

Let's talk about capital

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There has been a lot of debate on this blog recently about the way in which I use the word capital.

I have used it to describe the deposits made by people with banks because when a saver hands over their money to a bank it becomes the bank's property and the saver has little more chance of recovering from that bank in the event of the bank becoming insolvent than a shareholder has of securing a return on their investment in that same situation. This, of course, is why the government guarantees bank deposits to the sum of £85,000.

In that case, it is my suggestion that a bank treats the deposits made with it to by savers as a part of their capital because they provide it with a buffer against the risk of insolvency if they were to go bust.

I do that because the reality is that this is exactly how it would seem they would behave in that situation, and as a consequence, I think the description is correct.

Doing so I am doing nothing more than recognising the moral hazard created by this situation, where bank directors, protected by limited liability and the failure of regulators, can be indifferent to the risk faced by all providers of finance to their bank - which is exactly what bank depositors, who are unsecured creditors of the bank are. Adam Smith pointed this out in 1776. Not much has changed since then.

Despite that, many people have objected to my use of the word capital in this way. In particular, they say that capital has a very definite connotation within banking, which implies that it refers to the equity share capital of the bank.

However, equity capital is itself a nebulous concept. That form of capital can be made up of the money paid by shareholders on the initial subscription for shares. It can also include the share premium account paid by subsequent shareholders who apply for their shares after initial subscriptions are paid. And it can refer to the accumulated profits not paid out to shareholders. In addition, it can also refer to other reserves, such

as revaluation reserves that arise as a result of the bank deciding for its own good reasons that its assets have a worth over and above the sum that they originally paid for them, giving rise to their revaluation and these supposed reserves as a consequence.

Altogether, these figures can be described as shareholders' funds. But whether they are equity capital as such is less clear, precisely because some of them can be readily repaid to shareholders at the whim of the directors, and others have to be retained within the business for a very specific reason. That is why this form of capital is very particular and subject to regulatory definition, but to pretend that regulation used for this purpose defines what capital might be is absurd.

That is because that regulatory definition does not recognise the economic reality of the situation to which I was referring, and will continue to refer, which is that whatever regulation says, a bank can treat its depositors as the providers of unsecured funding to it that can be put at risk by their trading activities and be lost by those depositors in the event of insolvency. The fact that this has not happened for 160 years is neither here nor there. The truth is, it could happen, and therefore, my suggestion that those funds rank in a broadly similar fashion to and are akin to the supposed equity capital of the bank is fair, most especially when parts of the shareholders' funds of a bank are also capable of being withdrawn at short notice.

Those objecting say that I do not understand capital because it has this very precise regulatory definition. But the reality is that those making that claim clearly do not understand the concept of capital. In both accounting and economics as well as in reality, capital has many forms.

There is obviously equity capital of the form that I have already noted.

But there is also human capital, which represents the combined resources of those people who work for an organisation or who live in a country and who can apply their skills for the benefit of the company or society of which they are a part.

Then there is natural capital, which combines the environmental and other natural resources of a society, whether in a particular region or worldwide.

Environmental capital is a subset of natural capital.

Intellectual capital is also different from human capital because intellectual capital refers to knowledge, but human capital combines intellectual capital with wisdom, which is in itself another form of capital.

I recently heard a description of the difference between intellectual capital and wisdom. Intellectual capital embraces the knowledge that a tomato is a fruit. Wisdom makes it clear that tomatoes do not belong in fruit salad. The example is flippant, but the point

is clear. These two forms of capital are not the same.

What is also clear, as a consequence, is that capital comes in a multitude of forms. And yet, those who wish to use the term merely to describe the funds supplied by shareholders to a company ignore this point, and they are wrong to do so.

Organisations of all sorts apply the concept of capital in many ways. They will seek to increase the human capital of their organisations, and the intellectual capital, and the wisdom of the organisation as a whole. Many also now accept their responsibility to manage its environmental capital. In time, many more will accept the need to manage natural capital.

Along the way, directors have a responsibility when managing a company to ensure that it is solvent. That requires them to manage its working capital, which are the funds available to settle liabilities as they fall due.

What all this makes clear is that capital does not just exist in the form that is being claimed by those who criticise my interpretation of the word within the context of banking. Capital is a flexible concept that represents the value of the resources available to an organisation for it to use in pursuit of its goals. I suggest that those who deposit funds with a bank make resources available to it, which is indisputable. That is it. There is nothing more or less to it.

And even then, the term can also be used on the flip side. The flip side means that whilst all the concepts of capital to which I have just referred are on the credit side of the balance sheet, representing the net worth of the combined capital that an organisation has under its command on which others have a claim, there is of course a debit side to this equation, which is the actual value of this capital in use.

This debit side does not represent claims by others on the entity for the capital provided (that's the credit side) but does instead represent the actual assets in use in the organisation that make an organisation of any sort, whether it be a country, a local government, a charity, an NGO, or a company, actually function. These assets might be:

- * Tangible assets, like equipment and property
- * Intangible assets like copyrights
- * The knowledge of the people employed
- * The natural assets entrusted to the organisation
- * Short-term assets like stock (inventory), work-in-progress, debtors (receivables) and cash
- * Investments

They all fall in some way into the asset categories already described or are, in the case of the penultimate bullet point, working capital.

Capital is a vital concept. It is at the very core of accounting, which is the context in which I use it. In fact, what accounting measures is the change in the capital of an organisation over a period of time. It does not necessarily measure profit. That is just one particular form of accounting which measures the change in the retained shareholder funds of an organisation over a period. A broader concept of capital involves changes in equity capital, changes in human capital, changes in natural capital, and other concepts as well. In other words, an understanding of capital requires anyone who has a responsibility to realise that a narrow definition of capital is absolutely the worst form of understanding that they can have if they are to be prepared for the task that faces them.

In that case I use a broad definition of capital for good reason. I believe in holistic management, whether at a micro or macro level. If that's the right way to approach management, and I believe it is, then it is wrong to use narrow definitions of capital because what we need is this broad understanding that in our society there are many capitals that we must protect, nourish, invest in, develop, and preserve, and of all of these the one that might be least important is the concept to which those criticising me make reference, which is shareholder equity capital. That is because that cannot preserve our future or deliver our well-being. But the other forms of capital to which I refer most definitely can.