Jealous monopolists? British banks and responses to the Macmillan Gap during the 1930s

Introduction[1]

The British banking system emerged from the First World War with a degree of centralisation unprecedented among major industrial nations. Five major clearing banks formed a collusive oligopoly that constituted one of the most powerful and enduring monopoly positions in any major British industry. Such concentration had potentially far-reaching consequences for British economic development, as banks constitute the main intermediaries between domestic savers and non-mortgage borrowers.

Neoclassical economic theory indicates that monopolists will impose welfare losses on society, as profit-maximisation produces a lower output and higher profits compared with perfect competition. Excluded customers may be substantial in volume and would be worthy of finance in a competitive market, but will be those who represent, or (given imperfect information) are considered to be, the least profitable business. This, in turn, will discourage new competitors in situations where first mover advantages would make it

[1] Many thanks are due to the staff of the Royal Bank of Scotland Group Archives [hereafter RBSGA]; LloydsTSB Group Archives [LTSBGA]; HSBC Group Archives [HSBCGA]; British Library of Economic and Political Science Archive [BLPES] National Library of Scotland [NLS] and Bank of England Archives. We would also like to thank Mark Billings, Howard Cox and Phillip Winterbottom for their comments on earlier drafts of this paper.

difficult for entrants to compete for the monopolist's existing customers.

The welfare losses from monopoly might be offset by increases in technical efficiency due to increased scale. However, empirical research for post-1945 Britain has generally corroborated the existence of substantial welfare losses, while finding little evidence that these were offset by technical gains. While some studies found that monopoly positions were gradually eroded, this was shown to typically be a very long and slow process.[2]

Recent analysis of banking profitability lends support for the hypothesis that the banks reaped monopoly profits. True interwar banking profits were found to be both substantially greater than published figures and - particularly during the 1920s - to have compared well even with British manufacturing (which was regarded as being of substantially higher risk - as evidenced by the lower risk premium attached to banking shares and their purchase by institutions that would not consider even large manufacturers).[3]

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[2] See, for example, G. Walshe, *Recent Trends in Monopoly in Great Britain, NIESR Occasional Paper XXVII* (Cambridge: CUP, 1974); M.A. Utton, *Profits and Stability of Monopoly*, *NIESR Occasional Paper XXXVIII* (Cambridge: CUP, 1986); J. G. Walshe, "Industrial organization and competition policy", 335-380 in N.F.R. Crafts and Nicholas Woodward (eds), *The British Economy since 1945* (Oxford: O.U.P., 1991), 354-60.

[3] Forrest Capie and Mark Billings, "Profitability in English banking in the twentieth century", *European Review of Economic History,* 5 (2001): 367-401, Figure 11. For investors' perceptions of banking and industrial shares, see Peter Scott, "Towards the 'Cult of the Equity'? Insurance companies and the interwar capital market," *Economic History Review*,

The clearing banks have also come in for unfavourable comparison to their continental rivals - with regard to their domestic developmental role – one strand of a broader 'City/industry' critique of the internal economic consequences of Britain's metropolitan and externally-orientated financial system.[4] Conversely, banking historians have often been sceptical regarding whether Britain's concentrated interwar banking structure significantly reduced the volume of industrial lending, even with respect to small firms.[5] Indeed Ross even goes so far as to argue that the banking market was efficient and that excluded borrowers were limited to those not worthy of finance at the competitive market equilibrium.[6] Elsewhere, he notes that banks may have acted as *discriminating monopolists*, but argues that this would again have left only charlatans and very marginal cases for new entrants.[7]

LV (2002): 78-104, 90.

[4] See for example, Michael H. Best and Jane Humphries, "The City and industrial decline", 223-39 in Bernard Elbaum and William Lazonick (eds), *The Decline of the British Economy* (Oxford: Clarendon, 1986); Francesca Carnevali, *Europe's Advantage. Banks and Small Firms in Britain, France, Germany, and Italy since 1918* (Oxford, 2005).

[5] See, for example, Mae Baker and Michael Collins, "The durability of transaction banking practices in the provision of finance to the business sector by British banks", *Entreprises et Histiore*, 1999, No. 22: 78-92, 79-80.

[6] Duncan M. Ross, "The 'Macmillan gap' and the British credit market in the 1930s", 209-26 in P. L. Cottrell, A. Teichova and T. Yuzawa (eds) *Finance in the Age of the Corporate Economy,* (Aldershot: Ashgate, 1997), 209-10. ,

[7] Duncan M. Ross, "Commercial banking in a market-orientated financial system: Britain between

This article re-examines the attitudes of the interwar clearing banks regarding lending to firms of insufficient size to raise funds via a public share issue (for larger firms the stock market provided an important counter to the banks' monopoly power), particularly for longer-term requirements. Banks limited their lending to short-term working capital to a much greater extent than their local antecedents (despite firms' growing requirements for long-term capital). They aimed to maximise liquidity so as to minimise risk, and felt secure in dictating their own terms to industry as, given their tight cartel, they faced a largely captive market – at least for companies of insufficient size for a public share issue.

The banks' restrictive lending criteria became politically controversial from the time of the emergence of the 'Big Five', as evidenced by the debate over the alleged 'Macmillan gap' in finance to smaller enterprises.[8] Rejecting the existence of any significant Macmillan gap would imply one of three hypotheses: that smaller firms had no need for long-term external capital; that such capital was already adequately provided by other sources; or that the banks already acted as long-term financiers, despite their public and private protestations to the contrary. This last hypothesis has generally been rejected by recent research on bank lending, which has found that banks followed their own theoretical precepts in confining their activities to the formal provision of

the wars", *Economic History Review*, XLIX (No. 2, 1996): 314-35, 329-30.

[8] Committee on Finance and Industry, Report (Cmnd. 3897 of 1931).

short-term loans, for working capital.[9]

Rather than demonstrating that there were either sufficient alternative sources of long-term funding, or a lack of industrial demand for such finance, banking historians have taken the absence of concrete evidence for a substantial group of viable and profitable lending propositions that were not adequately served by existing capital market facilities as proof that that no significant gap existed. Yet, As Ziegler has noted, quantitative archival analysis of the Macmillan gap is fraught with difficulty. Bank archives are unlikely to provide any real reflection of rejected business, as applications of the type deemed unsuitable would be discouraged verbally by local managers (an informal screening process); meanwhile industrial archives are heavily biased

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[9] Michael Collins and Mae Baker, "British commercial bank support for the business sector and the pressure for change, 1918-39", in Makoto Kasuya (ed), *Coping with Crisis. International Financial Institutions in the Interwar Period* (Oxford, 2003): 43-60; Forrest Capie and Michael Collins, "Banks, industry, and finance, 1880-1914", *Business History*, 41, (No. 1, 1999): 37-62; Forrest Capie and Michael Collins, "Industrial lending by English commercial banks, 1860s-1914: why did banks refuse loans", *Business History*, 38 (No. 1, 1996): 26-44; M. Baker and M. Collins, "English Commercial Bank Stability, 1860-1914", *The Journal of European Economic History*, 2002, Vol. 31, no. 3:508-9; M. Baker and M. Collins, "English industrial distress before 1914 and the response of the banks", *European Review of Economic History*, 1999, 3.1: 1-24. There is some evidence of medium term lending and a difference between stated and actual duration of loans, but for an earlier period. See Michael Collins and Mae Baker, *Commercial Bank and Industrial Finance in England and Wales*, 1860-1913 (Oxford, 2005), 195-200.

towards survival and success.[10] Contemporaries also observed that propositions falling outside the banks' criteria for legitimacy were 'invisible' to the system; for example O. T. Falk of stockbrokers Buckmaster and Moore stated that, 'the banks as a whole deny the existence of the problem because it is so well known that they will not lock up capital that they are not approached by small people wanting to start a new business. Hence they do not come in contact with the gap.'[11]

Critics of the Macmillan gap have pointed to the limited success of the new lending institutions established during the 1930s, ostensibly to breach this gap, as proof that there was no un-met demand for finance which could be catered for without incurring risks that would "endanger the stability of the financial system as a whole."[12] This paper provides the first detailed examination of these new institutions using archival evidence (including internal business records, and reports and memoranda to the Bank of England and the clearing banks). This shows that, with the exception of Credit for Industry Ltd [CFI] and those organisations limited to severely depressed areas, the 'Macmillan gap' institutions essentially catered for companies that might be suitable for a public share issue within a few years, rather than typical

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10. Dieter Ziegler, "The origins of the "Macmillan gap": comparing Britain and Germany in the early twentieth century", in P. L. Cottrell, A. Teichova and T. Yuzawa (eds.), *Finance in the Age of the Corporate Economy* (Aldershot, 1997), 187-8.

[11] BLPES, AB 352, VI2, OERG, meeting with O. T. Talk, 6 March 1937.

[12] Ross, "The 'Macmillan Gap'", 222.

small-medium firms. Meanwhile CFI's operations were severely constrained by the clearing banks, which undermined its viability by 'poaching' clients it had vetted and approved. It thus makes an important contribution both to the debate regarding the banks' exercise of monopoly power and their responses to market entry – showing that they acted as 'jealous monopolists' - frustrating officially-sponsored attempts to foster the development of specialist medium-long term industrial lending institutions.

The next section examines the impact of the concentration of English and Welsh clearing banks into the London-based Big Five on bank-industry relations. In addition to reviewing evidence from other studies, regarding the trend towards short-term lending covered by collateral security as concentration grew, this section provides new evidence regarding moves towards quantitative credit rationing by the clearing banks and shows that the big banks demonstrated some reluctance to compete with each other for business. Contemporary criticisms of the new banking structure's impact on industrial lending, culminating in definition of the Macmillan gap, are then reviewed, together with the response from the banks. After outlining the Bank of England's initiative to establish a 'champion' to breach this gap during the 1930s, the record of the several institutions that entered this field is assessed.

Bank mergers and the restriction of industrial lending

The 1860s witnessed the onset of a merger movement among clearing

banks in England and Wales, which intensified from the 1880s. This centralised much banking business into large firms, headquartered from London, which serviced the provinces only through their branch networks. By 1911 London-based banking groups controlled 56 per cent of UK branches and 65 per cent of deposits.[13] The First World War witnessed a renewed burst of merger activity, buoyed up by particularly high banking profits. Banks were acquired at very high prices, threatening to seriously dilute the future profitability of the sector. Yet barriers to entry protected the banks from the fate that befell many industrial firms who had participated in the war/post-war merger mania. The main barrier was access to the London Clearing House, which was tightly restricted and had become essential for large-scale branch banking.[14] As Ackerill and Hannah noted, 'If a tighter banking oligopoly could reduce competition and raise sustainable long-run profits, the acquiring banks' shareholders might yet benefit. Fortunately for them (though arguably

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[13] Michael Ball and David Sunderland, *An Economic History of London 1800-1914* (London, 2001), 338-46; Michael Collins, *Money and Banking in the UK. A History* (London, 1988), 78-9. See also F. Capie and G. Rodrik-Bali, "Banking concentration in British Banking, 1870-1920", *Business History*, 24: 280-92 and Michael Collins and Mae Baker, "Sectoral differences in English bank asset structures and the impact of mergers, 1860-1913", *Business History*, Vol. 43, No. 4: 1-28.

[14] Forrest Capie and Mark Billings, "Evidence on competition in English commercial banking, 1920-1970", *Financial History Review*, 11 (2004): 69-103, 75.

less happily for the banks' customers)… this condition was fulfilled'.[15]

Bank lending had traditionally been short-term, having developed in an era when the long-term capital needs of industry were generally modest and most businessmen required loans primarily for working capital and cash flow.[16] The merger movement and the 1878 City of Glasgow Bank crisis[17] accentuated this emphasis on liquidity, London-based head offices issuing directives for more restrictive lending criteria than their provincial antecedents had imposed.[18] Recent examination of bank lending during 1880-1914 has

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[15] Margaret Ackrill and Leslie Hannah, Barclays. *The Business of Banking 1690-1996* (Cambridge, 2001), 69.

[16] Capie and Collins, "Banks, industry, and finance, 1880-1914"; Capie and Collins, "Industrial lending by English commercial banks, 1860s-1914; Baker and Collins, "English Commercial Bank Stability"; Baker and Collins, "English industrial distress before 1914 and the response of the banks"; Collins and Baker *Commercial Banks*.

[17] See Michael Collins "The banking crisis of 1878", *Economic History Review*, vol. 42 (No. 4, 1989); Michael Collins "English bank lending and the financial crisis of the 1870s", *Business History*, vol. 32 (No. 2, 1990); Mae Baker and Michael Collins, "Financial crises and structural change in English commercial bank assets, 1860-1913", *Explorations in Economic History*, 1999, Vol. 36: 428-444; Michael Collins and Mae Baker, "English commercial bank liquidity, 1860-1913", *Accounting, Business & Financial History*, 11 (Part 2, 2001): 171-91; Collins and Baker, "Sectoral differences in English bank asset structures", 7

[18] For a review of this literature, see Lucy Newton, "Government, the banks, and industry in inter-war Britain", 145-70 in Terry Gourvish (ed), *Business and Politics in Europe, 1900-1970. Essays in honour of Alice Teichova* (Cambridge, 2003), 156.

shown that most commercial bank support for industry constituted short-term credits for cash flow and working capital; the mean duration of loans (allowing for renewals of overdrafts) varying from 13-19 months at different sub-periods, while the median duration was only 8-12 months. Some loans were rolled over for long periods, but the fact that they could be recalled at short notice precluded borrowers from using funds for illiquid purposes such as capital expenditure. [19] Meanwhile unsecured loans, which accounted for 64.6 per cent of all industrial loans during the whole 1880-1914 period, had declined to only 27.3 per cent by 1910-14 (the remainder requiring collateral that almost always covered the full value of the outstanding loan).[20] Collins and Baker explain this in terms of the growth of incorporation, which removed the unlimited liability of many businesses.[21] However, this trend also coincided with the move from local to national banks.

Baker and Collins argue that, even by 1914, the absorption of regional, by national, banks had led to the nurturing of a highly liquid industrial loans portfolio, a decline in credit provision to the private sector, and an overall rise

[19] Capie and Collins, "Banks, industry, and finance", 54-8; idem, "Industrial lending by English commercial banks", 34; Collins and Baker, *Commercial Banks*, 196 and 198; idem, "British commercial bank support", 48.

[20] Capie and Collins, "Banks, industry, and finance", 43 and Collins and Baker, "British commercial bank support", 48.

[21] Collins and Baker, "British commercial bank support", 48.

in bank liquidity.[22] They also found that while banks were often prepared to continue support for distressed borrowers, they maintained an arms length approach even during such crises. Rather than intervention, their key strategy for minimising bad debts was avoiding entering into relationships with potentially problematic clients.[23]

By the end of the final major banking merger wave, in 1918, London-based head offices had assumed unprecedented importance in vetting loans. Practice varied between banks; the Midland, National Provincial, and Westminster adopted a centralised policy, while Lloyds was somewhat less centralised, local committees giving opinions on loan applications.[24] Barclays adopted the most decentralised vetting system among the major banks, its system of 'local boards', with discretion regarding advances below £20,000, having been cited as a reason for its success in expanding its proportion of the Big Five's interwar advances.[25] Once established, centralisation proved enduring. In November 1936 W. F. Crick, (head of the Midland's intelligence department and *de facto* its chief economist)[26] stated in private evidence to

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[22] Baker and Collins, "English Commercial Bank Stability", 510; Collins and Baker, "Sectoral differences in English bank asset structures", 19.

[23] Baker and Collins, "English industrial distress", 22-3.

[24] W. A. Thomas, *The Finance of British Industry, 1918-1976* (London, 1978), 57.

[25] Ackrill and Hannah, *Barclays*, 91.

[26] Duncan M. Ross, "Bank advances and industrial production in the United Kingdom during the inter-war years: a red herring?" in P. L. Cottrell, Hakan Lindgren and Alice Teichova (eds.),

the Oxford Economists Research Group [OERG] that local branch managers generally had very little discretion over loans, though this varied between banks. They could refuse palpably unacceptable applications, but had no power to grant loans, their positive influence being limited to the comments that accompanied each application.[27]

Concentration was accompanied by the development of an interest rate cartel among the London clearing banks. There is also some evidence that banks were reluctant to take business from each other, at least during times of unsettled business or international conditions. For example John Rae, Chief General Manager of the Westminster Bank, told the Macmillan Committee that, 'I have had fairly big approaches from customers of other banks wanting me to take on business, but out of regard for the other banks I did not feel justified in taking on that business.'[28] Occasionally more formal arrangements were introduced, for example a Head Office circular issued by William Deacons Bank in September 1938 (at the time of the Munich crisis) informed its staff that: 'it has been agreed by the Clearing Banks that, in the present circumstances and until further notice, no Bank will take an a/c from another

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European Industry and Banking Between the Wars. A Review of Bank-Industry Relations (Leicester, 1992), 188.

[27] BLPES, ABS 352-VII, report of visit by F. W. Crick of the Midland Bank to the Oxford Economists Research Group, 28 November 1936.

[28] Macmillan Committee, minutes of evidence, 7.

Bank.'[29]

Evidence also suggests that following the merger wave there was a move towards quantitative credit rationing. In August 1922 the business magazine *System* published an interview with an unnamed bank manager who explained that headquarters' vetting took account not only of the merits of the proposal, but of the, '*bulk total* of requests made by the branches all over the country… If the bulk of the loans asked for at any given moment is too heavy, then it means that some of the loans must be refused – *not because they are bad security*, but because of the general condition of the loanable funds of the bank at that moment'.[30] Such quantitative rationing, at times when the overall ratio of advances to deposits significantly exceeded the banks' 50 per cent upper benchmark, was also mentioned by John Rae, Chief General Manager of the Westminster (in evidence to the Macmillan Committee), who noted that his bank had on occasion had to call in advances due to their high aggregate advances ratio.[31]

Crick provided further corroboration, explaining to the OERG that banks engaged in quantitative rationing during periods of financial stringency, such as 1928 to the beginning of 1930 (when a reduction in deposits raised the

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[29] RBSGA: GB 1502/WD/100/28, Head Office Circular, William Deacons Bank, 29 September 1938.

[30] Max Rittenberg, "Getting more capital for a small business", *System* (August 1922): 100-130, 101-101. Emphasis in original.

[31] Macmillan Committee, minutes of evidence, 6-7.

advances ratio from 55 to 58 per cent; the banks' preferred maximum being given as 50 per cent). Refusals were concentrated among new customers, in order that long-established clients would be properly financed – paralleling the clearing banks' post-1945 rationing criteria.[32] Similarly, the bank manager interviewed in *System* noted that when loans had to be rationed: 'obviously they will be allotted to customers of old standing, for their normal trading requirements, rather than to the expansion of young enterprises.'[33]

The potential monopoly power of the Big Five gave rise to considerable political controversy. Government responded by appointing the Colwyn Committee in 1918. The Committee's report ended the merger boom and, while further amalgamations occurred, mergers between the Big Five were effectively prohibited. It noted the danger of reduced competition in the banking sector and the possibility of the emergence of a single 'Money Trust' with control over British clearing banking. The banks countered such criticism by arguing that amalgamation would lead to increased competition among the remaining banks. They also defended their actions on industrial

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[32] BLPES, ABS 352-VII, report of visit by F. W. Crick of the Midland Bank to the Oxford Economists Research Group, 28 November 1936. For the post-war period, Francesca Carnevali and Leslie Hannah, "The effects of banking cartels and credit rationing on U.K. industrial structure and economic performance since World War Two", in Michael D. Bordo and Richard Sylla (eds.), *Anglo-American Financial Systems. Institutions and Markets in the Twentieth Century* (Burr Ridge IL, 1995): 65-88, 75.

[33] Rittenberg, "Getting more capital", 101-102.

finance grounds, arguing that larger banks would be better placed to meet the needs of the post-war industrial recovery and the demands of the larger enterprises that were emerging from the industrial merger wave. In addition to efficiency gains from increased scale, they would be able to loan funds based on national, rather than local, pools of deposits.[34]

Carnevali has highlighted the heavy bias towards national banking interests among the Colwyn Committee's expert witnesses and the strong representation of bankers in its membership. Only one manufacturer, Thomas Bertram Johnston, was called to give evidence, and argued strongly – citing examples from the Bristol area - that support for local manufacturing ceased once local banks were taken over by national groups. Carnevali also argues that the evidence presented by banking interests in favour of large-scale banking presented an exaggerated picture of the degree to which British industry had become concentrated, and the extent to which Germany and Britain's other principal competitors had banking systems dominated by large combines.[35] Similarly, few independent contemporary commentators accepted the bankers' arguments; even *The Economist* noting that a major part of the banking system was centralising decision-making:

> to a degree that savours of the Government office and ration[ing]… its credit on a mathematical basis that takes little

[34] Newton, "Government, the banks, and industry", 146-7.

[35] Carnevali, *Europe's Advantage*, Chapter 2.

> heed of trade imponderabilia; [meanwhile] the other seems to be seeking some means… to restore a shadow of local autonomy to the units it has absorbed. We sincerely hope the latter method will prevail… not only that revival of district boards of leading residents who understand local conditions, but running *pari passu* with them extended and more trusted official district management. At present far too much goes to London.[36]

Similar points were made in Lavington's 1921 study of the English capital market, which noted that amalgamation had been accompanied by a centralisation of decision-making, a more 'mechanical' approach to vetting loan applications, and a switch in emphasis from assessment of the borrower to the security offered, thus excluding, 'business men who may be unable to offer security for a supply of capital but whose character and abilities give them a good social title to its use.'[37] Such a mechanical approach was, in part, necessitated by centralised decision-making. 'Local knowledge' is highly 'tacit' (not amenable to formal codification) and thus not easily transmissible upward through a hierarchical decision-making process, especially where this is separated by distance. Basing lending on criteria such as appropriate collateral facilitated the development of clear rules that could be easily

[36] "British banking and industry", *Economist* (21 May 1938): 1037-8.

[37] F. Lavington, *The English Capital Market* (London, 1921), 143.

communicated from head office to branch managers, thus avoiding misunderstandings or ambiguities within the decision-making system regarding what constituted appropriate business.[38]

Moreover, collateral requirements constituted a low cost screening process. Banking theory suggests that banks maximise profits by engaging in transactions which incur the lowest marginal costs relative to the price charged. These include ex ante assessment of loan propositions and ex-post monitoring of clients. Knowledge regarding the inherent risk of the loan is highly biased towards the borrower, while tacit information is concentrated among local business networks. Lenders without access to such networks are likely to find gathering information a costly and time-consuming process, which imposes high transactions costs.[39] They are therefore unlikely to engage in such gathering – unless competitive pressures by rival banks force them to do so.

The emergence of nationally-based banks thus resulted in a transformation of the banking system from 'relationship banking' – underpinned by close personal monitoring of clients by bank directors

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[38] Carnevali and Hannah, "The effects of banking cartels", 75. The archives contain numerous volumes of memoranda or circulars sent from bank head offices to their branches with specific instructions to staff and forms to complete with regard to lending decision-making criteria. See for example RBSGA: WD/100/25, 99.

[39] Carnevali, *Europe's Advantage*, 9.

embedded in their local business milieu - towards ‘transaction banking’,[40] characterised by bureaucratic and centralised decision-making; short-term loans; formal screening and monitoring processes; and an emphasis on collateral security .[41] Analysis of 586 English commercial bank loans to industry over the period 1920-39 by Collins and Baker revealed that the mean length had fallen to 6.5 months and the median six months, with 99 per cent being granted in the first instance for a year or less. Meanwhile some 86 per

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[40] See also Lucy Newton, “Trust and virtue in English banking: the assessment of borrowers by bank managements at the turn of the nineteenth century”, *Financial History Review*, 7 (Part 2, 2000): 177-99, 182-3; I. Morrison, “Moral conflicts in commercial banking”, in S. F. Frowen and F. P. McHugh (eds.), *Financial Decision-making and Moral Responsibility* (Basingstoke, 1995), 57; R. S. Sayers, *Lloyds Bank in the History of English Banking* (Oxford, 1957), 271; P. L. Cottrell, *Industrial Finance 1830-1914: The Finance and Organisation of Manufacturing Industry* (London, 1979), 236-44

[41] In its most extreme form, transaction banking involves the bank treating each loan as a separate transaction and not drawing upon any long-term bank/client relationship that may exist. In turn, customers are free to operate in the lending market to seek the most preferential borrowing terms. In this system banks lend for short periods, have a highly liquid portfolio, engage in rigorous screening and monitoring of borrowing customers and require collateral in order to ease the recovery of debt in cases of default. A less extreme form of this type of banking was practiced by the main British clearing banks. See Baker and Collins, “English Commercial Bank Stability”, 504-5 and 510; Collins and Baker, Commercial banks and industrial finance, 53-5; Michael Collins and Mae Baker, “English bank business loans, 1920-1968: transaction bank characteristics and small firm discrimination”, *Financial History Review*, 2005, 12.2: 136-8.

cent of loans were ostensibly for working capital (with only 6 per cent for fixed capital expenditure) and 84 per cent were covered by collateral security. They also found that the application of standardised screening procedures to restrict business to low-risk borrowers appears to have mitigated against SMEs.[42]

Banks justified their policies on grounds of liquidity and safety, stressing their essential obligation to depositors. As A. G. Sugg of the Westminster explained in 1927, the banker, 'has to bear in mind that the money he would like to loan … is derived from other customers' deposits, largely repayable on demand, and he must always aim, therefore, at keeping his position liquid, his assets easily realisable, his loans of short duration, and, of course, well secured'.[43] Loans were often 'rolled over' for longer periods than originally granted, but banks tried to safeguard themselves against a gradual transformation of short into long-term advances by reconsidering every advance at least annually and customers were deterred from using ostensibly short-term loans for long-term purposes by the knowledge that

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[42] Collins and Baker, "British commercial bank support"; idem, "English bank business loans". This later article notes (139) that surviving data are likely to have excluded small loans and therefore their sample is biased.

[43] A. G. Sugg, "When you ask the banker for a loan", *System* (July 1927): 31-7. See also BLPES, ABS 352-VII, report of visit by F. W. Crick of the Midland Bank to the Oxford Economists Research Group, 28 November 1936.

renewal was by no means automatic.[44]

The Macmillan gap identified

To what extent did these changes impact disproportionately on smaller firms? Provincial industrialists and their organisations made frequent complaints that centralisation, together with the banks' more mechanical approach to loan applications, was disadvantaging them. For example, following a complaint received by Lloyds from the Secretary of the Manchester Chamber of Commerce in November 1931, H. E. Levitt of the Institute of Bankers visited the Bradford and Manchester Chambers of Commerce and reported:

> a general feeling of dissatisfaction with the Banks … Many people stated that Foreign Banks in London were far more enterprising than English Banks and were anxious to help even the small businessman. There were also many complaints against the policy of centralisation. It was said that not only was the banking system being mechanised, but that local managers were being turned into machines for the transmission of requests to Head Office.[45]

When questioned regarding the impact of bank amalgamations on loans to

[44] BLPES, ABS 352-VII, report of visit by F. W. Crick of the Midland Bank to the Oxford Economists Research Group, 28 November 1936.

[45] LTSBGA: File 2327, General Management files.

new and small businesses, Crick stated that he thought amalgamation had reduced the volume of such advances, which he viewed as, 'all to the good, as it was precisely this type of advance which had been responsible for so many bank failures in the past.'[46] Yet he denied that 'legitimate borrowing by small businesses' was being turned down.[47] The question of what constituted 'legitimate borrowing' was to underpin much of the interwar debate on the Macmillan gap.

The official histories of the Midland and Barclays noted that they conducted a large volume of industrial lending, regarded this as an important area of business, and often repeatedly renewed overdrafts.[48] Yet a substantial proportion of this renewed lending concerned long-term indebtedness by firms in the staple industries, which had embarked on a spree of speculative investment in the immediate aftermath of the First World War, much of which served only to bid up the value of existing plant. Following the collapse of the short post-war boom, the banks found themselves saddled with heavy loans to companies that often had no immediate prospect of repaying them. In these circumstances, they felt obliged to continue assistance, in order to prevent a sudden collapse of these

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[46] BLPES, ABS 352-VII, report of visit by F. W. Crick of the Midland Bank to the Oxford Economists Research Group, 28 November 1936. This was somewhat disingenuous as there had been few bank failures since the middle of the nineteenth century.

[47] ibid.

[48] A. R. Holmes and Edwin Green, *Midland. 150 years of banking business* (London, 1986), 179-80.

sectors and the transformation of problematic debts into bad ones. For example, in the cotton industry, both national and Lancashire banks continued to support struggling firms, an increasing proportion of bank assets thus becoming frozen in this sector. Similarly, the ailing steel industry accounted for 7¾ per cent of Midland's overdrafts; 10 per cent of National Provincial's, and 3.4 per cent of Lloyds', in 1928. Again the banks provided protracted (though, in Tolliday's view, unwilling) support for ailing firms.[49]

Such debts were eventually alleviated, either due to a return to more prosperous conditions (as in steel), or, as in cotton, on account of Bank of England sponsored industrial rationalisation programmes. Yet the banks were reluctant to become involved in industrial restructuring and, Bamberg argues, the motivation of the Bank of England in sponsoring rationalisation was to protect the banks as opposed to offering serious solutions for industry.[50] Many effected companies also proved hostile to rationalisation schemes, their opposition contributing to the banks' reluctance to support such interventions.[51]

Despite a few case-studies, there is very little systematic demand-side evidence regarding the extent to which demands for credit from smaller firms

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[49] S. Tolliday, *Business, banking and politics: the case of British Steel 1918-1939* (Cambridge, 1987): 178.

[50] J. H. Bamberg, "The rationalization of the British cotton industry in the interwar years", *Textile History*, 1988, Vol. 19 Part 1: 83-102.

[51] Tolliday, *Business, banking and politics*: 179. See also Hannah, *Corporate Economy*, 64; Ackrill and Hannah, *Barclays*, 97.

(or those in sectors where the banks were less committed by indebtedness) went un-met - one major problem being the survival of documents.[52] What is clear from the available evidence is that bank lending to trade and industry was viewed as problematic by contemporaries. By the early 1930s a number of well-informed commentators, such as Henry Clay,[53] were calling for the banks to use more sophisticated vetting procedures, based on the merits of the proposal rather than the collateral security. This would involve employing expert industrial knowledge; banks were criticised for having insufficient technical knowledge to vet loans on their own merits, thus forcing them to fall back on liquidity and security as screening mechanisms.[54] Meanwhile the high fixed costs of expert technical knowledge inhibited entry into the industrial finance sector by new firms that would be initially relatively small in scale.[55]

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[52] For contrasting example, see Roy Church, *Kenricks in Hardware* (1969), 18; A. E. Harrison, "F. Hopper & Co. – The problems of capital supply in the cycle manufacturing industry, 1891-1914", *Business History*, 24 (1982): 3-23. The lack of evidence from a business perspective after 1914 is also noted in Tolliday, *Business, Banking and Politics*.

[53] Henry Clay was a distinguished economist, who jointed the Bank of England in 1930 and acted as economic advisor to the Governor from 1933-44.

[54] T. Balogh, *Studies in Financial Organisation* (Cambridge, 1947), 288; Thomas, *Finance of British Industry*, 57-8.

[55] A. T. K. Grant, *A Study of the Capital Market in Britain from 1919-1936* (2nd edn., London, 1967), 279.

In response to widespread public criticism, from a broad political spectrum, the Labour government launched the Macmillan Committee enquiry in 1929. The public reaction to its report, published in 1931, focused on its finding that: 'It has been represented to us that great difficulty is experienced by the smaller and medium-sized businesses in raising... capital... even when the security offered is perfectly sound' – which soon became known as the Macmillan gap.[56] While 'capital' could be interpreted as not strictly encompassing loan finance, the reference to 'security' indicates that the Macmillan Committee were using the word in a broad context; as a Bank of England memorandum noted, 'resources', rather than capital, might have more adequately reflected their meaning.[57]

Wealthy individuals had traditionally been an important source of long-term finance for small companies. Yet private funding of new businesses by individual capitalists was said to have diminished after the First World War, both due to changes in personal taxation and the growth of indirect investment vehicles such as insurance companies and investment trusts.[58] The impact of taxation may have resulted primarily from its form rather than its level (which was still very low by post-1945 standards) – death duties, or, rather, their avoidance, made it desirable for wealthy individuals to hold investments in liquid

[56] Committee on Finance and Industry, Report (Cmnd. 3897 of 1931), para. 404.

[57] Bank of England Archive (hereafter BEA), SMT2/308, "Finance for small businesses," memorandum, 8 May 1944.

form rather than in loans to, or shares in, unquoted companies.[59]

While large companies could turn to the stock market for long-term funds, a flotation was usually impracticable for firms requiring relatively small sums. The Macmillan Committee viewed £200,000 as the minimum economic size for a public issue. Analysis by J. B. Selwyn of new industrial issues during 1937 (when a number of institutions had already been launched with a view to reducing the cost of small issues) indicated that the cost of raising new preference and ordinary share capital of less than £150,000 was 11.6 per cent of the overall value for public issues and 17.1 per cent for public offers - where an issuing house bought the entire block of shares and then re-sold them via a prospectus issue. The average cost for all new capital (issues and offers) involving £150,000 or less was given as 15.0 per cent, compared to 6.9 per cent for those over £150,000. Meanwhile very small issues (below £50,000) were found to have an even higher expenses ratio, possibly in the order of 20 per cent (though the small numbers involved made assessment more difficult).[60] It was generally held that, while transactions costs might be lowered to permit some smaller public issues, market-based City institutions were unsuitable for bridging (as opposed to constricting) the Macmillan Gap. For example, in private evidence to the OERG, Mr Davenport of stockbrokers Chase, Henderson and Tennant stated that an

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[58] BLPES, AB 352, VI2, OERG, meeting with O. T. Talk, 6 March 1937.

[59] Grant, *A Study of the Capital Market in Britain*, 181.

[60] BEA, EID4/31, "The Cost of Raising Capital" memorandum, J. B. Selwyn, Economics and

important gap did exist, but that the City would never be able to fill it, 'as… institutions would find it too much trouble to supervise and watch really small issues.'[61]

The changed environment of the 1930s

During the 1930s the clearing banks faced declining advances; by 1933 these had fallen to 76.6 per cent of their 1929 value and annualised data for the first ten months of 1934 give a ratio of only 76.0 per cent.[62] A key factor was the banks' response to the government's new 'cheap money' policy, introduced in the aftermath of Britain's exit from the gold standard in September 1931. The banks resisted lowering overdraft rates in line with market rates. Other financial institutions also tried to temper reductions, instead competing by liberalising loan terms or moving into higher-yielding investments. Yet the banks rejected liberalisation (a policy adopted, with considerable success by the building society movement) or widening the scope of their investments (the approach taken, for example, by the insurance companies, which expanded into areas such as ordinary shares, industrial mortgages, and leaseback finance). In both these cases the change in policy

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Statistics Section 11 April 1938; Balogh, *Studies in Financial Organisation*, 294-5.

[61] BLPES, AB 3352, VI4, OERG, meeting with Mr. Davenport of Chase Henderson and Tennant, 5 November 1937.

[62] HSBCGA, 193/03/07, Midland Bank Intelligence Dept. memorandum, 4 Dec. 1934.

had been stimulated by intense competition within their sectors.[63] Conversely, the banks aimed for safety and high margins, relying on their tight cartel and near monopoly position (at least with regard to most small/medium firms) to maintain loan volumes. Despite their low advances ratios and political pressure for lower interest rates and/or liberalised lending criteria, the 1930s did not witness any significant modification of lending policy.[64] The banks succeeded in combining an increased premium on overdrafts (relative to the Bank of England base rate) with an extremely low level of bad debts – at the expense of a fall in market share.[65]

The sharpest declines involved larger firms, which turned to the stock exchange to replace bank loans by lower interest debenture issues. Firms of all sizes also made increased use of extra-bank lending. Insurance companies began to offer both long-term mortgage and leaseback finance to industry and shorter-term loans on security, while building societies provided considerable finance for the booming residential building sector and engaged in some mortgage lending on commercial premises. [66] Such encroachments were very

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[63] See George Speight, "Building society behaviour and the mortgage lending market in the interwar period: risk-taking by mutual institutions and the interwar house-building boom" (Ph.D. thesis, University of Oxford, 2000); Scott "Towards the 'Cult of the Equity'?, 78-104.

[64] Collins and Baker, "British commercial bank", 43.

[65] J. Winton, *Lloyds Bank 1918-1969* (Oxford, 1982), 64; Ackrill and Hannah, *Barclays*, 94.

[66] BLPES, ABS 352, VII, report of visit by F. W. Crick of the Midland Bank to the Oxford Economists Research Group, 28 November 1936; HSBCGA, 193/03/07, Midland Bank

limited in scope; for example insurance companies generally excluded industrial premises from mortgages and leaseback deals, while building societies mainly confined their activities to the building sector. Yet they were nevertheless irksome to the banks, as they tied up the type of collateral that might be used as security for bank advances. Hire purchase [HP] finance houses also expanded instalment finance on industrial equipment and plant, yet still accounted for only around £2.5 million of producer credit by 1938.[67] The growth of such competition (mainly limited in scope to loans directly secured by marketable assets), together with extra-bank competition for deposits, contributed to a substantial relative decline in the weighting of the banking sector in Britain's domestic financial framework, as shown in Table 1. Having accounted for 49.9 per cent of total financial assets in 1924, the contribution of UK banks fell to 45.7 per cent in 1929 and 43.3 per cent in 1937; while the share of the Big Five appears to have fallen even more sharply.[68]

The banks became very concerned about their declining market share and historically low advances ratios. Crick conducted regular analyses of the

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intelligence Dept., analysis of advances, 13 March 1934; "When the banker says no! – and why", Business (May 1932): 13-42, 14; Grant, *A Study of the Capital Market*, 190.

[67] D. K. Sheppard, *The Growth and Role of UK Financial Institutions 1880-1962* (London, 1971), 168-9; Sue Bowden and Michael Collins, "The Bank of England, industrial regeneration, and hire purchase between the wars", *Economic History Review*, XLV, 1 (1992): 120-36, 134.

[68] Collins and Baker, "British commercial bank support", 54.

Midland's advances to explore the reasons behind their sluggish growth and the particularly dramatic decline in industrial advances, which had fallen from

Table 1: The asset distribution of UK financial institutions, 1920-38 (%)

Year	Total assets (£ M)	Percentage contribution of particular intermediaries			
		Banks and discounting houses	Life Insurance Companies	Building Societies	Other
1920	4,552	59.5	16.4	1.9	22.2
1923	4,707	53.6	19.0	2.3	25.1
1926	5,096	50.5	20.9	2.3	26.3
1929	5,553	48.2	22.5	2.3	27.0
1932	6,138	46.7	22.6	2.6	28.1
1935	6,852	44.4	23.1	3.0	29.5
1938	7,687	41.5	23.7	3.3	31.5

Source: D. K. Sheppard, *The growth and role of financial institutions, 1880-1962* (London, 1971), 3.

64.8 per cent of advances in February 1934 to 53.4 per cent by February 1938.[69] He identified a combination of demand factors (including the growing integration of industry) together with the recovery of the new issues market during a period of cheap money and the growth of extra-bank competition.[70] In the light of their declining advances, the banks adopted a very defensive attitude to what they saw as encroachments into their core business. In 1933 the chairman of Lloyds complained that finance houses were now providing

[69] HSBCGA, 193/03/07, Midland Bank Intelligence Department, "comments on the results of the classification of advances," 1 March 1938.

[70] Ross, "Bank advances and industrial production in the United Kingdom", 195-7.

'loans of a purely joint stock banking character.'[71] One case involved a French coal trading company's use of non-bank credit in preference to the services of their Swansea branch. The final letter on this case from Lloyds' chief controller of advances noted that it entailed 'provision of working capital … accepting houses are giving their acceptances for a class of business that really should be financed on Bank overdrafts … the business of the Clearing Banks is being "cut into"...'[72]

Yet one area in which the banks still faced relatively little competition was lending to smaller businesses (with the exception of mortgages on non-industrial premises). Small accounts formed a considerable proportion of total advances; in 1935 the average advances of the Westminster, Midland, Barclays and Lloyds were only £1,070, £976, £774, and £806 respectively.[73] Yet during the early 1930s the Bank of England proposed to introduce a new competitor into even this area of business, to which the banks' response was, not surprisingly, cool.

The new industrial finance organisations

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[71] Quoted in Thomas, *The Finance of British Industry*, 70.

[72] LTSBGA: HO/O/Off/12/file 6842, letter from chief controller, advances department, 12th March 1936.

[73] Sources: Lloyds - Data provided by Mark Billings; others - HSBCGA: 193/03/02; RBSGA WES/1174/253, speeches by Charles Lidbury 1931-37. Disaggregated data for private and business accounts are not available.

As Carnevali has shown, large French and German banks made a similar transition from relationship to transaction banking at around the end of the nineteenth century, yet state intervention ensured that new banking institutions emerged to serve local business networks. These countries, and Italy, all experienced difficult relationships between nationally-based banks and small-medium firms, but smaller firms were protected via government support for segmented and specialised banking systems, in which local banks were allowed to concentrate on local industrial finance.[74]

The political power of Britain's small business sector was much weaker than that of its European counterparts. In 1930 firms employing 11-99 people accounted for only 24 per cent of employees for British manufacturers with over 10 workers, compared to 35 per cent in Italy and 37 per cent in France.[75] Yet in the more interventionist political environment of the early 1930s, and in the aftermath of the Macmillan Report, government proved more willing to intervene to assist the small firm sector, albeit at arms-length, via the Bank of England. The Bank's Chairman, Montague Norman, was predisposed towards bridging perceived gaps in the British financial system by encouraging the establishment of specialised financial institutions.[76] In 1932 he

[74] Carnevali, *Europe's Advantage*, 30-82 & 196-7.

[75] Source: Adapted from Carnevali, *Europe's Advantage*, Tables 2.1, 4.1, and 5.1. French data refer to 1931 and cover industrial plants; Italian data refer to 1927.

[76] Bowden and Collins, "The Bank of England, industrial regeneration, and hire purchase", 120-36.

made tentative efforts to meet the Macmillan Committee's criticism by establishing an 'Industrial Mortgage Corporation', financed by the banks. However the Committee of London Clearing Bankers [CLCB] rejected this proposal.[77] Yet in the light of continuing public pressure, on February 1st 1934 Norman informed them that:

> owing to great pressure from Downing Street, he had decided that we could no longer put off the formation of this company… it was a matter of policy that all the banks should assist owing to the public criticism that has been levied against them in not assisting various industries.[78]

The proposed company was to have a capital of £500,000, of which the Bank of England would contribute £100,000, the Big Five £50,000 each, and the smaller banks £10,000 each (the balance to be raised from two or three additional sources). Individual mortgages were not to exceed £50,000, or last for more than ten years. Four of the Big Five proved willing to go along with the Governor's proposals, the exception being Reginald McKenna of the Midland, who refused to subscribe more than £20,000. He asked the CLCB (apparently with the

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[77] NLS, Acc. 8699/1, memorandum of the Chief Executive Officers of the Committee of Clearing Banks, prepared for the consideration of the Committee of London Clearing Bankers regarding the proposed Industrial and Commercial Finance Corporation, 8 May 1944.

[78] NLS, Acc. 8699/1, note of a meeting of the London Clearing Bankers and the Bank of England regarding the proposed Industrial Mortgage Corporation by F. W. Tuke, 1 February 1934.

support of Lloyds) to consider a proposition by Charterhouse Investment Trust to set up a similar company (provisionally titled the Middle-Term Industrial Finance Corporation), 'which would relieve the Bank of England from any participation… and would not involve a contribution from the big banks of more than £10,000 each. This would also avoid the necessity of the banks' involvement being publicly acknowledged, or the amount of their subscription being made known.'[79]

However, on March 6th Norman informed the CLCB that the Bank of England had decided not to participate in the Charterhouse proposal. He hinted that he was suspicious regarding whether the company would make a genuine contribution to bridging the Macmillan Gap:

> If… the Charterhouse Trust sets up a company bona fide to do an industrial mortgage business in such a way as to fill the present need and to satisfy demands for this class of facility, we will make no move. But if, in your opinion, this is not the case, we should feel bound to proceed with the alternative scheme…'[80]

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[79] NLS, Acc. 8699/1, extract from the minutes of the Committee of London Clearing Banks, 8 February 1934; NLS 8699/8, John Kinross and A. Butt-Philip, "ICFC 1946-1951", unpublished manuscript, c. 1976, 5; HSBCGA, 30/29, memorandum to Midland board, 9 Feb. 1934, & 30/51, minutes of meeting of CLCB, 22 Feb. 1934.

[80] HSBCGA, Montagu Norman to Rubert E. Beckett, chairman, Bankers' Clearing House, 6 March 1934.

Norman may also have been deterred by Charterhouse's dubious reputation. One of its founders, Sir Arthur Wheeler, had been convicted on 26 counts of fraudulent conversion in October 1931 (by which time he had left the Charterhouse Board) in a major scandal which almost led to Charterhouse being wound up and, at the height of which, one of its directors, Walter Burt, had committed suicide by throwing himself in front of a tube train.[81] The clearing bankers were also less than sanguine about the proposal; the representative of Martin's bank reported back that, of the large banks, only Lloyds appeared likely to agree to join Midland in subscribing to the Charterhouse venture.[82]

In March 1934 Norman informed the CLCB that United Dominions Trust had made a satisfactory offer to establish a small firm finance company without the need for a direct financial contribution from the banks, via a new subsidiary – Credit for Industry Ltd [CFI]. This proposal received the Committee's support, their requested participation being limited to providing the company with ordinary banking facilities.[83] CFI constituted the only substantial national attempt to breach the Macmillan gap for typical small companies (rather than medium-large firms that might soon be suitable for a public share issue). Its performance is discussed below.

The Bank of England was also instrumental in establishing special

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[81] Laurie Dennett, *The Charterhouse Group 1925-1979: A History* (London, 1979), 34.

[82] Barclays Bank Archive, ACC80/579, Martins Bank, Standing Committee minutes, Volume 1, 13 February 1934.

financial facilities for new firms in four severely depressed ‘Special Areas’ – Clydeside, Durham and Tyneside, part of South Wales, and West Cumberland (excluding major cities in these areas, with the exception of Newcastle). In June 1936, following government pressure, it persuaded the banks, in conjunction with other financial institutions and industrial concerns, to launch the Special Areas Reconstruction Association (SARA) as a political gesture to help the Special Areas.[84] SARA was designed to provide loans to breach initial financial difficulties, for concerns that, ‘...whilst having reasonable expectation of ultimate success on an economic basis... are not for the time being in a position to obtain financial facilities from banks or financial institutions primarily engaged in providing financial facilities for long or medium periods’.[85] This initiative was later supplemented by the Nuffield Trust, financed by a gift of £2 million from Lord Nuffield, and the Treasury Fund, with a further £2 million - available to both the Special Areas and the more widely defined ‘certified’ depressed areas. These bodies enjoyed a strong measure of cooperation; they shared a number of key staff and jointly financed a substantial proportion of projects.

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[83] BEA, SMT2/308, “Finance for small businesses”, memorandum, 8 May 1944.

[84] Carol E. Heim, “Uneven Regional Development in Interwar Britain” (Ph.D. thesis, Yale University, 1982), 538; idem, “Limits to intervention: the Bank of England and industrial diversification in the depressed areas”, *Economic History Review*, 37 (1984): 533-50.

[85] Hansard, Vol. 318, 1936-7, Col. 1392, 2 December 1936, cited in Heim, “Uneven regional development”, 424.

According to a Bank of England memorandum, finance provided by the Special Areas finance organizations [SAO's] to the end of January 1939 amounted to £3,825,000, for some 207 enterprises, of which 109 were new to the Special Areas. About a third of these were located on government-financed trading estates.[86] Though they pursued more liberal lending policies than the other industrial finance organizations, their performance sheds little light on the scope of the national Macmillan gap. They were limited to very small and severely depressed areas, none of which (with the partial exception of Clydeside) had any significant light manufacturing base or representation of expanding sectors. Conversely, many assisted firms involved refugee industrialists from Germany, Austria, and Czechoslovakia, who were effectively 'directed' to these areas under the refugees' admissions process. Some other clients were large firms, which opened branch factories. Moreover these bodies (particularly the Nuffield Trust and Treasury Fund) were motivated by employment creation rather than purely commercial considerations.

However, one interesting aspect of this initiative involved attempts at 'active investment' - providing financial and managerial advice as well as capital. SARA employed trained accountants and other technical experts to vet applications to the SAO's and make inspection visits to smaller clients.[87] One of these, Cecil D. Morrison, was later employed by the Nuffield Trust to

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[86] BEA, EID4/159, "The Special Areas", 26 July 1939.

[87] ibid, 458.

visit firms and make recommendations concerning management or accountancy practices (sometimes even becoming a director).[88] Such after-care services bore some similarities to the 'active investment' modus operandi of the venture capital industry that emerged in the United States after 1945, involving participation in the management of assisted concerns, as directors rather than passive financiers.[89] After-care was developed more fully, with some success, in the government's post-war regionally assisted areas industrial finance machinery, at a cost equivalent to an additional interest rate of around 0.25 per cent.[90]

Reducing the upper limit of the Macmillan Gap

Despite failing to gain acceptance as the Bank of England's 'champion', Charterhouse Investment Trust went ahead with its proposal to form a new subsidiary, now re-named the Charterhouse Industrial Development Co. [CID], in June 1934. However, as Norman had suspected, this organisation proved much more limited in scope than either the Bank of England's proposed 'Industrial Mortgage Company,' or CFI. Its stated purpose was, 'to finance industrial business whose capital falls below the limit with which existing Issue Houses can

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[88] M. E. Daly, "Government policy and the depressed areas in the inter-war years" (D.Phil thesis, University of Oxford, 1978), 249-51.

[89] Richard Coopey and Donald Clarke, *3i: Fifty Years Investing in Industry* (Oxford, 1995), 307-9.

[90] Francesca Carnevali and Peter Scott, "The Treasury as venture capitalist: DATAC industrial finance and the Macmillan Gap 1945-60", *Financial History Review*, 6 (1999): 47-65.

deal by way of public issue or placing.'[91] CID is one of the best known of the Macmillan gap institutions and its very limited volume of business has been cited as evidence that there was no significant gap.[92] Yet in fact its scope and funds were severely limited. Furthermore, it was only one of a number of similar companies launched by issuing houses, merchant banks, and other organisations during the 1930s, some of which pursued more active lending policies.

CID had an authorised capital of £500,000, all of which was issued by November 1935. Charterhouse held 53 per cent (including all the original issued capital), while the Prudential subscribed 40 per cent and the Lloyds and Midland banks took 5 per cent and 2 per cent respectively.[93] It sought only concerns that would be suitable for a public issue within a few years (which would be handled via the Charterhouse Investment Trust); indeed the primary aim of CID was to generate new issues business.[94] Eligible clients were further restricted to firms already operating commercially with a satisfactory profit record covering at least three years; that offered the prospect of becoming big businesses; and that had a

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[91] BEA, EID4/159, Bank of England, Economics and Statistics Section memorandum, 22 July 1935.

[92] Ross, "The 'Macmillan Gap'", 213.

[93] HSBCGA: 30/29, letter from CIDC chairman to Managing Director, Midland Bank 13 Nov. 1935.

[94] BEA, EID4/159, Bank of England, Economics and Statistics Section memorandum, 22 July 1935; SMT2/10, extract from *The Times*, 20 Nov. 1935 "Finance for small businesses;" Dennett, *The Charterhouse Group*, 39.

management that was both capable of coping with this expanded scale and held a substantial financial interest in the business.[95] This type of assistance, involving 'nursing' companies in preparation for a public issue, was already being undertaken by a few companies, such as Investment Registry Ltd and the Industrial Finance and Investment Corporation (which was associated with the Prudential and held £174,000 of unquoted investments by September 1935).[96]

Applicants were vetted both by its own staff and independent accountants, valuers, or solicitors (at the applicant's expense) - firms employed including Price Waterhouse; Merret, Son & Street; Spicer & Pegler; and Thomson McLintock.[97] CID required board representation, via a director who would exercise specific control over borrowing powers, capital expenditure, and increases in management remuneration. It demanded both fixed interest and equity participation - through either a direct ordinary share allocation, share options, or 'by attaching participation rights to the fixed interest bearing capital'.[98] In most cases it acquired a controlling interest: its balance sheet for 30th September 1937 showed a cumulative investment of £403,575 in shares or debentures of companies where a controlling interest was held, together with £191,111 in other concerns.[99]

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[95] HSBCGA: 30/29, report on CID, 7 Nov. 1935; Thomas, *The Finance of British Industry*, 120.

[96] BEA, G14/236, excerpt from *The Times* 27 Sept. 1935.

[97] HSBCGA: 30/29, various reports on CIDC.

[98] HSBCGA: 30/29, report on CIDC, 7 Nov. 1935

[99] NLS, Acc. 8699/1, John Kinross, "The finance of small businesses", memorandum, May 1938.

CID received over 7,000 propositions by February 1940, but had proceeded with only 17.[100] It appears to have been relatively inactive after its first year of operation; nine of its 17 clients had received funding by September 1935, several others had been at least partially approved, and most of its original funds had been deployed.[101] Yet despite its short period of activity CID was successful in relation to its modest scale of operations. Gross profits increased from £10,032 in 1936 to £32,851 in 1939, by which time it had also accumulated reserves of £99,100.[102] Moreover, new issues business from CID generated major additional profits for Charterhouse, as discussed below.

A very similar organisation, Leadenhall Securities, was launched in July 1935 by the merchant bank J. Henry Schroder & Co. Leadenhall aimed to invest in firms with prospects for stock market flotation within five years, in which it acquired a combination of ordinary and redeemable preference shares. Again, new issues business was a key motivation, income being generated through securities dealing, 'bond washing' (which was not then illegal), and participation in underwriting syndicates.[103] By 1938 Leadenhall had an issued capital of £125,002 and had loaned sums of £2,000 upwards, usually for five years or less,

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[100] HSBCGA: 30/29, report on CIDC, memorandum, 7 Feb. 1940.

[101] HSBCGA: 30/29, report on CIDC, 7 Nov. 1935.

[102] HSBCGA: 30/29, report on CIDC, memorandum, 7 Feb. 1940.

[103] Richard Roberts, *Schroders. Merchants and Bankers* (Basingstoke, 1992), 271. Bond washing refers to transactions in securities that are about to yield income, in order to produce a beneficial tax position.

charging an interest rate of around 6 per cent. The company also requested a free 10-15 per cent equity allotment and a board representative, to act as a financial advisor.[104] A further company undertaking similar business was The New Trading Company, founded in October 1934 and largely funded by Brandeis-Goldschmidt & Co. This financed a number of small British businesses and floated several companies established in Britain by foreign interests.[105]

Another group of companies sought to assist firms that were too small for a conventional public issue not by holding their securities until they had reached the critical size, but by reducing the minimum size threshold. One early innovator was the Cheviot Trust, founded by John Kinross in October 1933 to specialise in small issues of £25,000-100,000. It sought to reduce the costs of small public issues through removing most of the advertising costs (which usually amounted to at least £8-10,000) by advertising the prospectus in only one daily paper - the minimum Stock Exchange requirement - and using direct mailing to active lists of small investors as its main marketing vehicle.[106]

Kinross claimed that over 1934-38 he made over a hundred public issues of between £30,000-200,000 under various 'labels', at costs that never exceeded 10 per cent of the capital raised. 29 were launched under the Cheviot name and about a dozen under the Covent Trust Ltd (Cheviot being reserved for what were

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[104] NLS, Acc. 8699/1, John Kinross, "The finance of small businesses", memorandum, May 1938.

[105] BEA, EID4/159, "New Trading Company Ltd", memorandum, 16 November 1936.

[106] NLS 8699/8 Kinross and Butt-Philip, "ICFC 1946-1951", 60; John Kinross, *Fifty Years in the*

considered the best issues).[107] All but two of these were said to be still operating in the mid-1970s (some having become part of larger groups). Ordinary shares were issued in small denominations, usually one shilling, so that Cheviot had sufficient volume for 'making the market' during the first few weeks of trading. Other issuing houses established to specialise in small company flotations included London Industrial Finance Trust, which made 31 issues between 1935 and 1939, Ridgeford Industrial Investments, Lonsdale Investment Trust, and Whitehead Industrial Trust, founded in February 1936, which became the most active issuing house for this type of business.[108]

Most such organisations had a very limited capital (Cheviot had an initial capital of only £1,000 and a full-time staff of one).[109] Even the 'nursing' companies such as CID and Leadenhall were established by relatively small organisations. They thus restricted their activities to very safe propositions, as they could easily allocate all their limited capital to such projects, while even a single well-publicised failure might terminate their activities. Furthermore, both classes of institution sought their main profits not directly - from interest on, and equity in, assisted companies - but from share issue, dealing, and associated

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City. Financing Small Business (London, 1982), 70.

[107] Kinross and Butt-Philip, "ICFC 1946-1951", 61; Kinross, *Fifty Years in the City*, 77-80.

[108] Kinross, Fifty Years in the City, 81; BEA, BEA, EID4/31, "The Cost of Raising Capital" memorandum, J. B. Selwyn, Economics and Statistics Section 11 April 1938; Balogh, *Studies in Financial Organisation*, 302.

[109] Kinross, Fifty Years in the City, 71 and 80.

activities – the scope for which in turn strongly influenced their criteria for selecting propositions. For example, Kinross stated that Cheviot made most of its money from dealing in surplus equity acquired in addition to the prospectus issue, which was sold to the trust's shareholders at a small premium prior to the start of dealing and used to make the market during the first weeks of trading, typically experiencing rapid price growth.[110]

As Thomas noted, most of the 'Macmillan gap' institutions were, in reality 'mere forcing houses for potential market material … they did not in the main tackle the problem of finding a home for unquoted issues.'[111] While they played an important role in reducing the upper limit of the Macmillan gap from £200,000 to £50-75,000 (the level given by E.H.D. Skinner of the Bank of England in evidence to the Committee on Post-War Domestic Finance in 1943), their facilities were limited to companies almost ready for a public flotation, effectively excluding most industrial firms.[112] In 1935 over three quarters of manufacturing establishments with 11 or more employees employed fewer than 100 people, while even an average establishment with 100 employees had an annual net output of only around £22,800, well below even the modified Macmillan Gap threshold.[113] With the exception of the tiny Northern Territories

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[110] NLS, Acc. 8699/12, memorandum on the Cheviot Trust by John Kinross, 31 October 1984.

[111] Thomas, *The Finance of British Industry*, 121.

[112] BEA, SMT2/307. Committee on Post-War Domestic Finance, minutes of fifth meeting held on 13 May 1943.

[113] United Kingdom, Department of Labour and Productivity, *British Labour Statistics: Historical*

Trust[114] and organisations limited to the chronically depressed Special Areas, no venture other than CFI provided capital to small businesses. CFI's experience is thus particularly important in terms of both the Macmillan gap and the barriers facing new entrants seeking to bridge that gap.

Credit for Industry

United Dominions Trust [UDT], founded in 1919, marketed itself as a commercial banking company, providing, 'a supplementary or complementary service' to the facilities offered by clearing banks.[115] In practice, its core business was HP finance. During the 1920s it was involved in extensive financing of new industrial machinery and plant - through HP and other instalment finance.[116] It had also established a national presence, with twelve branch offices throughout

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Abstract 1886-1968 (London, 1971), Tables 205 and 206. The net output figure is based on the net output per person for all manufacturing trades included in the 1935 Census of Production.

[114] The Northern Territories Trust was established in 1936, to provide loans to small businesses in the Northern counties (together with other classes of business). Its capital was composed of £50,000 in ordinary shares of £1 each, of which 10,000 had been allotted - BEA, SMT2/10, note regarding Northern Territories Trust, 29 Oct. 1935; SMT2/10, undated note.

[115] LTSBGA, UDT, "United Dominions Trust Ltd, Bankers 1919-1929", promotional leaflet, 1 May 1929.

[116] BLPES, Pamphlet Collection, J. Gibson Jarvie, "Credit for Industry", text of a speech delivered to the LSE Banking Society, 21 November 1935, 18.

Britain.[117]

Bank of England interest in UDT began during the late 1920s, when Montagu Norman became concerned regarding a possible deficiency in the supply of medium-term credit to small-scale manufacturers and traders for machinery purchases. Expanding HP finance appeared to offer a solution and Norman selected UDT as his champion in this field - as it was the largest HP finance house, had a respected and entrepreneurial leader in J. Gibson Jarvie, and had considerable experience of dealing with manufacturers.[118] The Bank of England provided £250,000 to double UDT's paid-up ordinary share capital, the ensuing publicity leading to UDT being approached during the early 1930s by a number of industrial concerns that sought longer-term credit and/or larger sums than were normally supplied under HP transactions .[119]

Discussions between Jarvie and Norman regarding the establishment of a small firm finance organisation had been in progress since at least December 1933.[120] This was provisionally entitled 'The Industrial Credit Bank Ltd', though by the time of its launch (as a wholly-owned UDT subsidiary) in March 1934 this had been changed to the more neutral, 'Credit for Industry'.[121] CFI's press

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[117] "Credit for Industry", Finance for Industry and Commerce, 33.

[118] Bowden and Collins, "The Bank of England, industrial regeneration, and hire purchase", 123-4.

[119] ibid., 134.

[120] LTSBGA, United Dominions Trust (hereafter UDT) minutes, 12 Dec. 1933.

[121] LTSBGA, letter, Jarvie to Norman, 13 March 1934 (appended to UDT Board minutes); BEA,

release claimed that, 'this new company will meet a specific criticism of our banking system made by the Macmillan Committee...'[122] Despite Norman's and Jarvie's efforts to involve the clearing banks, the CLCB declined an invitation to appoint a nominee director.[123] Norman also tried to persuade a prominent clearing banker to serve as a director in an individual capacity. Bromley Martin of Martins Bank was approached and initially accepted - subject to the consent of his board – but failed to gain their agreement.[124]

CFI aimed to assist established concerns whose capital requirements were too small to be served economically via the ordinary capital market. Funding was available only on adequate security and to companies which had traded successfully and could show a profit record of at least three years.[125] No equity interest was ever taken, finance being restricted to loans - usually secured on debentures or mortgages (though on occasions funds were loaned against

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SMT2/7, letter Jarvie to Norman, 3 May 1934.

[122] BEA, G14/236, CFI press release, 21 March 1934.

[123] BEA, G14/236.

[124] LTSBGA, UDT Board minutes, 8 May 1934 and 12 June 1934.

[125] BEA, EID4/31, "The Cost of Raising Capital" memorandum, J. B. Selwyn, Economics and Statistics Section, 11 April 1938. A review of June 1943 gave the main reasons for CFI having turned down loans (in addition to being 'outside the scope' of the initiative) as: the absence of an earnings record; an insufficient stake on the part of the borrowers; insufficient fixed assets to justify a fixed loan; and too large a percentage of the loan being required to repay existing indebtedness; BEA, SMT2/7, reply to questionnaire sent to CFI by Bank of England on 12 June

‘personal undertakings supported by approved collateral’).[126] Crucially – unlike the banks - it was prepared to lend long-term, for capital purposes; sums of up to £50,000 being available, for up to twenty years.[127]

CFI planned to establish regional advisory networks. By September 1934 it had set up a Scottish Advisory Board, which included several prominent Scots businessmen.[128] By 28th January 1935 its Scottish loans totalled £65,000, while a further £5,000 worth had been approved.[129] Further boards for the North of England and South Wales were envisaged, but the formation of SARA to finance firms in the Special Areas (which included substantial parts of these regions) appears to have led to these plans being shelved.

In the two months or so after March 21st 1934, when CFI released its first press announcement, it received around 1,000 applications, the quality of which

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1943.

126 BEA, SMT2/7, reply to questionnaire sent to CFI by Bank of England on 12 June 1943; NLS, Acc. 8699/1, John Kinross, “The finance of small businesses”, memorandum, May 1938; Credit for Industry, Money for Industry, 11.

127 BEA, EID4/159, Bank of England, Economics and Statistics Section memorandum, 22 July 1935.

128 LTSBGA, Acc. 71, CFI Scottish Advisory Board minutes, 7 September 1934. The Committee comprised Sir James Lithgow, W. T. Henderson, Sir A. Stephen Bilsland, Lord Elgin, and N.W. Duthie, with Gibson Jarvie as Chairman.

129 ibid, 28 January 1935.

was stated to be better than expected.[130] Of these:

> 300 come within scope of Corporation, have been partially investigated, and are likely to result in loans for, say, £400,000.
>
> 600 required further particulars;
>
> 50 are outside the scope...
>
> 40 or so came within the province of the United Dominions Trust.[131]

By June 30th 1943 CFI had loaned £896,264 to some 173 firms; loans ranging from a few hundred pounds to £60,000, with a mean value of £5,181. Applications had numbered around 8-9,000, while enquiries had been received from further 5-6,000 concerns.[132] Loans were widely spread by sector, though the largest group were the motor vehicle and engineering trades, which accounted for 41.0 per cent of firms and 46.3 per cent of loans.[133] This may reflect UDT's strong contacts in, and experience with, the motor, engineering, and allied trades – it was in these sectors that its HP business was initially concentrated.[134] All loans were to established businesses.

The scale of CFI's lending was substantially less than might have been expected given the optimistic evaluation of its early proposals. Initial

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[130] BEA, SMT2/7, "Credit for Industry", note from UDT to Bank of England, n.d., c. May 1934.

[131] ibid.

[132] BEA, SMT2/7, reply to questionnaire sent to CFI by Bank of England on 12 June 1943.

[133] ibid.

[134] Credit for Industry Ltd, *Finance for Industry and Commerce*, 4.

optimism rapidly evaporated when it became clear that it would not be allowed to finance a large proportion of proposals it vetted and approved. As Rajan and Zingales have noted, incumbent financiers have strong incentives to oppose measures of financial liberalisation and development, as these threaten to undermine their competitive advantage – through reducing their privileged access to, and rents from, investment opportunities, and by changing the basis of credit evaluation and risk management so that incumbents' old skills become redundant and new ones become necessary. "Financial development not only introduces competition, which destroys the financial institutions' rents and relationships… it also destroys the financier's human capital."[135]

CFI's approach to industrial lending was much more threatening to the banks that the 'nursing institutions' reviewed above. Banks had traditionally assisted client firms seeking a public share issue (by, for example, allowing their names to be quoted in the prospectus) and innovations which enabled such firms to access the stock exchange a few years earlier in their development were not a significant challenge to them. Conversely, CFI sought to apply expert financial advice to the assessment of loan propositions for firms too small to turn to the stockmarket in the foreseeable future – challenging that segment of industrial business in which the banks' monopoly

[135] Raghuram G. Rajan and Luigi Zingales, "The great reversals: the politics of financial development in the twentieth century," *Journal of Financial Economics*, 69 (2003): 5-50, 19. See also idem, *Saving Capitalism from the Capitalists. Unleashing the Power of Financial Markets to*

position was strongest. If successful, this approach both threatened to take business away from the banks and, more importantly, demonstrate the viability of screening mechanisms that might identify more worthy propositions, but at significantly greater cost than the banks' screening techniques. This might, in turn, lead to renewed public pressure for the banks themselves to employ expert advice, raising their transaction costs and eroding their monopoly profits.

The Banks had no difficulty in limiting CFI's expansion, as CFI relied on their support. They constituted significant shareholders of its parent company and also provided a large amount of UDT's working capital - via loans and acceptances.[136] Furthermore, given that assisted companies would still require normal banking facilities, the banks held an effective veto over CFI's clients – by threatening to withdraw facilities. Fears that the banks might sabotage the initiative are evident in a letter from Jarvie to Norman, which stated that CFI 'will not ask or expect anything from the joint stock banks beyond ordinary and justifiable banking facilities and a sympathetic co-operation.'[137] However, CFI did not receive such cooperation, as hinted at in a 1944 Bank of England memorandum on potential avenues for increasing the provision of finance to small businesses. This noted that, should the Bank of England choose to boost

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Create Wealth and Spread Opportunity (New York: Crown Press, 2003).

[136] Bowden and Collins, "The Bank of England, industrial regeneration, and hire purchase", 125.

[137] HSBCGA, J. Gibson Jarvie to Montagu Norman, 20 March 1934.

the financial resources of existing firms in this area, success would be blocked unless the banks would, 'assure us that any existing company which has enjoyed facilities from the banks would continue to do so, notwithstanding the fact that the long-term concerns were technical competitors with the banks in their new venture.'[138]

Given their powerful position, Jarvie made it a rule not to advance money without the prior approval of the applicant's bank. However, this led to a substantial loss of business, as in many cases, after CFI had gone through the process of investigating a funding proposal which the firm's bank had previously declined, the bank in question then stepped in and provided the finance, if vetting was positive.[139] This post-vetting 'poaching' both greatly curtailed the scope of CFI's lending and inflated its administrative costs. By the end of June 1935 CFI had approved loans (at least in principle) totalling £1,272,421. Of these, loans to the value of £649,900 had fallen through after being approved in principal, while a further £142,996 of firmly approved loans were still to be finally settled. Of the remaining firmly approved loans (£479,525), only £228,349 had been actually lent, as £251,176 of business had been lost through other parties providing the finance (mainly the firms' banks, which took business to the value of

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[138] BEA, SMT2/308, "Finance for small businesses", memorandum for the Deputy Governor, 8 May 1944.

[139] SMT2/308, "Finance for small businesses", memorandum, 8 May 1944; Commissioner for the Special Areas (England and Wales), First Report [7 July 1935] (Cmnd 4957 of 1935), para. 30.

£207,000).[140]The financial statement from which these figures are derived does not give any details of potential business taken by the banks between the stages of provisional and final approval. However, in a meeting with Deputy Governor Catterns of the Bank of England on 26th April 1944, Jarvie stated that 75 per cent of all potential investments 'had been snapped up by banks who were supposed to be supporting him, and this after CFI had agreed to find the money'.[141]

The surviving archives provide no definitive proof regarding whether the banks were merely 'cherry picking' the best CFI business, by free-riding on its screening activities, or were pursuing a more deliberate policy to block their new competitor. However, from CFI's perspective this made little difference, as the poaching prohibitively magnified its administrative costs; in June 1936 Jarvie had to report to his shareholders that these had become disproportionate to the company's revenue.[142] Thus CFI was prevented from taking any significant role in the small firm finance market or offering the sort of competition to the banks that might have made them modify their own lending policies. Jarvie's experience was repeated after 1945, when the Bank of England pressured the Big Five into establishing the Industrial and Commercial Finance Corporation (ICFC) as a new vehicle for bridging the Macmillan Gap. As the Corporation's official history notes, some of the banks persistently tried to poach ICFC loans it had

[140] BEA, SMT2/7, CFI summary financial data for period to 30 June 1935.

[141] Coopey and Clarke, *3i*, 26, note 15.

[142] LTSBGA, A. Muir and M. Davies, "United Dominions Trust. The History of an International

positively screened, in an attempt to undermine the venture.[143]

Conclusion

Economic theory indicates that monopolists will reject a significant proportion of business that - though unprofitable from their monopoly perspective - would nevertheless have been successfully transacted in a competitive market. In the corporate lending market this involved firms which required long-term capital, or broader screening criteria to identify their credit-worthiness. These were generally not the sort of high-risk, high-reward technologically-based start-up companies that might attract wealthy financiers, but typically firms operating in established, competitive markets, that offered returns which were modest (but sufficient to secure finance if the banking system had also been competitive). The volume of such excluded business cannot be quantified even to a broad order of magnitude, for reasons outlined above. Yet, as banks' lending criteria generally excluded loans for capital purposes, and capital expenditure by small and medium firms was thus often limited to internal resources, it can be expected to be substantial.

While returns on such lending were not particularly high, they were sufficient to attract new entrants, as evidenced by the example of CFI. Yet the banks ability to withdraw overdraft facilities for working capital from firms

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Banking and Finance Group", unpublished typescript history, n.d., c. mid-1970s, 96.

[143] Coopey and Clarke, *3i*, 36, 56-7.

that used such instiutions for longer-term investment acted as an effective sanction over market entry. By selectively poaching business from the pioneering entrant, the banks prevented the emergence of any significant specialist medium-long term industrial lender of the type that emerged (with government support) in, for example, France and Germany. They thus not only protected their market share, but blocked the development of new loan screening methods that were more costly but (if the willingness of the banks to take CFI's positively screened business is any indication) appeared to have been viewed as more effective than their own low-cost methods. In doing so they preserved their super-normal profits, at the expense of those smaller firms located between the margins of the monopoly and competitive supply of credit.

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