

## Supervision of the United Kingdom Banking System\*

An area in which there have been significant changes in Bank of England operations over recent years has been in the supervision of banks and related institutions in the United Kingdom. In its Memorandum to recent meetings of the House of Commons Select Committee on Nationalised Industries, the Bank of England maintained that the "basic principles" of its "prudential supervision of the banking system remained unchanged, but the intensity of its application was increased and there was a consequent adaptation of the organisational structure within the Bank." Also, the Bank extended its supervision "to cover all the significant deposit-takers outside the banking system not otherwise supervised." This was reaffirmed by the Governor of the Bank of England in his oral evidence, though he did allow that there had been "important changes".

Reference was also made to a paper prepared by Mr. George Blunden on "The supervision of the U.K. banking system" (published in the Bank of England *Quarterly Bulletin*, June 1975), in which Mr. Blunden points out that the system of banking supervision in the United Kingdom "just evolved naturally". There were at that time virtually no statutory powers — powers to issue directives to banks given by the *Bank of England Act 1946* "have never been exercised and, if ever exercised, would be used only for special situations; they would not be suitable as a basis for day-to-day continuing super-

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\* During 1976, assisted by the Author as a Specialist Adviser, the House of Commons Select Committee on Nationalised Industries, Sub-Committee C examined certain of the activities of the Bank of England. See *Seventh Report from the Select Committee on Nationalised Industries*, Report, together with Minutes of Proceedings of the Committee, Minutes of Evidence and Appendices, Session 1975-1976, *The Bank of England*, House of Commons No. 672. The quotations that appear below are either from documents or from evidence submitted and cross-examination of witnesses, as indicated.

vision." There are, however, a number of statutes affecting banks — such as the *Exchange Control Act 1947* — but these refer to specific activities and, in effect, the relevant Acts recognise the organisations concerned as 'banks' for these specific purposes. Banks that are listed for these several purposes form the basis for the Bank of England's own list of "statistical banks where figures are included in the comprehensive systems of banking sector statistics". Hence, it has heretofore never been possible "for the Bank to impose supervision on organisations arbitrarily to meet our own wishes". There was always the need "for an obvious cause acceptable to the supervised to justify any extension of our supervision." Thus, both the discount houses and the merchants banks accepted the necessity of supervision in the first case in order to enjoy lender of last resort facilities and, in the second, so that their acceptances might be discounted at the Bank of England. Acceptance of wider responsibilities was gradual and was "in response to market requirements or to events." The only legislation in prospect that may modify these arrangements is that adumbrated in the White Paper on "The Licensing and Supervision of Deposit-Taking Institutions", which provides for the licensing of banking institutions.

The essential characteristics of Bank of England supervision were four in number:

- (i) It was flexible; there was never any attempt to require banks to conform to rigid patterns. This was partly a consequence of absence of legislative sanction, but it also permitted the Bank to accommodate the fact that "each bank is a unique institution which must be judged individually".
- (ii) There must be a personal ingredient in judging "the quality and reputation of management and, where appropriate, of ownership." To this end, the number of Bank staff involved has been deliberately kept small and every effort is made to ensure a degree of continuity in this work. The staff "have thus been able to establish friendly, personal relationships over time with senior management in the banks which have helped the Bank to form effective assessments of them and have enabled them to talk to us with trust and confidence."
- (iii) There is provision for "progression", such that, on its way to becoming "a bank of the highest quality", an institution will be subject to "a series of recognitions". These may be both formal and informal — the first as a formal recognition under relevant

legislation; the second would include membership of associations, eligibility for discount of bills, and having an account at the Bank of England.

(iv) The system of supervision has been "participative" in the sense that, in assisting a bank, account will be taken of opinions held about it by other banks and of the recognitions given to it by other banks; also in the absence of legislative sanction, the Bank's supervision had to be voluntarily accepted by the banks concerned.

As already indicated, developments over recent years led to an "intensification" of the Bank's involvement in supervision. (1) There had been a great increase in the number of banks in London — from 200 in 1960 to something over 300 by 1975 (branches of foreign banks, subsidiaries, consortium banks, and — in the domestic sector — a rapid growth of 'secondary banks' made possible by the existence of the sterling inter-bank market). (2) An important associated problem derived from the nature of the new wholesale markets in sterling and in Euro-currencies; institutions were thereby enabled to obtain funds for onward lending "on a scale previously quite impossible for them". As a result, "sickness in one bank could rapidly develop into an epidemic affecting a whole range of banks". The collapse of the property market in late 1973 meant that "some of these newly-developed lending books in sterling became of doubtful quality and very illiquid; lenders on the wholesale markets suddenly withdrew the deposits which had financed these lending books"; there was a real chance of an epidemic developing that would affect the whole system. Indeed, it was this that led the Bank to review during 1974 its methods of support and supervision, also the range of institutions coming within its purview. (3) Again, during 1974, there was a number of serious losses suffered by banks in different countries operating in the foreign exchange and Euro-currency wholesale markets, with essentially similar repercussions. (4) There was a growing sensitivity about the protection of depositors. As a result, the Bank of England began to take a closer interest in institutions "low down on the ladder of recognitions". (5) Following Britain's entry into the European Economic Community, there was a discussion of how to harmonise the United Kingdom's approach to supervision with that of her partner countries.

Organisational changes were made to cope with the increased work load. The Discount Office in the Cashier's Department was

replaced by a new Banking Supervision Division in the charge of a Deputy Chief Cashier with a more senior official with the rank of Head of Department appointed to carry the main responsibility for banking supervision. The staff assigned to the tasks of supervision, which had numbered 18 in 1969, increased to 48 by 1975.

This led, too, to "the need for more frequent and more comprehensive information about the banks" for which the Bank of England had acknowledged a degree of responsibility. Previously, they had relied on an annual discussion about the affairs of each bank, based on its annual balance sheet. From September 1974, supervision was based on quarterly — sometimes more frequent — analyses of the returns submitted by banks for statistical purposes, supplemented by special new returns to provide extra information for supervisory purposes. These analyses were then discussed with directors or senior managers. The system was also applied to a wide range of finance houses and other deposit-taking companies (55 in all), which because they were not recognised as banks were formerly not covered by the Bank's supervisory network. As a result, all significant non-bank deposit-takers registered in the United Kingdom were now subject to prudential supervision by the Bank of England.

Separate arrangements were made for the London and Scottish Clearing Banks. Prudential examinations were now conducted in greater detail than previously on the basis of arrangements and principles worked out with the Clearing Banks in 1975 (see "The capital and liquidity adequacy of banks" in *Bank of England Quarterly Bulletin*, September 1975). Annual discussions would be held with each Clearing Bank about its position. "Such discussions will have particular reference to profitability, capital adequacy and liquidity, but could cover also other aspects of a bank's business." Although it was further agreed that in the case of groups discussions should be based in the first place on consolidated accounts rather than those of individual companies, it remained important that subsidiary companies should be seen to possess capital and liquidity appropriate to the business in which they were engaged; they should not appear to trade solely on the reputation and resources of their parent company or of the group. There was also a case for discussing their business with the managements of the subsidiary banking companies.

During 1974, financial markets throughout the world came under pressure as a result of large imbalances in international payments

due to the unprecedented rate of inflation that was experienced in a large number of countries and to the steep rise in oil prices. In addition, market operations had to be carried out within the relatively new framework of floating exchange rates and, in a number of instances, serious foreign exchange losses were incurred. In these circumstances, the Bank of England thought "it would be prudent to clarify the responsibilities of parent banks in respect of their subsidiaries or affiliates operating internationally, and to extend international co-operation in supervision." So far as the United Kingdom was concerned, the Bank sought — in the autumn of 1974 — from all overseas banks with wholly owned subsidiaries in London, or with significant shareholdings in joint venture banks registered there, "an acknowledgment of their moral responsibility to support those banks in any difficulties." By early 1975, satisfactory undertakings had been received from all the banks concerned. At the same time, the Bank wrote to all authorised banks in London reminding them of the dangers that could arise from unsatisfactory control of dealings in foreign exchange and suggested measures to strengthen further their internal administrative procedures. These were adopted by most banks and, in these ways, Bank action helped to restore confidence.

In collaboration with other national banking supervisory authorities and under the aegis of the Governors of the Central Banks of the Group of Ten countries an international committee of bank supervisors was set up in Basle towards the end of 1974 "to foster co-operation, mutual confidence, understanding, and some harmonisation of practices among supervisory authorities in the member countries", thereby assisting to promote sound development of the international banking system. The Bank of England provided the first Chairman of this Committee on Banking Regulations and Supervisory Practices (see George Blunden, "Control of the foreign operations of banks: banking supervision", being a paper delivered to the Société Universitaire Européenne de Recherches Financières (SUERF) Colloquium, meeting in Brussels, April 28 to May 1, 1976). This followed the initiative already taken by the E.E.C. Commission in working towards some degree of harmonisation of existing national banking systems. Furthermore, the setting up of the new Committee facilitated an important extension of the discussion beyond purely domestic frontiers to which traditionally banking supervision had previously been confined. It was also a recognition that the largest banks now often operated in a number of countries and thereby had developed an international

exposure that made them vulnerable beyond the area within which their own national supervisory system was able to cope. What the new Committee will help to provide will be an early warning system based on national reporting and calculated to pinpoint banking difficulties likely to have international repercussions.

Another area in which there had been developments in anticipation of British entry into the European Economic Community concerned bank mergers and participations. Thus, in November 1972, the Bank of England indicated that "they would no longer object in principle" to Clearing Banks acquiring holdings of more than 25 per cent in the capital of accepting houses and that they would be prepared to treat other E.E.C. banks in the same way as other British banks. Any plans for mergers or participations are drawn at an early stage to the attention of the Treasury and the Department of Trade "so that the application of the provisions of the Monopolies and Mergers Act 1965 to any proposals for participations in excess of 15% may be handled efficiently." In this context, it was felt that the consumer was still served by a sufficiently wide variety of banking outlets. Since the Select Committee last reported in 1970, it was true that the number of Clearing Banks had fallen, "but other outlets selling credit have increased."

It was this relatively informal system of supervision that the Governor of the Bank of England defended in oral examination. As he said: "The Bank has been accepted by long historical tradition as the supervisory body." He did not feel that "we would have any greater authority than we now have if we had a statute behind us." While he would be content to see "the basis of the system resting on a statute", he would be "very unhappy indeed if the details of the system were a matter of rules and regulations laid down by statute." He sought to maintain a system, which rested very much on co-operation and which was flexible. "Under the present system the banks come to us early on with their problems and we can act in those circumstances on an individual basis and talk with management and suggest the appropriate course of action." But it was less informal than previously, since "regular and frequent information" was now obtained from the banks, but this was supplemented by asking "very pointed questions about the methods they adopt in the conduct of their business." In general terms, too, representatives of the Clearing Banks favoured the relatively informal and flexible system of supervision operated by the Bank of England, which was

"a great deal better than we see in other countries" and was "much less rigid".

Against the background of the supervisory functions of the Bank of England, it is appropriate to consider the support operations mounted by the Bank of England towards the end of 1973, when "a number of deposit-taking institutions experienced pressure on their liquidity and found themselves in danger of being unable to meet a persistent withdrawal of deposits." Not all these institutions were recognised banks, but "to contain the spread of loss of confidence, the Bank took action to protect the interests of depositors by establishing, in conjunction with the London and Scottish Clearing Banks, a standing Control Committee to support those institutions under pressure where it seemed possible and justifiable to do so." The problems were largely due to the fall in property values which badly affected the property companies, to which many secondary banks had lent on the basis of large deposits borrowed through the wholesale market. As indicated in the Bank's Memorandum to the Select Committee, some of the institutions that received support in 1974 ran down their lending books and sufficiently recovered their deposit-taking capability to enable them to become independent of support. A number of others "embarked on programmes of re-organisation to help them adjust to the changed climate and the Control Committee has been closely concerned in these re-organisation plans." A few failed to avoid receivership or liquidation, "but in virtually all cases where any degree of banking recognition was involved the interests of the ordinary depositors have been fully protected." Furthermore, it was thought that the development of the new supervision arrangements would significantly reduce the possibility of a secondary banking crisis occurring again, largely because the division of responsibility which then existed had been eliminated. "We now have a system whereby we can supervise all the major deposit-taking institutions, and this has been done in agreement with the other authorities."

It remains to consider the White Paper on "The Licensing and Supervision of Deposit-Taking Institutions" (Cmnd. 6584, August 1976) presented to the House of Commons on August 3, 1976. It is on this basis that it is proposed in due course to introduce legislation "providing for a system of prior authorisation for deposit-taking institutions", first adumbrated by the Paymaster General's announcement in the House of Commons on October 29, 1975. The immediate

background to the proposals contained in the White Paper were (1) the problems in the secondary banking sector which came to a head in December 1973; (2) the need for the United Kingdom to conform to its obligations under the EEC's prospective directive on the harmonisation of banking law; and (3) the British Government's commitment to increasing the effectiveness of consumer protection measures generally. The Government believed that "institutions which take deposits from the general public or from the wholesale money markets should be subject to an adequate system of authorisation and supervision, backed by statute where necessary." The building societies and trustee savings banks were already subject to prudential supervision under statute. The primary banking sector was already subject to supervision by the Bank of England. There were, however, other deposit-taking institutions which were not subject at that time to continuing supervision. The proposals in the White Paper were therefore directed to the improvement of those arrangements and, in particular, to the extension of the system to close this gap. The Government were confident that the changes would both provide greater protection for depositors and strengthen the financial system generally.

The White Paper pointed to the need for legislation (which was also to apply to Northern Ireland). It was pointed out that, with certain exceptions (such as building societies), a deposit-taking institution in the United Kingdom requires no licence or other authorisation before it commences business. Nor has there been any statutory regulation of its subsequent performance. Nevertheless, the Bank of England has for many years operated a system of prudential supervision over banks and its supervisory role, though not deriving from specific statutory authority, has long been accepted throughout the primary banking sector. This system has already been described above and it has a number of advantages. For example, the banks are able to adapt to changing circumstances and have not been hampered by the comparative inflexibility which could result from a more formalised regulatory apparatus. Furthermore, it was thought that the customs and conventions of a self-regulatory system were likely to command more willing and effective support in this field than formal rules imposed by law. It was now intended to integrate the proposed new legislation with the existing system of non-statutory prudential supervision of the primary banking sector.

Although there is no comprehensive statutory definition of a

bank in the United Kingdom, institutions have been given specific recognitions as banking undertakings under a variety of statutes and for the limited purpose of each statute, e.g., under the *Exchange Control Act, 1947*. Indeed, under various statutes there had been something of a "proliferation of recognitions — with differing criteria and coverage". This has caused confusion and has made it "difficult for depositors to distinguish between the different categories of deposit-taking institution", not all of which have been subject to continuing supervision by the Bank of England. As already indicated, the events of late 1973 and 1974 had demonstrated these defects and arrangements had to be made to provide support through the "lifeboat" operation to safeguard the deposits of the public "in a large number of cases where deposit-taking institutions ran into difficulties." Again, institutions recognised under Section 123 of the *Companies Act, 1967* "frequently described themselves as banks in promotional material" and the Department of Trade had insufficient powers to supervise them, since the *Protection of Depositors Act, 1963* protected depositors "merely by providing for the publication of accounts in specified forms and by imposing certain not very effective limitations on advertising; it did not provide for the continuing prudential supervision of institutions falling within its scope." It was maintained that this state of affairs "scarcely conformed to the minimum desirable standards of consumer protection." The Government believed these deficiencies should be remedied.

The intention was, as indicated by the Minister of State when outlining the proposals to the Select Committee on Nationalised Industries on July 14, 1976 "to establish what will in fact be a two-tier system". There would be "a smaller ring of institutions"; these would be called "banks" and would be institutions "of the very highest probity and financial standing". Then there would be another group of institutions — the "licensed deposit-takers", which would represent an "outer ring", though there could be movement from one area to the other, i.e., from the outer to the inner ring if companies could show that they should be called "banks".

Under the new system, institutions will only be allowed to carry on the business of taking deposits if they hold a licence granted by the Bank of England. The only exceptions will be those banks that are granted a statutory recognition as a "bank" and which will be exempt; this would include the primary banking sector, i.e., the big Clearing Banks, the leading merchant banks, the discount houses and

many of the foreign banks. Alternatively, a licence would not be required where the institution concerned was already covered by one of the existing statutory schemes (e.g., for the building societies, the trustee savings banks, the National Savings Bank, or the National Giro). At the same time, it was indicated that "the trustee savings banks have recently begun a transformation process which will, over the next few years, enable them to expand progressively their range of banking services." The Government therefore envisaged that they will in due course be brought within the arrangements proposed in the White Paper and at the appropriate stage in their development. The arrangements will also not apply to stockbrokers who are regulated by the Council of the Stock Exchange.

To obtain a licence it would be necessary for the relevant institutions to comply with certain general conditions, which will be laid down in the proposed new legislation and "with published prudential criteria which will be determined by the Bank of England with the agreement of the Treasury." Although the Government has already formed some views about the nature of these criteria, they have preferred not to settle the details "in advance of consultations with those most closely affected".

Nevertheless, the White Paper has provided some degree of guidance. For example, no company will be granted a licence unless its capital and reserves exceed a minimum figure. It was appreciated that it will be necessary to strike a balance in fixing such a figure; it must be high enough to provide sufficient assurance of financial substance; but if it were too high, this would favour the larger institutions and tend to restrict entry. It would also be necessary to satisfy the Bank of England that the management of the relevant institutions is "honest, trustworthy and suitably qualified to undertake the kind of business which they intend to conduct". The Bank of England will furthermore look at the past performance of the relevant institution and will assess whether the institution concerned "is likely to be able to meet the standards of liquidity and solvency appropriate to a deposit-taking institution."

It is further laid down that licensed institutions will have to satisfy the Bank of England that "they continue to meet those criteria and conform to the required standards in conducting their business." In assessing an institution's business, the Bank will examine "appropriate balance sheet relationships and ratios" relating to the capital adequacy and liquidity of the institution concerned, the degree of risk

attaching to various assets, the matching of liabilities and assets in both sterling and other currencies, the reliance placed on deposits from connected companies and the institution's lending to connected organisations, the distribution of its lending among economic sectors, and the provisions and profits that have been made. "This information will be interpreted flexibly taking account of the particular circumstances of each institution." The Bank may attach further conditions to the granting and renewal of licences covering such matters as the appointment of directors or management, and the injection of extra capital. They will be able to revoke or suspend a licence, "if they consider that the company no longer meets the standards required of a deposit-taking institution." There will be "a right of appeal to the Treasury against the refusal or revocation of a licence", though as one arm of the 'monetary authorities' perhaps the Treasury is not to be regarded as a completely disinterested body. It should be noted that appeals will be subject to a statutory inquiry within the meaning of the *Tribunals and Inquiries Act, 1971*. In this context, it might be argued that some consideration be given to the setting up of an appeal tribunal separate from the Treasury and under independent chairmanship, served perhaps by a secretariat also independent of Bank and Treasury, though necessarily possessing relevant expertise. Ideally, any such tribunal should be small (not less than three and not more than five members) and comprised of persons with some spread of economic interests, including experience of banking matters, with (say) a judge as chairman.

Similarly, where exemption from the licensing provisions of the proposed Act is granted to a "recognised" institution, exacting criteria relating to minimum capital and reserves, the type or range of banking services required to be provided, and the reputation or status needed will be determined by the Bank of England with the agreement of the Treasury and will be published. It was anticipated that most of the institutions comprising the present primary banking sector would qualify for such recognition. However, the existing arrangements for their supervision (as already outlined above) would remain unchanged. Again, there would be a right of appeal to the Treasury against the refusal or revocation of this recognition.

Only "recognised" banks — and the National Savings Bank and the trustee savings banks — will be permitted to use the word "bank" in their name and to describe themselves as banks, or "as carrying on the business of banking". Licensed institutions will not.

It is proposed, too, that regulations will be issued by the Treasury in consultation with the Bank of England under the proposed new legislation "governing the content and form of advertising for deposits", thereby strengthening existing provisions under the *Protection of Depositors Act*.

Branches of overseas deposit-taking institutions operating in the United Kingdom will, like deposit-takers incorporated in Britain, need to hold a licence or be recognised as a bank in order to take deposits. The Bank of England will be concerned to ensure that they conform to all appropriate standards in the conduct of their business, but the arrangements for their prudential supervision will remain primarily a matter for the supervisory authorities in their country of origin. Branches of overseas deposit-taking institutions will not be required to have separate endowment capital in the United Kingdom. Branches of overseas deposit-taking institutions with head offices elsewhere in the EEC which are licensed in the United Kingdom may be entitled to use the banking names by which they are known in their country of origin.

Finally, as the White Paper points out:

"In any system of prudential supervision a balance must be struck between ensuring on the one hand that deposit-taking institutions conduct their affairs with an appropriate degree of caution, and on the other that they are free to explore and develop new areas of business which may be profitable not only to the institutions themselves but also valuable to the economy as a whole. No supervisory system can exclude altogether the possibility of an institution finding itself in difficulties."

It is therefore proposed to institute "a mandatory deposit protection fund" to provide the public with an additional safeguard against the loss of deposits. Details have still to be worked out, but it is intended that the fund should relate to "sterling deposits up to £10,000 (or the first £10,000 of larger deposits) with all licensed deposit-takers and recognised banks." The fund is to be administered by the Bank of England. Elsewhere (e.g., in the United States of America, which originated deposit insurance; India and the Lebanon), a separate insurance corporation has been the usual arrangement, though no doubt the moneys and accounts of the proposed "deposit protection fund" will be kept completely separate by the Bank of England. Nevertheless, though the geographic area to be covered is both smaller

and more compact, something like the American Federal Deposit Insurance Corporation might well have been contemplated. Interestingly enough, this was the only area in the White Paper to attract critical comment from the banking industry. Speaking for the big Clearing Banks, Mr. John Montgomery, Chief General Manager of Lloyds Bank and Chairman of the Chief Executive Officers' Committee of the Committee of London Clearing Banks believed "there was no necessity for a deposit insurance scheme for leading financial institutions as the proposed legislation should avoid the recurrence of a secondary banking crisis." The Clearing Banks' argument was that they will be putting money into the fund to underwrite "fringe" institutions, which will be able to raise their deposit rates and attract customers away from the Clearing Banks. These customers could seek out the highest rates secure in the knowledge that they would be rescued if their bank collapsed. The Clearing Banks also pointed out that deposit insurance was not compulsory anywhere else in Europe.<sup>1</sup> Nevertheless, it is believed that the EEC itself is "interested in getting a similar scheme established on a European basis to reduce any prejudice against depositing money with a financial institution in another country of the Community."<sup>2</sup> Also, one would have thought that the large Clearing Banks would be so conscious of the national interest that they would see — and accept with good grace — the need for deposit insurance in a world of uncertainties that could even possibly affect them as well. No man — or institution — is an island. It is also a recognised objective of insurance that one spreads the risk as widely as possible to include institutions of all sizes and all degrees of competence.

The Government believed that these reforms would be widely welcomed within the financial community. "By better protecting the interests of depositors, the new arrangements will increase confidence in the strength of the financial system and help to ensure that it will be able in the future to make an even greater contribution to the national economy." It was hoped to introduce the proposed legislation "as soon as the Parliamentary timetable permits".

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<sup>1</sup> See *The Times*, 4/8/76.

<sup>2</sup> See *Financial Times* leader, 4/8/76.