufacturers, and chambers of commerce did not offer an opinion. Since support for and against

Table 1: Support for changing the liability laws for banks among responses to the 1854 Mercantile Commission questionnaire

	For a change in the law for banks	Against a change in the law for banks	Against a change in the law for banks, but for a change in general
Merchants, manufacturers, and chambers of commerce	10	10	5
Bank of England governors and directors, bankers, bill brokers	4	6	1
Lawyers	6	5	4
Academics	1	1	1
MPs	1	0	0
Total	22	22	11

equal to the total number against. The relatively lower support for a change in the law for banks was reflected across the respondent types: for instance, there was only a small majority in favour of a change in the law for banks among the lawyers that responded. The distinction drawn between banks and other types of firm can also be seen in the number of respondents who were against a change in the law for banks but supported a change for firms in general (in the right-hand column in the table); e.g. half of the respondents that were against a change in the liability laws for banks supported a change in the law in general.

Bryer (1997) characterises the differences of opinion expressed by the questionnaire respondents and the commissioners as being based on two alternative world-views. On one side were those who wanted to change the limited liability laws to break down what they perceived as unnatural barriers to investment. Some of these respondents believed that, from a laissez faire standpoint, individuals should be free to contract on any terms they were willing to do so. Others saw unlimited liability preventing people with little wealth from forming companies to undertake beneficial public works. On the other side were those who were concerned about the unintended consequences of limiting liability (e.g. over-investment, or maniacal company formations leading ultimately to financial instability) and who still thought about the economy in terms of individual capitalists who should

changing the law for banks was close to even for all of these types, there does not appear to be a correlation between the response rate and support for/against a special treatment of banks.

be responsible for any losses their activities generate if they stood to receive all of the potential gains.

But Bryer's characterisation of two world-views in opposition with each other is less applicable to the views on banks. The arguments for and against changing liability laws for banks specifically in the questionnaire responses reflected instead three perceived key characteristics of banks: the special nature of banks' creditors; the effects of unlimited liability on the risk of bank runs during panic episodes; and the influence of unlimited liability on the quality of a bank's capital and its shareholders.

Some respondents argued bank shareholders should continue to have unlimited liability because banks' creditors – depositors and especially note-holders – were typically incapable of assessing the riskiness of their claims accurately. For instance, James Kennedy (vice-president of the Chamber of Commerce of Belfast) described the majority of banks' creditors as *'persons of humble life ... who for evident reasons are unfitted for making the necessary inquiries about, or forming a correct opinion of, the solvency of a banking establishment.'* Similarly, James Andrew Anderson (former manager of the Union Bank of Scotland) argued there should be no exemption from unlimited liability for banks *'because in very many cases they are trusted, of necessity, by those who have no adequate means of knowing their circumstances'.* A related argument was that the general public did not have the power to choose which banks they were exposed to because they were not in a position to reject payments in the form of a bank's notes: *'A workman can hardly refuse notes offered to him by his master'.*[6]

Others remarked that protecting banks' creditors from losses could act as a stabilising force during episodes of panic in the financial system because if a creditor did not expect to incur losses they would be less likely to run on a bank. For example, James Henry Barber, a banker, argued *'[w]here nobody could lose sixpence, nobody was concerned about the chance of loss, and the value of such confidence in panic-striken times is incalculable ... to a considerable extent [limited liability banks] would do away with this feeling of confidence.'* Others claimed unlimited liability had helped banks weather past crises. For instance, Lawrence Robertson, a banker, believed the main reason

[6]This remark was made by John Brooke, on representing the Chamber of Commerce of Huddersfield, although his response overall supported a change in the liability laws.

unlimited liability banks in Scotland had proven to be stable during *'seasons of commercial embarrassment or political distrust'* was *'the public confidence inspired by the unlimited responsibility of their known partners'*.[7]

The implication of these two characteristics of banks was it would be better if banks continued to operate with unlimited liability. But other respondents argued liability laws should be changed for banks because on the contrary unlimited liability was undermining, rather than supporting, banks' stability. They supported a change in the law because, they argued, unlimited liability risked overstating the capital strength of a bank since one could not be sure that shareholders would have the funds available to provide additional capital to cover losses in the event of a bank's failure. If too much confidence was placed in the shareholders' unlimited liability, banks would be able to expand their balance sheets excessively, potentially making poorer quality loans in the process. For instance, William Cross, a banker, was concerned a bank's *'directors are naturally inclined to push the great credit which [unlimited liability] gives to their company to a great extent, in order to make as they believe, the greater profit to themselves at the expense, of course, of the public'*. There were also concerns that richer shareholders were selling their shares to poorer investors, who would have less capacity to cover losses.[8] For example, Henry James Prescott (a director of the Bank of England) argued *'that the dread of full liability deters the wealthiest and most influential classes from connecting themselves with banks'*. Some felt a bank with higher paid-up capital, with the shareholders enjoying limited liability, was preferable to the uncertainty about just how well-capitalised an unlimited liability bank really was; for instance, Charles Holland (a merchant, representing the Chamber of Commerce of Liverpool) believed limited liability joint stock banks *'would make share capital the rule and loan capital the exception'*. Finally, some felt that the importance of unlimited liability to supporting the stability of note-issuing banks had been reduced by the restrictions that had been placed on bank note issuance.[9]

Among those that supported a change in liability laws for banks, some respondents favoured a

[7] Lawrence Robertson was the Cashier at the Royal Bank of Scotland, a limited liability bank!

[8] The idea that unlimited liability would cause more wealthy individuals to sell shares to the less wealthy, thereby eroding the protection of creditors' claims provided by unlimited liability, is described later by Rae (1885). But there is no strong evidence of this happening in practice (see Acheson and Turner (2008)).

[9] They were presumably referring to the Banking Act 1844 that restricted the right to issue notes to banks that had already issued notes up to this date.

shift to full limited liability because it would make banks safer (see previous paragraph). Others felt if enterprises in other sectors had limited liability it was appropriate for there to be limited liability in the banking sector too to avoid distorting the distribution of investment between sectors; for example, Robert Lowe MP thought an equal treatment of banks and other sectors *'would break down one great obstacle to the competition of capital with capital'*. Some respondents, however, supported a move towards a system of extended liability for shareholders of banks and/or of companies in general. William Gilbert, a banker, said he could support a move away from unlimited liability for shareholders of joint stock banks if other measures were put in place including three-four times extended liability.

4 Comparison with other views in the nineteenth century

The development of opinion about liability arrangements in the British banking sector during the nineteenth century is described by Turner (2009). Turner highlights that the main argument made against unlimited liability was that it did not provide credible protection for depositors because it deterred wealthy individuals investing in bank shares. William Clay MP made this point in the 1830s. He supported banks instead operating with limited liability, but with a sufficient amount of fully paid-up capital and that their accounts should be audited and published periodically.

Walter Bagehot made similar arguments between the mid-1850s and early-1860s. He also claimed that a dearth of wealthy shareholders could also mean there was a smaller pool of competent people to draw on to serve as directors of a bank. But whilst he was against unlimited liability, Bagehot did favour shareholders having double or triple liability. The same argument was to resurface again following the failure of the City of Glasgow Bank in 1878, leading to the final move away from pure unlimited liability towards a system of extended, or reserve, liability (Acheson and Turner (2008)).

The concerns expressed about the effect unlimited liability has on the quality of banks' shareholders are reflected in the Mercantile Commission report. Question 10 in the questionnaire asked whether unlimited liability was deterring investors in bank shares. And a number of responses remarked that unlimited liability risked overstating the quality of a bank's capital.

Turner (2009) also discusses some of the arguments made in favour of unlimited liability. He refers to an article in The Banker's Magazine from 1862 that argued that depositors needed the protection provided by unlimited liability because bank business was opaque and banks' assets were not tangible. This is similar to the point made in the responses to the Mercantile Commission questionnaire that unlimited liability was needed to ensure bank safety because most bank creditors could not assess the riskiness of banks accurately.

5 Comparison with modern views on banking and regulation

The arguments surrounding the appropriate liability regime for banks in the responses to the Mercantile Commission questionnaire show parallels with the arguments used nowadays when discussing the banking system and regulation. In particular, concerns about bank runs and the inability of depositors to monitor banks lie behind modern theories for why banks are subject to prudential regulation.

Banks are subject to prudential regulations of their balance sheets and activities to control the risk of them getting into distress or failing in ways firms in other sectors typically are not; e.g. banks are subject to minimum capital requirements (Basel Committee on Banking Supervision (2010)). The contemporary case for prudential regulation is based on market failures that are believed to exist within the banking system. Santos (2001) summarises two justifications given for banking regulation.

The first justification is that mismatches between the liquidity of banks' assets and liabilities – a by-product of the liquidity insurance banks provide to depositors (Diamond and Dybvig (1983)) – exposes banks to the risk of suffering runs. Deposit insurance systems developed to protect depositors of failing banks, reduce their incentive to run (see Calomiris and White (1994) for an account of the development of federal deposit insurance in the United States). But deposit insurance can create moral hazard because depositors do not have an incentive to demand interest rates that reflect the risk of the bank failing, which leads to an excessive risk-taking at banks when equity holders have limited liability. Prudential regulations, such as capital requirements, reduce the risk of a bank failing, thereby offsetting the effect of moral hazard on the risk of bank failure.

The fragility of individual banks can also lead to instability at the level of the system. For instance, problems at one bank could spread to other banks via inter-bank exposures (Allen and Gale (2000)) or by undermining confidence in the banking system in general (Chen (1999)). Systemic risk is thus another argument for prudential regulation.

The second justification is that a regulator acts as a representative of bank depositors who are not able to monitor banks themselves (Dewatripont and Tirole (1994)). The regulator needs to intervene more intensively in a bank to protect the depositors as a bank's performance deteriorates; e.g. as its equity to assets ratio declines. A minimum capital requirement represents the value of the capital ratio at which the regulator intervenes to take control of the bank because of the heightened risk the bank is going to fail.

One respect in which the questionnaire responses and modern views deviate is the role banks can play in driving credit cycles. This is nowadays seen as an added justification for prudential regulation, in particular capital requirements that vary cyclically, to correct for misallocations of credit at different points in the cycle (e.g. Gersbach and Rochet (2017), Repullo and Suarez (2012)). The questionnaire responses did not seem to appreciate how bank behaviour might interact with fluctuations in the wider economy.

6 Views on insurance

The responses to the questions listed in Figure 1 also reveal contrasting opinions about the merits of changing liability laws for insurance companies. Similar to the argument made about banks, some felt shareholders of insurance companies should have unlimited liability because creditors were not able to monitor risks to insurers' solvency effectively. For example, William Valentine, representing the Chamber of Commerce of Belfast, argued unlimited liability should continue for banks and insurers because both *'have dealings with the general public'* which were often located far away from where banks or insurers were established which made it difficult for the creditors to *'obtain correct information'* about the entities to which they were exposed. But one difference between the views expressed on banking and on insurance was that some did not oppose limited liability for insurers because they argued limited liability clauses were already included in many insurance policies; e.g. this point was made in the responses from Leone Levi (lecturer on commercial law at King's College London), David McLaren (representing the Chamber of Commerce of Leith), and John Malcolm Ludlow (barrister). Freeman et al. (2012) present evidence in case law and from guidance to promoters of insurance companies suggesting the inclusion of limited liability clauses in insurance policies was prevalent in this period.

7 Conclusions

The responses to the questionnaire issued by the 1854 Mercantile Laws Commission provide an insight into views on whether the liability laws needed to be amended, including laws related to banks. The responses highlight that there was a lower level of support for changing the law in relation to banks than for enterprises in general. The reluctance to move away from unlimited liability banking was due to concerns about the increasing the risk of bank runs and the inability of bank creditors to assess accurately the risks they were exposed to. On the other side, some favoured a move towards limited liability because it made banks' capital buffers more transparent. The debate echoes the wider debates during the nineteenth century and shows similarities to contemporary theories for why banks should be regulated.

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