PRIME MINISTER

BANKING SUPERVISION

The Treasury's paper below is a good and rigorous piece of work.

General

The Chancellor's proposals would take UK banking supervision towards the formal regulation of other major banking centres. Even so, UK supervision would still be rather less stringent. No harm in that since London's position as a major banking centre owes much to the informality of our supervision. Nevertheless, it is difficult to avoid the impression that the Chancellor's proposals are only a stepping stone towards an even more regulated regime, which will gradually be forced on the authorities in the years ahead.

If that prognosis is right, the obvious question is - why not move straight away to a tougher regulatory environment, in the hope of avoiding some future banking scandals? The answer, it seems to me, is that we neither have the regulatory experience nor expertise to introduce, at this stage, a more developed regulatory system without falling into the trap of erecting an over-rigid structure - which inhibits legitimate banking enterprise.

The Chancellor's step-by-step approach therefore looks to be the right one, provided it is appreciated that it does not provide a water-tight system and that it will need development in the light of experience.

Bank Auditors

On the role of bank auditors, the Chancellor proposes that the legal inhibitions on their communication with banking supervisors should be removed. He is surely right in resisting the opposition to this from some large banks and

/ accountants.

accountants. If the auditors are not enlisted fully into the supervisory process, the alternative would have to be the establishment of a full-scale bank inspectorate. Highly expensive (costs would have to be borne by the banks), cumbersome and probably lacking in the right expertise.

The Banking Commission

Despite the Chancellor's protestation to the contrary, the proposed Banking "Commission" within the Bank of England does represent quite a major change in the organisation of banking supervision. It may well be seen as the first step towards taking supervision away from the Bank.

No need to object on those grounds. Indeed, it may be helpful to create in due course a body, separate from Government and the Bank of England, which can carry the can for the occasional banking failure, which is inevitable in a free market system.

Notification of Large Exposures

On the more detailed point of the notification of individual large exposures to the supervisors (point 5 of the Chancellor's minute and paragraphs 44-47 of the paper), you will want to consider the proposal that banks would have to justify to the supervisors loans that exceed 25 per cent of a bank's capital base. This could so easily become a system whereby responsibility for decisions on difficult loans is transferred from a bank's management to the supervisors.

N.L.W

Nigel Wicks

18 October 1985

CONFIDENTIAL

Prime Minister
To read if you have time - ready for the meeting on 28th October.
pp. DRN.
15/10.

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

BANKING SUPERVISION

We are to discuss banking supervision on 28 October, together with the Governor. I attach a note prepared by Treasury officials, with help from the Bank of England, as background for that discussion. I have discussed the note with the Governor.

This is, I am afraid, quite long, as it has to be to deal with what are complex issues. It describes the existing system of banking supervision and systems in operation in other countries. It also sets out the main proposals for change. We agreed the broad lines of these in the summer, before I made my statement to the House on 20 June.

As you know, following the rescue of Johnson Matthey Bankers, we carried out a substantial review of banking supervision, in a committee under the Governor's chairmanship. This review has been published. I told the House on 20 June that we would act as swiftly as possible to bring forward new legislation to improve banking supervision. This is involving intensive work by Treasury and Bank officials, and we are consulting widely.

The timetable is extremely tight. Our aim is to publish a White Paper at the end of this year, with a view to introducing a Bill in 1986. This will not be easy, but I believe we can achieve it, so long as we now take a few key decisions quickly. The proposals in the White Paper will not be set in concrete. In practice there is likely to be a continuing process of consultation. But it will be difficult to introduce important proposals later on which are not mentioned in the White Paper. Although most of the proposals are agreed between the Treasury

and Bank, there are two or three issues on which the Governor and I have not yet reached final agreement. We will need to settle these at, or very soon after, your meeting if we are to stick to our timetable.

In many ways I believe our relatively flexible and informal system of banking supervision has served us well over the years. The Bank attach great importance to the active and willing co-operation they receive from the banks, and would not want to make any changes that inhibit this. Experience in other countries has been that systems of banking supervision based on detailed statutory rules have not prevented banking problems. Too much statutory prescription can encourage banks to follow the letter of rules, and not their spirit, and to operate right up to the maximum permitted limits. It tends to inhibit enterprise and undermine management responsibility. The fundamental principle should be that it is not the supervisor's task to manage banks, but rather to ensure that bank managements are doing their job in identifying and controlling risk.

Nevertheless, it is clear that arrangements hitherto have been too flexible. The JMB affair has made reform necessary and urgent. We need to introduce a greater degree of formality and to tighten up supervisory procedures. We need to increase the professionalism of banking supervisors and bring in more people, at all levels, with practical banking experience and a feel for the assessment of credit risk which is where things so often go wrong. I also see advantage in recognising in new legislation that the supervisory authority's responsibilities extend more widely than simply the protection of depositors. And I would wish to take the opportunity of legislation to build on and formalise some of the changes in the organisation of supervision recently announced by the Governor, and to achieve a greater separation between banking supervision and the Bank of England's central banking functions.

I see eight key areas where we need to make changes:-

(i) The role of bank auditors. Without a large scale inspectorate of the kind that exists in some other countries, the supervisors have to look to bank auditors to bring matters of concern to attention. I would not want to go as far as to make bank auditors directly responsible to the supervisors. This would be inconsistent with the general position and role of auditors under UK law. But we must remove legal inhibitions on communication between a bank's auditors and the banking supervisors, and provide a basis for a regular dialogue between the two that can in exceptional circumstances take place without the presence of the bank's management. This proposal has come in for some criticism from the large banks and some accountants, on the grounds that it could compromise the auditor-client relationship. But I am certain that it is essential.

(ii) Banking inspection. I am not proposing to develop a fully-fledged banking inspectorate. But I see clear advantages in the supervisors making regular visits to banks, and being in a position to make spot checks.

(iii) Two-tier system of supervision. We have decided to abolish the two-tier system of banking supervision, with its distinction between banks and licensed deposit takers. It is clear that all deposit-taking institutions need to be supervised with equal care. This means that the term 'bank' will come to be used by a wider group of institutions; but at the same time, we will be raising minimum capital requirements for authorisation, and tightening up on the use of misleading banking names.

(iv) Reporting requirements. Returns made by banks to the supervisors are at present provided on a voluntary basis. I see prompt and accurate reporting as of sufficient importance for the obligation to be laid down in statute. The legislation should also provide for a system of fines that the supervisors could levy for late or inaccurate reporting. We need to have penalties available other than the ultimate weapon of revocation of a licence.

(v) Individual large exposures. Such exposures have proved to be of particular importance in many bank failures. I propose, therefore, that there should be specific statutory

rules for the notification of such exposures to the banking supervisors. I have in mind that loans exceeding 10 per cent of a bank's capital base (normally a little under 1 per cent of a bank's total lending) should automatically be reported and that loans that exceed 25 per cent of a bank's capital base, normally around 2 per cent of a bank's total lending, would only be permitted in exceptional circumstances, which would have to be justified to the supervisors. I believe that these percentages are consistent with banking prudence.

(vi) Duty of supervisors. The only basis of the 1979 Act is the protection of depositors. In practice, it is a purpose of supervision also to guard against risks that could spread more widely in the banking system. I am proposing that the new legislation should impose a duty on the supervisors to maintain the soundness and integrity of the banking system, as well as the protection of depositors.

(vii) Improving professionalism of the supervisors. This is crucial. I welcome the steps the Governor is taking, in particular to arrange secondments to bring people with practical experience of banking and credit assessment into the Bank's supervision department.

(viii) A Banking Commission. I do not wish to propose major changes in the organisation of banking supervision. But I do see considerable advantage in achieving a greater separation between supervision and the Bank's other functions, to reduce the risk of internal conflicts of interest, if that can be achieved without unnecessary administrative upheaval. I am therefore much attracted by the creation by statute of a Banking "Commission" - in effect a board to oversee the work of the Bank of England's banking supervision department. I envisage that as well as a few full-time officials of the Bank, a Commission would include a number of outside members with relevant background and expertise. This is a way of bringing outside practical experience to bear at the highest level. The Commission should be chaired by the Governor. The legislation would confer the duties and powers of supervision on the Commission, rather than on the Governor and Court of the Bank of England. I believe this proposal would also serve to improve the status of the supervisors, and to give a new and better focus of public accountability for banking supervision.

CONFIDENTIAL

The Governor is still considering the proposal for a Banking Commission. He and I have asked officials urgently to work up in more detail what the constitution, and responsibilities of such a Commission might be. I understand he also wishes to discuss further whether there is a need to place a statutory duty on auditors to co-operate with the banking supervisors.

N.L.

N.L.
15 October 1985

BANKING SUPERVISION

I INTRODUCTION

This paper describes the present arrangements for banking supervision and discusses the main alternatives, with overseas comparisons. It also sets out the main proposals made for change, both administrative and statutory, the broad lines of which were agreed in the summer and set out in the Chancellor's statement to the House on 20 June.

II HISTORY OF PRESENT SYSTEM

2. Until the Banking Act 1979, supervision of the major UK banks was conducted on an informal basis by the Bank of England, without statutory powers. The Bank of England had no separate Supervision Division. There was a separate rudimentary system of licensing by the DTI for the smaller, or fringe banks, for which the Bank of England accepted no responsibility. After the fringe banking crisis of 1974 it was clear that more systematic and comprehensive supervision was needed. It was also necessary to develop formal, statutory, authorisation procedures to conform with the EC Credit Institutions Directive of 1977. It was decided that the Bank of England should undertake the supervision of all banks, and a separate supervisory division was formed.

3. The subsequent consultation led to the Banking Act 1979, passed by the Labour Government. Its principal purpose is to protect depositors. It gives the Bank of England a range of discretionary powers enabling it to authorise deposit-taking institutions, and to revoke authorisation. It established two categories of authorised institution, recognised banks and licensed deposit-takers. Broadly speaking, only the former are allowed to call themselves banks. Most of the Bank's powers relate to licensed deposit-takers since the Act was passed on

the basis that the informal supervision of the primary banking sector (ie the recognised banks), which had not been called into question by the 1974 crisis, would continue. The Act does not apply to institutions that take deposits only in wholesale markets. It established a deposit protection scheme.

4. Most countries with developed financial systems are reviewing or have recently reviewed their present methods of supervision. Financial markets, and the nature of banking itself are changing rapidly. New financial techniques are being developed; technological change is rapid; and financial businesses are becoming more and more international and multi purpose. These developments pose new risks, outrun legislation and complicate the task of supervision.

5. The regulatory framework has to keep pace with the rapid changes taking place in our financial system. Before the planned legislation on banking supervision is introduced, Bills will have been introduced early in the coming session to regulate investment businesses (the Financial Services Bill) and to permit a controlled evolution of building societies (the Building Societies Bill).

Review of the 1979 Act

6. During the period since the Act was passed, the Bank has raised a number of issues arising from its administration of the Act with a view to making improvements in the legislative framework for supervision when there was an opportunity for new legislation. The rescue of Johnson Matthey Bankers and rapidly changing markets have now made review an urgent priority.

7. The Chancellor announced in a Statement on 17 December 1984 that it was "clear that the [JMB] case raises important issues about our present procedures of banking supervision, and the legislative framework within which it is conducted". A Review Committee was established, under the Governor's chairmanship, and comprising senior officials of the Bank and Treasury, including Sir Peter Middleton. Its work was greatly assisted by the inclusion of Mr Derek Vander Weyer, a distinguished former

commercial banker. The Committee's report was published on 20 June 1985. Its main recommendations are described in Section IV below and in Annex 1.

8. In view of the urgency of its task, the group did not examine in detail the possibility of changing to a basically different system; but they concluded "we do not believe that the present system is fundamentally flawed, but we have identified a number of important improvements which we believe should be made". In his Statement on 20 June, the Chancellor said that he had "accepted the report as a basis for immediate consultation", but would be "considering the Committee's proposals carefully". He also made it clear that although the Review Committee had addressed itself to supervisory lessons to be learnt from the JMB affair, officials were continuing with a thorough review of the whole of the Banking Act 1979. The Chancellor announced that a White Paper would be published later this year, with the intention of bringing a Banking Bill before the House as soon as possible.

The objectives of supervision

9. UK legislation is couched in terms of depositor protection. But in practice supervision protects the integrity and soundness of the financial system. At the same time it needs to permit efficient competitive banking. A good system of banking supervision is an important element in London's position as a major international banking centre.

10. The Chairman of the Federal Reserve Board, Mr Paul Volcker, recently described the objectives of supervision in the following terms:-

> "The most prominent among these is commonly referred to as 'safety and soundness'. That goal is directly related to protecting individual depositors but also has profound implications for the operation of the financial system and the economy as a whole. Commercial banks, in particular, are custodians of the largest share of the money supply, liquid assets and the

payments system. The stability of one part of the banking system rests increasingly on the soundness of the whole as the interrelationships among institutions become even more complex. In the last analysis, prospects for growth and stability in the economy as a whole must be premised on a strong and stable financial system."

11. No supervisory system guarantees against bank failures, and it would be wrong to seek to do so. Like the UK, other countries have had significant banking problems. Indeed it is fair to say that there have been more problems in other countries than in the UK, with the possible exception of France (though this probably owes more to fact that the French banking system is nationalised than to the supervisory arrangements). Banking necessarily involves taking risk with depositors' funds. In a free enterprise system depositors, managers and shareholders of banks must be free to take some risks, and, on occasion, suffer the consequences of wrong decisions. The partial (75 per cent of £10,000 maximum) cover given UK depositors by the statutory deposit protection scheme recognises this principle.

Too low

12. Nor is it the job of the supervisor to manage the banks he supervises; or, indeed to duplicate the work of the external auditors. The supervisor's task is rather to make sure that management is doing its job in identifying and controlling risk.

13. Good supervision certainly should reduce the opportunities for fraud, for example, by keeping unfit people away from managing savings institutions. But it would be wrong to think that enhancing supervision is the answer to the problem of professional fraud. The Fraud Investigation Group (FIG) was established in January, with increased resources, to improve the police's ability to pursue serious fraud cases. This is important. There is no doubt that the City's reputation has suffered from alleged criminal activities at Lloyds and, in particular, by the absence of prosecutions for financial fraud.

III ACTION SO FAR AND LEGISLATIVE TIMETABLE

14. QL Committee has allocated a provisional firm place for

a Banking Bill in the Parliamentary programme for 1986/87. To meet the timetable the bulk of Parliamentary Counsel's instructions will have to be completed by the end of January 1986. A joint Treasury/Bank working group is now meeting regularly under Treasury chairmanship to prepare policy papers for Treasury Ministers.

15. The Bank of England has issued three consultative documents: on the legislative proposals which may feature in the White Paper; the relationship between auditors and supervisors; and on large exposures. The Bank is consulting the main banking associations and the auditing profession, and will shortly report the outcome. Because of the tight timetable, it is clear that consultation will in effect continue through to next year. It is intended that the White Paper published in December should contain firm recommendations; but there will have to be scope for modification in the light of representations.

16. Meanwhile action that need not wait for legislation is being pursued. On 25 September the Governor announced a range of moves designed to strengthen the Bank's supervisory capability. In addition to the senior staff appointments and an increase in the Bank's supervisory staff, inward and outward secondments are being stepped up, particularly with commercial banks and accountancy firms. The Governor has also appointed Mr Sid Procter, who is shortly to retire as Group Managing Director of the Royal Bank Group, as adviser on supervisory matters. The aim is to create a supervisory apparatus with, to quote Mr Volcker again, a "high degree of continuity, consistency, independence and professionalism".

17. The Bank is also seeking, ahead of legislation, to initiate a dialogue with the auditors of supervised institutions. It is taking further steps to ensure that the banks have effective internal control systems, and encouraging them to appoint finance directors and audit committees. Visits to bank premises by the supervisors are being stepped up. The supervisors are insisting on comfort letters from all significant shareholders in United Kingdom banks, and monitoring more closely the ability

of parent companies and other large shareholders to honour their undertakings.

IV SYSTEMS OF SUPERVISION

18. The British system is characterised by its flexibility and the part played by the voluntary co-operation of banks. Apart from the process of authorisation, under present legislation the Bank has no clear statutory duty to supervise. The prudential ratios and other controls prescribed by the Bank of England are agreed with institutions individually, and are not specified in statute. Though deriving from the Bank's statutory authority, they do not have statutory force. Statistical returns are made voluntarily. The supervisory process depends on a continuing relationship between the management of an institution and the supervisors. It depends heavily on mutual trust.

19. There are, of course, other ways of supervising banks. The table at Annex 2 sets out the key elements of supervisory systems operated in France, Germany, Switzerland and the United States. National systems have evolved in widely different ways, reflecting differences in historical development, institutions and legal systems. Whilst some aspects of overseas practice may look attractive, they would not necessarily transplant easily.

20. An important differentiating feature amongst supervisory systems is the degree to which they rely on specific statutory rules. The UK system probably relies less than any other on specific statutory rules. At the opposite end of the spectrum are the systems based on detailed rules and regulations set out in statute. The French system lays down in regulations risk asset ratio levels; rules for liquidity; and limits on large exposures. The German and Swiss systems are similarly enshrined in detailed legislation. The corollary of detailed prescription is an elaborate system of enforcement and penalties.

21. Although the United States has a large volume of detailed regulation, this has grown up piecemeal over the years, and

partly reflects tensions between different supervisory bodies and between State and Federal supervisors.

22. There are superficial attractions in a heavily regulated system in that if the penalties for breaching the rules are severe enough, and the supervisory aparatus is doing its job, it should in principle build caution into the system, and reduce the likelihood of failure. In a narrow sense the task of the supervisor is certainly easier, since departures from the prescribed norm are easily identified.

23. But there are dangers in such an approach, which has not avoided problems in other countries. In Germany, Switzerland, Canada and the United States, there have been bank failures and serious problems in recent years. Conformity with the regulations has not guaranteed good decisions by managements. In practice it can have the opposite effect, encouraging both banks and supervisors to abide by the letter of the rules and ignore their spirit and underlying purpose. Specific statutory 'ceilings' may in fact encourage banks, including the less experienced, skilled or substantial organisations, to operate right up to the maximum permitted levels.

24. There are other arguments against detailed statutory prescription. In particular it can inhibit diversity. One of the strengths of the UK system is that it permits prudential guidelines to be tailored to individual cases. This has allowed the development in London of a variety of banks and deposit-taking institutions specialising in different ways. It seems likely that our relatively flexible supervisory regime has been an important positive factor in the growth of London's role as the world's most important international banking centre.

25. However, whilst it is clearly necessary to avoid these dangers, there may be lessons to learn from other countries' systems and some element of statutory prescription in key areas should not be ruled out. There are certain aspects of the supervisory process which may well be of sufficient importance to warrant specific statutory backing. This would serve symbolically to emphasise certain key elements of supervision.

It would also provide a statutory basis for the imposition of fines and penalties for non-compliance in certain key areas, short of the ultimate weapon of revocation of a licence. The Treasury is therefore considering the feasibility of making prompt submissions of accurate statistical returns obligatory, with penalties, in the form of fines, for non-compliance. Because the problem of large and related exposures is at the root of so many bank failures, consideration is also being given to whether this too should not be the subject of statutory provisions. (In this area, it may be possible to avoid the worst problems associated with statutory ceilings by providing statutory requirements for the notification of exposures above a certain size - see paragraph 47.)

26. Considerable care would need to be taken in expressing such statutory requirements and penalties. There are problems of definition. A system of fines would need to allow for special circumstances. This might be achieved by prescribing maximum fines, but leaving discretion with the supervisors about whether to levy a fine, and if so at what level within the maximum, in particular cases. The maxima should relate to the seriousness of the 'offence' and, possibly, to the size of the institution. An appeals procedure would be required. Where necessary, financial penalties would have to be accompanied by appropriate supervisory action, for example a special investigation by the supervisors, or the imposition of conditions which the bank would have to meet to avoid revocation of authorisation.

IV MAIN ELEMENTS OF NEW LEGISLATION

27. Annex 1 sets out the main elements of the proposed legislation, as seen at present. In general these derive from the recommendations of the Review Committee.

28. The present Act is couched in terms of depositor protection. The Review Committee addressed itself to modifications of the present Act, without fundamental reconsideration of its scope. However, as noted earlier, the objectives of supervision include both protection of individual depositors and protection of the system as a whole. There is therefore a strong case for

acknowledging in statute the full role of a supervisory system in maintaining the integrity and soundness of the financial system as well as the protection of depositors. The present Act's concentration on the latter has the effect of putting outside its supervisory controls some institutions which do not take small deposits but which nevertheless have a part in the financial system as a whole - and whose difficulties could pose a threat to that system. At a time of innovation and change in financial markets - and particularly when we are tightening-up on supervision - it may be that more institutions will choose to operate in such a way as to remain outside the scope of a supervisory system aimed at protecting depositors. Whilst the Bank has traditionally sought to monitor and regulate activities in the financial markets overall, in most areas it relies on informal methods not supported by statutory powers and obligations.

29. Since it is likely that the changes to the 1979 Act already proposed are sufficiently extensive to justify a de novo Bill, further consideration is therefore being given to how the basis for the new Act could be extended to encompass the role of supervision in maintaining the soundness of the system, as well as the protection of depositors. It must be recognised, however, that we could not contemplate far-reaching changes in this respect without endangering the present extremely tight timetable for legislation.

30. These issues are also related to the question of the supervision of the increasing number of conglomerate financial institutions. The activities of conglomerates embracing deposit-taking, investment and insurance businesses will be the concern of several supervisory institutions. Problems arising in one area of business may feed across to others and, by contagion, to the wider financial system. The banking system, with its largescale interrelated dealings, would be the main vehicle of contagion; and, with a high level of liquid funds and relying as it does on a high degree of confidence, the banking system is also particularly vulnerable to the effects of such contagion. So the banking supervisors will have a special interest in the supervision of financial conglomerates. In these circumstances,

it will be essential that the different supervisory authorities cooperate with each other and are able to exchange relevant supervisory information. It is therefore proposed that the new legislation should relax existing requirements for the confidentiality of supervisory information to enable co-operation between supervisors.

31. As they now stand, the main features of the proposed legislation are as follows.

Relationship between supervisors and auditors

32. The Review Committee proposed that a mechanism should be established to enable a regular dialogue to take place between the supervisors and banks' auditors. This might include, for example, the auditors making a report to the Bank each year on the effectiveness of banks' internal control systems. The Institutes of Chartered Accountants of England and Wales and of Scotland gave evidence before these recommendations were advanced, and they have the Institutes' broad support.

33. The proposals derive from the fact that in the course of their duties, auditors and supervisors respectively unearth information and make judgments relevant to the effective performance of the other's functions. Both are at present inhibited by statutory or common law restraints from passing information to third parties, without the authority of the institution concerned; the supervisors by the Banking Act 1979, the auditors by the duty of professional confidentiality which they consider they owe to their clients. Although in many cases consent to disclose would be forthcoming and communication procedures would include the client bank, it is in just those cases where contact would be most useful that it is likely to be refused. Hence the need for legislative action to permit a dialogue without the participation or knowledge of the supervised institution in the last resort.

34. In other countries, notably Switzerland and Germany, auditors have a definite responsibility to the banking supervisors. In the UK, such an arrangement might conflict with the statutory duties of auditors, which are owed primarily to the shareholders

rather than to the depositors of a bank, and it would also undermine the traditional relationship between the auditors and the management of a client company. Principally, therefore, the proposed new arrangements would allow a dialogue between supervisors and auditors by removing existing constraints rather by introducing new obligations. But in order to make this dialogue effective, it might be necessary to provide for bank auditors to have a duty to co-operate with and to take part in annual meetings with the supervisors. Auditors would be free, but not obliged, to instigate more frequent or 'ad hoc' contact with the supervisors. This additional proposal is therefore also under consideration.

35. Two other proposals are aimed at keeping up the standard of Bank auditors. First that the Bank should be able to require a bank to appoint a second firm of accountants to carry out an investigation covering similar ground to a statutory audit, at the expense of the bank. The Review Committee also recommend that in cases of serious misconduct by a bank auditor, the Bank should be able to provide information to the auditor's professional body, so that it can consider instituting disciplinary proceedings.

36. These proposals mark important and necessary changes in the role of auditors of banks. In his statement of 20 June, the Chancellor strongly endorsed the proposal of a dialogue between auditors and supervisors. The Opposition indicated general support. It is clear, however, from some responses to the Bank of England's consultative paper that some members of the profession and some influential banks have reservations about the changes implied for the traditional relationship between auditors and their clients.

The two-tier system

37. The second major change proposed by the Review Committee was abolition of the distinction between banks and licensed deposit-takers. As already noted, the original intention was to create two categories, distinguished by both status and function. Recognised banks are required to have high reputation, standing, integrity and professionalism, and to provide a wide

range of services, LDTs have to meet a lesser test; to be run prudently by fit and proper persons. Banks have to have minimum net assets of £5m. For licensed deposit-takers the figure is £250,000. The principles underlying this distinction were that the Bank was to continue its traditional informal supervision of the primary banks and, by restricting the use of banking names and descriptions to the senior category, that depositors would in some way be sensible to the increased risk of depositing with an LDT.

38. But in practice, recognised bank status has not always guaranteed prudence and co-operation. The actual administration of the two tier system has required resources out of proportion to the benefits and has in some respects proved counter-prudential. JMB was a recognised bank. If the Bank of England's powers in respect of LDTs had extended to JMB, it is arguable that its problems would have been detected sooner. It is now proposed to introduce a single supervisory regime; a single set of criteria for authorisation; and to establish a minimum figure of £1m net assets, applicable to all authorised institutions.

39. There is wide support for the introduction of such a unitary system of supervision. However, one consequence of a unitary system - that all authorised institutions should be free to use "bank" in their name - has caused concern on the grounds that the popular understanding of the word "bank" would allow certain institutions to attract funds on a misleading basis.

40. But limiting the use of "bank" would inevitably re-introduce a form of two-tier system since the privileged group would have to be distinguished on the basis of prudential criteria relevant to supervision. Nor would it be reasonable to prevent the use by any authorised institution of descriptions of business involving "banking services" or similar phrases, even if banking names were more strictly controlled.

41. The proposed changes address this problem in three ways. First, the overall system of authorisation and supervision is being improved and tightened for all institutions. More than

ever, there should be no question of 'fringe' institutions obtaining authorisation or operating imprudently. Second, it is proposed that the minimum net assets required for authorisation should be raised from £250,000 to £1 million. Third, it is proposed that new powers should be taken to allow the supervisors to prevent the use by individual institutions of banking names which are misleading, for example, with regard to the institutions standing or importance. To take a somewhat extreme example an institution with only one branch would not, for example, be permitted to call itself the "Grand Universal Bank".

The Bank's powers

42. Most of the powers given to the Bank by the 1979 Act apply only to LDTs. It is now proposed to make them applicable to all authorised institutions, and to strengthen certain of the supervisors' powers (see Annex 1 for details).

An Inspectorate?

43. The Review Committee's recommendations fall well short of a fully-fledged inspectorate like the French system. There are however evident advantages in a system which would increase familiarity with banks on their own ground, and which could be used to perform spot checks.

Large exposures

44. The Bank published a consultative paper on large exposures in July. It is based on the conclusions of the Review Committee, which endorsed the Bank's existing policy of monitoring and investigating all exposures in excess of 10 per cent of a bank's capital base* and added that no exposure to an individual borrower (or group of closely related borrowers taken together) should exceed 25 per cent of a bank's capital base, except in the most exceptional circumstances, which would need to be justified to the supervisors.

45. A comparison with foreign practice invites two questions:-

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* For a major UK bank, 10 per cent of capital base is likely to be equivalent to ½-1 per cent of total lending.

(a) Are the figures of 10 per cent and 25 per cent consistent with banking prudence?

(b) Should the trigger of 10 per cent or the ceiling of 25 per cent, or both, be statutory obligations, rather than supervisory requirements without automatic sanction?

46. It seems clear that the answer to the first question is "yes". The overseas comparisons at Annex 2 show that whilst specific rules differ from country to country, those now proposed will be among the most conservative. For example in France the limit is 50%. It may also be of interest that it is proving difficult to reach agreement amongst EC countries on a ceiling as low as 40 per cent. Any more restrictive guideline would put British banks at a serious disadvantage in relation to overseas competitors. And it is necessary to allow for cases where, for example, there is a large exposure but for only a short period of time or where the supervisors can have regard to other factors, such as the resources available to the large parent of a small deposit-taking institution.

47. The answer to (b) is less clear cut. It is certainly true that large exposures lie behind many bank failures, and there is therefore a case, both in terms of enforcement and as a symbol of its importance for statutory rules in this area. But there are difficulties. First there is the problem of defining exposure legally - which will be made worse by the proliferation of new financial instruments and corporate structures. There is also the risk that a formal rule could encourage banks to lend up to the limit. But these arguments would not seem to outweigh the prospects offered by the inclusion in statute, or statutory regulations, of rigorous notification procedures. The Treasury will be considering this point further with the Bank in the light of responses to the Bank's consultative document.

Other legislative proposals

48. The more important of the Review Committee's other proposals are set out in Annex 1.

V ORGANISATION OF SUPERVISION

49. Under the Banking Act 1979, the system of recognition and licensing is entrusted to the Bank of England. The Bank has a duty to report annually to the Chancellor of the Exchequer on its activities in that year in the exercise of its functions under the Act and this report must be laid before Parliament and published. The Chancellor is responsible to Parliament for the legal framework of banking supervision. In practice he is given policy advice by Treasury and Bank of England officials working closely together. On specific supervisory matters, however, the Banking Supervision Division answers only to the Governors and Court of the Bank of England. There is a right of appeal, to the Chancellor, against decisions on authorisation and revocation, when he has the advice of an appointed, independent tribunal.

50. Foreign practice varies. Swiss supervision is conducted by the Federal Banking Commission, which is quite separate from the Central Bank. In Germany, the Federal Banking Supervisory Office, based in Berlin, reports to the Ministry of Finance in Bonn. It is responsible for detailed regulation, but works closely with the Bundesbank, which plays a dominant role in determination of ratios, and collects and processes supervisory data. The United States regulatory apparatus is complex. Different categories of banks are supervised respectively by the Comptroller of the Currency (based in the US Treasury) and by the Federal Reserve. The Federal Deposit Insurance Commission also has supervisory responsibilities. Most of the States also operate their own supervisory bodies. There is competition between the agencies, and divided responsibility tends to blunt the authorities' response to crises. The Belgians have a separate banking commission. In the Netherlands, and Italy the Central Bank is the supervisor. The French have a statutory Banking Commission. This is, however, chaired by the Governor of the Banque de France, and serviced by Banque de France staff. It is supported by separate statutory committees, which respectively determine the rules by which supervision should take place, and decide on questions of authorisation and

revocation. In Canada there is a separate regulatory commission. In Japan the work is done by a division of the Ministry of Finance.

51. In all these countries, however, the Central Bank is closely involved in banking supervision, even where it does not actually carry it out or does not have the direct statutory responsibility. This is not surprising given the historical Central Bank responsibility for a sound monetary and financial system and its role as lender of last resort.

52. In the UK, both supervisory and Central Bank roles are performed by the Bank of England.

53. There is a case for separating these roles. There may sometimes be conflicts of interest between the operation of monetary policy on the one hand and banking supervision on the other. It is at least debatable whether these are best settled privately within one institution. There can also be conflicts of interest between the Central Bank's role as a sponsor of the banking industry and its duties as bank supervisor. These factors argue for an element of independence for the supervisors.

54. It is also legitimate to ask whether the Bank is sufficiently accountable, or seen to be sufficiently accountable, for its considerable statutory powers; whether the present arrangements whereby in practice the Banking Supervision Division reports only to the Governors and the Court is right; and whether some separation of banking supervision from other central bank functions could improve accountability, and the status and professionalism of supervision.

55. These would be arguments for establishing a completely new and separate banking supervisory organisation. But, given the established role of the Bank and its staff in banking supervision, the likely benefits of an entirely new arrangement would not seem sufficient to outweigh the loss of continuity and administrative upheaval this would involve. There are in any event some advantages in maintaining reasonably close links between banking supervision and other matters for which the

Bank of England is responsible.

56. There are however attractions in an arrangement under which there was a separate statutory Commission, with a statutory duty of supervision, but chaired by the Governor, and serviced by Bank of England staff. Such a Commission would be given the responsibility for overseeing the work of the Banking Supervision Department. Some members might be full-time staff of the Bank of England, but others would be outside bankers, accountants or lawyers. It would reflect the importance, and might enhance the status of banking supervision. It would bring outside expertise in at the highest level. It should help encourage the development of a professional expertise in banking supervision. It would clarify and bring into the open any conflicts of interest with the other roles of a central bank - which are not best resolved within the Court - providing a more independent voice for the supervisors. At the same time, the Governor's role and the use of Bank of England staff would provide continuity and continued close relations with the 'central bank'. A Commission would also be more readily seen to be publicly accountable. It would perhaps be given a responsibility to submit annual reports to Parliament in the same way as the Chief Registrar of Friendly Societies. The Treasury and Bank are considering further what the detailed constitution and responsibilties of such a Commission might be, including such matters as the appointment of members and the nature of its accountability to Parliament.

57. It is relevant in this context that development of a banking Commission on these lines might pave the way for an eventual merger with the supervision of building societies. The Government has already announced its intention to move in this direction.

58. The Governor has recently announced important changes which represent a step in this direction. A new high level supervisory committee, under the chairmanship of the Deputy Governor, will take responsibility for supervision. Another variant, which would go further but not as far as a Commission, would be to provide specifically in the Bill for a separate Executive

Committee of the Court, or a statutory Governor's Committee, calling on outsiders, to oversee the Supervision Division.

59. It would be an unnecessary administrative upheaval to seek to establish a new organisation for carrying out supervision. But there are attractions in organisational changes that would achieve some separation of banking supervision from the Bank's other responsibilities, and improve its status and accountability. The recent changes in the administration of supervision that the Governor has introduced are welcome. The question now is whether to take the opportunity of legislation to go further. There would seem considerable advantage in working towards the establishment of a Commission on the lines described in paragraph 56 above.

HM TREASURY
October 1985

002/1945

CONFIDENTIAL

ANNEX 1

Banking Supervision : Main Proposals

1. Auditors and supervisors

The consultative document proposes the following as the main elements of the dialogue:-

(a) Regular meetings between supervisors and auditors, with representatives of the bank present.

(b) The supervisors to receive a copy of the "management letter" from the auditor.

(c) Supervisors to receive specific information on request from the auditors, e.g. on control systems and bad debts.

(d) The auditor to have access to any written communications from the supervisors to a bank.

(e) Supervisors to require periodic examination by the auditor of prudential returns.

(f) The supervisors to make ad hoc requests to the auditor for information on particular subjects.

(g) The supervisors or the auditor to be able to initiate bilateral meetings in exceptional circumstances where it would not be appropriate for representatives of the bank to be present.

2. Normally, information required by the supervisors from the auditors will be passed through the bank, which will be represented at meetings between supervisors and the auditor. Occasionally, however, it is possible that the auditors and supervisors will need to have direct bilateral contact, e.g. when one or other is concerned about the quality of the management of the Bank).

3. The Review Committee Report contains two further proposals aimed at keeping up the standard of Bank auditors.

4. First, it is proposed that the Bank should have powers to require a supervised institution to appoint a second firm of accountants to carry out an investigation covering similar ground to a statutory audit. This second firm should be chosen by the bank concerned, subject to the Bank's agreement, at the cost of the supervised institution.

5. Secondly, the Review Committee recommend that in cases of negligence or other serious misconduct by a bank auditor, the Bank should be able to provide evidence to the auditors professional body, to enable it to consider instituting disciplinary proceedings. Such evidence would be subject to strict confidentiality safeguards.

The Bank's powers and the two-tier system

6. Some of the powers given to the Bank by the 1979 Act apply only to LDTs. These are principally:-

(i) LDTs must give the Bank written notice of changes in directors, controllers and managers.

(ii) LDTs have to make available copies of their most recent audited accounts in all their deposit-taking premises.

(iii) The Bank can require information of an LDT; an approved accountant's report on that information; and books and papers.

(iv) The Bank can give directions to licensed institutions constraining the use of misleading advertisements for deposits.

7. The Review Committee proposed that the present two-tier system should be replaced by a single authorisation and that in future the above powers should apply to all authorised institutions. It is further proposed that they are extended as follows:-

(i) The Bank should have power to require information not only exceptionally but on a routine basis. (This stops short of a requirement on authorised institutions to submit timely and accurate statistical returns. Late and inaccurate reporting was a major feature of the JMB case, and I have asked officials also to consider in detail the feasibility of a statutory requirement in this area, with serious penalties for failure to conform.)

(ii) A widening of the Bank's powers to require information of holding companies and subsidiaries, and other persons connected with an institution, as well as from the institution itself.

(iii) Power to place restrictions on the conduct of a business. This would in effect be an indefinite extension of the present power to grant a conditional licence for one year only.

(iv) A power to require an institution to inform the Bank in advance of any prospective change of shareholder control; and possibly a requirement for the Bank's prior consent to be obtained to any merger or takeover. This would effectively be a power to stop mergers and takeovers on prudential grounds.

8. The minimum net assets criterion for authorisation under the new, unitary system should be £1 million.

9. Under the new unitary system all authorised institutions should be entitled to use banking names.

Enforcement

10. The Bank should be given powers, analogous to those of the DTI, to investigate suspected cases of illegal deposit-taking.

Confidentiality

11. The Bank, with the consent of the Treasury, should be able to disclose information to other Government departments (except the Revenue departments) where it considers this to be in the interests of depositors or in the public interest. This is in fact no more than a technical correction to the Banking Act 1979, (although it is clear that it is not seen as such by the banks) which permits the Bank to tell the Treasury in these circumstances, but does not allow it or the Treasury to pass on the information to other departments which might be concerned. It might be, for instance, that a Northern Ireland deposit-taker was in trouble, and that the NIO needed to know. It is easy to imagine similar cases where it would be appropriate to inform the FCO.

Consolidated supervision

12. The Review Committee warn that the relevant Government departments and supervisory authorities should consider carefully the issues raised by the supervision of financial conglomerates.

This work is in hand. It bears directly on our future institutional arrangements between the various supervisors.

Deposit protection

13. The Review Committee recommended that the amount of a protected deposit under the Deposit Protection Scheme should be increased from £10,000 to £20,000 (75 per cent is protected by the scheme).

14. The Committee's recommendation was based on the effects of inflation since the Banking Act was passed, which they calculated would justify an increase to £16,500, and on the desirability of a closer alignment between the arrangements for depositors with banks and that for depositors and investors with building societies who are at present covered up to £30,000 under the societies' voluntary scheme.

15. However, consideration also needs to be given to the 'moral hazard' aspects of any deposit protection scheme, which will have a tendency to undermine the proper responsibilities of, on the one hand, depositors who must choose between institutions on the basis of which of them is able to offer the safer or more profitable arrangement; and on the other, of managers whose responsibility it is to conduct the affairs of a bank so as to avoid losses to depositors. The larger the margin of absolute safety offered by a deposit protection scheme, the greater the distortion of decision-taking in these areas.

16. Moreover, the higher the level of 'insurance' the greater will be the strain on the banking system as a whole of meeting payments under a deposit protection scheme. The failure of a substantial deposit-taking institution could in this way threaten the solvency of other institutions connected only by their obligation to contribute to the deposit-protection scheme. This in turn could make it difficult for the system to allow the collapse of an institution which should otherwise be allowed to fail.

17. Ministers have therefore concluded that the current £10,000 level should be retained for banks and should also be applied to the scheme for building societies.

	France	Germany	Switzerland	US
Supervisory authority	1. Banking Commission*: responsible for monitoring compliance with regulations. No staff of its own - relies on central bank to carry out much of the supervision. 2. Committee on Bank Regulation - technical body to establish regulations, ratios, accounting standards etc. 3. Committee on Credit Institutions* - new licences, technical decisions. * Chaired by Governor of central bank. Governor also sits on COBR.	Federal Banking Supervisory Office, reporting to Ministry of Finance: exercises its functions in close collaboration with central bank. FBSO responsible for detailed regulations ; central bank consulted on appropriate ratios, etc, and collects supervisory data.	Federal Banking Commission (separate from central bank which has no formal supervisory responsibilities) is chief supervisor and licensing authority.	Supervision is divided between: 1 Federal Reserve System 2 Office of the Comptroller of the Currency 3 Federal Deposit Insurance Corporation 4 Various state agencies Majority of banks come under both federal and state supervision.
Legislation	Banking Law 1984 set up single supervisory structure.	Banking Law (last amended 1985) defines scope of supervisory system.	Federal Law Relating to Banks and Savings Banks, implemented via the Banking Ordinance.	Federal Law and individual state regulations.
Entry procedure	Criteria set down in Banking Law, covering capital, proposed activity and quality of management. Authorisations granted by CCI.	FBSO sole authority for authorisation; criteria covering minimum capital, proposed activity and quality of management.	Specific regulations governing minimum capital, proposed activity and management quality.	Minimum requirements for capital; approval of management and proposed activity. May vary according to whether the bank is applying for a national or state charter.
Permitted activities for banks	Banking and financially related activities, including securities, underwriting etc.	Banking and financially related activities. Also non-financial activities, eg capital investment in corporate borrowers etc.	Although not restricted by law, mostly financially related. Large volume of fiduciary business (undertaken at customers' risk).	Generally confined to traditional banking activities. With limited exceptions, banks cannot undertake securities business or engage in insurance or commercial activity (vide Glass-Steagall Act).
Capital adequacy	Minimum risk asset ratio levels set by COBR on an individual bank basis. Endowment capital required for branches.	FBSO, in conjunction with central bank, has established certain "Principles". Under one of these, a bank's loans and participations may not exceed eighteen times capital, calculated on a risk asset basis.	Minimum ratios set down under the risk asset approach. FBC can require higher ratios than banks engaged in international lending.	Federal Reserve regulations require separate ratios to be calculated for primary and total capital (on a gearing type basis): current minimum levels are 5.5% and 6.0% respectively.
Liquidity	COBR empowered to set minimum levels. Short-term ratio requires liquid assets of 60% of 3 month liabilities. Medium and long-term assets limited to three times a bank's savings deposits and capital.	FBSO's Principles also cover liquidity; complex formulae covering short, medium and long term liquidity.	Regulations require minimum liquidity based on two stage structure; a measure of liquid assets against short term liabilities (up to 1 month, plus 15% of savings deposits), and a measure of liquid assets and marketable assets against short term liabilities.	No specific requirements although close reviews are undertaken at the time of examinations.
Large loans	No more than 50% of capital allowed in lending to one customer (does not apply to bank or government guaranteed credits). In addition, total of loans exceeding 25% of capital must not be more than eight times own funds.	Loans to any group of related customers not to exceed 50% of capital. Also limit on aggregate of large loans. Special limit for loans to parties connected with lender.	Large loans limited in a range from 20% of capital for unsecured advances, to 160% of capital for Swiss public sector risk.	15% of capital for federally chartered banks. State limits vary between 10 and 25% of capital, depending on State and security held.
Foreign exchange exposures	Exchange controls exist. Specific authorisation required: maximum levels of exposure set by central bank.	Difference between assets and liabilities in foreign currency not to exceed 30% of capital.	Where total foreign exchange exposure exceeds 40% of capital a bank must inform FBC.	Not subject to regulatory limitation, although they are reported monthly to the federal authorities and reviewed during examination.
Country exposure	No specific limits; regular reporting to the commission.	No specific limits but regular reporting and monitoring.	No specific limits, but regular reporting and monitoring. Auditors required to comment on banks' efforts at evaluating country risk.	Quarterly reporting, and disclosure to the public of large exposures to individual countries. No specific supervisory limit.
Provisions	No minimum requirements, but assessed in the light of overall asset quality.	No minimum requirement, but regular assessment. Increases sought where necessary.	Provisions of 20% required for specified developing and newly industrialised countries.	Asset quality reviewed primarily during examination. Under the Allocated Transfer Risk Reserve requirement, "reserves" must be maintained against country risk credits which are classed as value impaired: minimum 10%, or as directed.
Inspection/ audit	On-site inspections by central bank (for a normal bank, every 4/5 years). Commission can refuse appointment of auditors.	FBSO entitled to inspect, with or without particular cause. Inspections take place periodically by public auditors. Auditors appointed by the bank must submit their report to FBSO.	Independent bank auditors are approved by and act as agents for the FBC: they examine compliance with regulations, and the form of their reports follow a guidance note issued by FBC.	Comprehensive on-site examination: for chartered banks this takes place at least once every three years. Also, limited interim examinations. Supervisory authorities tend to rely on their own examinations rather than on external auditors.

NB This matrix has been prepared on the basis of up-to-date information but in a highly simplified form. Some of the simple entries in the table need substantial expansion in order to permit sound comparisons between countries to be made.