The capital and liquidity adequacy of banks

The following is the text of a paper recently agreed between the Bank of England and the London and Scottish clearing banks

1 This paper reports the conclusions of a Working Party established by the Bank of England and the London and Scottish clearing banks at the end of last year. These conclusions have been accepted by the Governor and by the Chairmen of the clearing banks.

2 The terms of reference of the Working Party were:

(i) to consider the purposes for which capital and reserves were required; to develop principles for assessing their adequacy for such purposes and to examine the roles of the different components of capital;

(ii) to examine the traditional approaches to liquidity in the light of recent changes which have affected the liabilities side of bank balance sheets.

A Background

3 The discussions with the clearing banks and the setting up of the Working Party form part of the Bank of England's concern to review accepted standards, to establish fresh standards where these did not previously exist, and thereby to create a reasoned and generally accepted framework in which discussion of bank profits, retentions and liquidity can take place. The Bank's concern arose from the present and prospective effect of rapid inflation on banks' balance sheets; the changing nature of banks' deposit liabilities reflected in the growth of the wholesale money markets in sterling and foreign currencies; and the increasing tendency of banks to lend at medium term to industrial and commercial companies. The Bank were also concerned to encourage the growth of sound banking businesses while limiting the possibility of a recurrence of recent difficulties in certain sections of the British banking system.

B Method of approach

4 This paper sets out broad principles which can be applied generally to the assessment of banking balance sheets in the United Kingdom, not just to those of the clearing banks. It is recognised as inappropriate to attempt to quantify precise ratios between balance-sheet aggregates; such quantification would lead to insufficient flexibility both between banks or categories of banks at any one time and for any particular bank in different circumstances. It should nevertheless be possible to develop over time broad numerical standards for the different groups of banks which may be used as yardsticks. The special position which the clearing banks occupy in the financial system is recognised.

I Capital

C The need for capital

5 Two reasons have been identified which determine the need for capital and reserves:

(i) to provide the infrastructure of the business;

(ii) to protect depositors from losses as a result of business risks and to engender the confidence of potential depositors and trading partners.

6 It is agreed that the items included in (i) should normally be covered on a one-to-one basis by capital resources and should not be financed by depositors' funds. It is however recognised that, in the particular circumstances of the clearing banks, the ownership of a large number of prime sites of comparatively small size makes their investment in premises more readily realisable than is the case with

other banks. The exact amount of the value of clearing bank premises which need not be deducted from capital resources will be a matter for discussion with individual banks.

7 It is recognised that retained profits will need to make a substantial contribution to the maintenance of an appropriate capital base, particularly in an inflationary situation.

D The assessment of capital adequacy

8 The following terms are used in this paper:

Capital resources
The total of paid-up share capital, reserves, loan capital (as defined in paragraph 14), provisions against advances (specific, non-specific and interest in suspense) and for deferred tax and minority interests.

Free capital resources
Capital resources, less the book value of the infrastructure. In the case of the clearing banks, the deduction need not include the whole of the investment in premises (see paragraph 6).

Infrastructure
Premises, equipment (other than leased equipment), trade investments, goodwill, and, if considering unconsolidated accounts (see paragraph 21), investments in subsidiaries.

9 Capital adequacy is sometimes assessed by the banks, and often in press comment, in terms of the ratio of capital and resources to total deposits. The Bank of England have preferred in the past and in relation to non-clearing banks to employ a ratio of free resources to public liabilities whereby investments in fixed assets such as premises, in subsidiary and associated companies and in unquoted investments are deducted from capital and resources, and a residual figure is set against deposit liabilities and liabilities on acceptances. A figure of 10% has become known as the basic guideline for accepting houses and similar banks.

10 It is considered that although capital/deposits ratios do indeed provide some measure of the overall capital adequacy of a bank, in present circumstances a more effective measure is capital resources in relation to the risks, if any, in different classes of assets. The assessment of capital adequacy on this basis may be derived from figures of total capital resources, but a bank's capacity to withstand risk is also to some extent dependent on the element of freely usable reserves within that total.

11 It is agreed that it is neither desirable nor practicable at the present time to attempt to assess the capital required for protection against the risks involved in individual assets but rather that the assessment should be made in relation to broad categories of assets. For this purpose, assets representing the infrastructure have already been covered by paragraph 6 above. Assets such as cash and balances with the Bank of England, advances to, or guaranteed by, the UK public sector and advances to UK listed banks are to be regarded as risk-free. The remaining assets are subject to forced sale risks or credit risks or both. A complete and precise classification of assets on this basis has not been attempted but the following will illustrate the intention:

(i) *Forced sale risks* Treasury bills, local authority bills, British government and other public sector stocks, eligible bank bills, certificates of deposit with UK listed banks.

(ii) *Credit risks* Balances with other banks, advances other than to the UK public sector.

(iii) *Forced sale and credit risks* Certificates of deposit with other banks, trade bills, leased assets and other portfolio investments.

In respect of credit risks, it is appreciated that the situation is not necessarily stable through time, even within broad categorisation as

above. Also, it will be necessary to take into account the credit risks arising from acceptances and for some banks, as appropriate, from guarantees, indemnities, foreign exchange transactions, etc.

12 When making an assessment of the capital required to protect depositors against loss, account should first be taken of the level of earnings. In so far as these, after allowing for satisfactory distributions, can confidently be expected to cover normal loss-experience, there will be less need for capital resources.

13 The acceptable relationship of free capital resources to risk assets to be sought will vary for different categories of banks and even from bank to bank within a category. It will need to take account of each bank's historic experience, the spread of business and other special factors which might affect future profits.

14 It is considered that the function of loan stock is not to provide a reserve against losses but to finance a part of the infrastructure of the business, although it should certainly not finance it all. It is agreed that such loans should be subordinated – at least as far as new issues are concerned – and that they should be medium or long-term. An initial term to maturity of ten years seems desirable, but it is recognised that a term of five years might have to be accepted, particularly where euro-currency loans are raised.

15 In addition to the constraint based on the proportion of loan capital to infrastructure mentioned above, it is appreciated that market constraints would impose an overall limit on the amount of loan capital raised, as might also its relation to shareholders' funds.

II Liquidity

E The need for liquidity

16 The concept of liquidity, although separate from that of capital adequacy, is very closely related to it in some aspects. The need for liquidity arises from:

(i) the need to be able to meet overall increases in demand for advances and/or withdrawal of deposits or from timing differences in the maturity of assets and liabilities;

(ii) a shortfall in the anticipated inward cash flow usually as a result of the inability of a borrower to repay on the due date;

(iii) additional operating or capital expenditure;

(iv) losses.

17 The need for liquidity will vary from bank to bank depending upon the types of business conducted and its historical experience but, as a general rule, the more banks rely on wholesale funds, particularly if they are unmatched, the more vulnerable they will be, because of the volatility of such deposits, and they will therefore require greater liquidity.

F The measurement of liquidity

18 As stated in paragraph 4, it is not considered appropriate to prescribe precise ratios for liquidity which should apply to all banks. But it is accepted that an assessment of its liquidity position should form a vital part of the examination of any bank.

19 It is agreed that, on practical grounds, it would normally be necessary to evaluate a bank's liquidity position in sterling and foreign currencies separately; and in some cases it may be necessary to evaluate the liquidity of a bank's sterling wholesale book separately from its retail book. Satisfactory liquidity for wholesale books depends very much on matching, but still requires a proportion of liquid assets to be held in case of default or late repayment; the availability of stand-by facilities is also a significant factor in the assessment. A bank's ability to

buy in deposits from the wholesale market to meet any shortfall in liquidity must also be taken into account, although liquidity from this source may need twenty-four hours to marshal and cannot be relied upon if the market as a whole is short of funds. It is further agreed that account needs to be taken of the need to refinance credits matched to roll-over dates, even in those cases where the loan contract may in strict legal terms allow the lending bank to terminate its obligation to lend at those dates.

III Procedure

20 It is agreed that the Bank of England will hold annual discussions with each clearing bank about its position. Such discussions will have particular reference to profitability, capital adequacy and liquidity, but could cover also other aspects of a bank's business. Similar discussions are already being held quarterly by the Bank with all other UK registered banks and the principles of assessment agreed in this report will in future be applied in these discussions.

21 It is agreed that in case of groups, these discussions should be based in the first place on consolidated accounts rather than those of individual companies. It is regarded by the Bank of England as important, however, that subsidiary companies should be seen to possess capital and liquidity appropriate to the business in which they are engaged and not appear to be trading solely on the reputation and resources of their parent company or of the group. Furthermore, the management of subsidiary banking companies is best placed to answer questions about the business. Accordingly, the Bank will wish to discuss the balance sheets of banking subsidiaries with the managements of those companies and whichever representatives of parent companies individual clearing banks consider appropriate.

22 So far as the clearing banks are concerned, it is envisaged that these annual discussions would start with factual discussions between representatives of the Banking Supervision Division of the Bank of England and of the clearing banks to establish agreement on the position of each bank. Any matters of substance arising from these factual discussions would then be remitted for further discussion at Chief Executive Officer level. These discussions could, in their turn, lead to particular topics being submitted to the Governor and to individual Chairmen.