The banking crisis: cause and effect
The Collapse

Narrator
Banks were once seen as the cornerstone of modern British society.

Safe, solid and dependable, they provided the capital and security needed to ensure that businesses could flourish and the economy would develop.

But by September 2005, the UK's banks had changed beyond all recognition.

Finance had become so complicated that many people simply didn't understand what they were dealing with.

Paul Mason
"It became too complex, both for the regulatory framework, for the management styles, for the management skills and ultimately for the business model of banking."

Narrator
Bankers were gambling without being fully aware of the risks that they were taking.

Lord Skidelsky
"The failure to distinguish risk which we can measure, from uncertainty which we can't, is the big failure of contemporary economics."

Narrator
The quality of the products being sold plummeted.

Peter Hahn
"What we had was alchemy.

We started with high quality mortgages and packaging them into high quality bonds.

In the end, what we were packaging was garbage and telling everybody it was gold."

Narrator
In the first instance, it led to a credit crisis and our banks being pushed to the very brink of collapse.

Vince Cable
"We got to a point where there was one evening when banks would no longer lend to each other overnight.

If the Government hadn't intervened at that point, with fresh capital for the banks and guarantees, the banking system would have gone.

I mean it was actually that close."

Narrator
Then, within a year, a devastating recessionary wave crashed down on the wider UK economy.

Ken Jones

“We’ve not created it. Everybody out there who’s worked for a living is wondering what the hell is going on.”

Narrator
It became harder to get a mortgage; deposits required when buying a house increased and credit got tighter.

These events have changed the way that banks operate, the public’s perception of them and the entire landscape of personal finance.

But how did it happen, and what does the future hold for banking in Britain?

Narrator
Borrowing and lending money are the most basic principles of banking.

If done through the market, there are problems of information, as lenders know little about the borrower; and problems of incentive, as the lenders may base loan decisions on a 'willingness to pay' a high interest rate rather than an actual ability to pay.

Banks therefore solve both of these problems.

Phillip Booth
“Banks and financial institutions perform an intermediation role in the economy that takes peoples’ savings and allows it to be invested across a range of possible investment projects.”

Narrator
Because banks provide long-term loans, whilst giving savers instant access, they suffer an inherent imbalance or liquidity risk.

Sir Howard Davies
“We all know that banks are in fact a kind of confidence trick.

We deposit our money and, in theory, the banks says yes, you can have it any time you like, but actually we also know with another part of our brains that in fact they’ve lent it to somebody and they’ve lent it on a long term basis, whereas we might want it on a short term basis.”

Narrator
Historically in the UK, banks were divided into distinct types, with commercial or retail banks providing instant withdrawals and loans for businesses.

David Llewellyn
“Commercial banks, which are, if you like, the High Street Banks that we all know of, are making loans and providing financial services to companies, and a much wider range of customers.”

Narrator
On the other side of the equation were the Investment banks.

Involved in long-term capital business, they invest and trade in the global financial markets.

David Llewellyn
“These are banks that are engaged in corporate advice, big corporate loans, securities trading, normally they do not accept deposits from the general public.”

Narrator

In the UK, the Bank of England regulated the banking system before this power was handed to the Financial Services Authority in 1997 by the new labour government.

David Llewelleyn
“The Bank of England was the regulatory supervisor within the financial system, and although there we no legal regulations, the same as in other countries, the governor’s eye brows were very important.

That If he raised his eye brows and saying, “I don’t really like what you’re doing,” that was often enough to induce banks to stop doing that.”

Narrator
This UK system of regulation was in contrast to the more formal government regulations in the US.

Larry Elliot
“You had real constraints on what banks could do.
You had the Glass Steagall Act, which said there would be retail banks on the one hand, investment banks on the other, and never the two should meet. And more generally you had a whole system of capital controls, you had regulations which prevented banks and institutions from doing certain things.”

Narrator
Things remained the same until the early 1980’s, when a new political dawn in the US and UK led to further deregulation of the financial markets.

Archive of Reagan and Thatcher‘Ronald Reagan and Margaret Thatcher were political soul mates. The former Hollywood actor and the grocer’s daughter were now embarked on a true life political romance. (Thatcher) We in Britain think you are a wonderful president’

Lord Skidelsky
“Deregulation was the great ideology of the Thatcher/Reagan revolutions.

The idea behind it was that markets were perfectly efficient, financial markets were very efficient and they could regulate themselves.

Narrator
US and European banks descended on London to take advantage of this new, free-marketeering approach, fundamentally re-shaping the outlook of the City.

Vince Cable
“That whole process changed people’s mentality, and people were encouraged to believe that getting rich quickly was good for you and removed any sense of guilt and any sense of responsibility that went with it.”

Narrator
Retail banks became more active in the mortgage market, competing directly with building societies.

David Llewellyn
“During the 1980s, particularly as a result of the so called big bang in 1986, banks began to diversify.
They began to adopt a much more shareholder value ethos of profitability, and this distinction between wholesale banking or investment banking or retail banking, gradually became eroded.”

Narrator
Building societies also began to change the way they operated.

Howard Davies

“We used to have banks on the one hand and building societies on the other. Building societies did mortgage business and banks did other forms of consumer credit and typically didn’t lend on house purchase.

We then moved into an arrangement whereby building societies were liberated from the constraints that they had worked under before and were able to extend into consumer credit and subsequently into some forms of business credit and the banks also could compete in the mortgage markets.

So we ended up with a situation where the banks and the building societies were essentially competing in the same area.
Building societies were mutually owned entities until the 1980s and then they were allowed to convert themselves into companies which gave them more flexibility in terms of the way they acquired their funding.”

Narrator
Building societies such as Abbey National and Northern Rock were at the forefront of these changes, though many saw demutualization and the new focus on profit above all else, as dangerous precedents.

Larry Elliot
“For an awful lot of the last 150 years mutual organizations worked extremely well, they delivered what they said on the tin.

And I think the death of the mutual movement was to be lamented.”