

The demise of Overend Gurney

By Rhiannon Sowerbutts of the Financial Stability Strategy and Risk Directorate, Marco Schneeberg of the Major UK Deposit Takers Supervision Directorate and Florence Hubert of the Monetary Analysis Directorate.⁽¹⁾

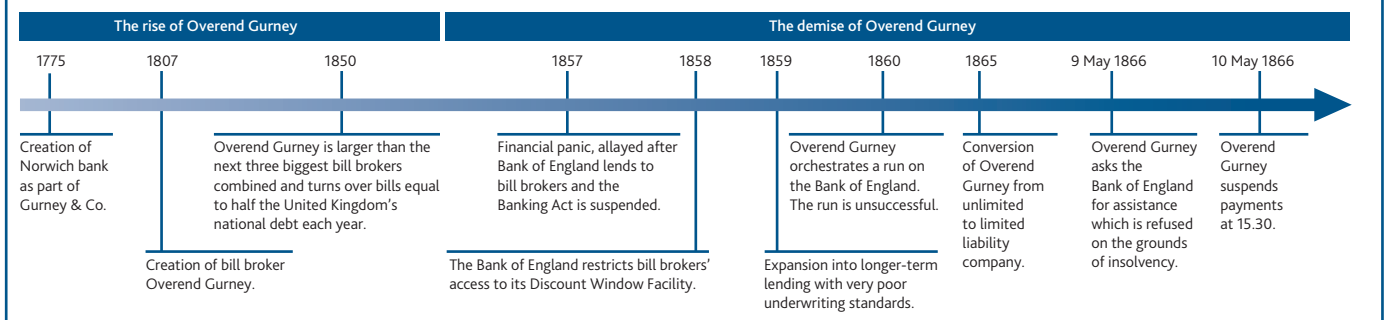
- 150 years ago, Overend Gurney, the largest discount house in the City of London, suspended payment. *The Times* immediately christened this date 'Black Friday' due to the financial panic that ensued. The failure of Overend Gurney was caused by a change of business model, whereby it entered the lending business but with poor lending practices and insufficient risk management.
- The Bank of England, a private bank at the time, refused assistance to Overend Gurney but supported the refinancing of viable banks and brokers by depleting its own reserves. Over a ten-day period, the bill discount rate (the Bank Rate of the time) was increased four times to 10%. Financial stability returned in the following months.
- This lending by the Bank of England led to valuable debates around optimal central bank lending and limited liability and inspired Walter Bagehot's principles for lender of last resort. There are several lessons which remain relevant today.

Overview

The failure of Overend Gurney — a discount house which had been larger than its three next largest competitors combined — sent shockwaves through the financial system in May 1866. The seeds of its demise had been sown many years earlier. Despite its profitable bill broking business, Overend Gurney had been on the brink of failure for some time, incurring enormous losses from the bad loans it had extended with little credit risk assessment. In 1865 in an attempt to salvage Overend Gurney, its partners had converted the broker to a limited liability company. But ultimately, the combination of more generalised economic instability, some unfortunate rumours and a court case which ruled they could not collect from a debtor pushed Overend Gurney into failure.

On 9 May 1866, Overend Gurney asked the Bank of England for assistance, which was refused on the basis of the broker's insolvency; Overend Gurney suspended payments at 15.30 on 10 May 1866.

To mitigate the panic that followed the Bank of England, a private bank at the time, extended the largest market-wide lending it had ever done and drew heavily on its own reserves. Bagehot praised the Bank for accepting its lender of last resort role, setting an expectation that the Bank would act in the same fashion in similar circumstances in the future. The best way to carry out central bank lending has been the source of academic and policy debate ever since.



(1) The authors would like to thank the Bank of England Archive, Ian Bond, Forrest Capie, Andrew Hauser, Sarah John, Matthew Manning, Aniruddha Rajan and Peter Thomas for their help in producing this article.

On 10 May 1866, 150 years ago, Overend Gurney, one of the largest bill brokers in the City of London, failed. The run on Northern Rock plc in September 2007 has often been compared to the panic that ensued after the failure of Overend Gurney.

The demise of Overend Gurney marks a turning point in Britain's financial history. In its aftermath, it led to valuable debates concerning the Bank of England's role as the lender of last resort (LOLR) and moral hazard. Lessons from these debates remain relevant today — not least those found in the 1873 treatise by Walter Bagehot (Editor in Chief of *The Economist* at the time) on the principles for LOLR in *Lombard Street: a description of the money market*.

This article looks back at these events. The first section discusses the rise of Overend Gurney and their initial core business of bill broking. The second section examines its decline and eventual failure. The third section discusses the actions the Bank of England took to help stem the panic caused by Overend Gurney's failure. Finally, the article highlights the debates and lessons that remain important today.

The rise of Overend Gurney

In 1775, the Gurney family of Norfolk, prominent merchants in the wool trade, expanded its business to banking in the prosperous farming district of East Anglia. The family did so by creating what later became 'Gurney & Co.', a bank which facilitated investing in London, drawing on their Quaker reputation to attract the savings of the local gentry and tradesmen. The Gurney family had a reputation for trustworthiness and wealth, both particularly important prerequisites for running a bank as these were run as unlimited liability partnerships.

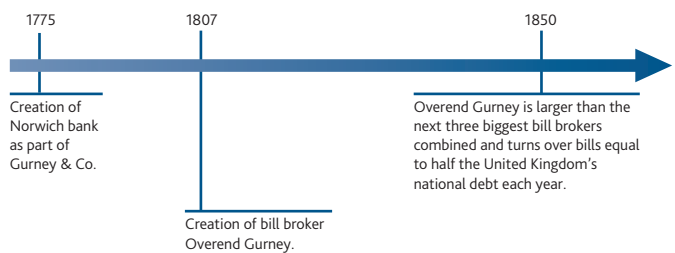
Gurney & Co. successfully grew to become the largest bank in East Anglia. In 1807, Samuel Gurney (the heir of the original founder of the Gurney & Co. bank) further expanded the family business by acquiring and restructuring the London bill broker 'Richardson, Overend & Company', and so the combined company he founded became known as 'Overend, Gurney & Company'. It was one of the first companies to offer, for a brokerage fee, to match buyers and sellers of bills of exchange, the major financial instrument of the time. Overend Gurney then quickly became a discount house, as it also started investing in the market for bills on its own account.

Bills of exchange were promises by one party (the borrower) to pay another party (the lender) a specified sum of money (the 'face value' of the bill). The lender could then sell these bills to third parties at a 'discount' to the face value of the

initial promise. For example, a bill of exchange with a face value of £10 could be sold for £9.50, meaning a discount rate of 5%; this effectively represented the interest rate the third party would receive for taking on the risk that the merchant would not repay the debt.

Overend Gurney, as a bill broker and discount house, thus enabled lenders seeking to obtain funds before the due date of their loans to sell their bills to commercial banks with excess deposits. The box on page 96 gives an account of the market for bills, the London Discount Market, and its relationship with the Bank of England, which at this point was a private bank.

Figure 1 The rise of Overend Gurney



Under the leadership of Samuel Gurney, Overend Gurney became the largest and most influential of the four major discount houses of the middle of the 19th century. Bagehot noted that it 'stood next to the Bank of England in the City of London; it was better known abroad than any similar firm'. By the 1850s, it had accumulated deposits equal to those of its three main competitors combined and its annual turnover of bills of exchange was equal in value to about half the United Kingdom's national debt.

An uneasy relationship between the Bank of England and the bill brokers

The first half of the 19th century had been plagued with recurrent panics in the money market (1825, 1837–39, 1847 and 1857) following large credit expansions. To stem the panics, the Bank of England had typically provided liquidity to the market but with a delay. The 1844 Bank Charter Act limited the number of Bank of England notes in issuance to the value of its gold reserves and this needed to be suspended to enable the Bank to provide the needed liquidity in the market, unconstrained by the total stock of gold it held. In the event, the fact that the Bank of England was able to provide liquidity often provided sufficient confidence to the market.

In 1857, bank failures in the United States caused several failures in the United Kingdom, in what became known as the first worldwide financial crisis. The panic this caused in the United Kingdom led to a surge of applications for assistance from bill brokers to the Bank of England. Overend Gurney was one of the largest beneficiaries of this assistance, partly by virtue of its size in the market.

Bill broking, the discount market and the Bank of England

In the middle of the 19th century, bills of exchange were the main financial instrument. They were used to record most business transactions and could be traded. As illustrated in **Figure A**, commercial banks who received bills from their clients and wished to sell those on the market at a discount could obtain a guarantee from a merchant bank, which would have to settle the debt in case of default of the client. They could then sell their bills through the agency of bill brokers to commercial banks, who wished to channel their deposits into productive investments. They also had the option to sell them directly to the Bank of England.

From 1830 onwards, bill brokers also became discount houses as they started investing in those bills for their own account, using the time deposits they collected from commercial banks. In this way, these firms became direct competitors of the Bank of England, which had been buying bills at a discount since its foundation, more than a century earlier.

The Bank of England was not the central bank we know today. It already enjoyed some privileges like control of the country's gold reserve and monopoly over the issuance of banknotes in London. However, the Bank of England operated as a privately owned customer bank, paying a dividend to its shareholders and offering accounts for private individuals and businesses. It also operated an office called the Discount Window, in which it provided 'Discounts' (exchanging through repurchase agreements at discount) on merchants', brokers' and other

Following the 1857 crisis, the Bank of England's directors grew increasingly concerned that the unconstrained provision of liquidity to bill brokers had led to moral hazard.

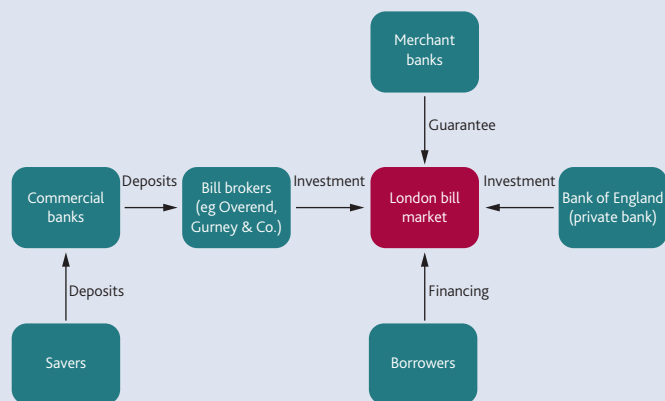
This was the idea that the Bank of England gave bill brokers perverse incentives, as the fact they could rely on the Discount Window when necessary led them to become highly leveraged and hold few reserves of their own. In March 1858 the Bank took the decision to restrict bill brokers' access to its Discount Window,⁽¹⁾ in an effort to incentivise them to hold more reserves rather than rely on it to provide liquidity.

Restricting the ability to access the Discount Window proved controversial even within the Bank of England, necessitating the casting vote of then Governor Sheffield Neave to be approved. Publicly the move was seen as specifically directed against Overend Gurney. Both *The Banker* and *The Economist* commented in 1858 that the policy was not credible in the event of a large firm needing assistance. In 1860 *The Economist* called for a compromise, noting that the profits of bill broking were being eroded by their need to hold higher

banks' bills of exchange. This was in addition to 'Advances' also provided through the Discount Window (see **Figure 4**). The discount rate the Bank of England charged on those bills is in some sense similar to the Bank Rate the Monetary Policy Committee sets today.

In case of crisis, commercial banks would be able to obtain liquidity by going to the Discount Window for Advances or Discounts. In addition, they would call back their deposits with the discount houses who, in order to meet the cash requirements of the commercial banks, would in turn have to re-discount the bills on their balance sheet with the Bank of England.

Figure A The London discount market in 1866



Sources: Bank of England and Flandreau and Ugolini (2014).

reserves of their own, eroding the 'credit' of the bill brokers and making a crisis more likely.

Failed attempt to run on the Bank of England

On 29 March 1860, the Bank of England unexpectedly raised its bill discount rate, the Bank Rate of the day. This went against a previous principle that the Bank would never raise interest rates during peak dividend season, because the large number of dividend payments in this period meant that liquidity would be tight for bill brokers. This was seen as an attack on the bill market and was highly criticised.

Infuriated by the actions of the Bank and drawing on their connections, the new generation of partners running Overend Gurney joined forces with other discount houses to withdraw a large amount of funds they had deposited at the Bank of England. The firm argued that it was unreasonable to

(1) Bill brokers were banned from Discounts and only allowed Advances during the 'quarterly advances' period, a time when liquidity was under pressure due to the number of dividend payments. For details of Discounts and Advances see the section 'The Bank of England's response to financial instability'.

leave large balances with the Bank of England which could be used to help it compete with them in the bill market. The aim was to make the Bank's reserves as low as possible in the hope that by showing the Bank of England it was dependent on the bill brokers, it would allow bill brokers access to its rediscounting facilities again.

The 1860 Daily Accounts of the Bank of England from its (public) Archive⁽¹⁾ show that between Monday 9 and Wednesday 11 April 1860, the stock of notes deposited by banks at the Bank of England declined by 22% — a reduction of £1.4 million of notes, £0.8 million of which were withdrawn by Overend Gurney.⁽²⁾

Since the passage of the 1844 Bank Charter Act the quantity of banknotes in circulation was a closely watched number and in that week the Bank of England's notes in circulation rose dramatically by £1,622,000. Unaware of the private attempt to cause a run on the Bank of England, concerns elsewhere in the City increased materially and there was an immediate rise in the Bank's bill discount rate by 1 percentage point to 5%. The matter was raised in the House of Commons, and then Chancellor of the Exchequer Gladstone showed he was sympathetic to the bill brokers over the issue of access to the Bank of England's Discount Window.

During this episode the Governor found an anonymous threatening note on his desk one morning stating 'Overends can pull out every note you have, from actual knowledge the writer can inform you that with their own family assistance they can nurse seven millions'. This was relevant as the Bank of England's reserve of notes was around £7.7 million at the time. The Bank of England refused to change its position. In the event, Overend Gurney redeposited their notes with the Bank of England and apologised. From then on, the relationship between Overend Gurney and the Bank of England remained strained.

The demise of Overend Gurney

The decline of Overend Gurney was protracted. The inability of bill brokers to access the facilities at the Bank of England's Discount Window meant that they needed to adjust their business model in response. This included holding greater levels of reserves, rendering the core business of bill discounting less profitable.

Poor credit underwriting standards

The decline in the profitability of their core business may have been one of the reasons underpinning the decision by Overend Gurney to expand into riskier customer lending. Additionally, poor management by the new generation of partners also played a substantial part in its eventual demise.

The loans made by Edward Watkin Edwards, an advisor to Overend Gurney, were widely considered to be a major contributor to the losses. Mr Edwards was hired by partner David Chapman — described as a 'pleasure loving gallant' — in 1859 to oversee the examination of securities and management of the lending business. Within a few months of hiring Mr Edwards, Overend Gurney expanded its activities to foreign plantations, grain speculation, iron production, shipping and railway.

Poor remuneration incentives may have contributed to the losses. Mr Edwards was effectively paid twice for arranging lending transactions, earning fees from both the borrowers and the investors funding the loan.⁽³⁾ In addition, records show that in some cases no serious steps were taken to ascertain the accuracy of the stated valuation or the existence of collateral (such as properties) provided by the borrower. The extent and breadth of the loan losses on riskier customer loans is illustrated in **Table A** which records the loans advanced and estimated recovery value at the time Overend Gurney converted to limited liability.

Table A Illustrative list of riskier customer loans at Overend Gurney

£	Due to Overend, Gurney & Co.	Estimated value at the time of transfer to limited liability	Loan loss estimate
The Atlantic Royal Mail Steam Packet Company	839,345	160,000	679,345
Millwall Ironworks Company and C J Mare	422,565	–	422,565
East India and London Shipping Company	397,653	25,000	372,653
Thomas Howard	331,765	–	331,765
Greek and Oriental Steam Navigation Company	144,144	7,000	137,144
David Leopold Lewis	341,560	182,000	159,560
Kelson, Tritton & Co.	291,391	187,500	103,891
Railways belonging to Overend, Gurney & Co.	243,070	54,000	189,070
Laurence and Fry	148,544	21,000	127,544
T and G Garraway	190,977	10,000	180,977
Charles Joyce & Co.	78,729	62,000	16,729
Halliday, Fox & Co.	34,628	3,000	31,628
Z C Pearson	35,693	–	35,693
Total	3,500,064	711,500	2,788,564

Source: Chubb (1872).

(1) The Bank of England Archive is open to the public and contains over 80,000 ledgers, files and individual records relating to all aspects of the Bank and its work since its foundation in 1694. More details on the Bank of England's Archive are available at www.bankofengland.co.uk/archive/Pages/default.aspx.

(2) The 1860 Daily Accounts of the Bank of England (Archive C1/8) are available at www.bankofengland.co.uk/archive/Documents/archivedocs/dailyaccountbooks/18511874/dab011860041860b1.pdf, with page 34 recording the specific withdrawal by Overend Gurney.

(3) He also made loans directly to David Chapman, who was living above his means. Chapman's partners claimed to be unaware of this compromised relationship, but were likely aware he lived beyond his means as his account with the firm was overdrawn.

Conversion to limited liability

By 1865, Overend Gurney was in financial difficulties. From late 1860, the firm was making average losses of £500,000 a year, despite £200,000 of profit on the bill broking business, and it would later be revealed that the firm was insolvent by between £4 million to £5 million, on a balance sheet of around £20 million. In 1865 the partners realised the extent of the losses and that the company was close to failure. They began talking about options and considered injecting new capital, appointing new partners and even selling the firm to a competitor — the National Discount Company — which rejected the offer to purchase the firm.

Finally in July 1865, the partners decided to convert Overend Gurney into a limited liability company, a company form which had only been extended to insurance companies, banks and discount houses in 1862. The company issued 100,000 £50 shares, accumulating a starting capital of £5 million. The shares were sold at £15 with a further £35 in uncalled share capital. This meant shareholders only paid £15 initially but a further £35 could be called up by the company if necessary.

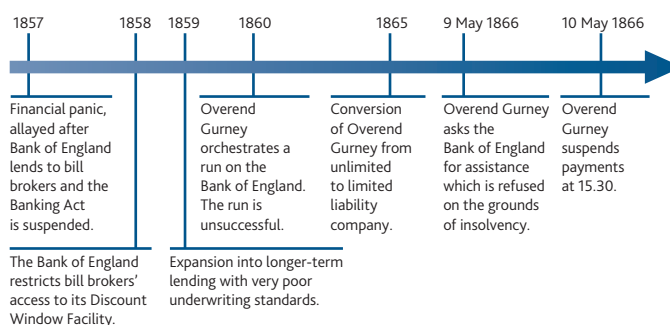
In the short prospectus (see the box on page 99) there is a line stating that the partners guaranteed the losses on any assets to be transferred over to the new company, which may have offered reassurance to the new shareholders. The guarantee would likely not have alerted share-buyers to any financial difficulties in the company as it was written in a rather standard manner. John Gurney (a partner) himself had cut out any reference to bad assets in the prospectus, and although the guarantee was time-limited, few people — if anybody — came to inspect the special deed of arrangement which would have made the time limit clear. The lack of due diligence did not just extend to the public: the new directors concluded they did not need to bring in an accountant to look at the books.

The reaction in the City to the conversion into a limited liability company was mixed. While *The Banker* called it 'the greatest triumph which limited liability ever achieved', it also observed that the uncalled capital could provide a welcome fallback for depositors. *The Economist* noted that Overend Gurney intended to focus on bill broking rather than lending in the future; being a public company and being forced to show what business they were doing would increase the confidence of the public. At first the shares performed well, trading at over £25 in October 1865. But by January 1866 the price began to fall and hit £12.25 immediately before Overend Gurney collapsed.

Protecting the Norwich bank: Gurney & Co.

The Gurney family were understandably concerned about the guarantee in the prospectus for losses made by Overend Gurney. Several partners in the London firm were

Figure 2 The demise of Overend Gurney



also partners in the Norwich bank, which meant that if the assets of the London partners were seized, this would undermine the Norwich bank. The Gurney family engaged in subterfuge, including paying one of the partners — John Gurney — £2,000 a year to 'keep up appearances' and ordering him not to dismiss his servants and cut expenses as this would spark rumours that the London discount house was in difficulties.

It was not possible to separate the bill broking business of Overend Gurney from its loan-making business, but it was possible to insulate the Norwich bank 'Gurney & Co.'. The Norwich bank created a new partnership and injected £635,000 in new capital. This new partnership effectively excluded the partners who were liable for the guarantee for the London bank and therefore protected the Norwich bank — although not the previous partners — from these losses.⁽¹⁾ This was just in time as the new partnership came into being on 23 April 1866, just over two weeks before Overend Gurney ultimately failed.

The demise of Overend Gurney

While Overend Gurney was, unknown to its new investors, already insolvent at the moment of transition to a limited liability company, the political and economic instability of the time helped push it to failure. Fear of war in Central Europe, a general stock market collapse, a fall in cotton prices and a long period of high interest rates contributed to a series of business failures and made it hard to liquidate investments. A few of those, such as Millwall Ironworks, were known clients of Overend Gurney. But unfortunate coincidences, such as the failure of the railway contractor Watson, Overend & Co. (which had no connection with Overend Gurney) helped rumours spread further.

Those rumours intensified as the partners of Overend Gurney started to sell their own estates in order to meet their liabilities. After a court ruled, on 9 May 1866, that Overend Gurney did not have the power to collect debt owed to it by

(1) Though some of the Gurneys and a Birkbeck partner were ruined, judicious use of inheritances and charity allowed considerable assets to remain within the family. The perception that the Gurneys had lost their fortune led to considerable public sympathy towards them, and favourable treatment in the later trial.

Transcript of the prospectus of Overend Gurney (Limited) published on 13 July 1865

THE COMPANY is formed for the purpose of carrying into effect an arrangement which has been made for the purchase from Messrs. Overend Gurney and Co., of their long established business as bill brokers and money dealers, and of the premises in which the business is conducted, the consideration for the goodwill being £500,000, one half being paid in cash and the remainder in shares of the company with £15 per share credited thereon — terms which, in the opinion of the directors, cannot fail to ensure a highly remunerative return to the shareholders.

The business will be handed over to the new company on the 1st of August next, the vendors guaranteeing the company against any loss on the assets and liabilities transferred.

Three of the members of the present firm have consented to join the board of the new company, in which they will also

retain a large pecuniary interest. Two of them (Mr. Henry Edmund Gurney and Mr. Robert Birkbeck) will also occupy the position of managing directors and undertake the general conduct of the business.

The ordinary business of the company will, under this arrangement, be carried on as heretofore, with the advantage of the co-operation of the board of directors, who also propose to retain the valuable services of the existing staff of the present establishment.

The directors will give their zealous attention to the cultivation of business of a first-class character only, it being their conviction that they will thus most effectually promote the prosperity of the company and the permanent interests of the shareholders. Copies of the company's Memorandum and Articles of Association, as well as the Deed of Covenant in relation to the transfer of the business, can be inspected at the offices of the solicitors of the company.

LONDON, July 12, 1865.

the Mid-Wales Railway Company, a run on its deposits ensued.⁽¹⁾ The partners then applied for assistance from the Bank of England. In response, then Bank of England Governor Henry Holland sent a staff committee including Robert Bevan and led by former Governor Kirkman Hodgson to investigate the books of Overend Gurney. Rescue was refused: in the words of Mr Bevan, 'the firm was so rotten' it effectively sealed its own fate.

At 15.30 on 10 May 1866, a note was posted on Overend Gurney's door stating: 'we regret to announce that a severe run on our deposits and resources has compelled us to suspend payment'.

The Banker magazine recorded that 'the effect on the city was as the shock of an earthquake' as depositors started queueing to withdraw their funds from all the banking establishments and the money market seized up (**Figure 3**). Bankers flooded to the Bank of England discount office in search of funds.

The Bank of England's response to financial instability

On 11 May 1866, Bank of England Governor Holland and Deputy Governor Hunt exchanged letters with Chancellor of the Exchequer Gladstone. These letters, the transcript of which is provided in the annex, vividly describe the financial panic that followed the suspension of payment by Overend Gurney on 10 May 1866. These letters also record the Bank of England's response to the financial instability that

Figure 3 Panic in the City of London on 'Black Friday', 11 May 1866



Source: Hobbblethwaite, M, 'Siege of the office of the bank Overend, Gurney and Co., Lombard Street, London', *L'illustration, Journal Universel*, 19 May 1866.

followed as well as the decision of the Government to seek suspension of the Bank of England Act in Parliament. Suspension would allow the Bank to extend liquidity without having to back the notes it printed with gold. It was hoped this would help appease financial markets and ensure confidence in the currency.

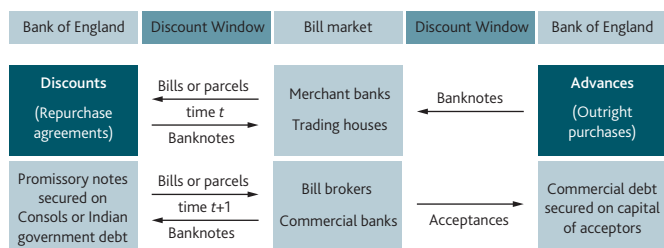
In their letter, Governor Holland and Deputy Governor Hunt noted that the Bank had extended over £4 million to support

(1) Although the value of the loan was small, it was known that Overend Gurney had many identical contracts with other firms.

market participants, and that to provide this support the Bank had drawn heavily on its own reserves.

Figure 4 illustrates how the Bank of England typically provided liquidity through the Discount Window at the time. First, the Bank provided ‘Discounts’ (or repurchase agreements) against government debt (either issued by the British government, such as Consols, or issued in the Empire, such as Indian debt), the high-quality liquid assets of the time. Second, the Bank also provided ‘Advances’ against commercial debt instruments backed by the capital of the acceptors, the high-quality less liquid assets of the time. Advances were outright purchases. Merchant banks and trading houses accessed the Bank of England Discount Window more regularly than bill brokers (who had restricted access) and commercial banks (who did not typically need to access the facilities).

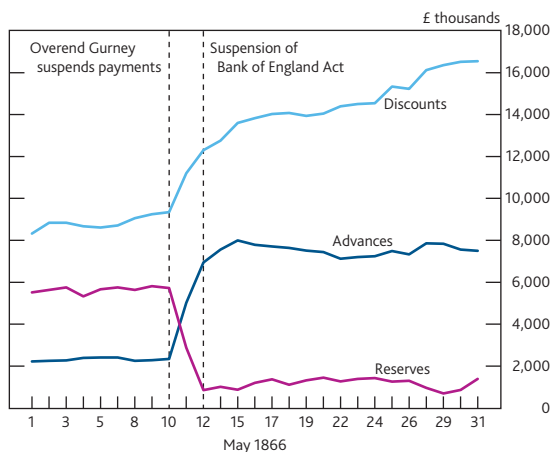
Figure 4 The Bank of England Discount Window operations in 1866



Drawing on the Daily Accounts of the Bank of England for May 1866 from the Bank’s Archive,⁽¹⁾ **Chart 1** illustrates that the bulk of the support the Bank provided occurred between Thursday 10 and Saturday 12 May 1866. Over this period, the Bank’s Advances (outright purchases of bills of exchange) tripled and its Discounts (repurchase agreements) of bills increased by a third. In contrast, the Bank’s balance sheet expanded by only 7% over the same period, as the lending was financed by depleting its cash reserves by 85%. **Chart 1** further illustrates that the Bank continued to support the bill market throughout the remainder of the month but at a slower pace, by continuing to expand its stock of repurchase agreements of bills.

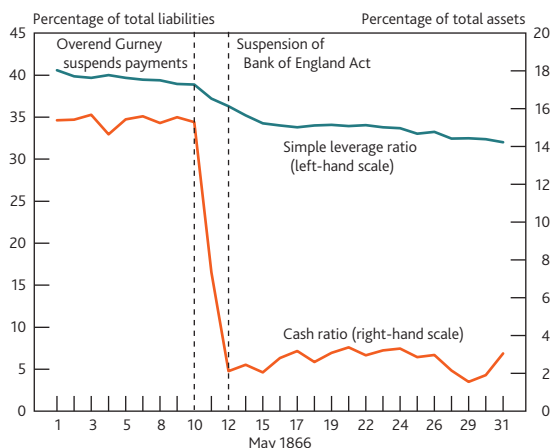
Chart 2 provides a more modern approach to examining the extent of the support provided by the Bank. It shows that the Bank utilised its own reserves (or liquidity buffer in today’s terms) to absorb some of the illiquidity shock in the bill market. The Bank’s own cash ratio, the ratio of its cash (including gold and silver coins) to its total assets, declined from 16% to 2% in three days. However, because the Bank utilised its own reserves this expansion in lending to the bill market did not lead to an excessive change in leverage. The Bank’s simple leverage ratio (the ratio of capital to total assets) modestly declined from a high base of 39% prior to the demise of Overend Gurney to 32% by the end of May 1866.

Chart 1 Bank of England support to the financial system in May 1866(a)(b)(c)



- (a) Advances refer to the sum of the outright purchases of bills of exchange (Figure 4).
- (b) Discounts refer to the sum of the repurchase agreements of bills of exchange (Figure 4).
- (c) Reserves refer to the amount of cash held by the Bank of England in the form of notes, gold and silver coins.

Chart 2 Bank of England capital and liquidity resilience in May 1866(a)(b)



- (a) The cash ratio refers to the sum of cash held by the Bank of England in the form of notes and gold and silver coins to its total assets on balance sheet.
- (b) The simple leverage ratio refers to the ratio of capital to total assets.

Chancellor Gladstone responded to the Bank of England Governors’ letter by suspending the 1844 Bank Charter Act. His motivation for doing so was that unlike the crises of 1847 and 1857 which had been commercial crises, the current 1866 panic was purely financial. The suspension of the Act authorised the Bank to issue notes unbacked by its stock of gold. The only obligation the Chancellor placed on the Bank was that the discount rate be raised further to 10%, with the Government being able to increase the rate again if necessary.

Limited effects on the real economy

The suspension of the Bank Charter Act had the desired effect of restoring confidence in the money market. In the event, the Bank of England did not have to issue unbacked notes.

(1) The 1866 Daily Accounts of the Bank of England (1866a) (Archive C1/14) are available at www.bankofengland.co.uk/archive/Documents/archivedocs/dailyaccountbooks/18511874/dab011866121866.pdf, with pages 34–38 showing the daily balance sheet for May 1866.

Following the panic, a number of companies failed but the crisis remained mainly financial in character.

When Overend Gurney became a limited liability company, the issued shares had uncalled capital; this capital was therefore called in order to cover the losses. Shareholders took the partners to court claiming the prospectus was fraudulent. They lost their legal battle and ended up paying an additional £25 per share. This episode decreased the appetite for investing in limited liability companies, particularly with uncalled liability, which had only recently become a permissible legal structure for banks and discount houses.

Before the failure, the partners had tried to protect the Gurney bank in Norwich by cutting all ties. This scheme succeeded as the day after the failure the *Norwich Mercury* newspaper was able to report that 'out of evil consolation is always to be found as Overend Gurney is in no way connected to Gurney and Co.', although a town hall meeting was also called to express 'the perfect confidence' in Gurney & Co. Confidence in the Norwich bank was maintained, partly due to its local market power and wealthy new partners, and the Norwich bank prospered in the years following Overend Gurney's demise.⁽¹⁾

Lessons for today

The failure of Overend Gurney and the subsequent events led to heated policy debate that helped shape the Bank of England for years to come.

Principles for central bank lending

A few months after the failure of Overend Gurney the Bank of England's Governor Holland gave a speech about its failure. He said that 'not only this house, but the entire banking body, acquitted themselves most honourably and creditably throughout that very trying period'. Importantly for the later debate, he added that 'we would not flinch from the duty which we conceived was imposed upon us of supporting the banking community and I am not aware that any legitimate application made for assistance to this house was refused'.

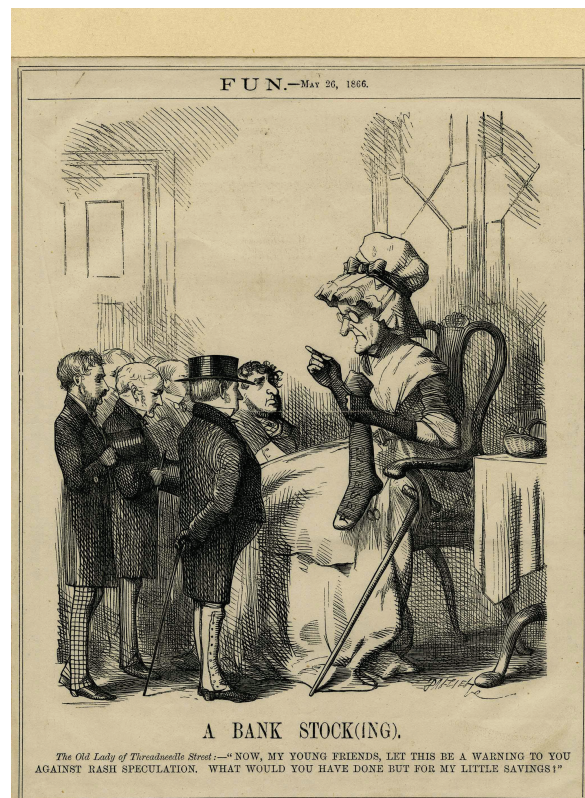
In a leading article in *The Economist* Walter Bagehot welcomed this speech as he considered that Governor Holland had acknowledged a 'duty' on the part of the Bank of England to support the banking community, and that he had implied that it would act similarly under similar circumstances. This was met with sharp disagreement by many of the Bank's directors, who noted that *The Economist* had drawn 'rash deductions' from a speech, which just reflected the opinion of the Governor of the day. Former Governor (and at the time director) Thomson Hankey, described this idea that the Bank of England should act as LOLR as 'the most mischievous doctrine ever broached in the monetary or Banking world' and

thought that it would encourage irresponsible behaviour, a sentiment echoed in **Figure 5** below. Profitability concerns — as the Bank of England was a private company — also played a part and some of its directors noted that 'as a dividend-earning business, its chief responsibility was to its proprietors' and that to keep the reserves necessary to be able to support the banking system would disadvantage it competitively.

In 1873, Bagehot published *Lombard Street: a description of the money market*, which was greatly influenced not only by the failure of Overend Gurney but also by developments and growth in the size of the finance industry in London since that time. In it Bagehot also noted his fear that the events of 1866 were being forgotten.

Bagehot considered that the uncertainty over whether the Bank would lend contributed to the panic. He wrote that 'either shut the Bank at once [...] or lend freely, boldly, and so that the public will feel you mean to go on lending. To lend a great deal, and not give the public confidence that you will lend sufficiently and effectually, is the worst of all policies; but it is the policy now pursued'.

Figure 5 A Bank Stock(ing) and a warning against speculation
The Old Lady of Threadneedle Street: 'Now my young friends. Let this be a warning to you against rash speculation. What would you have done but for my little savings?'



Source: Bank of England Museum.

(1) In 1896, Gurney & Co. merged with 19 other private banks to form Barclay & Co. Ltd, which later became Barclays plc.

Walter Bagehot's principles for central bank lending

First, that these loans should only be made at a very high rate of interest. This will operate as a heavy fine on unreasonable timidity, and will prevent the greatest number of applications by persons who do not require it. The rate should be raised early in the panic, so that the fine may be paid early; that no one may borrow out of idle precaution without paying well for it; that the Banking reserve may be protected as far as possible.

Secondly, that at this rate these advances should be made on all good banking securities, and as largely as the public ask for them. The reason is plain. The object is to stay alarm, and nothing therefore should be done to cause alarm. But the way

In *Lombard Street*, Bagehot recalled the lessons that had been learnt for what, in his view, the optimal principles for the LOLR ought to look like (see the box above). The key aspects are that the holder of Bank reserves (in this case: the Bank of England, although Bagehot notes that in theory it could be many banks) should:

- make loans only at *very high rates* of interest to prevent people applying for assistance when they do not need it;
- *advance loans on all 'good' securities*; there should be few restrictions on the type of security on which the LOLR should lend — but that it must be 'good' in normal times — once the panic has passed; and
- *make clear in advance* the Bank's readiness to lend freely to ensure the panic would be abated.

The separation of lending from bill broking

While Bagehot is most famous for his remarks about the LOLR he also made a number of recommendations about how different types of banks should be run, such as guidance on how members of the board should be appointed and emphasising the importance of the ability to monitor the loans that are being made. In *Lombard Street*, the management of Overend Gurney received considerable criticism: Bagehot notes that the loan 'losses were made in a manner so reckless and so foolish, that one would think a child who had lent money in the City of London would have lent it better'. Bagehot also noted that 'they ruined a firm almost inconceivably good by business so inexplicably bad that it could hardly be much worse if they had tried of set purpose to make it bad'.

However, Bagehot says very little about the separation of lending and broking activities, despite his focus on that in his

to cause alarm is to refuse someone who has good security to offer [...] No advances indeed need be made by which the Bank will ultimately lose. The amount of bad business in commercial countries is an infinitesimally small fraction of the whole business [...] The great majority, the majority to be protected, are the 'sound' people, the people who have good security to offer. If it is known that the Bank of England is freely advancing on what in ordinary times is reckoned a good security — on what is then commonly pledged and easily convertible — the alarm of the solvent merchants and bankers will be stayed. But if securities, really good and usually convertible, are refused by the Bank, the alarm will not abate, the other loans made will fail in obtaining their end, and the panic will become worse and worse.

Source: Bagehot (1873) Chapter 7, pages 57–58.

Economist column at the time Overend Gurney converted to limited liability. Although he notes that the younger generation of Overend and Gurney family partners ruined the firm via their banking activity, Bagehot ultimately concludes that 'such great folly is happily rare; and the business of a bank is not nearly as difficult as the business of a discount company', which could explain the lack of attention paid to the separation of activities.

Different circumstances and a different environment

As with any kind of insurance, liquidity insurance creates 'moral hazard', an incentive to take more of the insured risk. Ways to design policy to mitigate this effect have generated valuable academic and policy debates over the decades. Some academic historians have also argued that the decision not to assist Overend Gurney in 1866 was a rebuttal of 'too big to fail' and made the Bank of England's policy of 1858 to restrict access to the Discount Window credible.

In the aftermath of the demise of Overend Gurney, there are likely two main reasons for the academic and policy debates before the global financial crisis focusing more on moral hazard rather than on limiting the fallout of a bank failure. First, there were limited real-economy effects of the failure of Overend Gurney; second, its failure reflected its own idiosyncratic risks rather than systemic sources of failure common to many institutions across the UK financial sector. The real-economy fallout was low in part because while Overend Gurney has often been considered to be a bank, its primary business was bill broking. It did very little screening of its borrowers (as discussed in the second section) meaning that it lent to very few productive firms, meaning that the direct loss to the real economy of its failure was small.

When former US Secretary of the Treasury Lawrence Summers was asked what he had found useful in understanding the

2008 global financial crisis and the recession, Summers answered: 'There is a lot about the recent financial crisis in Bagehot'. This is certainly true, but it is also worth noting that the environment Bagehot considered and in which Overend Gurney failed is different to that seen in systemic banking crises. In *Lombard Street* he was considering the idiosyncratic failure of a bank and measures to stop that failure becoming systemic, rather than a systemic crisis with a common cause.

Lender of last resort today

Reforms of the Bank of England have ensured that the UK central bank is now able to provide structured LOLR assistance. Much of the framework for this is published in the 'Red Book', which sets out the Bank's Sterling Monetary Framework (SMF).⁽¹⁾ Historically this framework was focused on monetary policy implementation but in 2008 an explicit objective relating to the provision of central bank liquidity insurance was acknowledged for the first time. This is in contrast to the UK financial system relying on the discretionary actions of the private owners of a bank, as in 1866.

The extent to which central banks risk lending 'too little' or 'too much' during financial crises has remained at the centre of debates ever since Bagehot wrote *Lombard Street*. Bagehot's concern was that the LOLR would lend 'too little'. In contrast, proportionately more of the debate before the global financial crisis looks to have been around ensuring that central banks did not lend 'too much' and increase moral hazard.

It is notable that some aspects of the Bank of England's facilities could perhaps be described as becoming more 'Bagehotian' since the global financial crisis, with a focus on ensuring that the Bank does not lend 'too little'. Many of these changes were made in the heat of the crisis; they also reflect the Winters and Plenderleith Reviews, undertaken in 2012. The Winters Review examined the Bank's framework for providing liquidity to the banking system as a whole and the Plenderleith Review examined how the Bank discharged its responsibilities as LOLR in 2008–09.

Reflecting the principle of 'good collateral', the list of collateral that the Bank of England accepts is broad and in principle extends to any asset that can be effectively risk managed. In contrast, pre-2008 the Bank had a relatively limited list of institutions that had access to its balance sheet, along with a conservative list of collateral.

In terms of 'making clear in advance', the Bank is committed to providing clarity around the circumstances under which it would provide liquidity in the event of market-wide or large idiosyncratic stress. The Bank's 'Red Book' clearly sets out the aims and objectives of the SMF with regard to the provision of

liquidity insurance and the Bank aims to give participants clarity over when they can borrow. In contrast, before 2008 there was little clarity about the circumstances under which the Bank would extend liquidity support for financial stability purposes.

The reforms above widen the range of collateral the Bank accepts, provide clarity and help guard against the Bank of England lending 'too little', but safeguards have also been strengthened against the risk of the Bank lending 'too much'. These include better supervisory and resolution frameworks; transparent terms of access, pricing and collateral; stronger accountability and governance; and better information about borrowers.

This is possible because the Bank of England is both the supervisor, central bank and resolution authority. This allows the Bank to better scrutinise the institutions it lends to. And there is a presumption that all banks and building societies that meet the Prudential Regulation Authority (PRA) threshold conditions for authorisation would have full access to borrow in the SMF facilities against eligible collateral.

The Bank, including the PRA can also manage moral hazard through liquidity regulation and — in extreme circumstance — its powers to resolve institutions. As a result, the SMF no longer has to shoulder as much of the burden of tackling moral hazard.

Conclusion

The failure of Overend Gurney had its roots in poor lending practices and a lack of management oversight. Its failure caused financial panic in the City of London and the Bank of England had to draw greatly on its own reserves to support the bills market.

This panic and action by the Bank of England to support the market was a major inspiration for Bagehot's treatise *Lombard Street*, in which he outlined a number of principles for the provision of liquidity assistance in a panic. While these have been heavily refined and debated, it is notable that some of these principles can still be seen in the Bank of England's approach to liquidity assistance today.

(1) The Bank of England's Sterling Monetary Framework (or 'Red Book') is available at www.bankofengland.co.uk/markets/Documents/money/publications/redbook.pdf.

Annex
Transcript of the Minutes of the
Bank of England Court of Directors,
Saturday 12 May 1866

A Court of Directors at the Bank on Saturday, the 12 May 1866
 Present: Henry Lancelot Holland, Esquire Governor;
 Thomas Newman Hunt, Esquire Deputy Governor [...]

The Governor laid before the Court the following
 correspondence:

Bank of England, 11 May 1866.
 To: The Right Honourable, The Chancellor of the Exchequer,
 M. P.

Sir,
 We consider it to be our duty to lay before the Government
 the facts relating to the extraordinary demands for assistance
 which have been made upon the Bank of England today in
 consequence to the failure of Messrs Overend Gurney & Co.

We have advanced to the Bankers, Bill Brokers and Merchants
 in London during the day upwards of four million Sterling upon
 the Security of the Government Stock and Bills of Exchange
 — an unprecedented sum to lend in one day, and which,
 therefore, we suppose, would be sufficient to meet all their
 requirements; although the proportion of this sum which may
 have been sent to the Country must materially affect the
 question.

We commenced this morning with a Reserve of £5,727,000-
 which has been drawn upon so largely that we cannot
 calculate upon having so much as £3,000,000- this evening,
 making a fair allowance for what may be remaining at the
 Branches.

We have not refused any legitimate application for assistance,
 and, unless the money taken from the Bank is entirely
 withdrawn from circulation, there is no reason to suppose that
 this Reserve is insufficient.

We have honor to be, Sir, your obedient servants.

H.L. Holland, Governor and T.M. Newman Hunt, Deputy
 Governor.

Downing Street, 11 May 1866.
 To: The Governor and the Deputy Governor of the
 Bank of England

Gentlemen,
 We have the honour to acknowledge the receipt of your letter
 of this day to the Chancellor of the Exchequer, in which you
 state the course of action at the Bank of England under the
 circumstances of sudden anxiety which have arisen since the
 stoppages of Messrs Overend Gurney & Company (Limited)
 yesterday.

We learn with regret that the Bank reserve, which stood, so
 recently as last night, at a sum of about five millions and three
 quarters, has been reduced in a single day, by the liberal
 answer of the Bank to the demands of commerce during the
 hours of business, and by its just anxiety to avert disaster, to
 little more than one half of that amount, or sum (actual for
 London and estimated for Branches) not greatly exceeding
 three millions.

The accounts and representations, which have reached
 Her Majesty's Government during the day, exhibit the state of
 things in the City as one of extraordinary distress and
 apprehension. Indeed deputations composed of persons of the
 greatest weight and influence, and representing alike the
 private and the Joint Stock Banks of London, have presented
 themselves in Downing Street, and have urged with unanimity
 and with earnestness the necessity of some intervention on
 the part of the State, to allay the anxiety which prevails, and
 which appears to have amounted through great part of the
 day to absolute panic.

There are some important points in which the present crisis
 differs from those of 1847 and 1857. Those periods were
 periods of mercantile distress, but the vital consideration of
 banking credit does not appear to have been involved in them,
 as it is in the present crisis. Again, the course of affairs was
 then comparatively slow and measured, whereas the shock has
 in this instance arrived with intense rapidity and the
 opportunity for deliberation is narrowed in proportion. Lastly,
 the Reserve of the Bank of England has suffered a diminution
 without precedent relatively to the time in which it has been
 brought about, and, in view especially of this circumstance,
 Her Majesty's Government cannot doubt that it is their duty
 to adopt without delay the measures which seem to them
 best calculated to compose the public mind, and to avert the
 calamities which may threaten trade and industry.

Of them, the Directors of the Bank of England, proceeding upon the prudent rules of action by which their administration is usually governed, shall find that, in order to meet the wants of legitimate commerce, it is requisite to extend their discounts and advances upon approved securities so as to require issues of Notes beyond the limit fixed by law, Her Majesty's Government recommend that this necessity should be met immediately upon its occurrence, and in that event they will not fail to make application to Parliament for its sanction.

No such discount or advance, however, should be granted at a rate of interest less than ten per cent, and Her Majesty's Government reserve it to themselves to recommend, if they should see fit, the imposition of a higher rate.

After deduction by the Bank of whatever it may consider to be fair charge for its risk, influences and trouble, the profits of these advances will accrue to the public.

We have the honor to be, Gentlemen, your obedient servants.

Russell Gladstone, Chancellor of the Exchequer

Resolved that the Governors be requested to inform the First Lord of the Treasury, and the Chancellor of the Exchequer that the Court is prepared to act in conformity with the letter addressed to them yesterday.

Resolved that the minimum rate of discount on Bills not having more than 95 days to run, be raised from 9 to 10%.

Source: Bank of England (1866b), pages 27–32. The archived minutes are available at www.bankofengland.co.uk/archive/Documents/archivedocs/codm/18111911/codm041866111866b1.pdf

References

Bagehot, W (1873), *Lombard Street: a description of the money market*, Henry S King & Co, London.

Bank of England (1860), 'Daily Accounts of the Bank of England', Bank of England Archives C1/8, available at www.bankofengland.co.uk/archive/Documents/archivedocs/dailyaccountbooks/18511874/dab011860041860b1.pdf.

Bank of England (1866a), 'Daily Accounts of the Bank of England', available at www.bankofengland.co.uk/archive/Documents/archivedocs/dailyaccountbooks/18511874/dab011866121866.pdf, with pages 34–38 showing the daily balance sheet for May 1866.

Bank of England (1866b), Minutes of the Court of the Bank of England, Bank of England Archives G4/89, pages 27–32, available at www.bankofengland.co.uk/archive/Documents/archivedocs/codm/18111911/codm041866111866b1.pdf.

Bank of England, Sterling Monetary Framework (or 'Red Book'), available at www.bankofengland.co.uk/markets/Documents/money/publications/redbook.pdf.

Bignon, V, Flandreau, M and Ugolini, S (2012), 'Bagehot for beginners: the making of lender-of-last-resort operations in the mid-nineteenth century', *Economic History Review*, Vol. 65, No. 2, pages 580–608.

Calomiris, C (2011), 'Banking crises and the rules of the game', in Wood, G, Mills, T and Crafts, N (eds), *Monetary and banking history: essays in honour of Forrest Capie*, pages 88–132, Routledge, New York.

Capie, F (2002), 'The evolution of the Bank of England as a mature central bank', in O'Brien, P K and Winch, D (eds), *British Academy Centennial Volume*.

Chubb, H (1872), 'The Bank Act and the crisis of 1866', *Journal of the Statistical Society of London*, Vol. 35, No. 2, pages 171–95.

Clapham, J (1966), 'Epilogue: the Bank as it is (Vol. 2)', *The Bank of England: a history, Vol II: 1797–1914*, Cambridge University Press, Cambridge.

Elliott, G (2006), *The mystery of Overend & Gurney: a financial scandal in Victorian London*, Methuen Publishing Co, London.

Flandreau, M and Ugolini, S (2014), 'The crisis of 1866', *British financial crises since 1825*, pages 76–93, Oxford University Press.

Hankey, T (1867), 'The principles of banking, its utility and economy; with remarks on the working and management of the Bank of England'.

Hauser, A (2016), 'Between feast and famine: transparency, accountability and the lender of last resort', available at www.bankofengland.co.uk/publications/Documents/speeches/2016/speech881.pdf.

Kindleberger, C and Aliber, R (2011), *Manias, panic and crashes*, 6th edition, Palgrave Macmillan.

King, W T C (1936), *History of the London discount market*, G. Routledge, London.

Kynaston, D (1994), *The City Of London Volume 1: a world of its own 1815–1890*, Chatto & Windus, London.

Parker Willis, H (1965), *Theory and practice of central banking 1719–1913*, page 164, Routledge, London.

Plenderleith, I (2012), 'Review of the Bank of England's provision of Emergency Liquidity Assistance in 2008–09', available at www.bankofengland.co.uk/publications/Documents/news/2012/cr1plenderleith.pdf.

Shafik, M (2015), 'Goodbye ambiguity, hello clarity: the Bank of England's relationship with financial markets', available at www.bankofengland.co.uk/publications/Documents/speeches/2015/speech801.pdf.

The Bankers' Magazine (1865), 'Overend, Gurney, and Co. (Limited)', August 1865.

The Economist (1865), 'Overend, Gurney, and Co. (Limited)', 15 July 1865.

The Economist (1866), 'The great importance of the late meeting of the proprietors of the Bank of England, London', 22 September.

Turner, J (2014), 'Banking in crisis: the rise and fall of British banking stability, 1800 to the present', *Cambridge Studies in Economic History*, Cambridge University Press, Cambridge.

Winters, B (2012), 'Review of the Bank of England's framework for providing liquidity to the banking system', available at www.bankofengland.co.uk/publications/Documents/news/2012/cr2winters.pdf.