

PRIME MINISTER

DRAFT WHITE PAPER ON BANKING SUPERVISION

You have already commented that the draft White Paper starts in too complacent a way and I have told the Treasury this. They are looking at the opening paragraphs and say that the Chancellor's foreword ^{will} ~~would~~ also help to create the right initial impression. The foreword will come to you for urgent approval on Monday.

In the document itself, I suggest you need read only paragraphs 8.2 - 8.7. These discuss the relationship between auditors, supervisors and clients. This was the main area, aside from the Banking Commission, which was left to be sorted out after your meeting.

A note giving Policy Unit comments is below.

I suggest the following comments to the Treasury:

I think that would be too much.
i) Refer again to the need to make the opening of the White Paper less complacent-sounding;

✓ ii) Businesses with low capitalisation will also be expected to have adequate sub-division of duties and internal controls (paragraph 7.14);

✓ iii) The definition of "an individual customer" will need very careful consideration (paragraph 10.4).

✓ It would also be worth asking the Treasury to confirm that they are confident that the institutional arrangements now being put in place for supervision of banks, financial institutions etc. are comprehensive - that there are no gaps through which particular kinds of activity or business can fall; and secondly that for every kind of institution it will be possible to point to an individual or a body which will have, and will feel, a firm responsibility for monitoring and

regulating it. (Who for example under the new system would have been responsible for spotting and doing something about the problems in the tin market before they reached the present awful position?).

JW

David Norgrove

David Norgrove
5 December 1985

CONFIDENTIAL

4 December 1985

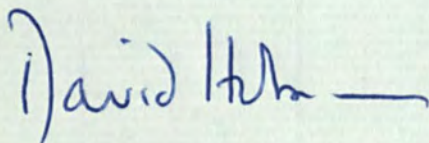
MR NORGROVE

DRAFT WHITE PAPER ON BANKING SUPERVISION

We feel that the document suffers from a degree of blandness, and that the drafting needs to be tightened in a number of places.

We suggest that there should be a reference in the opening paragraphs to the need for the banking supervisory system to be effective in the light of the expected changes in the City ("Big Bang" and Financial Services Bill) and indicating that the proposed improvements have been planned with this end in view.

A memorandum of detailed comments is attached. Particular attention is directed to paragraphs 1.5(vii), 7.14, 10.4 and 12.7.

A handwritten signature in blue ink that reads "David Hobson" followed by a horizontal line.

DAVID HOBSON

CONFIDENTIAL

3 December 1985

c David Willetts

BRIAN GRIFFITHS

DRAFT WHITE PAPER ON BANKING SUPERVISION

This is much better than the earlier material which was circulated.

Auditors

The argument here is likely to centre on the need for bilateral exchanges between supervisors and the auditor, as opposed to trilateral exchanges when the bank client is in the picture and may also be present. The profession is likely to doubt whether a requirement for bilateral exchanges is necessary, having regard to the possibility - referred to in Annex 4c(ii) - of bringing in a third party, such as a non-executive director. No-one likes such requirements, as they tend to undermine the relationship between auditor and client, and open up opportunities for further limitations on professional confidentiality. Some would think this a slippery slope.

Ministers are said to want the provision, so perhaps it should be left in the White Paper so that we can see what happens. It has been rendered as innocuous as possible, if it is necessary to break the confidentiality principle.

Board of Banking Supervision

This follows the Policy Unit views, and is welcome.

Other Points

1.1/1.2: Rather feeble as an introduction. It leaves the implication that more deficiencies will become apparent; it is not clear where.

1.5 (i)&(ii): The new Board has a sensible rôle, laid down in Chapter 5. The supervision division was poorly staffed and badly managed, and can no doubt do with a shake-up.

1.5 (vii): I doubt whether "the absence of routine inspection" matters. Bank of England supervisory clerks inspecting banks' books as a matter of routine are not needed. The point to be made should be that there is a need for communication between supervisors and auditors which appears to be precluded under current legislation. This communication is likely to improve the quality of both supervision and audit.

1.5 (viii): The new criminal offence seems to follow Section 393 of the Companies Act 1985, which deals with "knowingly or recklessly misleading an auditor". It was originally introduced in the Companies Act 1976.

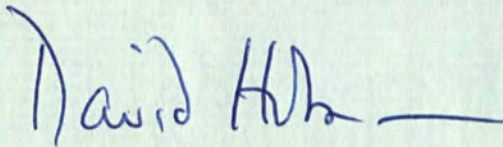
6.2: This certainly suggests that the right hand did not know what the left hand was doing, and that no-one could see the wood for the trees. Hopefully the new arrangements (6.3 to 6.5) will help to improve matters.

7.14: Do we need to wait until some more outfits go bust before increasing the minimum capital? Small financial institutions sound fine as being in line with Government policy of encouraging small business, but few with capital as low as £1 million will have sufficient staff to provide adequate sub-division of duties and internal control. Unless they can meet this requirement, they should be merged or closed down. This needs to be brought out in the document, as we don't want to have to experience further failures.

10.4: It is not clear what constitutes an "exposure to an individual customer". It seems that JMB may not have appreciated the inter-relationship between various exposures

to related parties. Careful definition of what constitutes "an individual customer" will be needed if it is intended to embrace related parties beyond a parent/subsidiary relationship.

12.7: The facilities for interchange of information between supervisory bodies are likely to be useful, but one question is left unanswered: where, in dealing with financial conglomerates, is the ultimate supervision to be exercised - the Bank, the SIB, an SRO, or elsewhere? Unless this is clear, buck-passing and indecisiveness may be the order of the day.

A handwritten signature in blue ink that reads "David Hobson" followed by a horizontal line.

DAVID HOBSON