The supervision of the UK banking system

A slightly shortened version of a talk given by George Blunden, who has responsibility for banking supervision at the Bank of England, to a seminar on financial institutions organised in London on 17 March 1975 by the Institute of European Finance of the University College of North Wales, Bangor.

My talk will have four parts, but not four equal parts. I shall first deal with the legislative background — or lack of background — to supervision; I shall then describe the essential characteristics of the Bank of England's approach to supervision; next I shall talk about recent developments, and this will be the largest section in my talk; and I shall end with a few words about balance-sheet relationships and other prudential ratios.

The Bank are generally accepted as the organisation mainly responsible for bank supervision in this country. That sounds like a bit of typical central banker's caution in stating the obvious; but in fact the qualifications are justified. Unlike the central banks or other supervisory authorities in — I think — all other countries, we have never had that role formally entrusted to us. Like several other aspects of the Bank's work, our role in banking supervision — both as regards the degree of supervision exercised and as regards the range of institutions covered — has just evolved naturally. It is true that powers to issue directives to banks were given to us in the Bank of England Act 1946 which nationalised the Bank; but those powers have never been exercised and, if ever exercised, would be used only for special situations; they would not be suitable as a basis for day-to-day continuing supervision. So we cannot point to any specific basis in legislation on which our authority in this sphere rests.

Nor is there a general-purpose definition in legislation of a bank. There are of course a number of Acts affecting banks as such and a number of recognitions of institutions as banks given under Acts. But all those Acts refer to specific activities and the recognitions are merely recognitions that the organisations concerned are 'banks' for those specific purposes.

Let me mention the most important of them briefly. Under the Exchange Control Act 1947, which the Bank largely administer as agents for the Treasury a list is established of banks which are authorised to deal in foreign exchange and to exercise certain delegated powers under the Act; these are known as authorised banks.

Next, the Companies Act 1948 required the Board of Trade, as it then was, to establish a list of banks permitted in their accounting to maintain hidden reserves. These are known as Schedule 8 banks after the relevant schedule in the Act; and for many years inclusion in this list was the prime indicator that a bank was of the highest standing, but its importance decreased considerably when the clearing banks decided a year or two ago to cease to exercise the privileges granted to them in this way. Also under the Companies Act 1948, the Registrar of Companies may refuse to register any name which he considers undesirable; he has used this power to limit strictly the establishment of new companies with names containing the words bank, bankers or banking. But he has no power to withdraw a banking name registered before 1948; nor has anyone powers to prevent the use of a banking name by the UK branch of a foreign company.

The next Act that I should mention is the Protection of Depositors Act 1963. This lays down conditions which must be fulfilled by anyone or any company wishing to advertise for deposits. The Department of Trade has power to exempt banks from the provisions of the Act. The exemption list was originally the same as the Schedule 8 list of banks; but this arrangement was subsequently amended in Section 127 of the 1967 Companies Act which led to the creation of a further list of banks, known as Section 127 banks. The Act prohibits the use of the words bank, banker or banking in advertisements for deposits by any company not on the exemption list. But it does not prohibit the use of those words in other advertisements or in descriptive material, letterheads and so on. Under the Protection of Depositors Act 1963 companies not on the exempt list wishing to advertise for deposits are required to publish accounts in a prescribed manner and at prescribed intervals. But the Department of Trade are not empowered to investigate the quality of the position revealed by such accounts or in any way to supervise the companies concerned.

The Bank of England are consulted by the appropriate department in all cases before banks are added to these three lists — the authorised banks list, the Schedule 8 list and the Section 127 list. And with few exceptions only companies that appear on one or more of these lists, or are likely shortly to be added to them, are included in the Bank's own list of statistical banks whose figures are included in the comprehensive systems of banking sector statistics.

There are two lesser lists of banks which I should also mention. Legal obscurities about the distinction between a bank and a money lender culminated in a suggestion by the Court of Appeal in 1966 that the Board of Trade should assume responsibility for deciding which institutions were carrying on a bona fide banking business for the special purposes of Section 6f of the Money Lenders Act 1900 and were thus exempt from the provisions of that Act. Under that Act it was open to a creditor in certain circumstances to justify non-repayment of a loan if the debtor was neither a licensed money lender nor exempt as a person carrying on a bona fide business of banking. Accordingly provision was made under Section 123 of the 1967 Companies Act for the Board of Trade to issue certificates that institutions were bona fide banks in this sense. A list of objective criteria was then established by the Board, based entirely on the functional characteristics of a banking business and regardless of quality or repute. Thereafter a large number of companies, which were not of sufficient size or quality to deserve the banking recognitions mentioned earlier, felt the need to obtain the protection of the certificate, the criteria for which they were fairly readily able to satisfy. The

possession of the certificate enabled some companies to claim that they were recognised by the responsible department as carrying on a banking business; of course those making such claims did not draw attention to the fact that they were only so recognised for one narrow purpose. As with the Protection of Depositors Act 1963 the Department of Trade are able to require holders of Section 123 certificates to deliver accounts, but only to enable the department to satisfy itself that the necessary functional characteristics have not changed; the department does not have powers to supervise the business of the deposit-taking companies included in the Section 123 list. The Money Lenders Acts which gave rise to the need for a Section 123 certificate are now being replaced by provisions made under the Consumer Credit Bill passed last year. So the Section 123 certificate will shortly cease to have significance.

Finally among these pieces of legislation affecting banks comes the recognition which the Inland Revenue grants, currently under Section 54 of the Income and Corporation Taxes Act 1970, to companies considered to be conducting a banking business conferring on them the right to pay and receive interest gross of tax. The criteria for granting this recognition have been broadly the same objective criteria about the nature of business, irrespective of its quality, as were used for Section 123 certificates, but they are even less rigorously defined.

This brief summary makes clear the point I made earlier — that there are a large number of recognitions of institutions as banks under legislation but none of them gives a general-purpose definition of an institution as a bank, all of them being merely recognitions for specific purposes. But unfortunately far too often the public, the press or even the banking community itself have misinterpreted the significance of these recognitions. In particular, the status of authorised bank is often held to mean more than it does. In fact — as I said just now — despite its prestigious sound, it merely means that a bank is authorised under the Exchange Control Act 1947 to engage in certain activities, mainly involving foreign exchange, without obtaining specific approval in each case. It does not imply any broader seal of approval or assumption of responsibility on the part of the Bank or Treasury. I repeat, there is no definitive legislative recognition of organisations as banks or legislative sanction for such banking supervision as we undertake.

It follows that it has never been possible for the Bank to impose supervision on organisations arbitrarily to meet our own wishes. There has always been need for an obvious cause acceptable to the supervised to justify any extension of our supervision. For example, our first move into supervision grew out of the need to satisfy ourselves and the City that one group of special financial institutions — the discount houses to which we gave lender of last resort facilities for the banking system as a whole — and one group of banks — those merchant banks whose acceptances we were prepared to discount — were appropriate recipients of those recognitions; and the organisations concerned accepted supervision as the price of recognition. Until comparatively recently our exercise of close and continuing supervision was confined to those two groups. Our subsequent acceptance of wider responsibilities in this field has been gradual and has, like our first move, been in response to market requirements or to events and has been recognised, sometimes grudgingly, as necessary or at least as tolerable by the organisations affected.

The natural evolution of our supervisory role has conditioned the nature of our approach to it and has given it four essential characteristics. First, it is flexible; we have never tried to make banks conform to rigid patterns. The absence of a legislative sanction and the need to carry the supervised with us have made this inevitable. But this flexibility is also welcome to us. We believe that each bank is a unique institution which must be judged individually. We do not accept the sort of system found in some other countries in which legislation lays down rigid standards and ratios with which all banks must comply at all times. We accept that such standards and ratios are of value but only as yardsticks, not as categorical imperatives. We believe, for example, that a particular relationship between capital and reserves and deposit liabilities may be a danger signal for one bank but can be accepted with equanimity for another. And a ratio which at one time in one set of market circumstances may be imprudent may be perfectly acceptable at another time in different circumstances. So we will not accept a system of supervision which puts banks into a strait-jacket. Each bank needs to be looked at as an individual entity and the criteria by which we judge banks must be adaptable to changing circumstances.

Secondly, and this follows very much from what I have just said about each bank being judged individually, our approach is personal. We believe that the most important factor in that individual judgment must be a judgment of the quality and reputation of management and, where appropriate, of ownership. We therefore have aimed to keep the number of Bank of England staff involved in this work small and involved long term — long term, that is, in the context of a large organisation in which there is of necessity much movement of staff. They have thus been able to establish friendly, personal relationships over time with senior management in the banks which have helped the Bank to form effective assessments of them and have enabled them to talk to us with trust and confidence. It is a measure of the success achieved by generations of Principals of the Discount Office — the title of the senior official of the Bank responsible for this work until last July — in establishing such personal relationships that it has never been necessary for us to formalise our need to be kept advised of banks' plans for new developments, new ventures and new associations. The Principal's room has always seen a constant flow of visitors anxious to talk as freely and frankly as they would in the confession box or to a marriage guidance counsellor.

Thirdly, our approach has always allowed for progression. We believe that a bank of the highest quality does not suddenly emerge like Venus from the waves. It attains that status only after a long period of growth. There has always been a series of recognitions,

both formal and informal, through which an emerging bank can progress. The formal recognitions under legislation I have mentioned earlier; the informal ones include such things as membership of associations, eligibility of bills, having an account at the Bank of England, and so on. For all the classical scholars present, the progression can be likened to the Roman cursus honorum. We have accorded differing degrees of supervision to banks at different stages in this progression. We have needed to be less concerned with institutions with little recognition and, in the absence of legislation, such institutions would have been little inclined to accept close supervision without the quid pro quo of recognition. On the other hand, we have needed to be thoroughly familiar with the state of play of those banks to which the highest accolades have been given and they have accepted greater supervision as a reasonable return for recognition.

Fourthly, our system of supervision has been participative, especially in judging when a bank was ready for further recognition. We do not believe that the man in Threadneedle Street knows best and we are very well aware that central bankers are not commercial bankers. So we have always taken note, in assessing a bank, of the opinions held about it by other banks and of the recognitions given to it by other banks. Similarly, our judgment of the balance-sheet structure adopted by a new or growing bank has been much influenced by knowledge of the structures adopted on the basis of experience by other established banks of the same type. And, as I have already suggested, our approach has also had to be participative in the sense that the absence of a legislative sanction has meant that our supervision had to be voluntarily accepted by the banks concerned.

Now let us turn to recent developments. I said earlier that a number of events in the last decade have led to an intensification of our involvement in supervision. First there has been a great increase in the number of banks in London: foreign banks have opened branches and subsidiaries here, or have joined together in the newly-emerging consortium banks to operate in the euro-currency market and, in the domestic sector, there has been the rapid growth of what have become generally known as secondary banks, made possible by the existence of the sterling inter-bank market. These growths have presented us with an obvious problem of work load but also with problems about who takes ultimate responsibility for different types of bank. But a more important associated problem springs from the nature of these new wholesale markets in sterling and in euro-currencies; they have allowed many institutions, including the new banks, to obtain funds for onward lending on a scale previously quite impossible for them and have meant that sickness in one bank could rapidly develop into an epidemic affecting a whole range of banks, even banks which did not have direct contact with the bank where the infection had first broken out.

With the collapse of the property market in late 1973 some of these newly-developed lending books in sterling became of doubtful quality and very illiquid; lenders on the wholesale markets suddenly withdrew the deposits which had financed these lending books and there was a real chance of an epidemic of the type to which I have just referred affecting the whole system. This situation led us to review during 1974 our methods of support and supervision and the range of institutions coming within our purview.

Also during 1974 a number of serious losses suffered by banks in different countries operating in the foreign exchange and euro-currency wholesale markets and the failure of one or two small banks among them led to similar reactions — withdrawals of funds and dangers of ripple reactions — in these markets. Once again we, in common with the similar supervisory authorities in other countries whose banks were active in these markets, were again forced to refine our supervisory techniques.

Another factor contributing to more extensive supervision has been growing sensitivity about the protection of depositors; this has led to us taking a closer interest than hitherto in institutions low down on the ladder of recognitions. Finally, joining the European Economic Community has led to discussion of harmonisation of our approach to supervision with that of our partner countries and so inevitably we have had to think again about how we operate.

Our responses to these developments have taken a number of forms, but I must emphasise that none of them represents a radical departure from the basic approach established by the long process of evolution. Our approach remains flexible, personal, progressive and participative.

Firstly, we have made organisational changes to cope with the increased work load. Eight years ago, contact with the banks on supervisory matters was still — as it had been for many generations — in the hands of the Principal of the Discount Office and his Deputy and Assistant Principals who were supported by a staff of about ten. In 1967 the number of Principals increased to four and the staff in support rose over the next few years to about fifteen. Since last July, however, there have been seven of us equivalent to the old Discount Office Principals involved in this work and we have a supporting staff of about thirty. And we are still growing. But we are still sufficiently small in number to maintain the personal — I hope I may still say, friendly — contacts which we consider so vital to effective judgment of a bank and its management and to the establishment of trust between us and the banking community.

Secondly, we have recognised the need for more frequent and more comprehensive information about the banks for which we have acknowledged a degree of responsibility. Traditionally we relied on an annual discussion about the affairs of each bank registered in this country, based on its annual balance sheet. The events of 1973 and 1974 have shown that this was inadequate as a reasonable basis for assessing a bank or for identifying likely trouble-spots in the banking system. Balance sheets are not standard in form; they do not provide all the information we need in today's conditions; they may even in some cases be designed to obscure

rather than to reveal; they probably present a picture of affairs on what may well be the least typical day in a bank's year; and in any case they are often not available until so long after the date to which they refer as to be virtually prehistoric. So we have designed and inaugurated a new system of 'prudential' examinations.

In order to ease the burden of compilation for those reporting banks already included in our list of statistical banks, we have built the prudential examinations around the statistical returns which they were already submitting. We have not asked them to report again any information which we need for prudential purposes but which was already available elsewhere in the Bank on statistical returns. Hitherto these statistical returns had been used solely for aggregation into statistical series covering groups of banks or the banking system as a whole. Now we are also using them on an individual basis.

From the main statistical returns we are able to obtain details of total deposits taken in sterling and currency from other UK banks, from other UK residents and from overseas residents, details of the employment of those funds both in liquid assets and in advances and details of acceptance credit facilities. From other existing statistical returns we can obtain an analysis of advances classified by types of borrowers and a maturity analysis of liabilities and assets in foreign currencies broken down between categories of lenders and borrowers. We also have available returns showing banks' trading positions in foreign exchange.

To supplement this existing statistical information we have devised some new returns for prudential purposes only. First we have asked for details of banks' books missing from the main statistical returns but necessary to enable us to create a full balance sheet — such items as capital and reserves, provisions and investments in fixed assets. We then ask for supplementary details, which may vary slightly between banks of different types depending on the nature of their business and control. These supplementary details include: information about the items against which provisions have been made; details of large deposits and large advances; information about transactions with associated companies, with directors and with companies with which directors are associated; details of stand-by facilities granted by other banks and loan and other facilities granted by the reporting bank but not yet drawn by their customers; and information on contingent liabilities. In addition we ask for a separate return giving a detailed maturity analysis of each category of deposit liability and lending in sterling similar to the return already available to us for similar items in foreign currencies.

We are collecting these returns from virtually all banks included in the statistical list of banks which are registered in this country — except the London and Scottish clearing banks and their subsidiaries and the British overseas banks; the returns are not tailored to their complex businesses but, as I shall mention later, we are not ignoring these two groups.

Furthermore in recognition of the greater interdependence of deposit-taking institutions brought about by the development of the wholesale money markets and of present-day sensitivities about protecting depositors, we have brought into the reporting network about eighty deposit-taking organisations not hitherto supervised in any way by the Bank. These institutions include the members of the Finance Houses Association and most of the small institutions included in the Department of Trade's Section 123 list or in the Inland Revenue's list, but not included in the statistical list of banks. These institutions submit to us not only the information requested in the new prudential returns from statistical banks but also the information which the latter provide on the existing statistical returns. Before the traumas of the last year many of these smaller deposit takers would probably have been unwilling to participate in such a supervisory scheme without the benefit of a greater degree of recognition from us; but because of those traumas the extension of supervision has seemed natural and desirable and has been accepted by them.

In most cases we are asking for these prudential returns to be submitted on a quarterly basis. But in a few cases where we are anxious to be in even closer touch with developments we are calling for them monthly or every six weeks. On the other hand we shall require them only annually from one or two very small deposit takers with soundly based businesses.

We are already satisfied that, as was the intention, analysis of these returns will give us a much more comprehensive, dynamic and up-to-date picture of a bank's business. If we had had this information a year or two earlier we would have been able — always assuming that we would have been wise enough, and that is a bold assumption — we would have been able to forestall some of the troubles to which I referred earlier, which have affected the banking system since late in 1973. But we are not relying just on a careful analysis of returns and abandoning our old-style, personal approach to supervision. By far the most important part of this new exercise is, and will continue to be, regular discussions with representatives of senior management from each reporting institution about their returns. Let me emphasise the word 'discussion' — we look for a relaxed two-way exchange not for an inquisitorial examination. We believe that, especially given the unitary nature of most of the institutions covered, such frequent discussions between senior management of banks and senior officials of the Bank of England are more conducive to the maintenance of good banking practices than the technique adopted in many other countries of sending in teams of inspectors to examine banks' books.

This exercise has another justification besides the need of the Bank to be satisfied that banks are conducting their business prudently. We must recognise that it is increasingly difficult, in the light of the increasing complexity of modern banking, for trading partners to judge the soundness of banks from balance sheets and other published information, even despite the great efforts which many banks have made in recent years to be more forthcoming. I would certainly not wish to discourage such efforts or to dissuade any bank from

further experiment. I note with interest, for example, that many banks in America are now publishing daily average figures for their balance sheets as well as the conventional snapshot at a fixed moment in time; and I should be interested to see the results if any London bank were to try the same experiment. But as I said just now, despite all the attempts to be more informative, it is increasingly difficult with the complications of modern banking for other banks and institutions or individuals to form a completely dependable assessment of banks with which they may wish to trade. They therefore need to be assured that someone is regularly examining their potential trading partners in depth. I believe that this makes it all the more important that we in the Bank of England are now collecting fuller information, some of which can be revealed only to us in strict confidence, that we are regularly involved in examining that information with the banks concerned, and that we are widely known to be doing so.

The next recent development to which I should refer is that we have clarified with banks in London associated with overseas banks, with their shareholder banks and with other central banks, where responsibilities for supervision and responsibilities for support lie. Our contentions, which have been generally accepted by those banks, are: first, that branches of overseas banks here are integral parts of the banks to which they belong and are thus primarily the concern, not of us as the central bank of the host country, but of their parents and of their parents' central bank or other supervisory authorities for both supervision and support; second, that, whilst — on practical grounds — we accept supervisory responsibility for banks registered here but owned overseas, such ownership entails responsibility for support, whether the bank concerned is wholly owned or is owned by a consortium; and third, that British-owned banks — and we as their supervisory authority — must accept like responsibilities for their branches and subsidiaries overseas and for their investments in banks overseas.

As many of you will know, as part of the process of establishing this recognition of responsibility we sought from shareholders in the consortium banks in London and from banks owning subsidiaries in London acknowledgements of moral responsibility for their investments in London. Moral responsibility in this context is interpreted as responsibility to support those investments beyond the narrow limits laid down by laws of limited liability and, above all, as responsibility to protect depositors with those banks. It was our contention that when a bank trades to any extent on the fact of its association with another shareholding bank overseas, that shareholding bank's reputation is inevitably at stake in the operations of the bank in which it has invested. I am glad to be able to say that we have for some weeks now had one hundred per cent coverage by way of shareholders' undertakings for the consortium banks in London and that the exercise in obtaining such undertakings for subsidiaries, which began somewhat later than the exercise for consortium banks, is now also virtually complete; there are only one or two technical reasons delaying one hundred per cent coverage of these banks also.

Another recent development which I might mention is a letter which we sent to banks at the end of last year, about operations in foreign exchange. In this we drew attention to a number of factors which we considered that it was important should be included in banks' internal control systems — particularly in the control of foreign exchange operations by branches and subsidiaries overseas. This was — I think — the first example of explicit interference by us — formally and over the whole range of London banks' — in banks' own internal control systems. Probably in the past, if we had felt it necessary to pass on such advice, we should have done so selectively and by personal contact. But with the large number of banks now in London such an approach would have been impossible. Even if no more than one or two recipients tightened up their procedures as a result, there must in consequence have been a lessening of risk of future troubles which, if they had broken, could have adversely affected confidence in the system as a whole. We believe that this fully justifies our action.

This is an example of the theme of the earlier part of this talk. By this action we have demonstrated the flexibility of our supervisory role by slightly changing its nature. But our action was stimulated by, and was a response to, developments in the banking system. And the advice given was not an example of our thinking that we knew best; it was participative in that we drew on comments made to us over the last year by experts in many of the banks. And the reaction of most banks to our letter has suggested to us that we were right in judging that the banking community as a whole was ready for us to take this new line.

I mentioned earlier that British overseas banks' operations had not been included in the coverage of the new prudential returns. But we started prudential coverage of the operations of these banks with this letter. In it we required them to report to us about the controls they exercise over, and the limits they impose upon, their branches and subsidiaries overseas. And it is our intention regularly to review these controls with them in the future — possibly as part of an extended system of prudential supervision of their activities.

There remain the London and Scottish clearing banks. We do not expect to impose upon them quarterly prudential returns in the same way as we have on other UK registered banks. The returns as now designed would not be appropriate to the very different operations of these giant deposit banks. And we are of course in many ways closer to them, and so more aware of their business, than we are to most of the other groups of banks. But we have recently been involved in joint discussions with them about balance-sheet relationships and it is likely that, as one result of these discussions, we shall devise a system for keeping closer touch with them on an individual basis about their business in future.

Another recent development which I should mention is that we have established jointly with our opposite numbers in other countries much closer international

liaison on banking supervision matters. Neither we nor our opposite numbers overseas look for a massive harmonisation of our approaches to supervision. The legislative backgrounds against which we operate, the banking systems which we supervise, and the political structures — for example unified or federative — of our different countries, are all so vastly different that we could not operate a unified system. But there is no reason why we should not learn from each other and adapt the best features of each other's systems for inclusion in our own systems. Nor is there reason why we should not establish among ourselves such a degree of personal contact and trust that we can help to forestall troubles in the international system by working closely together. For this reason we on the supervisory side of the Bank now meet informally and quite frequently with our opposite numbers in the EEC countries; and we are represented on a committee which the governors of the Group of Ten countries have established at the Bank for International Settlements in Basle for periodic discussion between supervisory officers and foreign exchange operators, particularly on matters affecting the international euro-currency and foreign exchange markets.

I now come to the last section of this talk — a few words about balance-sheet relationships and other prudential ratios. I mentioned earlier the discussions which we were having on prudential matters with the London and Scottish clearing banks. Balance-sheet relationships are an important item on the agenda for those talks and so until they are complete I would certainly not wish to say anything definitive to you; but I will indicate to you one or two ways in which my own thoughts are developing.

As I have already said, we in the Bank do not in any way accept the approach which claims that the strength of a bank can be assessed entirely in terms of rigid balance-sheet ratio relationships. But we recognise that such relationships are valuable as tools in forming individual assessments and for comparative purposes, both in the domestic banking scene and in relation to overseas banks, particularly in the context of the EEC. We believe that for far too long there has been too little discussion of these matters in this country and that such ratios and relationships as have been conventionally accepted here in the past are probably too simplistic to be satisfactory guides for modern banks on their own — I do not suggest abandoning them but supplementing them. For example we have probably paid too little attention in the past to the level of earnings as a first defence against losses and as a guide to management efficiency — though I should hasten to add that we recognise that excessively high earnings may be an indicator of potential trouble from imprudent lending.

On capital adequacy we have tended in this country in the past to relate capital and reserves by a variety of formulae to deposit liabilities. Such formulae are useful as a first guide to assessing whether the overall size of a bank's business is appropriate to its resources, and a clearly prudent relationship between capital and reserves and liabilities is a prima facie cause for confidence in a bank. But this approach takes too little note of the quality of the business. We should relate capital and reserves also to the purposes for which they are required. These are, in the first place, to provide the general infrastructure of the business — its fixed assets such as buildings and its trade investments in subsidiaries and associated companies — and, secondly, to provide protection for depositors against losses arising from imprudent lending or other investments in risk assets and from contingent liabilities. In assessing capital adequacy we need therefore first to ensure that shareholders' funds provide full coverage for investment in fixed assets and investment in subsidiaries and related trading companies; depositors' funds should not be used for these purposes. There should then be a margin of shareholders' funds available to provide coverage, in addition to the coverage provided by current earnings and by past provisions, against risks of loss. In assessing a bank one needs to relate these three sources of protection against loss to the volume of risk assets and contingent liabilities. The extent to which such risk assets and contingent liabilities should be covered by current earnings, provisions and free shareholders' funds must be a matter for individual assessment in each case. There can be no inviolable figure or proportion that must apply to every bank. In judging the degree of cover appropriate in each case, past experience must be the most important factor, but one must also consider whether changes outside the control of the bank itself (for example, in recent times the collapse of the property market) are likely to mean that future experience of loss is going to be significantly different from past experience. And for newly-emerging or fast-growing banks where there is likely to be inadequate guidance available from past experience, the experience of similar banks may be useful. The quality of management must also be a very important factor in judging the cover required.

We need also to look at the different roles to be performed by different types of shareholders' funds. For example, loan capital seems quite inappropriate as a defence against the risk of loss; it should only be employed to provide part of the infrastructure of the business. And equity capital too does not provide easy defence against loss since it cannot easily be written down. A large investment in risk assets is best made against the basis of freely-usable reserves.

But liquidity is probably even more important than capital adequacy; the difficulties experienced in the banking systems, both in this country and internationally over the last eighteen months, have generally been difficulties not of capital adequacy but of liquidity. Traditionally we have tended to relate quick assets to total deposit liabilities in assessing liquidity. But with the development in recent years of large-scale time deposits and with the ability — which still exists for the best banks though it does not exist on anything like the wide scale that obtained in 1970-73 — to buy in liquidity by bidding on wholesale markets, our concepts of liquidity must now be much more sophisticated. We need to develop fully-rounded principles of matching to govern the assessment of adequate liquidity for term deposits;

we need also to assess how far each bank can rely on buying in liquidity on the wholesale markets; only then can we consider what conventional liquidity in the form of quick assets will be required in relation to residual deposit liabilities and to provide ability to meet losses which require actual cash payments.

Lest this last section of my talk should have given anyone a wrong impression let me repeat, we in the Bank do not expect ever to judge banks solely in terms of balance-sheet relationships and ratios. We look upon them only as an adjunct to individual assessment of each bank in the light of its own particular circumstances.