7.4 COVERING SECRET

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5 December 1984

Andrew Turnbull Esq
10 Downing Street
LONDON
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Dear Andrew

CONTINGENCY PLANNING FOR BANKING PROBLEMS CAUSED BY EVENTS OVERSEAS

I understand that the Chancellor mentioned to the Prime Minister last week a Treasury paper that had been produced on this subject about a year ago, and undertook to show a copy to the Prime Minister.

... I attach a copy of the fairly full paper produced in the Treasury in November 1983. Although, as you will see, it takes for the sake of example support operations required in the case of a major debtor country's ceasing to service its debts, the analysis in practice would also cover a situation where problems were caused by the failure of one or more US banks.

Yours ever,
David

D L C PERETZ
Principal Private Secretary

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POSSIBLE SUPPORT OPERATIONS FOR BANKS BY UK AUTHORITIES IF A MAJOR DEBTOR COUNTRY CEASED TO SERVICE ITS DEBTS

I Introduction

The purpose of this paper* is to consider, so far as this can sensibly be done in advance of a crisis, what effects and decisions the UK Authorities would face if a major debtor country ceased to service its debts to banks. Brazil is used as a topical illustrative case, but the paper would in general be valid for other countries. The uncertainties are far too great for it to be realistic to attempt a detailed contingency plan. These uncertainties - about the development of a crisis and the reactions of depositors and the authorities in different countries - pervade the whole paper. But subject to these the paper aims to cover the following ground:

(a) the likely nature of the difficulties for banks in London caused by a crisis in which one or perhaps two major debtor countries ceased to service their debts to banks. This would not necessarily cause serious problems in the UK, especially if the UK authorities acted quickly to supply liquidity to their banks. But it could do so, probably in the form of a withdrawal of dollar bank deposits. Withdrawals would arise from loss of confidence in the quality of some banks' assets and hence in banks' ability to repay deposits. This scenario envisages liquidity problems but not a crisis of default by several major countries together in which the value of some British banks' assets could be reduced so far that they were worth less than their liabilities. Nevertheless, the scenario envisages a reduction in the profitability and the capital base of certain major banks as a result of the reduced value of their assets which could leave continuing problems even after a liquidity crisis of this kind had been handled successfully; (Sections II and VII).

(b) the broad decisions which would face the UK authorities about whether, when and how to act either by making statements designed to restore confidence or by providing liquidity support. These decisions would be difficult but would have to be taken quickly and almost certainly on the basis of inadequate information. Decisions would probably also be needed on intervention in the foreign exchange market and on the supply of UK Government debt; (Section III).

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* The paper reflects a major contribution from Bank representatives dealing with the Banking Department, overseas, banking supervision and home finance. But it has not been formally agreed with the Bank.

2. The paper assumes that despite the arguments for avoiding or minimising the extent and cost of support by the authorities acting as a lender of last resort in a crisis, the case for taking such action in certain circumstances is accepted in principle.* The difficult judgement is when those circumstances exist.

3. The immediate purpose of any domestic operations to provide liquidity would be to prevent a bank with assets worth more than its liabilities from becoming insolvent in the sense of being unable to meet its liabilities on the due date. But the underlying intention would be to protect economic activity (at levels compatible with adequate performance on inflation) from the damage which a breakdown in the financial system would or could cause. The purpose of support would not be to protect banks' shareholders, management or employees, or even their depositors. The extent to which the banks should bear the full losses arising from a crisis which called for a support operation is again something that can only be judged in an actual situation; however, a major aim must be to minimise any cost falling on the taxpayer.

II Future and Possible Effects of a Crisis

4. The effect of a crisis on UK domestic institutions will depend in the first instance on the form Brazil's failure to pay takes, the speed with which it develops and its presentation. The decision to stop payments could be explicit and sudden. But the most likely contingency may be a gradual slide in which it becomes clear - with no formal repudiation of debts (and indeed perhaps repeated assurances about resuming debt servicing as soon as possible) - that there is no prospect of repayment in the foreseeable future. Annex A describes more fully how a crisis might develop.

5. A cessation of debt service payments would affect the confidence of depositors because of fears about the effect on the value of some banks' assets. We cannot predict

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* In other words it is assumed that of the two doctrines expressed in the following quotations Bagehot, who believed in providing support on "onerous terms", prevails.

> "...... the most mischievous doctrine ever broached in the monetary or banking history of this country, viz. that it is the proper function of the Bank of England to keep money available at all times to satisfy the demands of bankers who have rendered their own assets unavailable". (Hankey, 1866)

> "Theory suggests, and experience proves, that in a panic the holders of the ultimate Bank reserve (whether one bank or many) should lend to all that bring good securities, quickly, freely and readily. By that policy they allay a panic; by every other policy they intensify it". (Bagehot, 1873)

> These quotations are lifted from a paper by Lipton and Griffiths-Jones on "International Lenders of Last Report.

which banks or class of banks will suffer first or worst from loss of confidence and withdrawal of deposits; nor the extent to which switching of deposits between different banks (or banking centres), accompanied and helped by "tiering" of interest rates, will prevent serious liquidity problems arising for the banking system as a whole in the UK (or the main centres taken together). But for the purpose of this paper we assume that a Brazilian debt crisis leads among other things to a very large withdrawal of dollar deposits from banks in London, including but not confined to some of the big 4 clearing banks. Total foreign currency liabilities of British banks in London alone are over $100 billion.

6. Although the exposure of British banks to Brazil is very large, even a complete and final default by Brazil would leave the banks' assets well above the value of their liabilities.

7. The total exposure of British banks to Brazil had risen to $5.8 billion or about £3.8 billion at the end of June. This figure excludes risks transferred to ECGD and also loans to American banks heavily exposed to Brazil. If the two clearing banks worst affected had to provide fully against their Brazilian assets at the end of the current accounting year, as a result of a default, they would lose all their profits and up to one third of their capital base. In practice whether full provision would be appropriate would depend on the nature of Brazil's inability to repay. The full figures would first emerge when the banks made their annual report to shareholders, unless an earlier announcement was made.

8. The difficulties would of course be worse in degree if another Latin American country ceased to make debt service payments. The total exposure of British banks to Argentina is $2.5 billion or £1.6 billion. Eighteen British banks have exposure either to Brazil or Argentina, of which 14 have exposure to both. Three of these had a combined exposure at the end of June 1983 exceeding 50 per cent of their capital base. Of these two are major (big four) clearing banks. None of them should become insolvent as a result - their assets would still be worth more than their liabilities - provided these two countries alone cease to service their debts.

9. That could change if Mexico and Venezuela, where British banks' exposure is of the same order as in Brazil and Argentina respectively, also ceased payments. But this paper does not cover that scenario. It is concerned with the liquidity problems that could arise if one or two major countries stopped paying. These problems would arise from loss of confidence as much as from banks' objective balance sheet position, even though the exposure of British banks as well as of other countries' banks is large in absolute terms.

10. So long as the banks losing deposits can replace them eg by paying higher interest rates to the banks gaining deposits, who will thus profit from the rising interest rate differential, there is no need for support by the authorities (except on preemptive "stitch in time" grounds - see paragraph 22 below). But once the market ceases to redistribute deposits between banks in this way, the authorities will need to consider acting. The potential liquidity shortage of individual banks would build up over time and could reach large figures. The Bank has calculated, on certain rather extreme assumptions, that two clearing banks could need liquidity assistance of up to $1 billion in foreign currency alone by the end of the first month after Brazil had ceased payments, even after realising as far as possible their foreign currency assets and using up their sterling liquid assets, at a time when other UK-based banks would certainly face unusual liquidity pressures.

III Main Decisions Facing Authorities

International Co-operation

11. It will be in the UK's interests to press for the maximum amount of agreement between national authorities on the responsibility for arranging and providing liquidity support. The UK authorities must avoid taking on an unfair share of support. The exposure of UK owned banks to Brazil is third in volume after USA and Japan; but the London market's exposure is second only to that of New York. This is discussed on Section IV.

Statements and other 'Pre-emptive' Action

12. Liquidity problems inevitably pose difficult choices for the authorities. These decisions, which are bound to be based on judgement and incomplete knowledge, may need to be taken fast. On the one hand it is not necessary for the authorities to respond immediately to the first rumours affecting confidence, tiering of interest rates or difficulties of individual institutions not important for the system. Such tremors have occurred in the past and been overcome without official action. On the other, since confidence is at issue, there is a case for early preemptive action by the authorities - either statements which may need to contain a blank cheque element to be effective but may cost nothing if they succeed; or perhaps providing 'early' liquidity help to an individual bank.

Intervention in Currency Market and Supplying More Debt

13. Apart from decisions on international negotiations, statements, and liquidity support for individual banks, the authorities may well face decisions on whether to intervene in the foreign exchange market and/or whether to supply additional domestic debt instruments.

14. It is uncertain in which direction any pressure on sterling might be working. It would be downward if banks in London had to purchase dollars to meet withdrawals of dollar deposits. Even if US banks were perceived to be at greater risk than UK banks depositors could shift into US Government debt. But it is also possible that sterling would benefit from movement of international funds out of dollars. The decision on whether and how to intervene to support sterling or to offset a rise in the value of sterling would have to be taken at the time as would possible decisions on interest rates. The scope for the UK Authorities acting alone to intervene is limited first by the size of the immediately liquid dollar reserves (around $4 billion) and second by the size of funds that could be borrowed abroad at short notice.

15. Additional demand for government debt might arise from switches out of bank deposits by depositors or by banks out of interbank loans or from an inflow into sterling. If so the authorities might wish to supply more gilts or Treasury bills in order to prevent interest rates from being bid down to an undesirable level.

16. To the extent that the authorities intervened to support sterling or supplied more debt, the scale of the money market shortage and hence of the Bank's normal operations to supply cash would be increased. But this would not in itself involve a major policy decision on support operations. These points are amplified in Annex B.

Providing Liquidity Support

17. There would be a preliminary stage during which the Bank would be monitoring London markets closely to get the information on which to base a judgement about the seriousness of the situation caused by the cessation of debt service payments. It would also be in close touch with central banks elsewhere especially in the USA. It would in particular be looking at a range of evidence including:

(i) unusual withdrawals of dollar or other deposits;

(ii) exchange rate movements;

(iii) interest rate tiering between different classes of banks, different banking centres, and between bank assets and UK or US government debt;

(iv) bank share prices.

Some tiering can be survived without any special official action. Annex D describes what happened in 1982 when no special liquidity support was provided.

18. During this period the Bank and the Treasury would be in close touch on how the situation was developing. A new phase would start if a decision were taken to embark on providing liquidity support to individual institutions, as distinct from the Bank's normal provision of cash to the money market through the discount houses. This decision would involve consultation between the Governor and the Chancellor.

19. Liquidity support to individual banks, which would be given in sterling, can be provided through the purchase of assets, lending or guarantees of loans made by third parties. These techniques and the terms which should fully reflect the risk so far as this was compatible with the purpose of liquidity support are discussed in some detail in Section VI. The knowledge that such sterling support was available would help confidence, but in certain circumstances the availability of additional dollar swap lines with the Fed might also need to be made known.

20. The next main issue is which institutions should and should not receive support once the case for some action has been accepted. The aim of preventing economic activity from being damaged by a breakdown of the banking system implies that support should be given to those banks whose survival is both at risk and vital for the system as a whole, but not to others, (though this would involve some inequity since not all those banks peripheral to the system would have been managed with less than average prudence.) We and the Bank have found it difficult to get beyond this level of general presumption in advance of an actual crisis, but the Bank have provided a description of their approach in paragraphs 21-26 below. This is helpful though it necessarily leaves many questions open including the treatment of branches or subsidiaries of foreign banks for which we hope the parent central bank would accept responsibility (see Section IV). The Bank's approach does not rule out assistance to banks not themselves essential to the system on grounds of specific knock on effects or confidence effects. But it does not seem realistic to settle general policy on this in advance of a specific crisis.

<u>The Bank's Approach</u>

21. Given the central importance of the clearing banks to the economy as a whole, as well as to the banking system, it must be presumed that it would always be necessary to arrange support for any of them which got into difficulties.

22. Beyond this group it is difficult to identify any bank whose survival would be so obviously important. It would be necessary to consider in each case the nature of the particular crisis and therefore what the reaction to it should be. This means that it is vital

not to rule in advance that any particular bank would always, or could never, be support-worthy. It may be that offering limited support early on in a crisis to an otherwise unlikely candidate would prevent the need for larger-scale assistance to a wider group of banks, more important to the system, at a later stage. (This was an important reason for support to the secondary banks in 1974-75.) Thus while there would be no presumption that any particular categories of banks would be supported it must be recognised that in the heat of a crisis the Bank would want to offer assistance in the most effective way even if this were to a candidate not obviously identifiable in advance.

23. It would, for example, be necessary to take account of the particular structure of an individual bank's balance sheet in deciding whether it should be a candidate for support. The liabilities of some banks are concentrated heavily in the form of interbank deposits, including deposits with clearing banks and important accepting houses; if the borrowing bank should as a result of the liquidity difficulties fail to meet these deposits as they fell due, the liquidity pressures could be transferred to its counterparties. The Bank does not have detailed information on all depositing counterparties with any given bank nor, if it did, would it necessarily be able to judge immediately how vulnerable they themselves might be.

24. On the assets side, likewise, without detailed knowledge of all of the borrowing customers of any given institution, the repercussions of a closure arising from liquidity difficulties is impossible to forecast; but it could be damaging to particular sectors or to particular customers in sensitive areas of the economy.

25. Another uncertainty concerns the amount of time available in which to decide upon action. The subsidiary of a foreign bank located here might be unable to ascertain that it would receive the necessary support from its parent because of such accidental factors as public holidays, the availability of senior officials, or the time needed to arrive at an agreed distribution of support in the case of multiple parentage. In such cases, the Bank's knowledge of the circumstances and its informal contacts with the responsible monetary authorities might lead it to the view that it was sensible and prudent to give support against a presumption of transfer of responsibility in due course.

26. Above all the Bank would have to take account of the effect on confidence of the failure, through liquidity difficulties, of even a small bank. The circumstances in which we envisage such an incident could very well be an important turning point in market sentiment and confidence, affecting the banking system as a whole. If the banking community should at such a juncture observe the Bank declining to assist a given institution the shock to confidence could, in some cases, be severe and seriously aggravate the situation. This is not

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to say that the Bank would always intervene to provide support whatever the nature of the institution in trouble. That again would depend on its place in the market, the complexion of its customers on both sides of the balance sheet, the amount of publicity which might attend the failure, etc. There are, no doubt, institutions where the balance of judgement would point to allowing them to fail; otherwise London would become the depository for the bulk of the bad or doubtful international assets in the banking system. But until a particular case arises it is impossible to anticipate where the balance would lie.

IV International Co-Operation

27. The September paper assumed that there would be agreement on parallel action to support banks at least by the US and UK authorities and preferably by other countries as well. We have explored with the Bank what such co-operation might amount to in terms of action as well as of possible statements. The Bank have asked that the information in paragraphs 28-31 below should not be passed on by the Chancellor to the Finance Ministers of other countries. The reason for this is that some other central banks, which have not passed similar information on to their governments, might react badly if they learnt that British Ministers had been given it. The risk is that this would harden attitudes and so make it more difficult to agree on action in an actual crisis.

29. The earlier paper quoted the 1974 statement on euro-markets by G10 Governors that:

> "...... it would not be practical to lay down in advance detailed rules and procedures for the provision of temporary liquidity. But they were satisfied that means were available for that purpose and will be used if and when necessary."

29. During 1982 the Bank initiated discussions in Basle aimed at reaching agreement on:

(a) a new reassuring statement that could be used if the international debt situation required it; and

(b) a broad division of responsibility between central banks which would enable them, if necessary, to honour the collective assurance given by the G10 Governors in 1974.

30. It proved impossible to agree on (a). Indeed the Bank doubts whether it would have been possible last year to agree even on the 1974 text if it had not already existed.

31. On (b) some progress was made in agreeing which central banks should be primarily concerned with banks' foreign establishments and should "take the initiative in making the arrangements" for dealing with their liquidity problems, as follows:

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Type of Bank	Central Bank Responsible
Branch	Parent
Subsidiary	Parent and host jointly
Joint Venture	Host

The responsibility for "initiating" these arrangements for subsidiaries was thus not clear cut and no decisions were taken about the sharing out among central banks of responsibility for providing liquidity support as opposed to initiating the arrangements. However, the UK authorities would clearly have responsibility for the consortium banks which would be hard hit in the scenario described in this paper.

32. Joint responsibility for initiating arrangements for subsidiaries reflects conflicting arguments. As subsidiaries are legally distinct entities incorporated in the host countries, the legal argument points to the host central bank being responsible. The practical argument points in most situations to the parent central bank since most large banks operating an international network treat wholly owned and even majority owned subsidiaries in much the same way as branches.

33. Turning from responsibility for initiating arrangements to the actual provision of liquidity, we have agreed in principle with the Bank that in an actual crisis our aim should be to agree with the US and as many other countries as possible that parent central banks should be responsible in general for providing subsidiaries as well as branches with liquidity. (In practice the host central bank might act as agent and unless the nature of the crisis pointed clearly, as in the case of difficulties for Crocker in California in the aftermath of an earthquake, to a particular situation there would be some tricky individual cases eg with Grindlays in London as well as Crocker in the USA.) This division of responsibility would be in the UK interest since the liabilities of subsidiaries and branches of UK banks operating in the US is about half of the equivalent figure for branches and subsidiaries of US banks in the UK (about $130 billion). Equivalent figures for other G10 countries are not available but in general the UK is more significant as a host than as a parent.

34. There are doubts about the willingness of other central banks to adopt a distribution of responsibilities for support on the lines suggested in paragraphs 32 and 33 above, and not even the US could at this point be counted upon to agree to them. However in a real crisis the US authorities* might be prepared to accept them and with the possible support of Canada and the Netherlands the Bank might be able to achieve an agreement on these lines

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* This paper is based on the assumption that this is correct. If it were not, the results would be serious as Annex C explains.

at a Basle meeting of the G10 Governors. But on past form a number of major countries are likely to prove difficult. These include Germany, France, and Italy. The pattern of Japanese business in London, mainly through branches, is very skewed in favour of this principle - their dollar liabilities in London are over $130 billion, while the British banks' yen liabilities in Tokyo must be negligible by comparison. There is a fair chance that the Japanese would follow the US-UK lead.

35. However, for self-protection we cannot rule out assisting non-British banks. Non-G10 banks have nearly $50 billion of liabilities in London; they are a mix of subsidiaries and branches and are a very heterogeneous group. It would be impossible to predict with any certainty which authorities would support their own and which would not. In aggregate, however, these banks clearly have enough weight to cause considerable damage. There might be a case, if the system seemed otherwise at risk, for making an exception to the home country principle. Before reaching that conclusion, we would seek to insulate the vital organs of the market from them - perhaps by attaching a condition to liquidity support that it could only be used to meet obligations to banks whose home central banks were co-operating in an international effort. Indeed, that intention might be an effective weapon of suasion.

36. The position therefore is that there is no clear cut internationally agreed plan for implementing the 1974 assurance: silence then and since then about what would actually be done is not attributable only to a wish to avoid moral hazard for the banks. We have discussed with the Bank the possibility of seeking to fill this gap. They are, however, certain that any attempt to do so in Basle in advance of a crisis would fail. The reasons for this include legal inhibitions (Germany), the political need to defend in public any agreement reached before a crisis arises (US), and the wish to keep one's hands as free as possible. The Bank consider that the same would be true if discussions were opened at Ministerial level. Failure accompanied by leaks about failure would be the worst of all worlds. Treasury officials agree that it seems best to rely on the pressures of crisis to bring about the sort of agreement described in paragraph 32 above. At that point the Chancellor and other G5 Ministers could exert pressure for a workable plan of action to be agreed.

V Statements

37. We have concluded that there is no point in embarking on a contingency drafting exercise. But Annex G usefully brings together a range of past statements that have been made. These include:

(a) the full communique issued by G10 Governors in 1974;

(b) a reference back to this in a speech by the Deputy Governor in 1982;

(c) a statement by the Canadian central bank Governor about the availability of lender of last resort facilities for banks in difficulties;

(d) a similar statement about an individual Canadian bank;

(e) a press report of a Bank of England statement about National Westminster in 1974;

(f) a statement by National Westminster itself on the same occasion.

38. If a crisis arose, statements might also be made by the IMF and perhaps by governments. Timing is clearly a vital factor for statements designed to maintain confidence. It would be risky to make one before confidence is in question. Equally statements should not be delayed until confidence has been destroyed.

39. Any statement implying a commitment to provide support by the authorities in the UK, which would be subject to parallel action by other major countries, would be cleared with Ministers.

40. Of course it is possible to get through a crisis without a statement. Apart from their comment on rumours about National Westminster in Annex ~~D~~ G, the Bank made no general statement during the domestic secondary banking crisis. It was, of course, known at a very early stage that the lifeboat had been formed.

VI <u>Operational Aspects of providing Liquidity Support</u>

41. (a) Techniques. The main forms of support for individual banks open to the Bank would be:

(i) purchase of assets;

(ii) secured lending;

(iii) unsecured lending;

(iv) guarantees by the Banking Department of loans from third parties.

... 42. Annex E gives details about the capacity of the Banking Department and Issue Department. The Issue Department has no powers to borrow currency or to give guarantees. Moreover since its assets back the note issue and its profits are paid into the National Loans Fund, it is preferable that it should not hold risky assets. In general the Bank would use the Banking Department when this was not ruled out either by the sheer size of the operation or

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by the risk in relation to the Banking Department's balance sheet - its free reserves are about £180 million - and profitability.

43. The terms for these operations should be as 'commercial' as is compatible with their object - in line with Bagehot's support for "onerous terms". There would thus in general be a presumption in favour of exhausting the scope for giving support by purchasing sound assets and by secured lending before embarking on unsecured lending or guarantees. In practice, however, the scope for using the less risky techniques may not be large for two reasons. First, the banks in liquidity difficulties may have sold off all their sound assets before the issue of support by the Authorities arises.

44. Second, to the extent that assets are still available for sale the safest assets to purchase would be claims on or guaranteed by the public sector (Treasury Bills, gilts, local authority debt, and export credit paper guaranteed by ECGD). On these grounds there would be a case in support operations with individual banks for buying these assets before even the best claims on the private sector such as eligible bills. On the other hand to insist on this in all cases might leave the supported bank with an inadequate balance sheet and a choice would have to be made at the time. (For the purposes of the Bank's normal money market operations so far as these could be distinguished it would clearly in the interest of confidence to continue the normal practice of dealing mainly in eligible bills.)

45. In the statistics the Banking Department is deemed to be in the private sector and therefore its transactions are not relevant to public expenditure or the PSBR. The Issue Department is considered part of the public sector but its expenditure on the purchase of eligible bills does not count as public expenditure nor add to the borrowing requirement. This is because these operations - or any dealings in short-term instruments which are close substitutes for money market transactions - are regarded as essential short-term provision of funds as part of the normal central banking. Nor do these operations increase monetary growth as they displace one asset by another in the banking system's total balance sheet: they do not increase the size of that balance sheet. But of course increased purchases of central government debt by the non-bank private sector which may be the originating cause of the shortage would <u>reduce</u> monetary growth. Support operations by the Issue Department would only be defined as public expenditure and increase the PSBR if they involved long-term commitments rather than money market operations - eg taking the form of long-term loans or the acquisition of capital. These criteria will apply whether money market operations take the form of general assistance to the market via the discount houses or direct support for individual banks.

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46. (b) Distribution of risk and reward between the Exchequer and the Bank. If an asset acquired by the Issue Department turns out to be worth less than it cost, the Exchequer bears it directly in the form of reduced Issue Department profits. This should not, however, occur unless the Department has begun to acquire assets of an unusual kind (see paragraph 51 below).

47. If the same thing happens to an asset acquired by the Banking Department, the Bank bears it unless there is a Treasury guarantee or indemnity. The same goes for loans by the Banking Department.

48. If the Bank asks for a guarantee of repayment or an indemnity against any loss on a Banking Department loan and the Treasury agrees to provide one, decisions would be needed on the allocation of risk and reward. The Treasury would want a slice of any profit if it was bearing part of the risk.

49. (c) Powers and Parliament. Any guarantees or indemnities by the Treasury to the Bank of England would be given not under a statutory power but under the Crown's common law power; this procedure is permissible since there is no legislation which precludes it. There are, however, standard procedures for non-statutory guarantees, including the laying of minutes before Parliament.

50. If there were any question of loans by a Government Department to individual banks, which is unlikely on the scenario considered here, the conditions for drawing on the Contingencies Fund would have to be satisfied; these are set out in Annex F.

51. The Accounting Officer for the National Loans Fund must be consulted if any unusual use of the Issue Department's resources is ~~likely~~ contemplated. This would include consultation between the Bank and the Accounting Officer before the Issue Department were used in a way that might be regarded by Parliament as an alternative to public expenditure.

52. The scale and destination of the flow of funds in a crisis are uncertain. But one possibility is that a surplus might build up in the National Loans Fund. This could happen if the authorities decided either to supply extra Government debt or to intervene in support of sterling in the foreign exchange market on a very large scale. The Treasury Solicitor's Department has confirmed that in those circumstances the Treasury has the power to borrow and to deposit the NLF surplus with the Banking Department. The Banking Department could then use the surplus to provide liquidity support under Section 12 of the National Loans Act 1968 as amended by Section 152(i) of the Finance Act 1982, so long as

The Treasury considered this "expedient for the purpose of promoting sound monetary conditions". However since the power conferred by this wide wording would in practice be being used in a scenario very different from the one originally described to the House - sales of debt designed to control the growth of monetary aggregates - there would be a strong case on grounds of Parliamentary propriety for informing the House if the powers are used in this way, preferably before they are so used, unless a Parliamentary statement would be incompatible with the purpose of the operation - preserving or restoring confidence.

VII Problems Remaining after a Liquidity Crisis

53. The loss or diminution of assets would remain a problem even after a liquidity/confidence crisis had been successfully handled. Doubts about the affected banks would have to be resolved and the supervisors would wish to ensure that this was done. The route would depend on the nature of the crisis and the way in which each bank had been affected. A bank which had suffered a loss of deposits, but without significant erosion of its net worth, would be in a different position from one which had suffered serious capital losses. In the first case the bank would need to restore its liquidity and re-establish its reputation. The workings of the markets and the concern of the supervisors might mean that some reduction in new lending for a period might be part of this process.

54. In the second case, however, it would be necessary to prepare a plan for a phased return to normal supervisory ratios over a longer period. The timescale would depend on the extent of its losses and the availability of support. It would be unhelpful to force a rapid return to normal ratios if this means cutting back the bank's existing good business or precipitate sales of assets at below book value as this would reduce the bank's ability to generate new capital resources. Mergers, sales of investments and participations and giving up less remunerative activities are all possibilities that would need to be considered. During the period of convalescence the Bank of England as supervisory authority would need to be flexible whilst laying down for each bank clear ultimate objectives.

HF Group
HM Treasury
4 November 1983

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LIST OF ANNEXES

A Scenario

B Support Operations and Money Market Flows

C Breakdown in the US

D Experience of Tiering

E Capacity of Bank to Provide Support

F Use of Contingencies Fund

G Statements – past examples

ANNEX A

BRAZIL: DOMESTIC SUPPORT OPERATIONS

SCENARIO

The analysis which follows is necessarily speculative; there are many possible scenarios, and the order of events cannot be predicted with any confidence.

Background

2. That said, the background in very broad terms could look something like the following:

(i) Brazil fails to meet due dates by growing delays and creditors/international institutions etc. are unable to gloss this over; this leads to gradual recognition that a state of default effectively exists as "excessive" arrears build up (eg arrears which trigger prudential or accounting responses and are perceived as threatening banks' asset positions). At the other extreme, though less likely, Brazil might simply repudiate her debts.

(ii) Other Latin American countries, notably Argentina, might follow suit.

(iii) Serious damage results to banks' asset side. The precise extent of damage may only emerge later, eg when annual accounts are published and the scale of provisions becomes evident. If it were great enough the solvency of some banks could be called into question. But there will be an growing impact in terms of loss of confidence as depositors and other members of the financial community take a view, probably on very uncertain information, of the impact on banks known or believed to be most exposed to these risks. This loss of confidence could be sharp if it were triggered by an unexpected event such as an assassination, coup or natural disaster. It could lead to substantial and unpredictable disturbances on banks' liabilities side, which would be influenced by factors such as the response of different national authorities and shifts in the relative confidence placed in different banks, different financial centres, and different currencies. The disturbances could lead to a local or to a more widespread liquidity crisis. Solvency difficulties could follow later for some banks when assets had to be reclassified formally - even if the liquidity storm had been weathered.

(iv) In these circumstances one cannot predict in which directions funds would flow, whether there would be marked exchange rate effects, whether UK banks would be net beneficiaries of a flight into quality, to what extent the interbank market

would continue to recycle liquidity, to what extent funds could escape from the banking system, or to what extent the authorities in different countries could intervene to restore the flow of liquidity to where it was needed. If, for example, funds went into notes and coin, the authorities could hardly direct holders to put them back. There is a question in extremis whether dollar clearing in New York would seize up if confidence in key US banks broke down.

(v) The scope for responses by Governments and Central Banks is considered in part III of the main paper. The paragraphs which follow set out the possible anatomy of the liquidity crisis in more specific terms, both in the international (ie mainly US dollars) and in the domestic context (both dollars and sterling) to the extent that they can be separated. Events would not necessary follow in the order suggested. Official responses would have to be made on the best available information about the position which the crisis had reached. The situation would be bound to be fluid and uncertain, and could accelerate out of control at any time. On the other hand, there are points where the authorities could reverse the chain of events - eg if the USA made it plain that whatever happened the 10/15 largest US banks would not be allowed to fail.

<u>Detailed consequences: international scene</u>

3. In more detail, we could expect most if not all of the following developments:

(i) Once confidence starts to erode Brazilian banks in international centres (mainly New York) could lose interbank deposits and be forced to close. Same could happen if another country defaulted to its banks.

(ii) Other Latin American banks in international centres could suffer acute confidence difficulties by contagion.

(iii) Major US banks with large exposures would face tiering in the markets and would have to resort to the Fed. discount window to obtain cash. Their branches outside the USA could suffer similar tiering.

(iv) Precautionary moves by banks generally could make the markets less efficient as a channel of liquidity. All banks would take defensive steps to protect liquidity.

(v) Tiering could spread to non-US banks with large exposures to Brazil (some UK banks) or particularly dependent on the interbank market for funds (Italian, perhaps Japanese).

(vi) Possible segmentation of international market if markets perceive different liquidity prospect between centres.

(vii) "Safe" banks offered huge deposits as there are only very limited opportunities for cash to "leak" from international wholesale market.

(viii) Non-bank depositors attempt to shift out of bank deposits into safer assets - government securities, other financial institutions etc. causing relative yields to shift sharply.

(ix) Possible exchange market pressures as depositors seek to move to "safer" currencies, and banks seek to retain the balance between their foreign currency assets and liabilities.

(x) In practice some of these developments could not be reconciled; the international money market could seize up; international and perhaps some national payments transactions (ie in the ordinary course of non-banks' business) could not be made.

Details: domestic scene

4. The major parallel developments on the domestic scene are:

(xi) If the flight into quality is against the UK, UK banks, including clearers, experience difficulty in obtaining new interbank funds to finance non-renewal of bid deposits in foreign currency with fixed maturity dates. Limited stocks of short-term currency assets held for normal market conditions become inadequate to meet non-renewals.

(xii) UK banks face exceptional sterling withdrawals which their stock of liquid assets cannot finance - as with (xi), though liabilities structure is very different - most sterling liabilities are withdrawable at or very near sight but are historically very stable.

(xiii) Points (v), and (viii) and perhaps (vii) and in the worst case (x) apply within the UK domestic system and on the national level as well as on the international plane.

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ANNEX B

SUPPORT OPERATIONS AND MONEY MARKET FLOWS

Faced with a run on its liabilities a bank needs to dispose of its assets rapidly, or replace its liabilities to the public with borrowing from other banks. If overall portfolio preferences are unchanged (depositors still wish to hold their funds with banks but allocated differently between them) then the banking system may be able to reallocate the funds to keep the threatened banks liquid. But the system could begin to fragment with strong banks reluctant to increase their claims on weak banks. These pressures could first affect dollar deposits. It could be that even with no move out of dollar deposits as a whole, UK banks could lose dollar deposits to overseas banks. But these changes in dollar holdings would not lead to overall sterling shortages unless the Authorities intervened to provide dollars to UK banks.

2. If there were an overall change in depositors' sterling portfolio preferences and they wished to hold their assets as liabilities of the public sector rather than the banks, then the Authorities would perceive an increase in the demand for public sector debt. The Authorities would then need to decide rapidly whether to intervene with extra supplies of public debt (to keep prices more stable) or to limit their supply to a more normal level and allow prices to adjust. If they intervened and supplied more debt there would be an increase in the size of money market shortages. The shortages would have to be relieved as the short-term money flows between the public and private sectors have to balance and if no explicit assistance were provided the ultimate balancing mechanism would be a reduction in bankers' deposits at the Bank of England.

3. An analogous situation could arise _if_ the events also gave rise to downward pressure on sterling in the foreign exchange markets, for example if sterling depositors sought to move their deposits into dollars or to acquire US government debt; or if banks had to convert sterling liquid assets into dollars to meet withdrawals of dollar deposits. If the Authorities decided to intervene they would be running down foreign claims in the reserves and the payment for these claims would increase the size of money market shortages to be relieved. If the Authorities did not intervene then the flows into and out of sterling would balance but possibly at a much lower exchange rate. It might well be that, in the circumstances, other countries would also be intervening in the foreign exchange market on a larger than normal scale. The scope for the UK Authorities acting alone to intervene is limited first by the size of the immediately liquid dollar reserves - at present not more than around $4 billion - and second by the size of funds that could be borrowed abroad at short notice. It might be possible in a crisis to negotiate an increase in swap lines with the Fed. At present these

stand at $3 billion. The Bank believe that an attempt to increase the swap network now would not be successful, but that it would be successful in an emergency.

4. It is possible, of course, that the pressures on sterling could be in the other direction with sterling actually benefitting from international movements of funds. In these circumstances the Authorities could intervene to sell sterling to stop the exchange rate rising. This could happen at the same time as the Authorities were selling more domestic claims on the UK Government. In these circumstances the foreign exchange transactions would be offsetting the money market flows caused by Government debt sales.

5. The prime agent for assistance to relieve money market shortages is the Issue Department of the Bank of England. The total size of its balance sheet is determined by its liability, the note issue. Increased acquisition of assets from the banking system to relieve money market shortages needs to displace another asset already held by the Issue Department - its ways and means advances with the NLF. These currently stand at approximately £1½ billion. If and when these had been reduced to zero, [any surplus in] the NLF ~~would start~~ accumulat~~ing a surplus~~[ed] under the terms of the 1982 Finance Act ~~which~~ would be deposited with the Banking Department, to enable the Department to carry on purchasing assets from banks.

6. In some circumstances depositors might set such store on security that the Authorities would also notice an increase in demand for their non-interest bearing liabilities. There could be an increase in demand for notes (though rapidly meeting the physical constraint of our limited stocks). This would constitute a negative money market influence as they would need to be paid for by the banks, but as the notes determine the size of the Issue Department's balance sheet there would be a corresponding increase in the capacity of the Issue Department to relieve shortages. The other component of the wide monetary base could also increase if banks increased the desired level of their balances at the Bank of England, which would increase the capacity of the Banking Department to purchase bills and hence would also not involve the NLF going into surplus.

N.B.
The point about the [illegible] is that the Bank/Treasury could actively acquire assets of any kind to displace Ways & means held by Issue Department – when these are instructed – only to the extent that there is a surplus can the Banking Department take over. Thereafter on any day when the Exchequer/NLF is "in deficit" the NLF surplus will reduce. After the surplus is reduced [illegible] further deficits involve the availability of W&M in Issue [illegible]. The position is thus rather different since the W&M are exhausted, the initiative to purchase assets only exists so far as there is a daily surplus.

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ANNEX C

BREAKDOWN IN THE US

It is widely believed, probably correctly, that the Fed would step into rescue any very large US bank. Most of those with the largest exposures to Brazil are in this category. However this cannot be taken entirely for granted and a situation is not impossible in which the US authorities were unable or unwilling to participate in international action to provide emergency liquidity. The American domestic political climate is at present very unsympathetic towards the banks and any actions requiring congressional support could be frustrated by opposition. More likely the sheer size of the problem could be beyond the resources immediately available to the Fed if several major banks were ailing at the same time. In such a crisis there could also be a breakdown of the US dollar clearing system, which is managed by the large New York banks most likely to be affected, and through which all international and domestic US dollar transactions are cleared. US banks are particularly concerned over the problem of "daylight overdrafts" ie the exposure arising from the despatching of payments early in the day before the receipts needed to meet them arrive. Fear that some banks were insufficiently liquid to meet their own obligations could paralyse the system, including dollar transactions between banks and central banks in other centres.

2. It is also possible that the Fed could refuse access in the US to its discount facilities, if the intention were to use them to meet a dollar liquidity shortage in another country. It is unlikely, but not impossible, that a liquidity crisis would start elsewhere, but, if it did, normal market mechanisms could lead to such an intention. Non-US banks without a US dollar base of their own typically have lines of credit arranged with branches of US banks either in their own centres or in New York. If these were honoured in a crisis, the US branches could finance such drawings by using their non-overdraft facilities with their head offices. If this led to a liquidity shortage in New York, the first recourse of US banks would normally be to the discount window of the Fed, but such access is at the discretion of the Fed, not automatic.

ANNEX D

TIERING IN THE INTERBANK MARKET

There is always an element of price discrimination in the interbank market but the discrimination against the less than prime banks is generally modest with normally no more than 1/8 or 1/4 percentage point separating the best from the worst rate. It may however be greater when the market is unsettled and this is when the market tends to talk of "tiering".

2. Tiering in this sense occurred in the summer and autumn of 1982. By July 1982 it was reported that it had become quite pronounced and that a span of ½ per cent had developed between the best and the worst rates. At that time the prime US banks were able to fund themselves the most cheaply, as is usual. Thereafter, using the rates paid by the US banks as a base, the following tiers could be identified:-

1/16% premium - UK clearers and prime continental banks (excluding French and Italian banks).

1/8% premium - French and Japanese banks.

3/16% premium - smaller banks (including UK merchant banks).

1/4% premium - Latin American and other banks from developing countries.

1/2% premium - East European banks

3. In addition to this general "stretching" of the tiering structure, at various times individual banks or groups of banks (notably American, Canadian, German and Italian), many of them normally accepted as prime names, found themselves having to pay more than usual for funds because the market associated them closely with country debt problems and/or the events surrounding Dome Petroleum, AEG, Drysdale, Penn Square and Ambrosiano. By September, when the debt problems of Mexico had become fully apparent, it was being reported that US banks were no longer unquestioned prime names in the interbank market and that the UK clearers and Japanese banks were able to raise funds more cheaply than many of them. Continental Illinois and Canadian Imperial Bank of Commerce may have faced discrimination against them of as much as 1 per cent. Such rates may, however, have been quoted as signals of unwillingness to deal and it does not follow that business was actually transacted at those rates.

4. There is a limit to the amount of tiering which is likely to occur in the market because of the reactions of both <u>borrowing</u> and of <u>lending</u> banks. Borrowing banks will strongly resist

tiering against them because if their cost of funds gets seriously out of line with that of the market as a whole they could find that they can no longer make an adequate return on their syndicated lending. Borrowing banks fear that by making a concession on price they will simply confirm the lending bank's view of their creditworthiness (and desperation for funds) and encourage lenders to demand higher and higher premia in future. Their reaction is therefore not to borrow from counterparties at rates which are "over the odds" but to delay their funding, if possible, or to seek alternative sources of funds (borrowing on standbys from parents for example). Equally, on the side of the lending banks, a point is reached in their perception of counterparties in the market at which they are not prepared to assume the credit risk even at higher than normal rates. Their reaction is rather to withdraw deposits, cut lines etc. The outcome of lines being cut is, of course, the reduction in interbank activity which has been detectable over the last year.

5. In addition to the market effects described, there has been unusual pricing of interbank loans to Mexican and Brazilian branches outside those countries. Some banks have sought to take advantage by asking as much as 3 per cent or 4 per cent over market rates, but we believe that the branches have refused. They are typically paying 1 per cent above for 6 months money, a little less for shorter maturities. The deposits are however part of the agreement by the international banking community to maintain their exposure and their pricing is to an extent artificial.

6. From October 1982 onwards market sentiment began to improve and is now considerably stronger than that prevailing last autumn. This is due to a number of factors, including the market's inherent ability to adjust, reasonably successful handling of debt problems, and the emergency of generally easier market conditions as interest rates have both declined and become more stable. A selective enquiry carried out by the Bank in August this year revealed that no systematic tiering in price seemed to be taking place (though the French banks were said to be paying over their normal position in the market from time to time) and that the span of rates appeared to have returned to a more normal range of 1/4 per cent. There were, however, indications of lines to banks from developing countries and small banks being cut.

7. Another aspect of the uncertainties prevalent in the international banking markets last year was a shift in investor preference away from commercial bank instruments into US government paper. As a result, starting in May 1982, at around the time of the Drysdale affair, an unusually large differential opened up between US Treasury Bill rates and US commercial bank CD rates. After peaking in September 1982 (see attached table) the differential has narrowed considerably this year.

3 MONTH TREASURY BILL/CD AND CP DIFFERENTIAL (%)

	Treasury bills	CDs	Differential	CPs	Differential
7 May (average)	12.48	14.06	1.58	14.00	1.52
14 May (average)	12.32	13.74	1.42	13.56	1.24
Monday 17 May	12.27	13.75	1.48	13.44	1.17
Tuesday 18 May†	12.21	14.00	1.79	13.56	1.35
Wednesday 19 May	11.87	13.85	1.98	13.56	1.69
Thursday 20 May	11.37	13.35	1.98	13.31	1.94
Friday 21 May	11.70	13.55	1.85	13.31	1.61
28 May (average)	11.49	13.35	1.86	13.11	1.62
4 June (average)	12.01	13.76	1.75	13.34	1.33
11 June (average)	12.02	13.77	1.75	13.49	1.47
Monday 14 June	12.32	14.15	1.83	13.94	1.62
Tuesday 15 June	12.25	14.20	1.95	14.19	1.94
Wednesday 16 June	12.30	14.30	2.00	14.19	1.89
Thursday 17 June ≠	12.61	15.00	2.39	14.56	1.95
Friday 18 June	12.69	15.05	2.36	14.56	1.87
25 June (average)	12.77	15.11	2.34	14.59	1.82
2 July (average)	12.68	15.11	2.43	14.69	2.01
9 July (average)	12.12	14.44	2.32	14.22	2.10
16 July (average)	11.65	13.88	2.23	13.34	1.69
23 July (average)	10.57	12.41	1.84	11.89	1.32
30 July (average)	10.34	11.96	1.62	11.71	1.37
6 August (average)	9.70	11.64	1.94	11.21	1.51
Monday 9 August	9.70	11.80	2.10	11.44	1.74
Tuesday 10 August	9.99	11.75	1.76	11.44	1.45
Wednesday 11 August	9.87	11.75	1.88	11.19	1.32
Thursday 12 August ϕ	9.19	11.55	2.36	11.06	1.87
Friday 13 August	8.84	10.80	1.96	10.56	1.72
Monday 16 August	8.53	10.30	1.77	9.94	1.41
Tuesday 17 August*	8.03	9.70	1.67	9.56	1.53
Wednesday 18 August	7.97	9.70	1.73	9.06	1.09
Thursday 19 August	6.90	9.80	2.90	9.31	2.41
Friday 20 August	7.20	9.55	2.35	9.31	2.11
Monday 23 August	7.45	9.55	2.10	9.31	1.86
Tuesday 24 August	7.52	9.60	2.08	9.06	1.54
Wednesday 25 August	7.32	9.65	2.33	9.19	1.87
Thursday 26 August	6.95	9.85	2.90	9.44	2.49
Friday 27 August	7.94	10.35	2.41	9.69	1.75
Monday 30 August	8.04	10.25	2.21	9.69	1.65
Tuesday 31 August	8.40	10.40	2.00	9.56	1.16
Wednesday 1 September	8.37	10.60	2.23	10.31	1.94
Thursday 2 September	8.29	10.65	2.36	10.31	2.02
Friday 3 September	8.37	10.60	2.23	10.31	1.94
Tuesday 7 September	8.37	10.45	2.08	10.19	1.82
Wednesday 8 September	8.16	10.55	2.39	10.19	2.03
Thursday 9 September	8.20	10.65	2.45	10.31	2.11
Friday 10 September	8.32	10.85	2.53	10.44	2.12
Monday 13 September	7.97	11.00	3.03	10.56	2.59
Tuesday 14 September	7.72	10.80	3.08	10.56	2.84
Wednesday 15 September	7.95	11.05	3.10	10.56	2.61
Thursday 16 September	7.95	10.95	3.00	10.69	2.74
Friday 17 September	8.08	10.95	2.87	10.56	2.48

† Drysdale affair

≠ Sudden change in outlook for interest rates after a poorly received Treasury auction led to increased fears of bankruptcies

ϕ Collapse of Lombard Wall

* Henry Kaufman's statement about interest rate prospects.

ANNEX E

CAPACITY OF BANK TO PROVIDE SUPPORT

I POWERS

	Banking Department	Issue Department
Power to borrowing sterling	Yes	No
Power to lend sterling (see Notes 1 and 2 below)		
(a) Secured	Yes	Yes
(b) Unsecured	Yes	Yes
Power to hold sterling assets	Yes	Yes
Power to borrow currency	Yes	No
Power to lend currency	Yes	Yes
Power to hold currency assets	Yes	Yes (last used 1932)
Power to guarantee		
(a) Sterling	Yes	No
(b) Currency	Yes	No
Contraints on size of operation	Prudential considerations - Size of Department's own balance sheet	Operational requirements of Issue Department - Size of Note Issue
Could Treasury guarantee?	Yes	HMT automatically liable to make good any depreciation at quarterly revaluation of assets
Other Comments		Size of note issue may expand if demand for notes increases in extreme crises

Note 1

Banks which have issued laon stocks have generally written in to those agreements provisions which would make the stocks repayable immediately if other creditors were offered better security. This could in practice to prevent the Bank from taking security against support loans, whether in sterling or currency.

Note 2

Anybody who knowingly lends to an insolvent institution risks being ruled by the courts to have assumed responsibility for all that institutions liabilities. In practice, however, it is unlikely that a support loan made in good faith would be taken as evidence of intent to keep

the borrower in business for fraudulent ends and of course the implication of providing assistance is that the question of default to other creditors will not arise.

II METHODS OF SUPPORT

Method		Role of Bank	Amount Now Available To 4 Major Clearers (Highly Speculative)	Comment
(a)	Recall of funds lent to discount and gilts market	Waive undertakings given by banks	Up to £3 billion	
(b)	Purchase of assets			
(i)	commercial bills	Purchase by Banking, then Issue Departments	Up to £2 billion	The value of commercial bills may be less certain
(ii)	Treasury and local authority bills	Purchase by Banking, then Issue Departments		
(iii)	gilts	Purchase by Banking, then Issue Departments	Over £3 billion	Risk that purchase and resale agreements could be construed as loans against security
(iv)	CDs of other banks	Purchase by Banking, then Issue Departments	Up to £2 billion	Asset, might be of dubious value
(v)	loans to local authority	Purchase by Banking, then Issue Departments	£1 billion	Unwieldy formalitites necessary
(vi)	ECGD + DTI shipbuilding guaranteed assets	Banking, then Issue Departments	£4 billion	Up to 30 per cent can be refinanced in times of liquidity difficulty under present arrangements
(vii)	Loans and advances to non-bank private sector, excluding loans to persons and overdrafts	Purchase by Banking, then Issue Departments	£24 billion	Possible major administrative difficulties uncertain value profound long term consequences

NB - CONSTRAINTS ON USE OF BOTH DEPARTMENTS MEAN THAT FIGURES CANNOT BE CUMULATIVE

SECRET

SECRET

Method	Role of Bank	Amount Now Available To 4 Major Clearers (Highly Speculative)	Comment
(c) Bank guarantees	Bank Banking Department, possibly supported by Treasury guarantee,	£+ Prudential constraint	
(d) Direct Treasury guarantees to ultimate borrowers			
(e) Treasury loans/grants/equity purchase			Initial recourse to Contingencies Fund. Thereafter legislation needed. Extreme option.

SECRET

SECRET

ANNEX F

CONDITIONS FOR THE USE OF THE CONTINGENCIES FUND

The Treasury Solicitor has advised that the Contingencies Fund could be used to enable the Treasury to make loans to individual banks providing the conditions for drawing on the Fund are satisfied. Payments would ultimately be made from a Treasury vote and would be accounted for by a Treasury Accounting Officer.

2. The main considerations which would need to be borne in mind are the following:-

(a) the advances must be in respect of urgent services in anticipation of the provision made or to be made by Parliament for those services becoming available (Section 3(1) of the Miscellaneous Financial Provisions Act 1946);

(b) the Treasury must be satisfied that it is not precluded from providing the money either by the absence of statutory powers (see (c) below) or by the implications to be drawn from any relevant statutory provision. For example, if the law already provided powers to make payments for a certain purpose, but these powers did not extend to a related purpose, the inference might be that Parliament had precluded payment for that related purpose. However, the Treasury Solicitor has not identified any such inhibitions in the circumstances we have been looking at;

(c) the general rule is that "the use of the Contingencies Fund to finance expenditure which requires specific legislation in order to meet accepted constitutional propriety is to be condemned" (the 1932 concordat between the PAC and the Treasury);

(d) advances from the Fund should not be made unless it is reasonable to assume that the provision in terms of legislation to authorise the use of public funds for this purpose will be made by Parliament so that the Fund will thus be repaid (this requires inter alia an informed assessment of the outcome of the vote);

(e) in principle, advances from the Fund should be deferred until the legislation has had a second reading. Exceptionally, if it is impossible to postpone the payments until the necessary money has been voted, the Fund may be used to meet urgent expenditure in anticipation of legislation which the Government has the firm intention of introducing at the first available opportunity; and

(f) use of the Fund should be preceded by a statement to Parliament either separately or during the Second Reading Debate on the legislation.

ANNEX G

G10 GOVERNORS' COMMUNIQUÉ ISSUED SEPTEMBER 1974 (rc)

At their regular meeting in Basle on 9th September, the Central Bank Governors from the countries of the Group of Ten and Switzerland discussed the working of the international banking system. They took stock of the existing mechanisms for supervision and regulation and noted recent improvements made in these fields in a number of major countries.

They agreed to intensify the exchange of information between Central banks on the activities of banks operating in international markets and, where appropriate, to tighten further the regulations governing foreign exchange positions.

The Governors also had an exchange of views on the problem of the lender of last resort in the Euromarkets. They recognized that, it would not be practical to lay down in advance detailed rules and procedures for the provision of temporary liquidity. But they were satisfied that means are available for that purpose and will be used if and when necessary.

(b)

more sharply aware of the risks involved in their exposure to particular countries in difficulties, there could be a problem if they began more generally to withdraw from, or at least to run down their involvement in, individual countries or groups of countries, without a fully balanced assessment of those countries' positions. We have seen similar behaviour in respect of involvement in lending to companies, both domestically and internationally. Excessive prudence can be as dangerous in some circumstances as excessive exuberance in others.

Perhaps it would be useful at this point to recall the line which we at the Bank have taken on the whole subject of country lending—and I think it has been a broadly consistent line ever since the problem leapt into prominence in 1974.

First, we have always wanted to see the maximum possible contribution from the official international institutions—and especially the IMF. This has been because we believe that funds from these institutions with their associated conditionality are likely to carry the best prospects of facilitating appropriate adjustment. At the same time it has always been clear that the magnitude of the financing task has been such that official funds could not play more than a minor role. The major part has had to come from the banking system. That being so, we have concentrated on trying to ensure that international bank lending was prudently and appropriately carried out. We have encouraged the provision and distribution of as much information as possible. We have, with other central banks, worked to develop a collaborative approach to supervision of international lending. And we have encouraged banks not to react abruptly or short-sightedly to changes either in a borrowing country itself or in other countries with superficial similarities.

You will recall that the Governor addressed this question in a speech he gave in Bonn in December.[1] He noted that, as with domestic bankers in their dealings with companies, international bankers face a dilemma when a country begins to experience debt difficulties. Prudent banking practice may suggest that exposure should be reduced, by the refusal of requests for new credit and the termination of existing lines or deposits as they mature; on the other hand, action of this sort, if precipitate or taken simultaneously by a number of the country's creditors, may well hasten and exacerbate the very difficulties from which the banks are trying to escape. Action by a single bank taken in its own narrow interests can easily prove detrimental not only to its own longer-term interest, but also to the interests of the wider banking community. In such circumstances there can be no guiding rule, but each case must be judged on its individual merits.

A more widespread difficulty might arise if problems deriving from a particular rescheduling caused banks to react defensively towards other indebted countries, precipitating difficulties for them. Banks must consider carefully whether the difficulties faced by a country are transient or whether they reflect fundamental maladjustment or mismanagement. A solution may, in some cases, lie in a widening of spreads with a consequent increase in the return on capital, so as to encourage further lending. But any banks which do withdraw support at an inappropriate moment, even if in one particular instance they manage to protect their immediate interest at the cost of precipitating difficulties for others, could find that damage done to their standing in the market might not serve them well in the longer term.

I do not underestimate the difficulties there are in making the appropriate differentiation between borrowers. Obviously there will be occasions when some common external factor, economic or political, influences a range of countries. Nevertheless, more often than not, there will be differences in the impact such factors have or in the reaction to them; and it is of great importance that such differences be properly assessed and appropriately responded to, in the longer-term interests of the banks, the borrowers and the wider world community.

The question is sometimes raised whether central banks are adequately prepared to deal with failures if, despite all efforts to guard against them, they arise. Recently the Group of Thirty risk study group has noted commercial bank concerns in this area. Traditionally, at times of uncertainty, confidence has been restored by resolute action by the relevant central bank. If problems were to arise from international lending, co-ordination between a number of authorities would be required, simply by virtue of the international nature of markets: responsibility would need to be shared amongst them. This need is fully acknowledged by the central banks of the major industrial countries. Indeed, as long ago as September 1974 the Governors of the Group of Ten central banks stated publicly in the wake of the Herstatt affair that they were satisfied that means were available for the provision of temporary liquidity to the euromarkets and would be used if and when necessary.

That statement still stands. As was also said in 1974, however, it would not be practicable or advisable to lay down in advance detailed rules and procedures for the provision of such liquidity. In particular, if such provision were to be in any sense automatic or if the factors or criteria which determined it were precisely specified, there would be a danger that the disciplines of the market would be overriden—if the arrangements looked too restrictive—or undermined, if they looked too lax.

Financial sanctions on Argentina

After these rather general remarks, I would now like to turn to one particular question on which I am sure you will expect me to say something.

(1) See the March *Bulletin*, page [illegible]

(C)

Miss Carney: You have mentioned that the Bank of Canada's responsibility relates to the liquidity of the chartered banks. What role would the Bank of Canada play if a chartered bank became illiquid; if a chartered bank, say, ran into trouble because of a failure of a large corporate client?

Mr. Bouey: There are two aspects to that I think I should mention. One is that in terms of short-term problems, if a bank finds difficulty in meeting its reserve requirements, for some particular reason, then we will lend the money pretty well automatically, at least up to some limits. And that is a temporary thing having to do with the way in which their clearing swings moved against them—unexpected swings arising out of certificates of deposits that were not rolled over, or something like that. We do that fairly frequently; not all the time, but fairly frequently.

The situation you are really talking about I think is where a bank gets into a more serious liquidity problem, really because some lack of confidence develops and people are reluctant to renew their deposits or place as many deposits in the bank as one would like to see. In that case, the Bank of Canada will certainly stand behind the bank and we will lend against its assets. We can only make secured loans.

Miss Carney: Okay. Is there any limit to that? Say one of the large corporate chartered banks in Canada ran into really serious problems, because some of them are over-extended in relation to one or more companies, how far would you support them? Would you bail out the chartered bank? Is that within your power?

Mr. Bouey: This is a very hypothetical question. I do not believe any bank is in that situation. But if a bank, and I am not going to refer to any particular kind of bank, was suffering liquidity problems for some reason of lack of confidence, the bank will go as far as necessary. That is not bailing them out; that is just lending money against sound assets. ?

Extract from Minutes of the House of Commons Standing Committee on Finance, Trade and Economic Affairs.

(d)

BANK OF CANADA

BANQUE DU CANADA

press statement

communiqué

FOR IMMEDIATE RELEASE

January 26, 1983

CANADIAN COMMERCIAL BANK

OTTAWA, January 26, 1983. In response to a number of enquiries concerning the Canadian Commercial Bank which arose following the annual meeting of that bank in Edmonton yesterday, Gerald K. Bouey, Governor of the Bank of Canada, stated that the Canadian Commercial Bank is a solvent and profitable bank and if it requires any liquidity support, the Bank of Canada will provide it.

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National Westminster Bank Limited

41 Lothbury, London, E.C.2

PRESS RELEASE

In view of the fall in the price of National Westminster Bank shares during this week and particularly on Friday, we have felt it necessary to make a statement concerning certain rumours of which we are aware and which have absolutely no foundation.

In the first place, there have been rumours surrounding the allegations made by Signor Sindona in his submission to the Milan Tribunal, and I now state that, after a detailed investigation, International Westminster Bank is satisfied that the alleged letter of 30th November 1972 is false and supporting documents have been submitted through our legal representatives to the Milan authorities.

Furthermore, we would reiterate our earlier statement that the Bank has no outstanding liabilities or losses in relation to the Sindona Group of banks or from foreign exchange operations undertaken by any of its units throughout the world.

A further rumour current this week relates to the suggestion that we have received a substantial amount of support from the Bank of England on the grounds, apparently, that we feel unable to make a Rights Issue. This rumour has been categorically denied by the Bank of England and is again wholly false. Indeed, we have had no discussions whatever concerning the possibility - or otherwise - of our making a Rights Issue.

National Westminster Bank much regret that our shareholders, depositors and staff should have to be faced with suggestions currently appearing in the Press and elsewhere which are, as I have stated earlier, totally without foundation.

J. F. Prideaux

30th November, 1974. Sir John F. Prideaux, O.B.E.

Chairman

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EVENING STANDARD 29.11.74

Bank of England denies Natwest rescue move

THE BANK OF ENGLAND this afternoon firmly denied a rumour that had swept round the City that the National Westminster Bank had sought or been offered substantial support by the Bank.

"Absolute nonsense," said a spokesman.

Natwest's shares had been clobbered by the rumour, dropping 6p to 88p at one time—12p below their par value. Earlier this year they were more than 300p. Other Bank shares fell in the atmosphere of uncertainty surrounding the commitments to the "fringe" banks and the wobbling property world.

Elsewhere business was down to the merest trickle and market minds had plenty of time to exercise a rather-rueful sense of humour.

Although Mr Harold Wilson is not the City's best friend he could take credit for supplying the ammunition for today's fun.

So dealers spent their time contemplating the "weevils nibbling away at the pound in their pockets." They also posted such notices on their price boards as "please don't feed the weevils" while others, according to an Exchange Telegraph reporter, clasped their hands to ears, mouth and eyes and protested "Hear no weevil, speak no weevil and see no weevil."