# The liquidity of banks[1]

*This paper was issued by the Bank on 12 March 1981.*

**1** In March 1980 the Bank published a consultative paper on the measurement of liquidity. Extensive discussion with the banking system ensued but no substantive progress was feasible until an examination of possible changes in monetary control had been completed.

**2** The March 1980 paper set out the reasons why banks need liquidity, suggested that it would be appropriate to form an overall view of each bank's liquidity position, and described certain deficiencies as seen by the Bank in its existing tests of banking liquidity which needed to be rectified. Discussions with the banking system have shown a general acceptance of these propositions.

**3** Since March 1980 the Bank has engaged in extensive consultations and discussions on improvements in the present methods of monetary control and the results were set out in the Bank's background note *Methods of monetary control* of 24 November 1980.[2] A further paper—*Monetary control: next steps*—has now been prepared[2] for discussion with the banking system and, among other things, addresses the problem of ensuring an adequate supply of liquid assets for monetary control purposes following the abolition of the reserve asset ratio.

**4** In the light of these developments, the Bank now proposes to remove the primary liquidity requirement from its earlier proposals on the measurement of liquidity. But in assessing individual banks' positions, the Bank will have regard to the quality of their liquid assets, which in part will depend on the arrangements for monetary control and may change as they change.

**5** The rest of this paper provides a basis for resuming discussions with the banking system on the prudential aspects of liquidity measurement and monitoring.

**6** Banks must be capable of meeting their obligations when they fall due or are called. They can do this mainly by holding cash or liquefiable assets and by arranging an appropriate profile of maturing assets. In this context, banks' obligations are mainly deposits at sight or short notice, deposits with fixed maturity dates and commitments to lend (including unutilised overdraft facilities). For each particular institution the mix of these obligations will vary. In the Bank's view, a bank's ability to meet these obligations rests on two essential elements:

(i) sufficient immediately available cash or liquefiable assets, subject to the qualification that marketable assets vary in quality in terms of the prices at which they are capable of being sold, which in part will depend on the monetary control arrangements now being established and the method of their operation;

(ii) an appropriate future profile of known cash flows, subject to the qualification that there may be shortfalls in practice if borrowers are unable to repay.

In addition, banks may derive some protection from their capacity to bid for deposits. This capacity and the cost of exercising it depend importantly on the individual bank's standing in the market-place and on the general liquidity situation in the system at the time.

**7** The Bank's supervisory objective is to ensure that banks' management policies apply a prudent mix of these different forms of liquidity and that these policies are sustained at all times. The Bank regards a prudent mix as one which offers security of access to liquidity other than in exceptional market circumstances without undue immediate exposure to suddenly rising costs from liquefying assets or bidding for deposits. The Bank's approach to meeting this objective is twofold.

**8** First, the primary responsibility for ensuring the liquidity of a bank rests on its own management. The Bank does not therefore seek to impose across-the-board liquidity ratio norms, just as it does not seek across-the-board capital adequacy ratio norms, and thereby to supplant the exercise of judgment by bank managements. Instead, as part of its regular discussions with senior management, the Bank will require to be fully satisfied that banks have both prudent policies and adequate management systems to ensure that the policies are followed; and it will continue to monitor banks' liquidity management during the normal course of its supervision. In determining what is a prudent policy for a bank, the Bank will continue to take full account of its particular characteristics and situation within the banking system. Thus, for example, the Bank will wish to examine the extent to which potentially immediate obligations (deposits at sight and short notice and commitments to lend) should be supported by cash and immediately maturing or liquefiable assets and their appropriate quality; and the extent to which deposits with fixed maturity dates should be matched by assets with the same maturity dates.

**9** Secondly, however, the Bank continues to believe it necessary and desirable to develop an acceptable and

(1) In this paper the word 'bank' is to be read to include institutions licensed to take deposits under the Banking Act 1979.

(2) The November 1980 note was reproduced in the December 1980 *Bulletin*, page 428; the more recent paper is reproduced on page 38 of this issue.

generally applicable basis for measurement of the overall liquidity of banks. The Bank will provide a paper as a basis for further discussion of this aspect. This measurement should relate to the total obligations and claims of banks in a way which best measures the cash flows to be expected. The Bank recognises that the development of a single comprehensive measurement has to be reconciled with giving due weight to the particular circumstances of each bank, but it believes it possible to achieve a common basis of measurement which may then be applied after due consideration to these circumstances.

**10** The Bank's paper *Monetary control: next steps* envisages the early abolition of the reserve asset ratio. This ratio is not a prudential ratio and has not been regarded by the Bank as such but, as its constituents are liquid assets, the requirement to observe it has had some relevance to the maintenance by banks of adequate levels of liquidity. The Bank proposes to proceed immediately to discuss with each individual bank the appropriate normal level of its holdings of assets at present required for the reserve asset ratio. These discussions may not have been completed when the reserve asset ratio is abolished as a minimum requirement. The Bank therefore requests an assurance now from all those institutions to whom the reserve asset ratio applies that they will discuss with the Bank in advance changes in their policies for the management of their liquidity and its composition. The Bank would expect any changes to be made only gradually and after full consultation. At the same time the Bank will seek to develop the single comprehensive measurement referred to in paragraph 9 which would in due course become the prime basis on which discussions with banks' managements of their liquidity policies would be based.