

The secondary banking crisis and the Bank of England's support operations

Introduction

1 The Research Panel of the Wilson Committee has asked for a background paper describing 'the lifeboat operation'. This paper is a response to that request, but, as its title suggests, goes somewhat beyond the lifeboat operation itself. Part I considers the nature and antecedents of the secondary banking crisis, to which the lifeboat operation was a response. Part II goes on to consider the crisis which broke in December 1973 and the action taken by the Bank and the banking system to deal with it, including the manner in which the lifeboat operated. Part III describes subsequent developments in their historical and economic context, covering both the lifeboat operation and the banking support operations undertaken by the Bank on their own account.

I The antecedents of the secondary banking crisis

2 The causes of the secondary banking crisis are to be found in a complex skein of macro and micro-economic factors, which combined and interacted in a way that even in retrospect is difficult to unravel. They can most easily be analysed under two main headings: developments in the structure of the financial system, and the economic conjuncture.

Structural developments

Limits to the Bank's supervisory function

3 The Bank's long-established system of supervision over British banks rested on a well-understood distinction between deposit-taking institutions that were recognised as banks and those which were not. Deposit-taking alone does not constitute a bank. It was always (and still is) open to any company or partnership to take deposits and to on-lend them. If such a deposit-taking institution prospered and its reputation and standing in the market-place equally grew, it could eventually come to be accepted as a full member of the banking community. This progression came in time to be marked by a variety of 'recognitions'. Some of these were accorded by the market, for example, the granting of bankers' payment facilities by a clearing bank; others were accorded by the Bank, for example, their willingness to open a banker's account for the institution in question or to rediscount a bank's acceptances at the finest rate; yet others came to be granted in the post-war years under legislation.

4 The Bank and the banking community had naturally always required individual members to adhere to certain well-understood standards of conduct; and new entrants to that community had only been accepted where these standards were met by the management of the institutions concerned. In all this the Bank acted as both guide and interpreter of banking opinion, and in themselves granting any recognitions they were careful not to run ahead of such opinion. Nor were recognitions an end of the matter. When a company had been accepted as a fully-fledged bank, it was understood both by that company and by the rest of the banking community that its activities would be subject to a continuing supervision by the Bank.

5 Such supervision (which will be discussed in greater detail in the Bank's evidence to the Committee itself) rested, first, on analysis of the company's annual accounts followed generally by discussions with senior management about the character and quality of the business; and, secondly, on the Bank continuing to inform themselves about the reputation and quality of the management. Experience has shown this latter to be a most important factor in the successful conduct of a banking business, where what matters crucially is enjoying and deserving the confidence of both bankers and the public.

6 Following the end of the Second World War, certain pieces of legislation were introduced which had the effect, *inter alia*, of creating, for particular purposes, a number of legal categories involving banks. Section 4 of the Bank of England Act 1946 itself enabled the Bank to 'request information from and make recommendations to bankers' and, if so authorised by the Treasury, to 'issue directions to any banker for the purpose of securing that effect is given to any such request or recommendation'. The same section goes on to define 'banker' as 'any such person carrying on a banking undertaking as may be declared by order of the Treasury to be a banker for the purposes of this section'. In fact no such declaration has been made under this section and no directions issued.

7 Legal categories of banks, however, were established as a result of two other pieces of legislation. The Exchange Control Act 1947 required the Treasury and the Bank to establish a list of banks authorised to deal in foreign exchange and to exercise certain delegated powers under the Act ('authorised banks'); and the Companies Act 1948 required the Board of Trade and the Bank to establish a list of banks permitted accounting privileges relating mainly to the maintenance of inner reserves ('Schedule 8 banks'). The main criteria on which the Bank based their recommendations to the appropriate department for admission to such lists was that the company concerned should be acceptable to the Bank and the banking community as a bank in the full sense just described. The list of authorised banks was much larger than the Schedule 8 list, since foreign banks wishing to deal in foreign exchange required 'authorised bank' status. There were, on the other hand, very few Schedule 8 banks which were not also authorised banks. Thus 'fully recognised' and 'authorised' banks came to be regarded as synonymous, both (rightly) carrying the connotation that, provided they were UK companies, they were supervised by the Bank.

8 This general system proved very effective. Depositors had no reason to doubt the safety of money placed with fully-recognised banks. At the same time and desirably, so as to secure an adequate amount of competition and the infusion of new blood into the industry, the system allowed the establishment and advancement of deposit-taking institutions that had yet to gain any recognition as banks and were therefore outside the supervisory control of the Bank.

9 In the 1950s and early 1960s there were isolated examples of such non-bank deposit-taking institutions getting into difficulties, particularly in times of general financial stringency. Public criticism at that time was mainly concerned that such companies had an unrestricted right to solicit public

deposits without being required to make adequate or prompt disclosure of the nature and scale of their business. The Protection of Depositors Act 1963 was introduced as a result. Its object was to limit the freedom of companies to advertise for deposits without making available specified information about themselves. They were accordingly obliged to publish accounts in prescribed detail and at prescribed intervals (more frequent than those applicable to ordinary companies) and to submit them to the Board of Trade [now the Department of Trade]. The Department examines these accounts but is not required or empowered to investigate the quality of the business underlying the accounts; it may petition for the winding up of one of those institutions only in the circumstances set out in Section 16(1) of the Act. The Act made a distinction between banks proper, which could be exempted from the provisions of the Act, and other seekers of deposits. The exemption was originally applied to the Schedule 8 list of banks established by the Bank and the Board of Trade; it was subsequently amended in Section 127 of the 1967 Companies Act, which resulted in the creation of a further list agreed between the Board of Trade, the Treasury and the Bank, the normal criterion for inclusion in which was, in the case of branches of foreign banks of high international reputation, to have been an authorised bank for at least two years, and, in the case of UK-registered banks, to satisfy the Bank that it was acceptable as a bank in the full sense described above.

10 The Act also limited the use of the words 'bank', 'banker' or 'banking' in advertising for deposits by any company other than a fully-recognised bank, but this does not prevent their use in letter-headings etc., which are not associated with advertising material *per se*.

11 Despite the evident weaknesses of the Protection of Depositors Act, there would probably not have been any great danger of the public being unable to distinguish between banks and other deposit-taking institutions, had the statutory position then existing remained unchanged. For no domestic institution of any importance could in practice, readily and without challenge, hold itself out to be a bank, or be accepted as such, unless it was within the supervisory area administered by the Bank.

12 But the statutory position did not remain unchanged. The Moneylenders Act 1900 makes exempt from its provisions 'any person bona fide carrying on the business of banking'. Legal circles had long been dissatisfied that on each occasion that the point came up, the courts had to establish anew whether a company was indeed carrying on such a bona fide banking business. This culminated in a suggestion by the Court of Appeal in 1966 (*UDT v Kirkwood*) that the Board of Trade should assume responsibility for recognising which institutions, for the special purposes only of Section 6(d) of the Moneylenders Act 1900, were carrying on a bona fide banking business. Powers conferred by Section 123 of the Companies Act 1967 enabled the Board of Trade to grant certificates to companies satisfying them that they could properly be treated for the purposes of the Moneylenders Acts 1900 to 1927 as bona fide carrying on the business of banking. Applicants for certificates are required to complete a detailed questionnaire, which is considered by the Department of Trade in consultation with the Bank of England. The department is not, however, empowered or qualified to carry out day-to-day supervision of either Section 123 or Section 127 banks. The criteria used in judging applications for Section 123 certificates are

necessarily, given the terms of the recognition, based on the functional characteristics of a banking business rather than on judgmental tests of quality or repute. A large number of companies which were not of sufficient size or quality to warrant the more advanced banking recognitions mentioned above felt the need (not least because they could not otherwise safely make personal loans) to obtain the protection of a Section 123 certificate, the criteria for which they were fairly readily able to satisfy. Revocation of a certificate once granted is difficult since the Department must 'cease to be satisfied' that the company is bona fide in the business of banking — again a functional not a qualitative test.

13 The possession of the certificate was proof that the company concerned was not subject to the Moneylenders Act, but in more general and unanticipated ways it allowed the impression to be created that the companies concerned were recognised by the responsible government department as carrying on a banking business, without drawing attention to the fact that they were only so recognised for one narrow purpose.

Credit control

14 Apart from their prudential supervisory rôle in relation to the banking system proper, the Bank were responsible for the operation, when necessary, of arrangements for the control of credit provided by that system. In the latter part of the 1960s credit control was operated with considerable strictness, in the form of ceilings on the total amount of credit that might be extended to private sector borrowers by each bank individually, often combined with guidance on where the available credit should be directed. The strictness of the control on banks provided the opportunity for other institutions, outside the scope of the control because they were not banks, to establish and expand in the business of lending. To some extent they were able to undertake relatively good business that, other things being equal, would have gone to the banks proper — and to charge high rates for it. Much of their business was in the field of consumer credit and personal loans, often secured on second mortgages. These opportunities were sufficiently exploited that, by the end of the decade, the effectiveness of the credit control technique was being appreciably affected.

15 One possible response might have been to seek to extend the scope of the Bank's influence 'by custom and practice', by bringing the growing 'fringe' institutions within the credit control system without classifying them as banks. This had, for instance, occurred with the larger deposit-taking members of the Finance Houses Association (FHA), who had voluntarily submitted to the system of quantitative credit control from 1965 onwards. But efforts in this direction were resisted in a number of other cases. There were also considerable doubts whether the powers contained in the Bank of England Act 1946 could or should be used to compel such institutions to come into the system: for their part the Bank believed that it would be improper and misleading to accord such institutions the status of banks.

16 The alternative approach, which was one of the ideas underlying the Bank's 1971 discussion paper *Competition and credit control* and the subsequently adopted policy, was to remove the restraints whose prolonged application to the banks and the deposit-taking members of the FHA had enabled the fringe to develop as it had. The expectation was that, perhaps not immediately but in a short while, the fringe would contract

to a level of comparative unimportance. To see why this expectation was not fulfilled it is necessary to examine the economic circumstances in which the newly-adopted approach of competition and credit control came to bear on the financial structure whose weaknesses it sought to counter.

The economic conjuncture

17 From about the middle of 1971, after a period of slack domestic economic activity and rising unemployment, the overall thrust of economic policy was increasingly being directed towards expansion. Part of the strategy was to make finance readily available in order to provide a major stimulus to investment, and the restored freedom of the banks to lend accorded with such a strategy. Investment by the industrial sector was, however, slow to pick up. The rates of return foreseen in a still rather stagnant economy did not seem very attractive. This provided a marked contrast with another sector of economic activity, namely property development.

18 There are two particularly relevant characteristics of property development. One is that there is often a long interval between the decision to undertake a project and its eventual completion. The other is that its economic prospects are notably subject to abrupt change as a result of changes in overall policy and developments in areas such as planning control, rent restriction, taxation and monetary policy. The planning restrictions of the later 1960s prompted a drying-up of new projects. By the early 1970s, this was being reflected in an inadequate supply, particularly of office property, and a sharp increase in rent levels when they were free to be negotiated. There was no other general area of economic activity which seemed to offer as good a prospective rate of return to an entrepreneur as property development. The consequence was that, with the necessary finance so readily to hand, far too much of it was undertaken all at once. This was given particular encouragement at that time of generally rising inflation by the widely held belief that property was the inflation hedge *par excellence*, a belief which was adhered to in some quarters with blind assurance.

19 The finance of property development by banks had been discouraged in the credit restrictions of the sixties, and was so again from August 1972, when concern was felt about possible erosion of the banking system's capacity to meet the hoped-for upturn in industrial demand for credit. The fringe had accordingly had the opportunity to capture a share of the lending that was done. Banks, moreover, had traditionally had reservations on prudential grounds about becoming too heavily involved in commitments of the length that development projects require. So, although it is the case that such reservations became progressively weaker and bank lending to property companies increased substantially over the period after the introduction of competition and credit control, the nature of borrowing demand in this period was such as to encourage the fringe to extend their position in property lending, particularly at the speculative end of the market.

20 This was greatly facilitated by the relative ease with which the fringe was able to obtain deposits. Individual depositors accounted for only a small part, despite the energetic use of advertising. The bulk of the fringe's deposit requirements was met from the money markets, which by the early 1970s included as lenders not only banks, but also industrial and commercial companies and major institutional investors.

21 This was a time when money markets were expanding vigorously. During the period when the ability of banks to lend was subject to restriction, there had already developed, largely through brokers, an inter-company market in which company treasurers and some important institutional investors lent or borrowed funds among themselves. Following the removal of lending restrictions on banks, however, the distinction between the inter-company and inter-bank market became blurred. In the new, more competitive conditions, the banks were keen to increase their loan books in order to maximise their market shares. But with the slow pick-up in loan demand from the manufacturing sector, the banks generally had more lendable funds than they were finding traditional opportunities to lend. They were, therefore, increasingly prepared to on-lend surplus resources through the medium of the money markets.

22 The ambiguity of Section 123 recognition and the varying degrees of reputable institutional sponsorship enjoyed by a number of the fringe institutions encouraged a further blurring of the distinction between bank and non-bank in the inter-bank markets. Through brokers, fringe institutions found that they were able to attract wholesale deposits, in substantial volume but mainly at short term, by offering only modestly higher rates than banks. Because of the attractions of the property market noted above, a large proportion of the funds flowing into the fringe institutions was employed in that market or in lending for employment in that market, the apparent ability to renew the deposits at maturity leading the institutions to disregard the risk of becoming locked in. Accordingly when renewal of deposits became difficult, liquidity problems rapidly arose.

23 These developments were taking place against a generally deteriorating economic background. The first half of 1973 was characterised by an almost continuous international currency crisis. Initially sterling was relatively unaffected, and the critical focus was on the dollar and the deutschemark; but despite a good export performance the terms of trade were moving against the United Kingdom and, with interest rates in other countries rising, sterling began to depreciate from mid-May onwards. Initial increases in domestic interest rates were dictated mainly by such external events, but as the year progressed it became necessary to tighten monetary policy in an effort to curb the excessive monetary expansion that had taken place. Minimum lending rate was raised to 11½% towards the end of July and there were further calls for special deposits. Bank lending, however, continued to advance, and by mid-November a further call for special deposits was made and minimum lending rate was raised to 13%. This was followed in December by the introduction of the supplementary special deposits scheme, which imposed a penalty on any untoward increase in banks' interest-bearing liabilities resulting from strong bidding for funds in the wholesale money markets.

II The crisis and the response

The onset of the crisis

24 This then was the situation when in November 1973 London and County Securities found itself in liquidity difficulties, through being unable to renew deposits taken through the money markets. London and County had been a quoted company since 1969, had held a Section 123 certificate since 1967 and had substantial deposit liabilities to the public. Its troubles had been well publicised, culminating in the

resignation within five months of joining the company of a respected City banker who had been appointed to strengthen the banking division. Meanwhile the uncertainty that had been introduced into the property scene following the imposition of a freeze on business rents in December 1972 had been overlaid with an increasing awareness of the potential effect of the rapid increase in interest rates on property companies (particularly on their asset valuations) and on those lending to them. In such circumstances the resignation was sufficient to trigger a liquidity crisis for London and County, but it very soon became apparent that some more sophisticated depositors in the money markets were taking fright at their potential exposure to any such institution.

25 The Bank thus found themselves confronted with the imminent collapse of several deposit-taking institutions, and with the clear danger of a rapidly escalating crisis of confidence. This threatened other deposit-taking institutions and, if left unchecked, would have quickly passed into parts of the banking system proper. While the UK clearing banks still appeared secure from the domestic effects of any run — indeed the money-market deposits withdrawn from the fringe were largely redeposited with them — their international exposure was such that the risk to external confidence was a matter of concern for themselves as well as for the Bank. The problem was to avoid a widening circle of collapse through the contagion of fear.

26 It is hardly necessary to dwell here on the damaging consequences that a collapse of confidence extending into the banking system would have had. As a result of their experiences with the Overend Gurney crash of 1866, the Baring crisis of 1890 and the prolonged international crisis of 1929-33, the Bank — and the world at large — had come to regard the taking of prompt and decisive action to prevent a spreading loss of confidence as one of the essential rôles of a central bank. In the circumstances of the closing weeks of 1973, therefore, the Bank felt it essential to meet their responsibility for fully-recognised banks by mounting a rescue operation for the benefit of the depositors of a group of institutions which were not fully-recognised banks, but whose otherwise inevitable collapse would have threatened the well-being of some recognised banks. The need for rapid joint response to the developing situation was immediately accepted by the English and Scottish clearing banks when the Bank approached them.

The lifeboat

27 In the immediate aftermath of the London and County collapse, various *ad hoc* arrangements were made to deal with the first casualties; but by the end of the year these arrangements had been superseded by the establishment of a Control Committee of the Bank of England and the English and Scottish clearing banks, consisting of senior representatives of each under the chairmanship of the Deputy Governor of the Bank, which first met on 28th December 1973. This was the body subsequently known as 'the lifeboat'.

28 All deposit-taking companies with known or anticipated liquidity difficulties were identified (whether introduced by the clearing banks themselves or on direct application by the companies concerned) and the bank with the closest banking connexion with a problem company was appointed 'the related bank' to that company. The related bank made or commissioned a rapid, but as thorough as possible,

investigation of the affairs of the company in question and reported back to the Committee. The criteria on which the Control Committee decided whether or not to provide support were straightforward. The Committee required to be satisfied:

- (i) that the company seeking support was currently trading solvently and, on the basis of best estimates possible at that time, was likely to remain solvent provided it received liquidity support by way of recycled deposits;
- (ii) that the company exhibited sufficient banking characteristics to justify inclusion in the scheme (e.g. the possession of a Section 123 certificate) and had attracted a significant level of deposits from the public; and
- (iii) that the company did not possess any institutional shareholders whose interest in the company was such that they might properly be expected to provide the necessary support.

29 While it was at this stage expected that the majority of the situations would be solved by recycling the lost deposits until confidence was re-established, it was common ground that, if the initial investigation showed an already unviable position, no support would be given. It was also common ground that where other financial institutions were involved, either as significant shareholders or as large depositors, they would be pressed to contribute to any support operations by increasing their lending or, at the very least, not withdrawing their deposits.

30 Once a company in difficulty had been investigated, the Control Committee decided on the criteria explained above whether it was worthy of support, and, if so, to what limit and on what terms. In most cases accepted by the Committee the risk was shared between all members of the Committee (on a formula based on the relative size of their eligible liabilities), though members would on occasions maintain pre-existing facilities at their own risk, and in some instances the related bank declared itself ready to handle a case at its sole risk without assistance from other members. The provision of any support agreed was co-ordinated by the Bank. The Bank's share in the provision of finance and the acceptance of risk on companies supported on a shared-risk basis was agreed at 10% of the amounts outstanding; in one or two cases where a related bank (or banks) was bearing sole (or joint) risk, the Bank agreed to participate in the risk on an *ad hoc* basis.

31 It was a matter of principle with the Control Committee that interest on support lending should be charged at a commercial rate, based on the appropriate inter-bank rate, to which a margin was added, which varied according to the Committee's perception of the risk involved (typically 1½%–2%). The Committee was also anxious to ensure that the rate charged would constitute an incentive to the company to regenerate its own funding capability at the earliest opportunity. It was recognised, however, that in certain cases a fully realistic interest rate might significantly prejudice the chance for the supported company to re-establish its position in the market and thus sever its dependence on support funds, and the Committee took account of this consideration where appropriate. Commitment fees were charged for facilities approved but not yet drawn.

32 The related bank was expected to advise the Committee on whether security should be sought for the support lending and, if so, what appropriate security was available. Wherever the Committee considered it appropriate and it was available,

security was taken, although the form varied according to the circumstances of the case, ranging from a full floating charge to charges taken over individual assets and personal guarantees. The related bank was also responsible to the Committee for monitoring the progress of the company receiving support, perfecting the security, reporting back to the Committee and recommending any variation of the terms of the facility approved.

33 By the end of January 1974 the system was fully established on lines which were not substantively changed thereafter. In fact, four fifths in number of all companies approved for support had been identified before the end of March 1974. Appendix I contains summary information about the companies which have received support and a quarterly breakdown of outstanding amounts of lifeboat support at shared risk.

III The three stages of development

34 Once the crisis had broken, there were three distinct stages of development. During the first, from November 1973 to March 1974, the main preoccupations were domestic, and the problem was perceived primarily as one of recycling deposits. The second lasted from March 1974 to the end of that year, by which time the international dimensions were becoming increasingly apparent and some very much larger institutions sought the help of the lifeboat, with the sums involved rising substantially. The third phase was from the beginning of 1975 onwards. By this time the lifeboat operation and other measures taken by the authorities had to a considerable extent restored general domestic banking confidence, but the United Kingdom's external position remained weak and international turbulence continued. In this phase UK financial institutions which ran into trouble became the responsibility of the Bank alone, without help from the other institutions manning the lifeboat.

Stage one: November 1973 to March 1974

35 Initially, as noted above, the problem was perceived primarily as one of recycling deposits, since most of the deposits withdrawn from the supported institutions were redeposited with the banks manning the lifeboat. Once established, the lifeboat was kept busy: during this first phase twenty-one institutions were considered to require liquidity support, representing four fifths of the total number of companies eventually approved for support. Of those twenty-one, sixteen were institutions with Section 123 certificates and two were Section 127 banks. By the end of March the amounts advanced by members of the lifeboat at joint risk amounted to just under £400 million.

Stage two: March to December 1974

36 The economic situation of the United Kingdom during the first half of 1974 deserves brief recall: the miners' strike, the three-day week, the general election and a tough March Budget with promise of another budget later in the year combined to sap the confidence of business opinion at home and abroad, which had already been seriously undermined by the implications of the quadrupling of the price of oil at the end of 1973.

37 This apart, it became increasingly clear that the problem had become more complicated than a simple recycling of

deposits. Confidence in fringe deposit-taking institutions showed little signs of returning and the collapse of property values was now fully apparent. Having peaked in the last quarter of 1973, property values remained in a state of suspended animation during the first quarter of 1974 with little dealing taking place: they then began to tumble. The final collapse of the Stern Group with liabilities in excess of £100 million occurred in June. With the fall in property values and with the rate of inflation steadily increasing throughout the year, the underlying assets of several companies which had appeared to justify support began to look vulnerable; in some cases it gradually became apparent that what had begun as a liquidity problem had become a solvency problem, making liquidation inevitable. Arrangements were made, under the aegis of the Bank, to offer to take assignments of debt from the relatively few remaining independent depositors in the companies concerned. The cost of such assignments fell on the Bank — the clearing banks having insisted that in the light of their obligations to their own shareholders they could not voluntarily expose themselves further in any situation which had become palpably insolvent. The Bank, however, considered it necessary to undertake this additional obligation in order to preserve the credibility of the lifeboat operation at a time when confidence was still fragile. The Bank also recognised that they had acquired a degree of moral responsibility towards depositors who had not withdrawn their funds because of their awareness of the support operation. As a matter of principle, however, assignments were not taken either from depositors who were or had recently been involved in the direction of the failed company or their close relatives, or from anybody who had lent to the failed company on such terms that the Bank could not regard it as a deposit taken in the normal course of business.

38 After the first half of 1974 the total amount of support outstanding began to increase sharply. Concern about property market prices focused attention on the large finance companies which were known to have substantial property portfolios, and in particular on First National Finance Corporation and United Dominions Trust. These companies found it increasingly difficult to maintain their money-market deposits and consequently came to rely heavily on support group funds. By August the total support committed approached £1,200 million. Such a figure amounted to approximately 40% of the estimated aggregate total of the capital and reserves of English and Scottish clearing banks. They felt that to go further than this would risk provoking doubts about their own financial soundness. They therefore decided that they would not continue with the operation on a joint basis beyond that point; any further funds or risk-taking had to be for the Bank alone.

39 The Bank's reaction to this new situation was conditioned not only by the fragility of domestic confidence, but also by increasing evidence of international malaise. Up to the summer of 1974 the phenomenon of falling property prices and a run on deposits had seemed primarily confined to the United Kingdom, although it was already clear that commercial property in most European centres had ceased to appreciate. But equally by that time the lifeboat was well established and the outline of subsequent action was becoming clearer (i.e. which supported institutions would survive, which would require major surgery and which were unlikely to avoid liquidation). In June, however, the international financial community, already aware of trouble at Franklin National

Bank in New York, was shaken by the sudden closure of Bankhaus Herstatt as a result of massive foreign exchange losses. There had already been warning signs: a number of small German private banks had failed earlier in the year, and the Westdeutsche Landesbank and Union Bank of Switzerland had sustained substantial foreign exchange losses arising from the turmoil in currency markets of the previous twelve months, which, however, their size enabled them to absorb reasonably comfortably. The reaction of international bankers was in many ways very similar to that of UK institutional depositors in December 1973 — lines to smaller banks were drastically reduced or withdrawn.

40 In July, the Israel-British Bank of Tel Aviv failed, in conjunction with its wholly-owned London subsidiary, in circumstances involving major fraud, and in September Lloyds Bank International was to announce that, again due to fraud, their Lugano branch had suffered exchange dealing losses of £33 million.

41 This combination of events caused a great deal of nervousness in international banking circles, and the Bank were particularly concerned that UK banking institutions should not be seen to default on any external obligations. Even though the international financial community had recognised and welcomed the general success of the lifeboat operation and the original fears of major failures had receded, there was still a significant risk that an isolated default by a UK bank, in the highly charged atmosphere of the time, might have triggered a chain reaction.

42 In all these circumstances, domestic and international, the Bank felt impelled to shoulder the additional risk implied by the unwillingness of the other members of the lifeboat to extend their commitments beyond £1,200 million. That the Bank's concern was not fanciful was subsequently underlined, when the National Westminster Bank found it necessary at the beginning of December to issue a statement to the effect that current rumours that they were receiving support from the Bank were without foundation.

43 By the end of September the total amount of support outstanding at shared risk had risen to £994.3 million and by the end of the year it was within £18 million of the banks' maximum of £1,200 million. For a short time the Bank extended additional help at its sole risk to companies already in the lifeboat after the cut-off point for commitments at shared risk had been established (which brought the maximum overall total of such lifeboat support to £1,285.4 million in March 1975). The need for this additional help, however, was only short-lived. Thereafter the total began to recede, as some companies were able to re-establish themselves and sever their dependence on the lifeboat. In the nine months from April to October 1974 only four additional institutions required support, of which three were authorised banks.

Stage three: January 1975 onwards

44 The focus of attention, which in 1974 had moved from the United Kingdom to Germany at the time of Herstatt and to Italy with the much publicised fall of Signor Sindona's empire in August, then moved to the United States itself. The problems of Sindona had led to difficulties for Franklin National Bank which were only finally resolved in October 1974, and later that year the Comptroller of the Currency in the United States announced publicly that 150 of the nation's banking institutions

were under close scrutiny. The general recession in the United States had fed through to the property scene, and early in 1975 the problems of real estate investment trusts, heavily supported by US banks, gave added cause for concern. In June 1975 an additional shock to confidence was provided by the financial troubles of New York City, which threatened to rub off on to the financial obligations of other US municipalities which formed an important part of the asset portfolios of most US banks.

45 These were specific blows to confidence, additional to the persistent and growing concern about the consequences for the whole international financial and economic system of the unequal distribution of oil surpluses and deficits and to doubts about the ability of the international banking system to cope with the enormous recycling problem which had to be overcome if the world was not to be plunged into an ever-deepening recession.

46 In the United Kingdom itself, where the year opened to the reverberations of the rescue operation for Burmah Oil, inflation accelerated for the greater part of the year, although the introduction of stage one of incomes policy in August held promise of improvement in 1976. There was better news on the sterling front, with the current deficit on the balance of payments being more than halved from £3,650 million in 1974 to £1,700 million in 1975, and the high total of foreign currency borrowing in 1974 of the equivalent of £1,880 million being reduced in 1975 to £850 million.

47 It was still not a situation, however, in which to run any avoidable risks of damage to confidence, and in the judgment of the Bank it remained imperative that in the third stage of the crisis the success of the first two stages in rebuilding confidence should not be jeopardised by any suggestions of weakening of resolve in carrying through the policies that had been embarked upon, or by any failure to resist further potential shocks to the system. While it is perhaps possible that those at home were anaesthetised to further shocks by what had already been experienced, it was far from clear that this was the case internationally, where the recovering credit of the United Kingdom still looked fragile.

48 This was the background to the Bank's involvement in support operations on their own account outside the lifeboat, of which two were of particular significance. In late 1975 Slater Walker Limited, the authorised banking subsidiary of the financial group, Slater Walker Securities Limited, found itself in difficulties, as in May 1976 did Edward Bates & Sons Limited, which had originally joined the lifeboat for a strictly limited amount in September 1974. Both were part of sizable groups with sensitive external ramifications. Foreign currency obligations of the non-banking companies of the Slater Walker group, for example, amounted to some £75 million equivalent, a significant part of which was publicly held. Additionally, the Group was responsible to a large number of investors and pensioners through the funds managed in its unit trusts and life assurance business. As regards Edward Bates, a reconstruction had been put in hand in 1975 involving the introduction of new shareholders from the Arab world. During 1976 it became increasingly apparent that further reconstruction would be required of both groups, which in each case would be likely to involve a substantial writing down of assets. The reconstruction schemes entered into for the Bank's own account both held promise that they might in fact reduce the loss that would have been sustained if the Bank had followed routes involving

liquidation. Further details relating to the Bank's involvement in these companies are contained in Appendices 2 and 3.

IV Conclusion

49 The lifeboat and subsequent support operations were undertaken in the compelling interests of maintaining confidence, domestic and international, in the banking system. In this they were wholly successful. Such operations rarely prove to be costless, even when on a scale much smaller than was required in this case. But the potential losses have been fully provided for in the books of the members of the support group; and whatever the ultimate losses may prove to be, they will be far less than those that would have been sustained by the support group and the economy at large had the support operations not been undertaken.

50 Outstanding lifeboat support at shared risk has been reduced to virtually half what it was at the peak and the greater part of the amount outstanding is accounted for by two institutions. It may well be several years before these situations, the various liquidations and the realisation by the Bank of assets acquired as a result of their own support operations are worked out.

51 The events here described have led to wide-ranging changes in the machinery of supervision, both domestically and internationally. This is not to say that there will never in future be either instances of individual banks running into difficulties or more general crises of financial confidence calling for supporting action by the Bank. What can be said is that, drawing upon the experience of the events here described, substantial improvements have been made or are in prospect. Domestically the Bank have greatly extended the scope and intensity of their supervisory arrangements; internationally, comparable advances have been made in a number of countries and machinery for close international co-operation between supervisory agencies has been established and put into operation. Prospectively, the projected legislation relating to deposit-taking institutions will bring such institutions under the control of a single agency, with specific arrangements designed to provide a substantial degree of protection to the smaller depositors.

52 The question of the lessons learnt from the secondary banking crisis and the support operations will be dealt with in evidential papers to be submitted by the Bank to the Committee in due course. The Bank believe, however, that these new and proposed arrangements will go far to reduce the risks of major difficulties arising and will provide a satisfactory basis for dealing with any which do occur.

Appendix 1

The lifeboat

1 The companies receiving support

The Control Committee approved support of varying degrees for twenty-six companies, of which eighteen were institutions with Section 123 certificates and five were either authorised banks or Section 127 banks. Of these twenty-six companies, eighteen are still trading, either in their original form or after reconstruction or absorption into other companies. Of this group of eighteen companies, only four are still relying on recycled funds through the Committee's operation, of which two account for by far the major share.

There were eight companies which, having been in receipt of support from the Committee in one form or other, subsequently were placed in receivership or liquidation:

	Date of placing in receivership or liquidation
David Samuel Trust	May 1974
Guardian Property	June 1974
Cannon Street Acceptances	September 1974
Triumph Investment	November 1974
First Maryland	January 1975
Burston Finance	February 1975
London and County Securities [a]	March 1975
Audley Holdings	May 1975

[a] Following a Department of Trade investigation.

2 Total amount of lifeboat support at shared risk outstanding at end-quarters

End-quarter	£ millions	End-quarter	£ millions
1974 Mar.	390.2	1976 Mar.	876.1
June	443.4	June	827.2
Sept.	994.3	Sept.	774.5
Dec.	1,181.7	Dec.	782.7
1975 Mar.	1,173.4	1977 Mar.	752.1
June	1,148.5	June	731.7
Sept.	949.9	Sept.	713.8
Dec.	913.5	Dec.	676.5
		1978 Mar.	656.5

Appendix 2

Slater Walker Limited (SWL)

1 The Bank's direct involvement with Slater Walker began in October 1975, when Mr Slater's sudden resignation threatened the existence of the Group (Slater Walker Securities Limited — SWS), and particularly of its authorised banking subsidiary, SWL. The Bank's main concern was to protect depositors in SWL, and their support was directed solely to the banking subsidiary, where the problems were concentrated. However, the support given for the main purpose carried with it the advantage of avoiding disturbance in other related financial fields in which the Slater Walker Group was involved. In the circumstances of the time the risks here were considerable. Investments worth some £250 million were managed through the Group's unit trusts, in which there were over 300,000 unitholders, while the Group's life assurance business amounted to some £42 million and involved pension schemes for 29,000 present and future pensioners. Additionally, the Group had loan stock and analogous borrowings outstanding in a total amount of £100 million, of which £75 million equivalent was in foreign currency, mainly in the form of publicly quoted issues raised in international capital markets. There were thus strong ancillary reasons supporting the decision to protect depositors in SWL.

2 The SW Group had used SWL as a 'house' bank and there was a risk that had a failure occurred at that time in some other part of the Group, the consequent diminution in asset value within the Group would have flowed through to SWL. After providing immediate first aid in the form of a banking facility to make liquidity available to SWL, the Bank went on in December 1975 to guarantee SWL's loan portfolio in return for the company's profits for a long period ahead, this being the course which seemed to allow the best chance for the orderly realisation of the SW Group's assets and for minimising the cost to the Bank of protecting SWL's depositors. In connexion with these arrangements, SWS also undertook to inject fresh capital into SWL when it was able to do so, thus giving the Bank some claim on assets elsewhere in the Group.

3 In the course of 1976, however, it became clear that these arrangements did not go far enough to overcome the Group's difficulties. Proposals were therefore put to shareholders and loan stockholders for redeeming certain loan stocks (and so removing the restrictive borrowing limits attaching to them) in order to facilitate the continuing orderly realisation of assets, and to enable the Bank to take SWL under their direct control, severing completely their involvement with the remainder of the SW Group. The purpose of such severance was to enable the Bank to effect an orderly recovery and realisation of SWL's assets in a manner most beneficial to themselves, while leaving the Board of SWS free to concentrate on running what would become essentially a financial services company. In order to provide SWS with necessary liquidity to put the proposed scheme into effect, the Bank consented to the purchase by SWL of certain assets from the Group.

4 These proposals were implemented in August 1977, with the result that SWL is now a wholly-owned subsidiary of the Bank.

Appendix 3

Edward Bates & Sons Limited (EBS)

1 EBS, an authorised bank, was the principal subsidiary of Edward Bates (Holdings) Limited (EBH). The bank was affected by the widespread deterioration of confidence following the failure initially of London and County Securities and later of Bankhaus Herstatt. The loss of deposits suffered by the company was accelerated as the market became aware during 1974 that EBH has sustained a serious loss as a result of the difficulties of its newly-acquired wholly-owned insurance company, Welfare Insurance Company Limited (which was eventually sold in 1975 at a loss of very nearly £10 million). This both sapped the Group's worth and damaged EBS's credibility as a banking company. The situation worsened to such a degree that EBS turned to the Control Committee in September 1974, who bought out part of the bank's shipping loan portfolio to ease the burden on its deposit-taking capacity.

2 The Board of EBH hoped to restore its position by drawing in Arab interests and in May 1975, after long negotiations, the First Arabian Corporation (FAC) acquired a 25% shareholding in EBH. FAC was a Luxembourg-registered holding company owned by a number of prominent Arab interests. In connexion with these arrangements the Bank sought, and received, from FAC a letter of comfort recording the fact that FAC recognised that their shareholding carried an obligation to support the Group which went beyond the limited liability represented by their shares.

3 In May 1976 it became apparent to the directors of EBH that the scale of provisions needed against loans made by EBS to the more speculative end of the property and Greek shipping markets put the solvency of the Group in doubt, and they accordingly asked the stock exchange to suspend the quotation of the company's shares. Investigation showed that the position was a great deal worse than the directors recognised. The Bank were faced with the urgent need to decide whether to allow the liquidation of EBH and its banking subsidiary or to try to find a solution which would prevent the failure of an authorised bank with a large proportion of Arab deposits, many from official sources. It was decided that the Bank should support depositors, and, since it was judged that the realisation of its assets outside a liquidation would give the Bank a better prospect of recoveries, that the liquidation of the Group should be deferred while other solutions were examined.

4 A report was made by a prominent firm of chartered accountants and, after prolonged negotiations with various parties, including shareholders in FAC who recognised their responsibilities under the comfort letter mentioned above, a reconstruction scheme emerged. As a result of this, part of EBS's business was acquired by a consortium of predominantly Arab investors. They recapitalised it partly from their own resources and partly by introducing Barclays Bank, with a 20% equity interest and a major responsibility in the management of the new bank in at least its formative years. A newly-formed realisation company, wholly-owned by the Bank, has undertaken the task of realising the remaining assets in the Bates Group.