

10 DOWNING STREET

Prime Minister

Received too late for me to  
read I'm afraid.

Treasury tell me there are  
one or two points still to be settled.

If you have time I suggest you  
read chapter 1.

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Agree to circulate, but  
say you may have comments when  
you have had an opportunity to  
consider it further?

The tone doesn't  
match the renewed  
frankness of the situation. It doesn't  
increase one's confidence in the new arrangements.  
JRS  
29/11

CONFIDENTIAL



BF

// Await P/U comments

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

29 November 1985

David Norgrove Esq  
10 Downing Street  
London SW1

Dear David

**WHITE PAPER ON BANKING SUPERVISION**

I wrote to you on 20 November setting out the timetable for the White Paper on Banking Supervision. I now enclose the draft White Paper. Subject to the Prime Minister's views, the Chancellor intends to circulate this to colleagues on E Committee on Monday. The main points are summarised in the introduction and summary (Chapter 1). The Chancellor will also write a personal foreword for the White Paper and plans to show the text to the Prime Minister next week.

In Folder attached.

As recorded in your letter to me, the Chancellor was asked to report back on two points discussed at the Prime Minister's meeting on 28 October:

(1) The role of bank auditors

As the Prime Minister knows, this is a key area. Our detailed proposals are in Chapter 9 and Appendix 4 of the White Paper.

The Bank of England and the Head of the Government Accountancy Service have made very considerable progress towards reaching agreement in exploratory talks with representatives of the auditing profession and the banks, on the basis of the draft guidance note, reproduced as Appendix 4. These proposals do, however, raise points of principle both for the auditors and the banks, so that extended consultation will be necessary on the basis of the White Paper. But the Prime Minister may like to know that the British Bankers Association, in their representations to the Bank of England, accepted that there could be exceptional circumstances where it would be right for the auditor to approach the supervisor directly, without the knowledge of his client.



The Chancellor hopes that agreement will be reached on a code of practice like that in Appendix 4. This could be issued by the Bank of England with the agreement of the auditing bodies and the banks. It would be supported by minimal statutory provision, to put beyond doubt the auditors and the supervisors' ability to disclose information to each other, and to give qualified legal immunity to such contacts.

If agreement could not be reached on a voluntary code, more extensive legislation would have to be considered.

**(ii) Board of Banking Supervision**

The Prime Minister also asked the Chancellor to discuss further with the Governor his proposal for a Banking Commission. The Chancellor and the Governor have now agreed on a statutory Board of Banking Supervision within the Bank of England, which would advise the Governor. The proposed terms of reference and arrangements for the Board are set out in paragraphs 5.5 to 5.8 of the White Paper. The Chancellor is satisfied that these proposals will secure an independent input at the highest level from experienced commercial bankers into the supervisory process.

I am copying this to John Bartlett (Bank of England).

*Yours ever  
Rachel*

RACHEL LOMAX

BANKING SUPERVISION

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## 1. Introduction and Summary

1.1 The system of banking supervision that has been developed in the United Kingdom has served the nation well.

1.2 But changes are needed. The system of supervision must be adapted in the light of developments in banking and across the whole financial services sector. Moreover after six years in operation, the Banking Act is due for review. A number of deficiencies, some minor and technical, others more significant, have already become apparent. And the lessons learnt from the Johnson Matthey Bankers affair in Autumn 1984 have added urgency to the need for the reform of banking supervision and its statutory framework.

*Have they been fully learnt*

1.3 In the light of these considerations, the Chancellor of the Exchequer set up a Committee under the chairmanship of the Governor of the Bank of England, to consider the system of banking supervision. The Government have now considered the recommendations in the Committee's report (Cmnd 9550). This White Paper sets out the Government's proposals.

1.4 The Banking Act 1979 provides the present statutory framework for the authorisation of deposit-taking businesses. It makes the Bank of England responsible for authorising and supervising them. The Act does not cover specialist institutions such as building societies, and credit unions, which are regulated under separate legislation.

1.5 The main proposals for change are as follows:

(i) A Board of Banking Supervision

The Government propose to provide in statute for a new Bank of England Board of Banking Supervision to assist the Governor in his banking supervisory responsibilities. This will bring independent commercial banking experience to bear on banking supervisory decisions at the highest level. (Chapter 5)

(ii) The Banking Supervision Division of the Bank of England

Important improvements in the organisation of supervision, for which legislation is not required, are being introduced. In particular, steps are being taken to improve the commercial banking and accountancy expertise of the supervisors, by training and by a programme of inward and outward secondments. (Chapter 6)

*This says that  
they were really  
rather bad - if  
that is so - why?*

(iii) **The coverage of banking supervision**

The basis of the 1979 Act is the protection of depositors, and the supervision of deposit-taking businesses. This will also be the basis of the new banking supervision legislation. But in order to ensure that it can be adapted to cope with changes in banks and banking techniques, the Government propose that the new Act should permit amendment by secondary legislation of the definitions of "deposit" and "deposit-taking business". (Chapter 4)

(iv) **The two-tier system**

Under the 1979 Act authorisation and supervisory powers are based on a distinction between recognised banks and licensed deposit-taking institutions. The Government propose that all authorised institutions should be subject to the same criteria for authorisation, and to the same supervisory powers. (Chapter 7)

(v) **Banking names**

In the light of representations, the Government propose that the use



of names including the word "bank" be confined to institutions with at least £5m paid-up equity capital. Chapter 7)

(vi) **Inspection of banks**

The Government have considered establishing a banking inspectorate, on the lines followed in some other countries, but have concluded that it would be more effective to strengthen the Bank's existing statutory powers and resources. The Bank intend to increase the frequency of supervisory visits to banks, both where the Bank have prudential concerns and on a routine basis. (Chapters 6 and 10)

(vii) **The role of bank auditors**

The absence of routine inspection adds importance to the relationship between supervisors and auditors. Statutory provision will be made for increased co-operation and discussion between supervisors and auditors of authorised institutions. (Chapter 8 and Appendix 4).

(viii) **Supervisory information and statistics**

Routine statistical returns and other supervisory information are at present provided to the supervisors on a voluntary basis. The Government intend to create a new criminal offence of recklessly or knowingly misleading the supervisor. This would apply equally to information provided voluntarily and under statute. Breach of information requirements will also be seen as a warning sign, requiring close investigation by the supervisors. It is also proposed to extend to all authorised institutions the Bank's present power to require information; and to cover routine submission of supervisory information. Failure to comply would expose banks to criminal sanctions. (Chapter 9)

*Has the Bank advised? And the 2nd Channel*

(ix) **Individual large exposures**

Such exposures have proved to be of particular importance in recent bank failures, in the UK and overseas. The Government therefore propose to provide in statute for the notification of such exposures to the supervisor. (Chapter 10.)

1.6 These and other proposed changes are described in more detail in this White Paper. A summary of other, minor changes appears in Annex 1.

## 2. The background

2.1 The environment in which financial institutions operate has in recent years been subject to widespread and rapid change, both in the UK and abroad. Banks have discovered new opportunities. But there are also new risks. The legislative framework must keep pace.

2.2 The number of banks operating in the UK has increased rapidly over the last decade. There are now some six hundred recognised banks and licensed deposit-takers. The number of representative offices of overseas banks has also been increasing. The range and complexity of services offered to the public and to corporate customers has grown. New instruments and markets are constantly being devised. Competitive pressures are intense.

2.3 Banking legislation will complement other measures designed to bring the statutory framework of supervision up to date. The Building Societies Bill, currently before Parliament, provides for the gradual extension of the powers available to building societies, and strengthened prudential powers to be exercised by a new Building Societies Commission. The Financial Services Bill provides for a new statutory framework, based on self-regulation, for a range of investment, securities and insurance businesses. The Government believe that these measures will provide for effective but flexible supervision of rapidly changing markets.

2.4 Other countries face similar changes. Some have recently brought their banking supervision up to date, or are planning to do so. These include Germany, France, Italy and the United

States. Annex 2 to this White Paper provides a brief analysis of practice in a representative group of countries. Supervisors in all countries have similar objectives, though their means of pursuing them naturally vary with local conditions, and the historical development of their banking, auditing and legal systems.

2.5 As noted earlier, the Bank of England is responsible for banking supervision in the UK. Foreign arrangements vary. Swiss supervision is conducted by the Federal Banking Commission, which is separate from the Central Bank. In Germany, the Federal Banking Supervisory Office reports to the Ministry of Finance. It is responsible for detailed regulation, but works closely with the Bundesbank. In the United States, different categories of banks are supervised respectively by the Comptroller of the Currency (part of the US Treasury) and by the Federal Reserve. The Federal Deposit Insurance Corporation also has supervisory responsibilities. Most of the individual States also have their own supervisory bodies. In the Netherlands and Italy the Central Bank is the supervisor. In Belgium there is a separate banking Commission. In France too there is a statutory Banking Commission, which is chaired by the Governor of the Banque de France, and serviced by Banque de France staff. In Canada there is a separate regulatory commission. In Japan the work is done by a division of the Ministry of Finance.

2.6 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), reflecting the historical Central Bank responsibility for a sound monetary and financial system.

2.7 Financial markets are becoming ever more international, aided by technological advances and the growing removal of artificial impediments such as exchange controls. There have been corresponding developments in co-operation between banking supervisors internationally. In modern circumstances, no national banking supervisory system can be effective in isolation.

2.8 The United Kingdom has played a leading part in these contacts. The banking supervisors of the Group of 10 countries<sup>1</sup> plus Luxembourg meet regularly in Basle, under the chairmanship of the Bank of England. The Basle Supervisors Committee met first in 1975. It seeks to encourage the gradual convergence of supervisory standards, for example in relation to the capital adequacy of banks. It has also aided co-operation between national supervisory authorities by promoting the development of supervisory policies, improving personal contacts, and thus helping in the resolution of specific problems. One of its main achievements has been agreement on the Concordat, revised in 1983, which sets out the principles for determining the shared supervisory responsibilities for banks' international establishments.

<sup>1</sup> The United States, United Kingdom, Japan, Germany, France, Italy, Belgium, Netherlands, Sweden, Switzerland, Canada. (The name "Group of 10" has been retained, even though with Switzerland the group now contains eleven countries.)

2.9 Within the European Community Member States' banking systems vary widely. Nevertheless, the first Credit Institutions Directive (1977) provides an outline framework for authorisation throughout the Community as a step towards a common market in banking services. The Banking Act 1979 implemented this Directive for the United Kingdom. The Consolidated Supervision Directive (1983) provides for groups headed by a bank to be supervised on a consolidated basis.

No further PM comments on remainder of draft, which has been removed from the file and destroyed. Copies will be available elsewhere.

Wayland

9 January 2014