STUDENTS BRIEF

The Development of the Scottish Clearing Banks

In 1694 the Bank of England was established - by a Scotsman. Not to be outdone the Scots, still with their own Parliament, introduced in 1695 an Act sanctioning the incorporation of the Bank of Scotland and granting it a 21 year monopoly to provide banking services in Scotland. The Bank of Scotland was never designed primarily for the support of the government but to promote the trade and industry of Scotland. Accordingly, the Act set out to attract foreign shareholders, offering as an inducement the right to become naturalised Scotsmen - a singular honour indeed!

The Bank of Scotland's monopoly was breached only by the Darien Company who, as an adjunct to their ill-fated colonisation scheme, introduced a lending service and issued their own notes using some of the funds subscribed for the Darien Expedition. (These funds had been submitted early by enthusiastic investors. Rather than have cash lying idle the company, applying sound banking principles, used the cash balances until they were required.) The aim of the Darien expeditions was to create a new trading company and colony at Darien on the isthmus of Panama. The funding of the scheme came largely from Scottish investors after English backing for the project was withdrawn. When it failed through disease, the tropical climate and attacks by Spanish soldiers, the loss for Scottish investors was equivalent to a quarter of the country's liquid assets.

Fortunately, the last Act of the Scottish Parliament before the Act of Union in 1707 directed that an amount "not exceeding the sum of £232,884 5s 0 3/4d sterling", be paid to the Darien subscribers. In other words it became part of the National Debt of Scotland but compensation would have to come from England. Eventually it was agreed to issue Debentures paying 5% interest to Darien shareholders. Many of the original shareholders, having waited 20 years, had long since sold their shares at a discount mainly to English investors who subsequently formed the quaintly named "Society of the Subscribed Equivalent Debt" to collect the interest due on the Debenture stock. From this Society a company called the Equivalent Company was formed and registered in Scotland where the Bank of Scotland's monopoly had lapsed and the Bank of England's was not relevant. The Equivalent Company was interested in "keeping other people's cash as well as their own." In other words, they wished to become bankers and applied to Parliament for a charter to provide a banking service in Scotland. Wisely, the name Equivalent was dropped due to its many disagreeable associations for Scotland and the charter incorporating the Royal Bank of Scotland was granted in 1727.

Thereafter banks continued to increase in number and the following list is only a few of those which opened in Scotland:

British Linen Bank in 1746

Ship Bank (1750), Arms Bank (1750)

Thistle Bank (1761), G Dempster & Co (1763)

Aberdeen Banking Co (1767)

General Bank of Perth (1767)

Commercial Bank (1810), National Bank (1825)

Union Bank (1845) and Clydesdale Bank (1838)

Competition between the banks was intense, especially in the circulation of bank notes. Most of the banks issued their own and obtained a large proportion of their profits from the business generated by this activity. In the early years each bank would accept only their own notes, although the Bank of Scotland and the Royal Bank of Scotland did introduce an arrangement in 1751 where each would accept notes from the other. It was not until 1771 that a general agreement for a "clearing house" was introduced. This was an important innovation for the world of banking which has, of course, had universal acceptance.

Apart from the "clearing house" idea Scottish banks have made a number of other important contributions to the practice of banking. For example Scottish banks were the first public commercial banks organised on the principle of limited liability. In 1728 the Royal Bank introduced the concept of the "cash credit" which has developed into the modern day "overdraft" facility. Associated with the clearing house concept was the system of holding each others notes which, as a bonus, helped to maintain confidence in the banks especially in times of stress for the economy. This system was the blue-print for the system of Special Drawing Rights (SDR's) operated by the International Monetary Fund (IMF).

Perhaps the most important contribution has been the development of banking based on a network of branches. Banking in England, and elsewhere, had relied on a large number of private and local banks. When many of these private banks failed during the financial crisis of the early 19th century it was considered that the hitherto unrestricted issue of notes by these banks had been an important contributory factor. Accordingly, the Bank Charter Act of 1844 was introduced and eventually made the Bank of England responsible for the note issue in England.

In more recent times the Scottish banks have tended to lose their reputation for innovation. They have, for example, been relatively slow in responding to the modern trend for diversification into international banking activities. These can take two forms:

1. Domestic banking overseas

2. Cross-border banking where the assets are in one market but the liabilities in another

The latter, often referred to as wholesale banking, has grown as a result of the large growth in Euromoney markets. Fortunately the Scottish banks are increasing their participation in these activities, most of which have grown as a direct result of the financing needs of North Sea oil. Despite being slow into the international markets, subsequent growth has been rapid. In June 1972 the Scottish banks had only £1 million in syndicated loans, whereas by September 1976 they had £263 million on loan.

Note Issue

To say that there were no bank failures in Scotland would be untrue, nevertheless the number was much smaller thanks to the branch system. In consequence the Scottish banks were allowed to continue issuing their own notes. This tradition continues today with each of the three Scottish clearing banks circulating their own notes. Strictly, these notes are not legal tender - money, after all, is anything which is **accepted** as money (e.g. cigarettes are often used in prisoner of war camps and during hyperinflations as the medium of exchange). The notes in circulation of the Scottish Clearing Banks must be covered by balances held in the form of Bank of England notes, most of which are deposited in London. Incidentally, these notes, which are not in active circulation, are held in very large denominations of £1,000 or more. The number of notes issued by the Scottish banks is only 3.7% of the number issued by the Bank of England although the Scottish banks hold 21.2% of the assets of all UK clearing banks. In December 1978 the Scottish banks had a balance sheet total of around £5 billion.

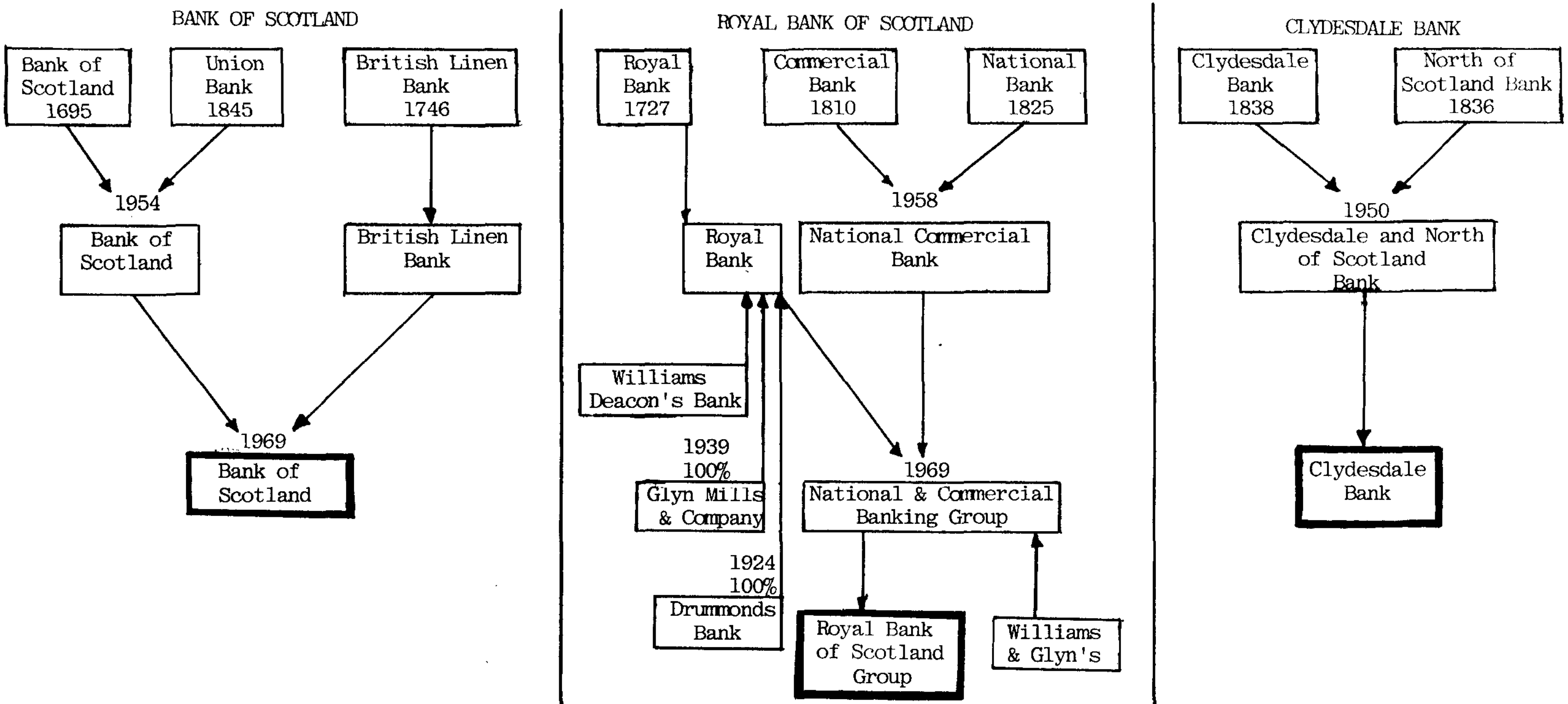
As far as note circulation is concerned the Scottish banks no longer rely on it as a major source of bank profits (although profits are still obtained from it) but rather as a source of prestige and advertisement.

Rationalisation in the Scottish Bank System

Throughout this century there has been a steady reduction in both the number of banks and in the number of bank branches. Scotland has been described as overbanked (by the Committee of Scottish Clearing Banks, in their evidence to the Wilson Commitee), with one bank per 3,520 head of population, compared with one per 4,200 in England and Wales in 1977. Since 1938, for example, the number of branches had declined from 1900 to 1450 in 1976. To some extent the geography of Scotland is responsible for the higher per capita number of branches, although in the very remote rural and island communities the banking service is provided by a variety of mobile units using land, sea or air transport.

Figure 1 illustrates the mergers and takeovers which have occurred since 1918. By 1949 there were eight Scottish banks, but by the time of the Radcliffe Report in 1959 there were only five. Since then there has been a further reduction to the present level of three Scottish Clearing Banks - The Bank of Scotland, The Royal Bank of Scotland and The Clydesdale Bank. Mergers in the system have been necessary in order that the banks are able to respond to the growing demands from large industrial and commercial organisations for finance. Otherwise there was a danger that large Scottish companies might have to rely on financial support from the English Clearing Banks. As shown in Figure 1, the English clearers already hold a significant share in the Scottish banks. Indeed the Clydesdale Bank is fully owned by the Midland Bank. The Scottish banks themselves have been

Figure 1 Scottish Bank Amalgamations



BARCLAYS BANK holds 35% of the equity of the Bank of Scotland. This stems from acquisition of 100% of the British Linen Bank in 1910.

LLOYDS BANK holds 16% of the equity of RBSG. This stems from 100% ownership of NB of S in 1918, diluted to 36.6% of NCB of S in 1958 and to 16% of RBSG in 1969

MIDLAND BANK own 100% of the equity of Clydesdale Bank. This stems from the acquisition of 100% of the equity of Clydesdale Bank (1919) and N of S (1923).

Source: Committee of Scottish Clearing Banks; Evidence to the Committee to Review the Functioning of Financial Institutions. Statistical Memorandum 1 Part 1, April 1977.

active over the border where the Royal Bank of Scotland has taken over Williams Deacon's Bank, Glyn Mills Company and Drummond's Bank. Frequently the bank mergers in Scotland created a duplication of services in some towns and in parts of the main urban centres. Accordingly the banks have taken the opportunity to rationalise their branch network. Even so it is likely that Scotland as whole will continue to benefit from an extensive network of bank branches.

Structure of Loans and Advances

The broad composition of the balance sheets of the Scottish banks are similar to those of the English Clearing Banks. To some extent this is a consequence of the government controls over lending rules and indeed over the direction in which funds are lent. There are notable differences however in the structure of loans and advances.

The Scottish banks tend to hold a higher proportion of their Sterling assets in the form of advances and a lower proportion in investments than their English counterparts. Secondly, even after the growth in international banking activities, the Scottish banks continue to do most of their loan business directly with the ultimate borrowers rather than via the mechanism of the Euro-loan markets.

The Wilson Committee noted that the Scottish banks lending to manufacturing sectors was relatively less important than their English counterparts. On the other hand loans for agriculture, forestry and fishing, and North Sea oil activities were significantly higher. In 1976 for example the Scottish banks lent £203.7 mill. for agriculture, forestry and fishing purposes, representing 10% of their total advances. For the UK as a whole lending to this sector averaged only 3.2% of total advances. Loans to financial institutions form only a small proportion of Scottish bank lending, only 13.4% compared with the UK's 20.4%

During the 1970s many banks, and especially the secondary banks, were caught out by the rapid slump in the property market. Scottish banks were hardly affected by the downturn had never become too committed to financing property companies. At the peak of the property boom their commitment was only £86.1m and in 1976 it was only marginally lower at £77.2 mill., or 3.8% of total Scottish advances. Meanwhile banks in the UK were still lending over 8% to property development companies.

References

A number of books have been published documenting the history of the Scottish Clearing Banks. These include

S G Checkland — Scottish Banking. A History 1695-1973

N. Munro — The History of the Royal Bank of Scotland 1727-1927. R&R Clark. Edinburgh 1928.

C.A. Malcolm — The Bank of Scotland 1695-1945. R&R Clark. Edinburgh.

More recent information about the history and performance of the Scottish banks is contained in the Wilson Committee reports:

1. Committee of Scottish Clearing Bankers: Evidence to the Committee to Review the Functioning of Financial Institutions. Memorandum 1. April 1977 and Memorandum 2 October 1977.

2. H. Wilson (Chairman) Committee to Review the Functioning of Financial Institutions. Cmnd 7937 HMSO London 1980. (The Wilson Report).

Frequently articles are published on the Scottish Banks, in the Three Banks Review and in the Scottish Bankers Magazine. Despite its name, the Three Banks Review is not a publication from the present 3 Scottish Clearing banks. Rather it is a publication of the Royal Bank of Scotland Group and the name is taken from the original publishers in 1949 - The Royal Bank with Williams Deacon's and Glyn Mills & Co.