in association with the Securities and Investments Board

SIB

FINANCIAL STABILITY

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Culture of regulation

Following the Bank of England's Review of Supervision, the Deputy Governor looks at two different views of the relationship between institutions and their supervisors.

Electronic money

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Building society conversions

Many building societies are converting into banks. This will involve changes for them and for their regulators. What are the reasons for this trend, and how should the conversion process be handled?

ISSUE ONE

AUTUMN 1996

Articles published in the Financial Stability Review, whether written by Bank or SIB staff or by outside contributors, are intended to contribute to debate, and are not necessarily statements of Bank or SIB policy. Correspondence and comments on articles are welcome and should be addressed to: The Editor, Financial Stability Review, Bank of England, Threadneedle Street, London EC2R 8AH. Fax: 0171 601 3217

Financial Stability Review aims:

- **to promote the latest thinking on risk, regulation and financial markets**
- **to facilitate discussion of issues that might affect risks to the UK financial system**
- **to provide a forum for debate among practitioners, policy makers and academics**

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From November 1996, copies of the Financial Stability Review may be obtained from the Bank at a cost of £10 for a single issue (£5 for students) and £18 for a year's subscription (£9 for students). An extra charge will be made to overseas subscribers to cover postage. All enquiries regarding subscriptions should be addressed to: Subscriptions, Financial Stability Review, Bank of England, Threadneedle Street, London EC2R 8AH. (Tel: 0171 601 5191.) Back issues will also be available from the same address.

FINANCIAL STABILITY

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Published by
Bank of England
London EC2R 8AH
Telephone: 0171 601 4444

MESSAGE *from the* GOVERNOR *and the* CHAIRMAN OF THE SIB

"Banking is a watchful, but not laborious trade. A banker, even in large business, can feel pretty sure that all his transactions are sound, and yet have much spare mind. A certain part of his time, and a considerable part of his thoughts, he can readily devote to other pursuits."

Walter Bagehot, Lombard Street (1873)

Financial markets have changed a great deal since Bagehot's day. The risks faced by market practitioners have become more complex, and the techniques used to control them more sophisticated. Risk management is no longer a part-time pursuit of gentlemen; taking and managing financial risk is the very essence of the business of banks and securities firms alike. It is their contribution to society. So it is more important than ever for practitioners and regulators to keep abreast of the latest developments.

With that objective in mind, the Bank, in association with the Securities and Investments Board, has decided to launch the *Financial Stability Review*. It will provide a regular forum in which a range of contributors can set out their ideas about risk management, financial regulation, and developments in financial markets. Hitherto, much of the work of the Bank and the SIB on these issues has been carried out behind the scenes. At the same time, public expectations of the financial services industry, and of the regulatory framework that underpins it, are higher than ever. In these circumstances, there is a clear need to ensure that the objectives, and limits, of financial regulation are well understood. We believe that, by placing more of our ideas and research in the public domain, we will be better able to do this. But regulators have no monopoly of wisdom in this area. So the columns of the *Financial Stability Review* will also be open to those in the financial services industry, and other commentators, who have a worthwhile contribution to make.

We hope that you enjoy reading this first issue of the *Financial Stability Review*. We would welcome your views and comments, both on individual articles and on the publication as a whole.

E A J George
Governor of the Bank of England

Sir Andrew Large
Chairman of the Securities and Investments Board

FINANCIAL SECTOR ISSUES

In different ways, two features of recent financial sector developments provide an opportunity for reflection on the role of senior management in maintaining wider financial stability. The banking cycle has reached a critical point for key strategic decisions about credit risk and its pricing. And recent irregularities in two fund management firms have underlined the importance of effective management controls and a culture of compliance. Below, we discuss these two issues and the way in which current regulatory thinking is developing in relation to management accountability. We also look at recent developments in UK payments systems, where progress is being made in reducing systemic risk.

A new credit cycle

The half-yearly results of the major clearing banks remain one of the main indicators of the performance of the UK financial sector. The most recent figures suggest that the banks are in good shape. They are strongly capitalised and, on that basis, well placed to expand their lending. But it is just at this point in the cycle that an over-expansion of lending can create problems for the future.

There are two distinct elements in the banking cycle. On the one hand, banks' fortunes are connected to the wider economy. When the economy is buoyant, there is strong demand for loans and borrowers are less likely to default. Conversely, in a recession, demand for credit is weaker and the value of a loan book is likely to be reduced by an increasing proportion of bad debts.

Banks can exacerbate this underlying cyclical pattern through their lending and pricing decisions. It has often been the case that, in periods of economic growth, banks have concentrated on expansion of the balance sheet. With a combination of optimism about the economic future and competitive pressure to maintain market share, rigorous credit assessment often takes second place. This leads to imprudent loans being booked during the upturn, so that subsequent problems are more severe than they need be.

The latest set of clearing bank results suggests that just such a critical stage in the banking cycle has been reached. The economic upturn in the United Kingdom has been under way for some time. On top of that, bad debt provisions, in many cases against loans made before the previous downturn, have progressively declined so that we are now probably at the bottom of the provisioning cycle.

The challenge for senior management is clear. Their institutions have the means and the business case to expand their lending. But new business is worth booking only if it is good business. When expansion is the priority and the economic climate is favourable, the warnings of the credit assessment function will often appear unduly obstructive.

In the United States, for example, where the banking cycle is somewhat further advanced, bad debt write-offs on loans to individuals have already begun to rise despite a

Individual employees … deal in sums of money which, if lost, could be material to the firm and its depositors or investors

continuing recovery. It is up to senior management to ensure that credit officers are not ignored in the rush for new business.

'Riskless' business?

The UK group Robert Fleming was fined recently and ordered to pay compensation for the actions of a fund manager working for Jardine Fleming Investment Management, a Hong Kong associate. A few days later, trading was suspended in three collective investment schemes managed by Morgan Grenfell Asset Management. These two events are important for those with responsibility for the protection of investors, depositors and markets; they also raise a number of more general issues which are relevant to the whole financial sector.

First, the cases again illustrate the need for directors of firms to ensure that their compliance and internal monitoring systems are set up to a sufficiently robust standard and operate properly. Individual employees of financial firms are often given considerable discretion to act on behalf of their firms, and to deal in sums of money which, if lost, could be material to the firm and to its depositors or investors.

Regulators have a role in monitoring firms to ensure that controls are adequate. But this does not remove the responsibility of the senior management of financial firms to ensure that failures of systems and controls do not occur. The trustees or other parties charged with looking after collective investment schemes must also satisfy themselves about the systems of the fund management firm.

Second, these cases underline the extent to which functional and national boundaries are being eroded in the financial industry. The Jardine Fleming case involved the Hong Kong associate of a UK financial group, while the Morgan Grenfell case involved the fund management subsidiary of a UK group (owned by a German bank) which had invested on markets regulated by the Securities and Exchange Commission in the United States.

In such cases, effective regulation requires there to be clear division of responsibilities between regulators and well established arrangements for sharing information across jurisdictions. This is discussed in greater detail in the article on 'International Regulatory Co-operation' on pages 44-50.

Third, these problems grew up in an area of financial activity which is regarded as less risky than conventional banking or securities business. As fund management does not usually involve a firm in taking proprietary positions, regulatory capital requirements are typically small for this kind of business. However, this does not mean that these kinds of businesses are free of operational or legal risks.

The large value of funds under management may mean that, in cases of fraud or negligence, there is a risk of losses on a scale much larger than the financial resources of the fund manager itself.

Last, the two cases show that when firms are members of larger groups, the market standing and good name of an entire financial group can be put at risk by the activities of one part. In the case of Morgan Grenfell, Deutsche Bank decided that the potential loss of reputation was significant enough to make it worthwhile to commit to cover investors' losses.

This 'reputational risk', which can arise in respect of agency activities as well as an institution's proprietary business, can lead to substantial calls on capital.

Individual accountability

The Securities and Futures Authority recently issued a consultative document which proposes that the senior executive officers of financial institutions should be required to ensure that all employees act to avoid serious damage to the firm. Penalties could be imposed on senior management for general control inadequacies rather than specific failures of day-to-day management.

This proposal can be seen as part of a wider discussion on the personal accountability of the senior management of financial institutions. The Bank of England, for example, recently wrote to all banks to require that their key supervisory returns be signed by a director. It is a general feature of financial regulation that the directors — and, more widely, 'controllers' and senior managers — of an authorised institution should be 'fit and proper' for the particular position they hold.

Under the Financial Services Act, this is reflected in a direct authorisation of individuals; under the Banking Act the requirement is indirect, but the authorisation of a bank may be withheld if one or more of its directors or senior staff is judged to be unsuitable. None of these arrangements imposes direct and specific accountability on staff; such direct accountability is, however, already a feature of the regimes in New Zealand and Canada.

Objections have been made to the principle of increasing the potential sanctions on the senior management of companies. Since modern firms tend to be complicated, it is not always realistic to expect a director to be aware of everything that is going on. If the regulatory approach were to move too far in the direction of punishing senior management for the consequences of actions of their employees, it could become more difficult to persuade able people to become directors.

However, there are good reasons why individual responsibility is particularly important in the financial sector. The balance sheets of financial institutions can change rapidly and it is, therefore, difficult to keep investors and creditors up to date. The scope for unscrupulous or negligent managers to take advantage of their creditors and investors tends to be greater.

Increasing the accountability of directors gives them a greater incentive to prevent malpractice in their firms and strengthens market discipline. In modern institutions, it is

... individual responsibility is particularly important in the financial sector often only the management of a firm that will be able to spot breaches, so their role is central to maintaining the soundness of institutions.

The trade-off between giving the proper incentives to company directors and not placing on them an unreasonable liability which few will accept is well known. Although there are currently no plans beyond the current SFA consultation document to alter the terms of that trade-off, it is a question in which regulators have good reason to be interested.

Payments and settlements

The United Kingdom implemented a new real-time gross settlement (RTGS) system in April. This provided an immediate benefit in reducing risk in the high-value interbank funds transfer mechanism; it also provides a building block for further improvements in the United Kingdom's payment and settlement systems.

The immediate benefit of RTGS was in removing the credit risk that a settlement bank incurred on other banks in the system. Previously, settlement banks would send each other payment messages through CHAPS (the Clearing House Automated Payment System) but the obligations would be settled only at the close of business. If a settlement bank failed during the course of a day, the recipient could not rely on the funds being paid.

The debit positions run by some banks during the working day were very large and so the exposures were a significant concern.

In the new system, payments are settled on a transaction by transaction basis in real-time across accounts at the Bank of England. Funds are, therefore, final on receipt and settlement banks are not exposed to the risk of the failure of their counterparties in the settlement system. Similar systems have been, or are being, developed in all European Union countries. It is planned to link these systems together to create a trans-European real-time gross settlement system for euros (TARGET). This should bring these benefits to those high-value cross-border transactions in euros which are put through the system.

The benefits of the RTGS system can also be extended by linking it to the securities transfer systems. This will enable the real-time movement of title to securities to be synchronised with the real-time movement of final funds. This is known as 'delivery versus payment'. That this should be the next step was the main conclusion of an internal group established by the Bank to review the strategic requirements for payment and settlement arrangements in consultation with representatives of UK financial markets.

The Bank has now established a small group with the Association of Payment and Clearing Services and other market representatives to agree on the broad design of delivery versus payment systems and to prepare for the more detailed design work.

The largest settlement risk, in terms of the sums involved, is in foreign exchange. A report by the G-10 group of central banks in March set out a three-part strategy to reduce these risks.

Progress can be made by individual banks tightening their procedures for monitoring and controlling the extent of their exposures to individual counterparties. But RTGS systems are an important component of the overall strategy for reducing risk. They ensure that payments are made both in real-time and with finality, which makes it easier to assess when an exposure has been extinguished.

This is an important feature both for individual institutions and for collective settlement arrangements. Indeed, netting schemes, as well as mechanisms such as the continuous linked settlement scheme proposed by a group of banks called the Group of 20, operate to tight deadlines and need finality of payment at precise times of the day. In due course, it may also be possible to link RTGS systems in different countries and currencies to provide a direct form of 'payment versus payment' allowing for the safe exchange of value in the foreign exchange market. ■

'Prudence'

CULTURE OF REGULATION

By Howard Davies, Deputy Governor of the Bank of England

In the first half of 1996, the Bank carried out, with help from Arthur Andersen, a major review of its policies and practices in banking supervision. A number of practical recommendations for change are being implemented. But getting the culture of regulation right is also key; how close should supervisors be to the institutions they regulate? Should the rule-book, or judgment, be the supervisor's ultimate guide?

Howard Davies chaired the internal steering committee to review supervision

Our review of supervision proved an even more extensive exercise than we had at first envisaged. The initial focus was on the establishment of a quality assurance function, in response to a specific recommendation in the report of the Board of Banking Supervision on the Barings collapse. We knew this would in turn require us to define what we meant by good quality supervision.

But as we, with Arthur Andersen's assistance, began to unpick the different elements of the supervisory process, we recognised that the exercise provided an opportunity for a comprehensive overhaul of the business, from data collection through to the exercise of supervisory judgments.

Furthermore, it was apparent that the circumstances of the Barings collapse had created an environment in which supervisors across the world were willing to talk very frankly to us about their procedures and practices and, particularly, their arrangements for international co-operation.

As a result, we were able to benchmark our procedures against best practice in a way that had not previously been possible. Other regulators were willing to share the details of their procedures with us, and for the first time we debated with our overseas counterparts the practicalities of managing a banking supervision function: how we recruit, how we train, how we manage, how we motivate.

This exercise added greatly to the value of the review, and the outcome was a restructuring and re-engineering of the business which will take some time to complete, but which is now well under way.

By and large the response to the publication of the Arthur Andersen report, and our decisions based upon it, has — so far — been positive, in both the financial and political marketplaces, though informed commentators have reserved judgment.

Banks, reasonably, want to see what the consequences will be for them. And others in the media and Parliament have, equally justifiably, argued that any system of regulation is only properly tested in conditions of stress. But the broad lines of the approach we set out has attracted a good deal of support: supervisory judgment still at the centre of the stage, but supported by a more rigorous and comprehensive assessment of risk, and by enhanced collaboration between supervisors, at home and overseas.

Nonetheless, one critical point was made — not once, but many times: that the key to successful

THE BANK'S REVIEW OF SUPERVISION

In July 1996, the Bank announced a restructuring of its Supervision and Surveillance divisions, which took effect from 1 September. The restructuring is part of a major programme of change following a review conducted with the help of a team from Arthur Andersen, working to an internal steering committee chaired by the Deputy Governor. The Bank had asked Arthur Andersen to review the appropriateness and effectiveness of the operations of the Bank's Supervision and Surveillance divisions, within the current legislative framework, and to make recommendations for improving their methods, organisation, structure and staffing.

Arthur Andersen reviewed all aspects of existing supervisory work in the Bank, and held discussions with the Bank's staff at all levels. The process included detailed consultations with a sample of UK-authorised banks, leading banking associations, UK and overseas regulators, as well as other relevant parties.

The Arthur Andersen report concluded that the Bank's basic method of supervision, based on a non-rules based, judgmental approach, should not change. But it identified a need for supervisors to have better tools at their disposal.

Key elements of the resulting programme for change were:

- clarifying the standards and processes of supervision and how these are linked to the overall objectives of supervision, to ensure appropriate internal focus and to promote better understanding among the banks and public at large;
- developing a more systematic model of risk assessment which will then drive the supervisory programme in respect of individual banks. A version of this model has already been prepared, and tested successfully, but further modifications will be needed as it is applied throughout the banking sector;
- strengthening some of the key tools of supervision, including prudential meetings and returns and a review of the Section 39 (Reporting Accountants) regime;
- a reorganisation of the Supervision and Surveillance divisions into a larger number of units, and the creation of an operations division to encompass training, information technology and other support functions.

The Arthur Andersen report also set out plans for the establishment of a quality assurance function, as recommended by the Board of Banking Supervision in their report into the collapse of Barings. This function will be headed by an outsider with relevant experience.

The changes proposed following the Arthur Andersen review are extensive, and will require significant increases in the number and experience levels of staff (including the appointment of a small number of experienced senior bankers), enhanced information technology, and a greatly expanded training programme.

They are designed to enable the Bank to build on a record which compares very favourably with that of banking supervisors in other countries. Like its counterparts overseas, the Bank needs to respond to the growing complexity of the banking industry and its aim is to be at the leading edge of global best practice in banking supervision.

financial regulation was to 'get the culture right' and, by implication, that the Bank had not yet done so.

If this is meant to imply that the Bank's staff are far too cosy with their clients then it is wrong. But we would certainly accept that creating the right supervisory culture is absolutely critical.

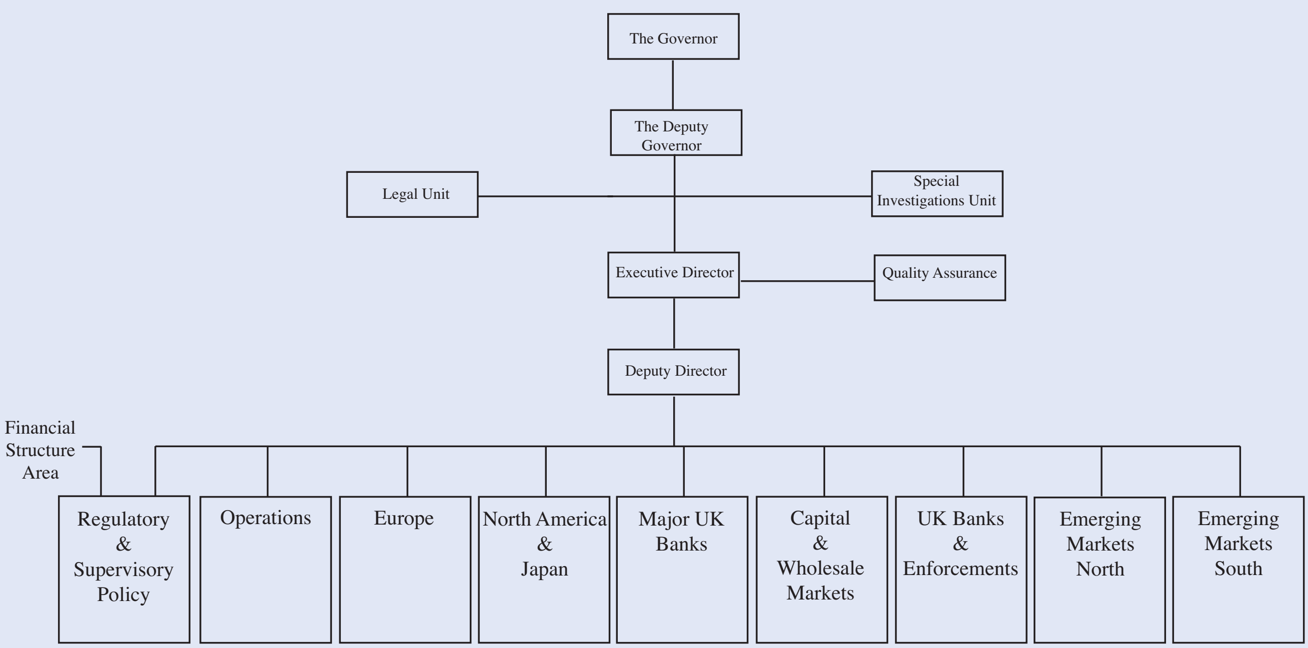
The difficulty is that different respondents prove to have sharply contrasting ideas about just what the appropriate culture is. Banks themselves emphasise the need for supervisors to understand the nature of the business they oversee. They argue that, if they are properly to understand the business, supervisors need to develop a close and informed relationship with the bank's management. Only if a relationship of mutual trust exists can the two sides co-operate sensibly, in the interests of managing and minimising risk.

Furthermore, since management competence is a crucial ingredient of sound banking, supervisors must know senior management well enough to be able to make informed judgments about their competence. That cannot be done by rule-book based examiners focusing on compliance.

Others, outside the banking system, emphasise rather different characteristics in the way they attempt to

... should supervisors be 'cops' or 'doctors'?

New Bank of England Structure of Supervision & Surveillance



> … the focus of the work may often be to help management solve problems and manage risk … but the supervisor is not acting for the shareholder

define the culture of regulation. They deprecate the cronyism, the cosy chats, the old school tie attitude they claim to detect in judgment-based supervision. Regulators should, on this view, keep a decent distance from their clients: personal contacts should be kept to a necessary minimum. Certainly tea parties in the Bank's Parlours are out of the question. Supervisors should be suspicious, reserved, sceptical folk, taking nothing on trust.

This description of the two polar viewpoints is something of a caricature, but beneath it lies a real difference of view. John Heimann of Merrill Lynch, a former Comptroller of the Currency in Washington, puts the dilemma succinctly: should supervisors be 'cops' or 'doctors'?

He has a clear answer, too. Securities regulators should tend to the cops end of the spectrum: banking supervisors should model themselves more on the medical profession. The rationale he offers for this distinction is straightforward, and related to systemic risk. Bank failures have a far greater potential to create collateral damage, and indeed produce victims who may have had no dealings whatsoever with the failed institution in question. So the supervisor's aim must be prevention rather than cure, with amputation as very much the last resort.

There is a lot in Heimann's point. But the 'doctor' tag is merely a note towards the definition of culture: it is not a fully adequate definition of the appropriate supervisory approach.

When I managed the Audit Commission, which supervises and, in some respects, regulates local and health authorities, we faced a similar problem. District Auditors have draconian powers: they are the council taxpayer's last line of defence. They can, and do, surcharge individual councillors and even suspend them from elected office.

Yet, at the same time, they act, in effect, as management consultants: studying a council's working practices, measuring them against best practice elsewhere, and suggesting improvements to them.

These two activities are carried out by the same teams, at the same time, and require auditors to strike a delicate balance between an advisory and a whistle-blowing role.

Supervisors must strike a similar balance. Bankers are right to argue that they must understand the business, and the people who run it. Without such an understanding, prophylactic supervision, a substantial component of the Bank's work, cannot hope to be effective.

Supervisors can help head off emerging problems and can act as the agents of best practice in risk management across the industry. They can usefully challenge strategies and address questions of management competence but, again, only if they have first hand knowledge of the bank and its people and if they have won those people's confidence.

But while the focus of work may often be to help management solve problems and manage risk, the supervisor must never forget that she is not

> **The successful supervisor should have a doctor's bedside manner ... but he must be capable of the unsentimental detachment of the policeman**

acting for the shareholder, nor is her prime objective to keep the existing management in place. Rather she is seeking to specify and enforce minimum standards (and encourage best practice), recognising that the ultimate purpose of the duty to supervise is the protection of depositors. Where that duty is at risk, then no personal relationships or sympathy with a bank's strategic aims, can be allowed to stand in the way.

It is possible to make this sound like an insoluble conundrum. Yet in my long experience at the Audit Commission, and short experience at the Bank, I have found that the dichotomy is more of a problem in theory than in practice.

Some do argue that the two approaches are incompatible, and that the first makes the second impossible. But in practice the switch is not so difficult, as long as the auditor or supervisor is convinced of his ground. And he is more likely to be sure of his ground, and to identify the problems which do require a firm response, if he is properly trained, well embedded in the business and fully aware of its dynamics and the nature of the risks to which it is subject.

The successful supervisor should, therefore, have a doctor's bedside manner, and his skill in following diagnostic pathways. But he must be capable of the unsentimental detachment of the policeman, when the circumstances demand it.

As Lord Justice Bingham said in his report on BCCI, "The Bank's traditional techniques of supervision, based as they are on trust, frankness and a willingness to co-operate, seem to me on the whole to have served the community well. But one of the virtues claimed for the Bank's supervision is its flexibility. This should mean that a quite different supervisory approach is adopted where trust and frankness are lacking. In such cases also special qualities are required of the supervisor".

Those who train and manage supervisors must, by their actions, create a climate in which they are able to use those different approaches and develop those 'special qualities' in the appropriate circumstances.

No restructuring, or re-engineering programme, can do that overnight. But in a number of important ways the Arthur Andersen report points to practical changes which can reinforce desirable behaviour patterns and build the right culture.

The most important, I think, is the development of more sophisticated supervisory tools — particularly the risk assessment model — which give supervisors confidence in the analytical foundations on which their judgments are based. If those judgments are sound, then, whether positive or negative from the perspective of the supervised institution, there is no reason why they should not be delivered over a cup of tea. ■

BUILDING SOCIETY CONVERSIONS

By Kevin Ryan, Supervision and Surveillance, Bank of England

Over the past two years, many of the largest building societies have announced plans to give up their mutual status and move into the banking sector. What motives have building societies cited for wishing to convert, and what are the counter-arguments? How does the Bank of England handle the authorisation process for societies that are converting? A number of policy issues need to be addressed.

Building societies were first established in the late eighteenth century as small, locally-based organisations, funded by subscriptions from members. The funds were used to purchase land and build houses for members, or for making loans to them for similar purposes. Once all the original members had been housed, the society was wound up. These organisations were described as 'terminating' societies.

As societies developed, they began to accept funds from individuals who did not wish to have a house built, but who simply wanted to invest their money and receive a rate of interest. In time, these societies became permanent, taking on new members, as the original members paid off their loans. Hence they became the organisations we know today — mutual savings and housing finance institutions open to the whole community.

The building societies' business today is still concentrated in the two traditional areas: taking savings deposits from the personal sector, and residential mortgages. As much as 80 per cent of the societies' funds come from members and 95 per cent of their commercial assets (ie total assets less fixed and liquid assets) are house mortgage loans. The societies are a significant force in those markets. They account for 45 per cent of personal sector savings deposits and 60 per cent of house mortgages in the UK.

By 1900 there were more than 2,000 building societies in Great Britain with over half a million members and total assets of about £60 million. As the above market shares would indicate, the movement has certainly prospered since, with the number of investing members rising to 38 million, and total assets to £300 billion, by the end of 1994. However, the number of societies has fallen continuously through mergers. There are now fewer than 80, and the largest 20 societies account for some 95 per cent of the assets.

In the 1980s, banks and other financial institutions started to compete in the mortgage market. The building societies were considered at a disadvantage because of the restrictions, under the then legislation, on the services they could provide. The 1986 Building Societies Act gave them new powers to provide a wider range of financial services. For the first time, it also provided arrangements to enable them to convert into public limited companies (plcs) and become authorised as banks.

Abbey National, for a long time the second-largest society behind the Halifax, believed that societies were nevertheless disadvantaged because of the restrictions on their activities and the management of their treasury operations. It also felt there was no certainty that future extension of its powers would match changing conditions. Accordingly, the society decided to convert in 1989. It is interesting to take a brief look at how Abbey developed over the subsequent years relative to Halifax.

As Chart 1 shows, following its conversion, Abbey overtook Halifax in terms of asset size. (The end-1995 comparison is distorted because it includes Halifax's merger with The Leeds, but not the acquisition by Abbey of National & Provincial.)

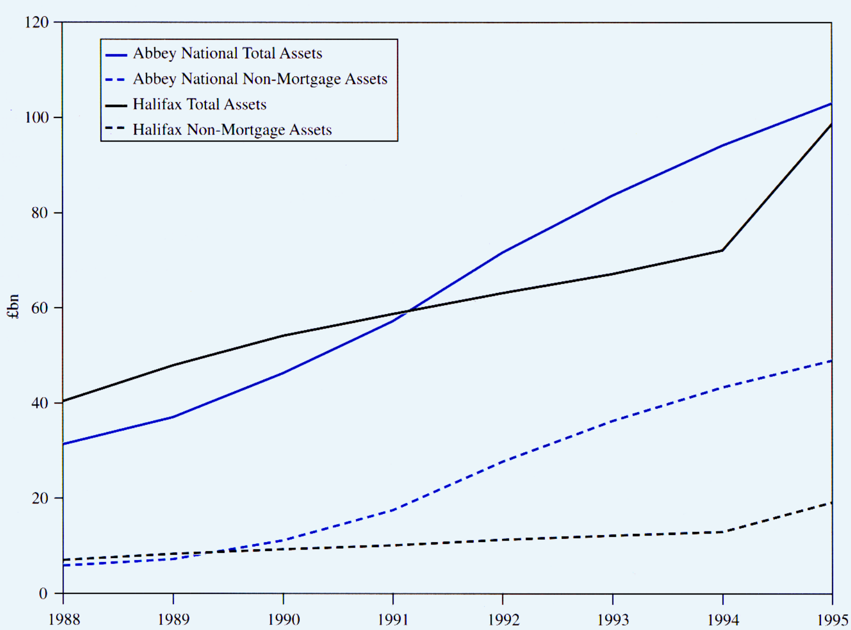
Abbey achieved this, not by gaining a larger share of the house mortgage market than Halifax, but mainly by building up a wholesale banking business — for example holding a large investment portfolio and entering the leasing market. This new business was largely funded by wholesale liabilities, which were higher than would have been allowed had it been a building society.

However, Abbey has not overtaken Halifax in terms of profit. Abbey earned pre-tax profits of £1,026 million last year, compared with £1,104 million at Halifax.

No other building societies followed Abbey along the conversion route over the following few years. The other societies seemed content that they could operate effectively in their chosen markets while remaining societies. Their powers were being gradually widened to reduce the restrictions on them. For example, they were allowed into new areas of business such as life assurance, to raise more wholesale funds, and to

No other building societies followed Abbey along the conversion route over the following few years

Chart 1: Abbey National and Halifax since 1988



Eight of the largest societies … have either moved, or are in the process of moving, into the banking sector

hold a greater range of liquid assets. Furthermore, as societies they considered they had a better public image than banks, which were perceived to be closing businesses in the recession and reducing the quality of their own services while charging more for them. Finally, there was no pressure for conversion from the societies' members.

However, in early 1994 Cheltenham & Gloucester announced its agreement to be purchased by Lloyds Bank. That November, Halifax announced its intention to merge with The Leeds, the fifth-largest society, and subsequently to convert to banking/plc status. Over the next 18 months Woolwich, Alliance & Leicester, National & Provincial, Northern Rock and Bristol & West all announced their intention to give up mutuality and move into the banking sector in one form or another.

Chart 2: Converting societies and remaining mutuals at end-1994

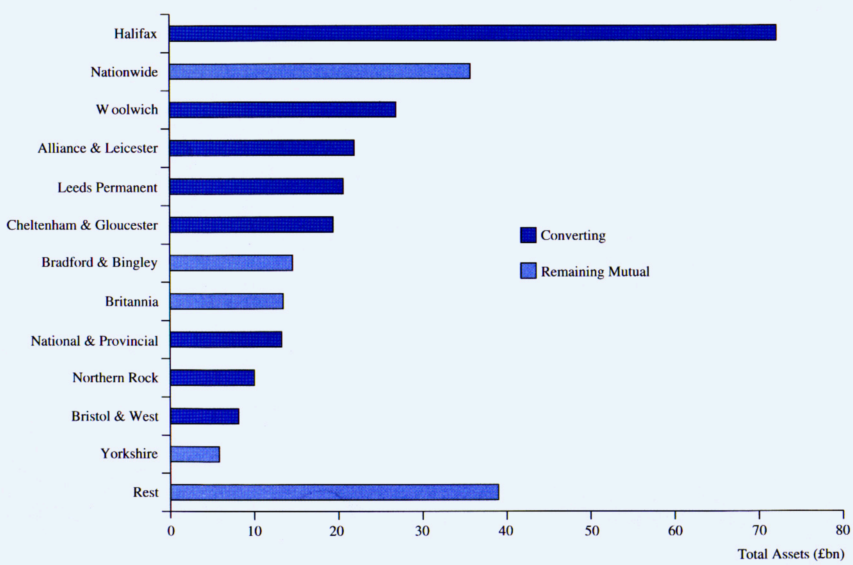


Chart 2 shows the largest societies by asset size at the end of 1994 (before any of the recent conversion activity had taken place) and highlights which of them have decided to convert.

Eight of the largest societies at that time have either moved, or are in the process of moving, into the banking sector. This amounts to nearly two-thirds of the building society sector's assets. Three of the remaining large societies, Nationwide, Britannia and Bradford & Bingley, have stated that they intend to remain mutual.

Drivers behind conversion

As noted above, the societies' powers have been gradually widened and restrictions on them reduced. Moreover, the draft of a possible future Building Societies Bill, published earlier this year, would replace the present prescriptive regime applying to societies with a permissive one, making it easier for societies to respond to market changes.

Why therefore have most of the larger societies decided to convert? While the reasons cited vary from one society to another, in line with their individual strategies and circumstances, some common themes emerge from the various public statements societies have made.

First is the need for growth to remain competitive. For example, Cheltenham & Gloucester said that "… growth, when combined with appropriate control over costs, ensures the competitive advantage of a low management expense ratio which leads to the ability to offer attractive rates of interest to customers". Alliance & Leicester noted the fall in net UK mortgage advances from £40 billion in 1988 to £20 billion in 1995, and the fierce competition between banks and building societies for a share of this smaller residential mortgage market.

In other words, the competition of the 1980s was less intense because the more buoyant housing and mortgage markets at that time allowed the societies and their competitors to continue to achieve sustained organic growth.

Might it be possible to grow as desired while remaining a building society? National & Provincial argued that, following the Abbey flotation and the earlier announcements regarding Cheltenham & Gloucester and Halifax, members now expected to place a financial value on the ownership interest in their society.

However, only a limited amount of value could be released to members through the payment of a bonus on the merger of two societies. Peter White of Alliance & Leicester was quoted as saying at the Building Societies Association conference in 1995 that "faced with their society's merger and its conversion to plc status, so far members have more concern about the amount of the pay-off than the change of status".

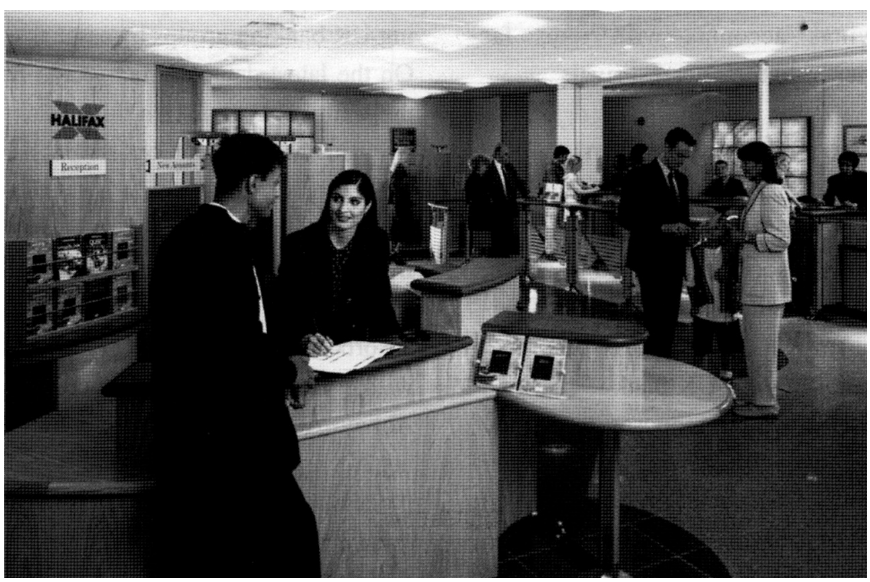
The converting societies also question the continued relevance of mutual status. For example, in announcing their proposed merger, Halifax and The Leeds claimed that mutual status was becoming less appropriate for their societies because many of their customers, particularly in new business areas such as life assurance, unit trusts and pensions, were not members.

Northern Rock expressed a need to define more clearly its responsibilities to members in their separate capacities as owners and customers. Qualifying members could then choose to hold the free shares they would be given, and so retain a continuing interest, or to realise the value of their ownership rights.

Certainly not all agree that demutualisation is either necessary or appropriate. At the same Building Societies Association conference, David Miles of Merrill Lynch said there was no evidence to suggest that plc status offered lower costs or higher profits than mutuality.

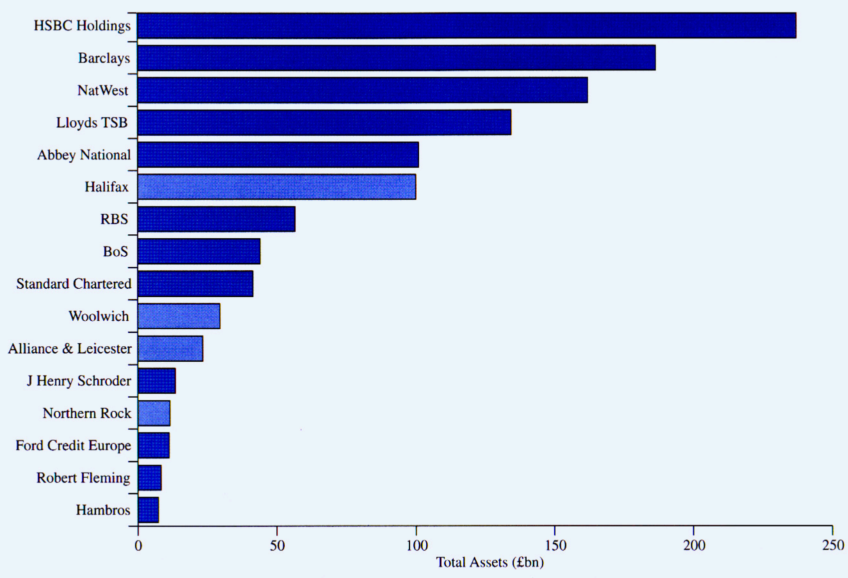
Mike Jackson of Birmingham Midshires said that members would

... some common themes emerge from the public statements societies have made



Inside a building society branch

Chart 3: Large UK banks and converting societies by asset size (1995)



be offered "jam today in the form of bonuses in return for the stale crusts of poor service and lower returns tomorrow". More recently, John Wrigglesworth of Bradford & Bingley said "by remaining mutual Bradford & Bingley can continue to offer its customers mortgages and savings accounts with rates far superior to their nearest rivals".

Types of conversion

There have been several variants on the theme of conversion among the eight societies referred to above. Some have involved take-over: Cheltenham & Gloucester has become a subsidiary of a UK bank — Lloyds; Bristol & West proposes to do the same but with a bank from another country — Bank of Ireland; National & Provincial has been absorbed into Abbey National. Other societies have chosen to retain their independence. Woolwich, Alliance & Leicester and Northern Rock intend to convert as substantially the same organisations they were as building societies. Halifax is converting only after its merger with The Leeds. Chart 3 shows how the societies converting as independents rank with the existing UK banking groups by asset size. On the latest data, Halifax would be the sixth-largest bank on this basis.

The method of conversion has a bearing on the Bank's authorisation process. The simplest variant, from the perspective of the Bank's approval, is where the society is absorbed into an existing bank, as with National & Provincial and Abbey. Accordingly, no new Banking Act authorisation, with its formal process, is required. The Bank must satisfy itself that the existing bank can absorb the new business without undue stress, management and systems capacity, and the quality and relative size of the mortgage book acquired, being the key issues.

All the other variants do result in the former society requiring a new authorisation as a bank. Like all new applicants, it must be assessed against the minimum criteria for authorisation set out in Schedule 3 to the 1987 Banking Act. These include:–

a) business to be prudently run;
b) systems and controls to be adequate;
c) capital and liquidity to be adequate;
d) directors, other managers and controllers to be fit and proper persons.

If a society becomes a subsidiary of an existing authorised institution, the Bank will normally be able to take some comfort from the fact that it is already familiar with that bank's management and systems. While approval of a 'controller' of a converting society should never be considered a mere formality, it is, realistically, less likely to be a problem with an established authorised institution.

Other potential owners may be less well known to the Bank. Overseas banks without a UK presence, for example, may fall into this category. In these circumstances, the Bank would need to liaise closely with the home supervisor of the acquiring bank.

If the acquiring bank is of good standing and well-managed, and has a sensible business plan, there would be no reason to object to its ownership of a former society.

Where a society retains its independence when it converts, additional issues arise as a result of regulation.

First, under the Building Societies Act, a society transferring its business to a public limited company formed explicitly for the purpose of concluding its business enjoys a five-year protection period against take-over.

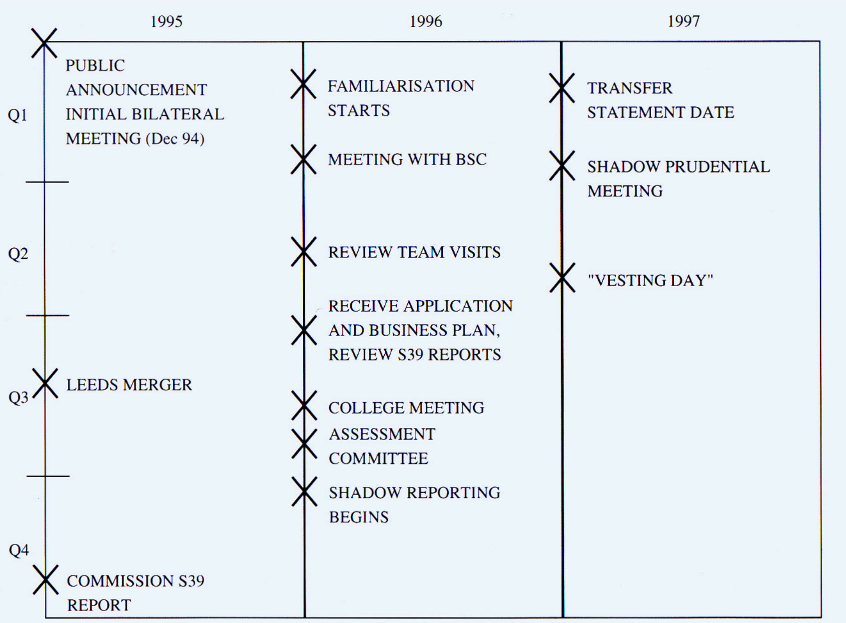
Second, the capital requirements of an independent converting society are likely to be higher than those of a society which is a subsidiary of an authorised institution. In part, this is because of Priority Liquidation Distribution Rights, which are described further below. The main reason, however, is that the Bank generally sets authorised subsidiaries of banks the same capital requirement as the main bank itself, and this will tend to be lower than the ratio set for a new bank.

Chart 4 uses the example of the Halifax Building Society to illustrate the work the Bank is carrying out in the conversion process.

Halifax is the only example to date of conversion taking place after a merger. An aspect of its timetable is the extended period — two-and-a-half years — between the public announcement and the conversion. The main reason for this is the need to ensure that the register of members of the merged society is sufficiently accurate for the requisite voting process. However, it also enables the Bank to assess how the new, combined, society is operating.

The Bank is sometimes asked for an assurance that it will authorise a society when the latter announces its decision to convert. The Bank cannot say anything concrete at that

Chart 4: The conversion process



The Bank must satisfy itself that the existing bank can absorb the new business without undue stress stage as the outcome of the formal authorisation process cannot be prejudged. It must, however, be able to give such an assurance at the time when a society issues the Transfer Statement, which it is required to send to the voting members before they vote on the conversion proposal. The Bank therefore works back from that date in scheduling its own work.

A formal assessment committee — at which the converting society is assessed against the Banking Act criteria by a number of experienced supervisory officials — is held some three months in advance of the transfer statement date. This is to allow time to address any concerns raised by that committee.

The main documents which will be considered by the committee are the society's business plan, and a report commissioned from a firm of accountants, normally the society's auditors, on its systems and controls. This is similar to the reports commissioned on banks under section 39 of the Banking Act. The officials who will be responsible for the post-conversion supervision of the society will carry out a programme of 'due diligence' over the preceding six months.

In addition to preliminary discussions on the business plan and any follow-up work relating to the 'quasi section 39', Bank teams will visit key risk areas of the society's operations, typically the treasury and credit functions. There will also be a broader range of familiarisation meetings, to enable the Bank to gain a better understanding of how the society carries on its business, and to meet its key personnel.

There is close liaison with the society's existing supervisor, the Building Societies Commission, at this stage, to draw on its knowledge of each society's strengths and weaknesses. Establishment of a good working relationship with the other supervisors of the societies and their subsidiaries is also crucial.

Incentives such as cash-backs are another feature of this market, although many lenders have recently reduced these incentives

In addition, a 'College of Regulators' meeting is held. All the various UK regulators of the financial activities of the converting societies and their subsidiaries are brought together to discuss the business plans of all converting societies, and resulting supervisory issues.

Provided that the application for authorisation is successful, the Bank will, during the period up to actual conversion, try to prepare a society for a smooth change to supervision by the Bank of England. Important components of this are likely to be the early submission of prudential returns on an informal (or shadow) basis, and a shadow prudential meeting with the society's senior management.

Key supervisory issues

Priority Liquidation Distribution Rights (or PLDRs) arise from certain provisions of the Building Societies Act which apply only to societies converting as independents via the successor company route, not to those being taken over.

These provisions confer on the former members a right to a distribution of the pre-conversion reserves of the society in the event of the liquidation of its successor company — the authorised bank. This enjoys priority over depositors and other creditors and is in addition to any deposits they may hold with the successor company.

Since PLDR can deplete the protection afforded to depositors, it should, in principle, be deducted from a former society's capital. However, the legislation is framed so that PLDR reduces as a consequence of any (gross) withdrawals from the accounts of the members in question. The Bank therefore believes it is reasonable to base the capital requirement on the forecast amount of PLDR a year later, given that a society is unlikely to fail so soon after conversion.

In addition, as the liability only crystallises in a liquidation, the Bank can allow the requirement to be covered by types of subordinated debt that would not normally be allowable for capital purposes, which should serve to reduce the cost of meeting the capital requirement. In accordance with its normal approach, the Bank will also be flexible in allowing capital to be repaid when it is no longer required, ie as the PLDR falls.

To calculate how much capital they will need for PLDR purposes, the societies in question also need an early indication of the capital ratios above which the Bank will require them to operate.

This is a decision that can only be made finally at the assessment committee stage. However, the Bank has been able to give indicative ratios following discussions with the BSC, which has given access to its internal ratings and relevant background information.

As fairly large retail banks, converting building societies will generally be supervised in a similar way to the clearing banks. For example, they will be subject to the 'stock' liquidity regime, as described in this year's Banking Act Report, as opposed to the 'mismatch' approach applied to the rest of the banking sector. Because this differs from that applied to societies by the BSC, converting societies' asset mix may change. Rules applied to the clearing banks will be extended to the converting societies where appropriate.

What are the main supervisory risks? Unrealistic expansion plans or ones which involve moving into areas where a society lacks expertise may be a problem. Treasury is an area of potential risk, as conversion will considerably increase the potential range of trading strategies the societies may adopt.

the societies in question also need an early indication of the capital ratios above which the Bank will require them to operate

A second set of concerns refers to the level of competition in the traditional building society markets. Residential mortgage lending is currently highly competitive and likely to remain so. In particular, those building societies which are committed to mutual status are charging lower rates as a tangible way of demonstrating its benefits.

Incentives such as cash-backs are another feature of this market, although many lenders have recently reduced these incentives, partly in response to concerns expressed by regulators and to the pick-up in the housing market.

At the same time, the deposit rates paid by converting societies are less likely to be competitive in the period prior to conversion, given the need for investors to maintain their deposits with these societies to secure the benefits they will obtain on conversion.

Clearly this situation carries a number of risks. Going forward, it is important that societies recognise the extent to which both their lending and deposit books are becoming more mobile and interest rate sensitive, and plan and act accordingly.

Competition may well reduce margins on both sides of the balance sheet. If this is the case, the converting societies will have to be able to achieve cost reductions in order to maintain their profitability. It would be of more direct supervisory concern if profitability pressure or a desire to maintain market share led to pressures on converting societies to reduce lending standards.

THE SIB REVIEW OF THE METALS MARKETS

By John Mackeonis, the Securities and Investments Board

The London Metal Exchange (LME) is the largest exchange in the world trading base metal derivative contracts. The Securities and Investments Board is currently carrying out a review of the metals markets, at the request of the LME. How does the London Metal Exchange differ from London's other investment exchanges and what are the main regulatory issues currently under discussion?

Earlier this year the Securities and Investments Board announced that it had been engaged in a statutory investigation into various copper-related transactions. Following the announcement by Sumitomo Corporation of losses incurred in relation to activities in the copper market, the SIB has been pursuing two further strands of work: first, monitoring, with others, the state of the metals markets in London; and, second, carrying out at the LME's request a review of the metals markets and the role of the LME within those markets. This article focuses on the second strand of work; it describes the LME and its role in world metals markets and sets out some of the main issues currently under discussion.

The 'Ring', where trading is conducted on the LME

The London Metal Exchange

The London Metal Exchange is the largest exchange in the world trading base metal derivative contracts. According to some estimates, its trading volume accounts for 95 per cent of the world's on-exchange metal contracts. These contracts provide a means by which suppliers, processors, stockists and users world-wide can hedge the risks associated with metals trading. They also provide investment opportunities for financial institutions.

It is estimated that 75-80 per cent of the LME's volume comes from those using the exchange for hedging purposes. By contrast, most of the other futures exchanges tend to be dominated by investors. Most non-ferrous base metal trading is done bilaterally between suppliers, processors, stockists and users ('physical trading'), rather than through metal exchanges. But it is estimated that the vast majority of such trades are priced with reference to the LME's benchmark prices in its seven metals contracts.

Like other derivatives exchanges in London, the LME is a recognised investment exchange under the Financial Services Act 1986. As such, it is supervised by the Securities and Investments Board and has to meet the criteria set out in the Act. These include: ensuring that business on the exchange is conducted in an orderly manner; limiting dealing to investments in which there is a proper market; having satisfactory arrangements for recording transactions; monitoring and enforcing compliance with its rules; and ensuring the performance of trades, either through its own arrangements or through clearing arrangements made with a recognised clearing house. The LME's contracts are cleared and guaranteed by the London Clearing House.

The LME differs from other futures markets in important respects. In particular:

- it is a dealers' market;
- the LME has a practice of 'non-cash clearing' — that is, profits and losses on LME contracts are settled on expiry of the contract, not (as on other exchanges) throughout the duration of the contract;
- LME member brokers typically extend credit to their clients to a greater extent than on other derivatives exchanges;
- under certain circumstances the LME and the clearing house permit contracts to be registered at a price other than the current market price.

A dealers' market

The LME's characteristics as a dealers' market, otherwise known as a quote-driven market, deserve particular mention. They raise issues relating to transparency. When prospective clients wish to trade in a dealers' market they telephone a dealer who may quote them a price. The deal can be agreed there and then, with no need to go to a trading floor to find a price. A dealer who quotes a bid and offer price for trades in a given contract is said to make a market in that contract. If the client accepts, the trade is then, from the client's perspective, complete. The dealer either takes the other side or trades on the market to cover the resulting exposure.

The other recognised investment exchanges in the UK which trade derivatives are order-driven markets. Decisions on market structure, for example whether a market is quote- or order-driven, are primarily a matter for market participants and users. Regulators' interest focuses on securing a fair market for all participants.

LME member brokers typically extend credit to their clients to a greater extent than on other derivatives exchanges

The LME's price vendor system helps market participants assess whether the quoted price is a fair one. When a customer phones an LME dealer and asks for a price, he is given a firm selling and buying price in the tonnage for which he asks (or for which the dealer is prepared to quote). The dealer is then held to this.

The customer can have simultaneous offers and bids from a number of dealers. This makes it possible to trade large quantities of metal at the same price, which may be to the customer's advantage. This contrasts with a futures pit where the almost total transparency allows other traders to identify large customer orders to their own advantage, thereby potentially making it more expensive for the customer to fill his order.

The SIB's current work

The SIB is concerned to ensure that confidence in the metals markets, which has been developed over many years, is maintained and that the LME continues to fulfil its responsibilities as a recognised exchange. In addition to the review of metals markets, it has therefore been monitoring with other relevant authorities conditions in the copper and other metals markets in London, as well as investigating various copper-related transactions.

As part of its LME review, the SIB issued a consultative paper in August, inviting views on a number of issues relating to the rules and trading practices of the exchange in the context of the wider global metals market. As well as asking for views on the particular features of the LME outlined above, the paper also highlights issues of transparency, manipulation and volatility.

The review is focused on ensuring that the LME continues to meet the needs of its users and that it has in place the standards — in terms of transparency, fair treatment for users, reliable price information and freedom from abuse — to continue to secure long-term user confidence.

Transparency

The issues here relate both to pre-trade and post-trade transparency. The first may be defined as the visibility of prices at which brokers are prepared to deal. In a dealers' market, it may be interpreted as meaning that bid and offer quotes give a good indication of the prices at which brokers intend generally to do business.

Post-trade price information helps clients assess whether brokers have given them a good price by comparison with general activity in the market. This spurs competition between brokers and allows the market to be self-enforcing, in that accurate post-trade information can reveal and deter misconduct.

A key question posed in the consultation is whether the level and form of price information available on the LME meets users' needs. The SIB paper also suggests ways in which post-trade transparency might be improved.

Manipulation

If an investment market is to maintain the confidence of its users, it needs to operate with a high level of integrity. Among other things, this means that the market should not be misled, manipulated or abused. Various forms of market manipulation — difficult though they may be to define — can undermine this confidence by distorting price movements and hence weakening the reliability of the price formation process.

If an investment market is to maintain the confidence of its users, it needs to operate with a high level of integrity

One way in which the market may be manipulated is by means of misleading statements or practices covered by the statutory ban in section 47 of the Financial Services Act. Breach of section 47 is a criminal offence.

The SIB paper asks for views on whether there is sufficient clarity on what constitutes manipulation in the metals markets and whether the rules and procedures of the LME are adequate to protect against manipulation. This should enable regulators to assess whether any changes in market mechanisms would help guard against this risk, given that many of the market's users are outside the jurisdiction of UK regulators.

Price volatility

Volatility arising from underlying structural features of the physical market for metals does not fall under the scope of regulation. Grounds for regulatory intervention in respect of volatility in any investment market might arise in two ways:

- the rules and procedures of a market, or misconduct by market participants, may exacerbate the market's natural volatility, so the reliability of the price formation process (one important aspect of a fair market) is brought into question;
- volatility may be such as to increase systemic risk to the market.

The SIB paper invites views on the level of volatility in the metals markets and on possible underlying causes. It also asks whether consideration should be given to certain short-term measures such as circuit-breakers and position limits that are used on other exchanges to reduce price volatility in the very short term.

Conclusion

It is apparent from the number and quality of the responses to the discussion paper that the issues raised are of major importance to market participants, market users and others throughout the world. The SIB is now analysing the responses and will publish recommendations, where appropriate, by the end of 1996.

ELECTRONIC MONEY: PUBLIC POLICY ISSUES

By Mark Robson, Financial Structure, Bank of England

Many different types of 'electronic money' are currently under development or being piloted around the world. These are commercial products which can bring social benefits. If their use becomes widespread, they could be a substitute for cash. What new public policy issues do they raise, and how might central banks best respond to them?

Technical innovation and falling costs in computing and telecommunications have led to extensive change in banking services in recent years. In most cases, the main consequence has been improved efficiency and speed of transactions. Cheque details can be printed automatically instead of being written by hand, or dispensed with entirely, as in the case of debit cards. Such changes have been seen as matters of degree. Does the recent possibility of creating 'electronic money' raise more fundamental questions?

What is electronic money?

There is no settled and universally accepted definition of 'electronic money', also referred to as 'electronic cash' or 'electronic purse'. However, there are common features of schemes now being developed.

First, prepayment is required for a store of 'electronic value', which is represented by data held on a microchip, located either on a plastic card or within a personal computer. Second, the aim of scheme developers is that, like other forms of money, such electronic value will be widely acceptable in payment for a range of goods and services.

This working definition excludes products which merely provide a novel way of communicating with providers of financial services. These so-called 'access products', such as home banking facilities, use new technologies to carry out familiar transactions.

The definition also excludes single purpose products, such as disposable telephone cards, which clearly represent prepayment for one specific service; and retailers' 'loyalty' cards, where value redeemable for goods or services from a particular retailer is earned in proportion to purchases.

In the United Kingdom the most widely known electronic money product to date, because of its pilot operation in Swindon, is 'Mondex', developed as a NatWest/Midland/BT joint venture. About 10,000 Mondex cards have been issued so far. Europay, Mastercard, Visa and others have also been developing card-based electronic money schemes, each with its own particular features and characteristics, and many different national and international schemes are currently running pilot projects throughout the world.

More recently, some personal computer-based schemes, using networks such as the Internet, have been developed, although several companies (with names like CyberCash and DigiCash) now offer proprietary electronic money services via Internet sites.

THE TECHNOLOGY OF ELECTRONIC MONEY

Consumer use of plastic cards bearing data held on a magnetic stripe, which can be used to withdraw banknotes from an Automated Teller Machine, or as a credit or debit card, or perhaps all three, is now widespread. Some 80 per cent of adults in the United Kingdom hold at least one such card.

Magnetic stripe cards are also used to charge accounts at major retail stores, in supermarket 'loyalty' programmes, and will soon be used by the Benefits Agency to make benefit payments.

The most significant hardware innovation in the past few years is the incorporation into cards of a tiny microprocessor or 'chip', interrogated by a card reader through metal contacts on the surface of the card. While this technology was developed about 20 years ago, it has only recently begun to be used widely. Contactless cards are also under development, which are particularly useful in transport systems where queueing and congestion must be avoided. An important software innovation is greatly enhanced data security through advanced cryptography; the most obvious communications development is growth in use of the Internet and other telecommunications networks, including mobile phones. The feasibility of secure, privately-issued 'electronic money' is just one of many applications of these new technologies.

For example, plastic *cartes bancaires* with built-in microprocessors have been issued in France for some years. The function of the chip on these cards is not to record amounts of stored electronic value, but as a security enhancement for credit or debit card applications. The user's PIN number, as used in the United Kingdom when withdrawing cash from an ATM, is entered into the retailer's terminal before the transaction is processed and paper record printed out, so that on-line verification and a signature on a paper roll are unnecessary.

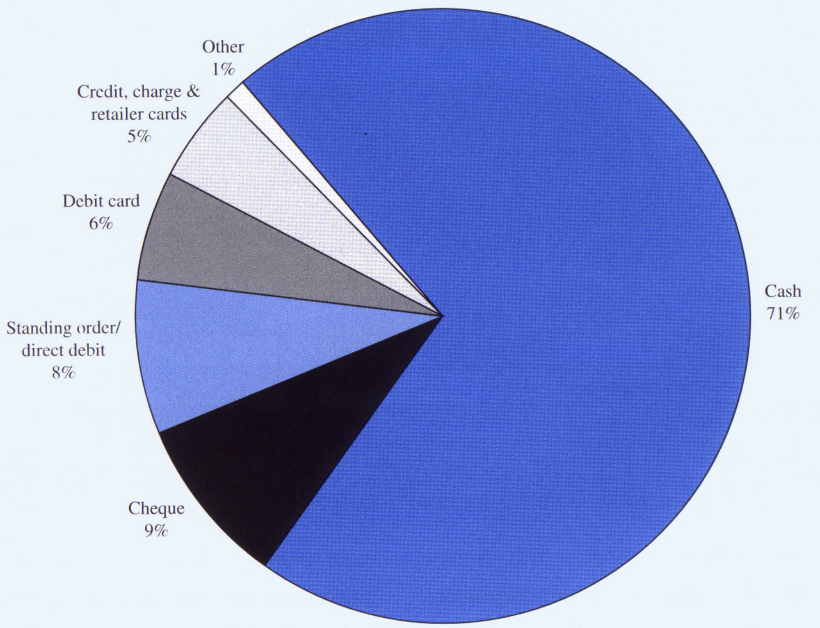
The motivation behind Internet and other network-based electronic money systems is rather different from that of card-based schemes, although the software used for encrypting the data is the same. Obviously the consumer cannot be in the presence of the retailer. Physical security of a special purpose microchip, which is of crucial importance on cards to protect the issuer against forgery, is not applicable: all depends on security of the software cryptography. The commercial motivation for Internet electronic money is that small sums (perhaps only a few pence) could be debited from a user's electronic money account when he or she requested access to particular items of information. In the case of a magazine or newspaper published on the Internet, a user could be charged for reading particular articles of interest, rather than for the whole of the physical product.

In the case of card-based schemes, the extent to which the chip is capable of withstanding physical attack or interference provides a further level of security in addition to cryptography. No transaction can occur without using the card, unlike credit card transactions effected by a phone call or fax message.

If card-based microprocessors are secure, on-line verification such as that carried out by telephone when using a credit or debit card in a shop may not be necessary. For off-line transactions, the user enters his or her PIN number into the card reader. Verification might be dispensed with entirely for low-value transactions: the card is then analogous to a bearer instrument, such as a telephone card, whether or not it is linked to a bank account or is reloadable.

There are many different commercial and technical possibilities for electronic money: hybrid schemes can also be developed, with a card reader attached to a PC used to visit Internet sites, combining the benefits of both technologies. Cards might combine multiple payment applications, with the electronic money chip mounted onto a credit or debit card; and these applications could be combined with others, for example, storing medical information or collecting detailed records of goods and services bought, for marketing purposes. But such developments raise other public policy questions relating to confidentiality and privacy.

Chart 1: Personal payments, by number of transactions (1995)



Source: APACS

Why use it?

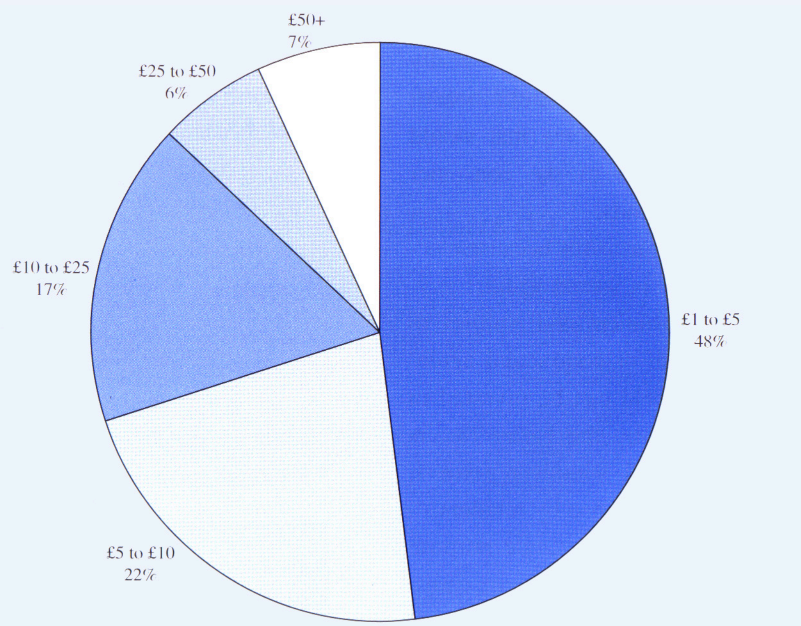
Handling cash can be expensive and inconvenient for retailers, but it is often cheaper than other forms of payment and, from the customer's point of view, universally accepted.

The use of credit or debit cards for low-value transactions (typically, below a level of about £5) is usually uneconomic, due to the cost to the retailer per transaction. Similarly, cheque clearing through the payer's bank branch is expensive for small amounts.

Cash is generally accepted, and Chart 1 shows that it still dominates retail transactions, most of which are for small sums. But it has several disadvantages. If the cost of processing non-cash transactions could be reduced significantly, many small payments could be made in other ways. One obvious way of reducing cost is to avoid 'on-line' verification, which is normally carried out by a telephone call to the credit or debit card issuer, to ensure that the card is not stolen and that sufficient funds are available for the purchase being made. Whereas credit cards can be characterised as 'pay later' and debit cards as 'pay now' products, electronic money is 'paid before': provided that security is adequate, routine 'off-line' verification is feasible.

Cash can sometimes be inconvenient for users. Exact change is often required, particularly for vending machines, parking meters and launderettes. Notes can be awkward and bulky to transport, to load into ATM machines, for example. Unattended machines full of cash are also vulnerable to theft. Telephone cards were developed for these reasons.

Chart 2: Cash payments over £1, by number of transactions (1995)



Source: APACS

Widespread acceptance of a multi-purpose pre-paid card for a variety of applications could avoid much of the inconvenience associated with cash.

If the use of electronic money were to become widespread, there could be benefits for retailers and card issuers, as well as individual consumers.

Handling large amounts of cash is costly. Just as payment of employees' salaries in cash has been widely replaced by direct credit transfers to bank accounts through BACS, a retailer who could dispense with the need to count and bank large quantities of notes and coin could save time and cost, as well as being less vulnerable to robbery. Bank branches would similarly avoid the need to hold and handle so much cash.

Who holds the funds?

To the extent that electronic money does not earn interest for the holder (although this would be technically possible), the issuer would benefit from the 'float' income that would otherwise accrue to the consumer investing the funds.

This income arises because electronic money is issued against payment by consumers and, subject to any regulation or contractual agreement, funds held can be invested in the meantime by the issuer for its own benefit, in whatever form it chooses, until claimed by retailers.

In the case of a single purpose pre-paid card, as for telephone cards, the issuer will normally be the service provider itself, or its special purpose subsidiary or agent. Payment is usually made in one direction only, although there may be the possibility of a refund against unused value.

Consumer protection issues may arise but these are not usually the concern of the central bank or banking supervisor, as the cards represent prepayment for specific goods or services. Customers in the UK who make advance payment for a product or service which is not provided to their satisfaction, or at all, may seek redress through local Trading Standards Officers.

In the case of a single issuer of a particular type of electronic money, three distinct parties are involved: the electronic money issuer, the consumer and the retailer or product

Chart 3

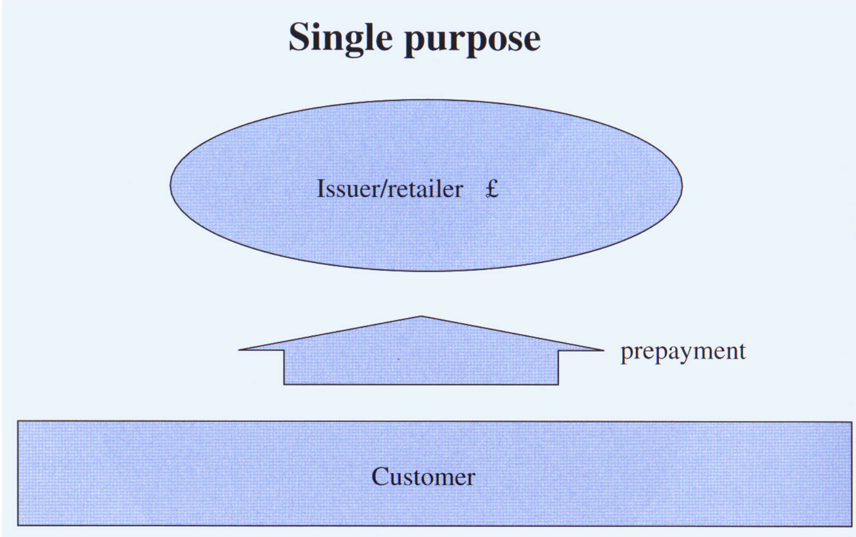


Chart 4

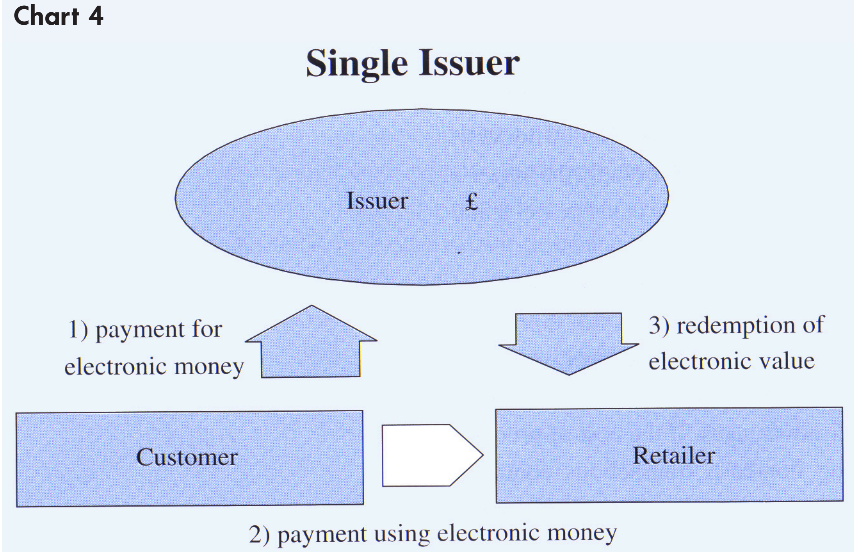
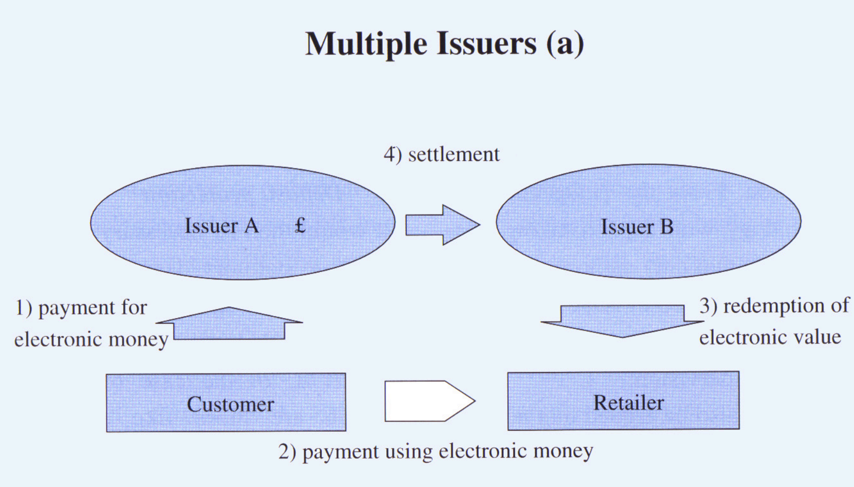


Chart 5



provider. Under such schemes, each issuer is responsible for redeeming only electronic value which it has issued itself. The consumer makes payment for electronic value to, and the retailer makes a claim from, the same institution.

The situation becomes more complicated in the case of multiple issuer schemes, which may be more likely than single issuer schemes. There are two main variants. In (a), the retailer need not claim from the issuer with which the customer dealt, but issuers will settle between themselves, typically at the end of each business day. In (b), a special purpose vehicle holds and invests the funds given up by customers in exchange for electronic value.

Depending on the precise contractual position, this special purpose vehicle might be the real issuer of electronic money, with back-to-back and quite possibly off-balance-sheet transactions in the so-called 'Issuer A' and 'Issuer B', which act as little more than conduits for the purpose of dealing with the public.

Policy issues

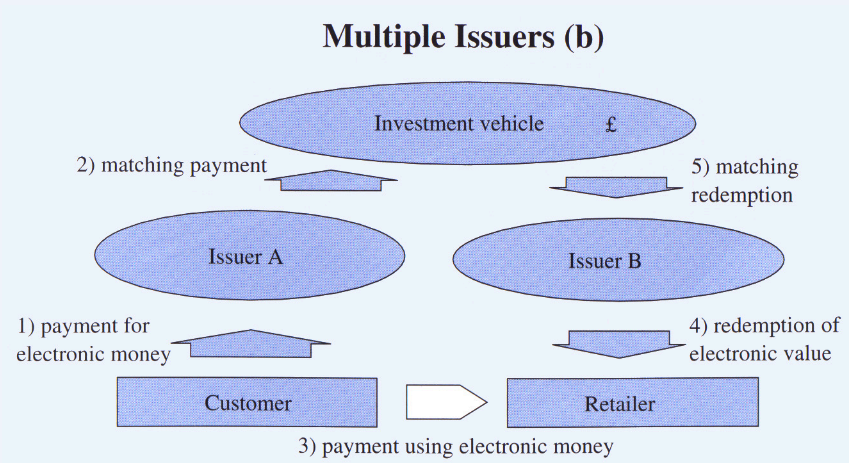
- ***How should electronic money be regarded?***

The issuing of electronic money has been made possible by advances in technology. There are some analogies in this new product with deposit-taking. The issuer takes in funds from the public, invests them for its account, and repays them on demand, either to the original consumer or someone else according to the consumer's instructions or actions. This can be compared to a bank account which can be used to make payment by giving instructions to the deposit-taker to pay to the credit of a third party: typically by means of a cheque or debit card. Cheque guarantee cards offer comfort to the retailer that the customer's bank will honour the payment, up to a limit, whether or not the customer has adequate funds.

Debit card transactions can be authorised by the issuer on-line. Some electronic money products, however, have more in common with cash than with deposits. In the case of electronic value stored on a pre-paid card, where a transaction takes place off-line, without recourse to or knowledge of the issuer at that time, there may be absolute settlement of the transaction just as if cash had been used instead.

Electronic money products are being developed for which the cus-

Chart 6



tomer may have no contractual right to repayment from the issuer, but which have cash-like features. One example is a multi-purpose card bought for cash in a high-street shop or vending machine, just like a single-purpose card, but which can be used to make a wide variety of purchases from different suppliers, who will claim on the issuer. Such a product would fall outside the definition of deposit-taking in English law.

- ***Who should issue electronic money?***

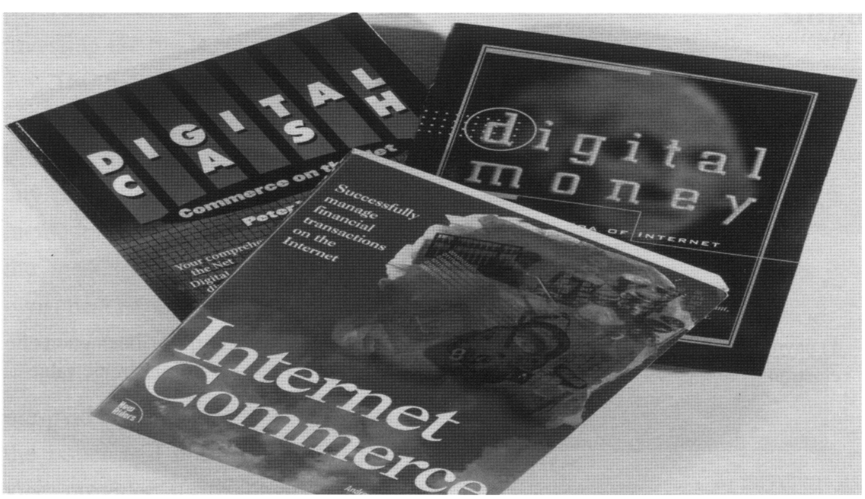
From the perspective of the analogy with cash, one can ask whether the private sector should be permitted to issue it at all. In most countries the state has a monopoly on coin and note issue. In the United Kingdom, the Royal Mint is exclusively responsible, under the direction of the Treasury, for issuing coinage and in England and Wales, only the Bank of England may issue notes.

Scottish and Northern Irish banks do issue their own notes, but these must be fully backed by Bank of England notes, deposited with the Bank. The nominal value of all cash is thus backed by a state guarantee.

Deposit-taking is carried out by private sector institutions, subject to regulation. From the perspective of the analogy with deposit-taking one may argue that only authorised banks should be allowed to issue electronic money, subject as they are to Bank of England supervision.

It can also be argued that neither of these analogies is adequate and that there is no reason to restrict the issue of electronic money at all. Provided that the public were well educated as to its status, regulation might be left to market forces and the self-interest of potential issuers, such as retailing and telecommunications companies, in protecting their reputation.

Yet another model would be to allow 'special purpose vehicles' to issue electronic money subject to some degree of tailor-made regulation. For example, it could be required that the funds backing the issue of electronic money be held in assets of sufficiently high quality, sufficiently liquid to be able to meet claims, and be subject to a risk-adjusted capital requirement.



- ***Deposit protection***

It would then be necessary to decide whether statutory deposit protection arrangements should apply to electronic value, regardless of who issued it. In the case of products which are more like cash than deposits, it would not be possible to apply the existing model. Unlike the position with deposits, in the event of insolvency the issuer would not know exactly how much value was held by whom.

- ***Security issues***

Counterfeiting of bank notes would have its counterpart in the introduction of 'false' electronic value into the system, whether by an outsider breaking the security, or by it being compromised by a corrupt director or employee of the issuer. Unlike counterfeit notes, such value might be completely indistinguishable from 'real' value, in particular to the public. If counterfeit value caused the failure of a particular issuer, there could be serious consequences for confidence in electronic money and, conceivably, smart cards more generally.

- ***Criminal activities***

Misuse of the financial system for money laundering and other criminal activity, such as drug dealing and tax evasion, is a problem for all countries. Just as electronic money may be more convenient than cash for legitimate purposes, an ability to transfer large sums of money which had been earned illegitimately, from card to card or down a telephone line, could be attractive to criminals if such transfers could be made off-line, without intervention of the issuer. Whether or not electronic money issue were to be regulated, it would be important to ensure that the efforts of enforcement agencies were not hampered and that current reporting requirements applying to cash transactions could be extended to electronic money. Requirements to keep an audit trail for electronic money transactions, even if more limited than for banking or credit card transactions, would reduce the attractiveness of these products to criminals relative to cash.

- ***Monetary policy***

Even if electronic money were substantially to replace cash, the consequences for control of monetary policy are unlikely to be serious. Any innovation in retail payments systems may affect the velocity of money, and policy makers and analysts are used to coping with such changes in setting and revising policy rules. There would be some statistical questions to resolve: on how the amount of electronic money outstanding should be treated and how frequently it should be measured.

- ***Seigniorage***

Loss of seigniorage income from the displaced notes and coin is potentially significant for central banks which, unlike the Bank of England, are funded from this source. Although in terms of the overall government budget loss of seigniorage would be small, it could be sufficiently large relative to the budgets of some central banks to reduce their financial independence from government.

- ***Wider public policy questions***

Potentially important policy issues arise for other government departments. These include disclosure to consumers of their rights, in the United Kingdom primarily a matter for the Department of Trade and Industry and the Office of Fair Trading, and data protection and privacy, for the Home Office and Data Protection Registrar to consider.

The EMI report

Electronic money is an international phenomenon, and there have been a number of international studies of its implications. One recent contribution to the debate was the European Monetary Institute report on multi-purpose pre-paid cards in 1994, which recommended that the issue of electronic money be restricted to 'credit institutions'. In the United Kingdom, this means banks and building societies, authorised respectively by the Bank of England and by the Building Societies Commission.

An exception was suggested in the EMI report, namely, that at the discretion of a national central bank, "issuers do not have to be fully fledged credit institutions provided that (i) they provide only domestic payment services; (ii) they are subject to appropriate regulations, in particular with respect to liquidity requirements; (iii) they are supervised by the institution which supervises credit institutions".

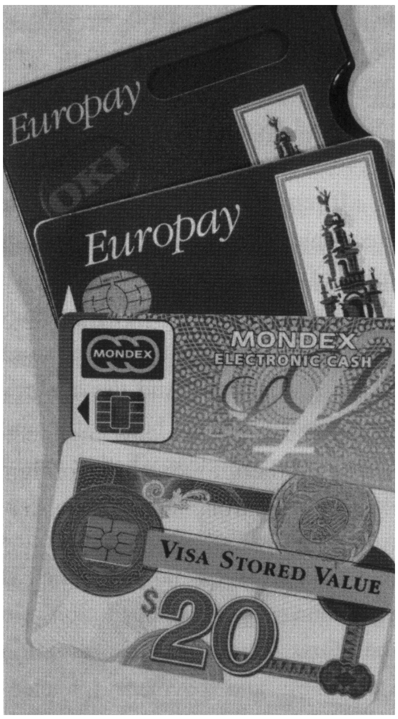
The report also acknowledged the difficulty of drawing a sensible boundary between single- and multi-purpose cards, proposing that issue of limited-purpose cards — able to be used in a small number of well identified points of sale within a well identified location, such as a university— need not be restricted.

It remains difficult to categorise electronic money, as the development of further new products since 1994 has demonstrated. Uncertainties about legal interpretation were raised in the EMI report. And the analogy with deposits has not been sufficient; it is not always clear whether established legal frameworks apply.

An issuer of electronic money may not necessarily fall under the EU definition of 'credit institution' (in the First Banking Co-ordination Directive); and payment for electronic money made by a consumer may not fall within the definition of 'deposit' (in the Deposit Guarantee Directive). At the same time, other schemes clearly fall within those definitions and most EU countries have indicated they will insist that electronic money is issued only by credit institutions.

G10 and G7 Reports

The Bank for International Settlements in Basle has this year issued two reports on electronic money, arising out of work done by G10 central banks. The first is concerned exclusively with security issues, while the second considers a wider range of matters of public policy interest.



Work in the G10 is continuing, following the commissioning by the G7 heads of government of a further study from G10 central banks and finance ministries for the heads of government summit in Denver next summer.

Limiting risks

The immediate public policy issue is whether and how electronic money should be regulated, or whether instead market forces and public education would provide sufficient protection.

Many of the concerns about the integrity of electronic money schemes might be met by a combination of explicit regulatory requirements. These might include a high degree of technical security of hardware and software, to protect against counterfeiting electronic value; low card limits, to discourage money laundering; minimum standards of auditable records; and fitness and properness of the directors, to guard against embezzlement of funds.

In the United Kingdom and elsewhere, however, instruments which have some functional similarities to electronic money are not regulated by the central bank. These include travellers' cheques and luncheon vouchers, bureaux de change and credit card issuers.

In practice major credit card companies have not allowed non-credit institutions to issue their cards, for reputational reasons. The same might happen for electronic money; but it is easy to imagine that non-banks — perhaps not only the larger telecommunications or software corporations but also smaller companies — would want to become involved in issuing it. Smaller companies might be able to take advantage of the basic hardware and software systems developed by others, once these were widely installed to a common, open standard.

Some European countries do not need to consider the scope of the EU credit institution/deposit definitions, because unlike the United Kingdom they define payments instruments and money transmission mechanisms to be banking business, subject to supervision, in their domestic law. Individual countries can be expected to arrive at different conclusions on the appropriateness of regulation, depending on their existing structures. But given the ease of transferring electronic money across national boundaries, it is clearly desirable to have some understanding between countries on cross-border schemes.

In any event, the existence of regulation in some countries is likely to mean that the major international issuers will probably find it convenient to issue through a credit institution and to meet requirements of the regulators.

Electronic money can bring significant social benefits, in convenience and efficiency. It may catch on only slowly at first, but with demand then taking off suddenly, as with credit cards; or it may flourish only as a novelty.

Policy makers face a difficult task balancing the interests of social and consumer protection against the need to avoid restricting innovation. But product development is not a new problem for policy makers and they too will have to strive to be innovative and efficient.

Where new regulation is introduced, it will have to take account of the likelihood of rapid innovation, and not be so stringent as to kill off product development or drive it offshore. It will also be important to ensure that consumers are aware of the scope and boundaries of regulation.

RATING SOVEREIGN RISK

By Christopher Huhne, IBCA

The phenomenal growth of cross-border capital flows has placed a premium on understanding sovereign risk. Banks have undertaken country risk analysis for many years, but there is now increasing interest in the published credit ratings of countries. What risks are the rating agencies measuring and how can they be compared with the normal credit risks involved in lending to companies?

Sovereign risk generally refers to two types of risk: either a default by a sovereign government on its foreign currency obligations, or the risk that the country's lack of foreign exchange will cause the default of other entities. When an entity borrows in a foreign currency, it has to go through two stages to service its debt. It has to be able to generate debt service in its own currency, but it also has to be able to purchase enough foreign exchange to meet foreign currency obligations. In many emerging markets, this second risk — transfer risk — may dominate the assessment of the creditworthiness of the institution.

A recent example of the risk is Venezuela, which introduced foreign exchange controls in July 1994. Borrowers had to request foreign currency from an exchange board controlled by the Finance Ministry, which led to delays in payments on private sector debts. This transfer risk is usually held to be synonymous with the sovereign risk of holding the government's own foreign currency obligations, since any government would use its powers of taxation, regulation or foreign exchange control to give priority to the service of its own debt.

Indeed, in Venezuela's case, government eurobonds have continued to be serviced. The government's rating is thus the best rating of any entity in the country. This is the essence of the 'sovereign ceiling doctrine'. A corollary of this is that no entity can have a higher rating than its government.

Although sovereign analysts are attempting to assess the vulnerability of a sovereign to foreign exchange crises which may lead to sovereign default or to transfer risk, the analysis can also help investors to understand other, related risks. The increasing acceptance of the benefits of free capital flows, and therefore the reluctance to impose foreign exchange controls, may mean that a government responds to a foreign exchange crisis by maintaining a free capital account but allowing the currency to fall — sometimes dramatically — to a market-clearing level.

This was the response, for example, of Turkey in early 1994. It was also the response of Mexico at the end of 1994, although Mexico would also have defaulted without an international support package. These currency shocks are a market risk, and can entail increases in credit risks within the private sector, particularly for banks or corporates that have assets and liabilities whose currency composition is not matched.

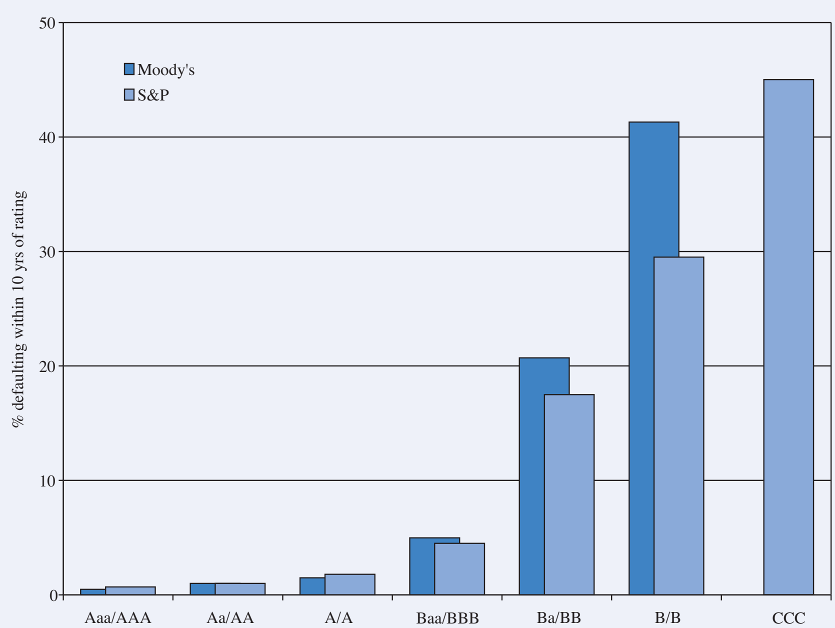
The focus of sovereign ratings is nevertheless default, and the definition of default is important; an entity need not be declared in default by a court for a default to be registered by the rating agencies. Any alteration of the terms of the original contract, which may be a rescheduling rather than a repudiation, and which could ultimately inflict capital losses on the creditor, is regarded as a default.

Indeed, for sovereigns any other definition would be unrealistic. Although the absolute sovereign immunity which existed until the Second World War has been moderated in Britain and the United States — the two jurisdictions under which most sovereign debt contracts are adjudicated — the ability to bring suit against a sovereign, let alone attach assets, is still much more limited than in the case of commercial creditors.

Number of sovereign ratings per agency, August 1996

	Number of Sovereign Ratings
Moody's Investor Services	67
Standard & Poor's Corporation (S&P)	59
IBCA	40
Japan Bond Research Institute (JBRI)	17
Japan Credit Rating Agency (JCR)	10
Duff & Phelps	8
Nippon Investors Service (NIS)	3
Fitch Investors Service	1

Chart 1: Ten year cumulative default rates of rated bonds (%)



Ratings and default

The key rating for sovereigns is the long-term foreign currency rating. The short-term rating, which applies to debt with a maturity of less than one year, is usually based on the long-term rating.

What does the rating imply in terms of default probabilities? The truthful answer is that we cannot yet be sure, because sovereign ratings have only been assigned on any scale since the late 1980s and the beginning of the Brady bond market. However, we can say what we hope the long-term sovereign ratings mean. The agencies try to align their judgments of sovereign default with the default probabilities observed in the US corporate bond market, which is the only bond market with a long history and a large sample of rated entities: an AA-rated sovereign ought to be equivalent to an AA-rated company. Both of the big US agencies publish studies of the US corporate market which show a fairly stable picture over time of default rates.

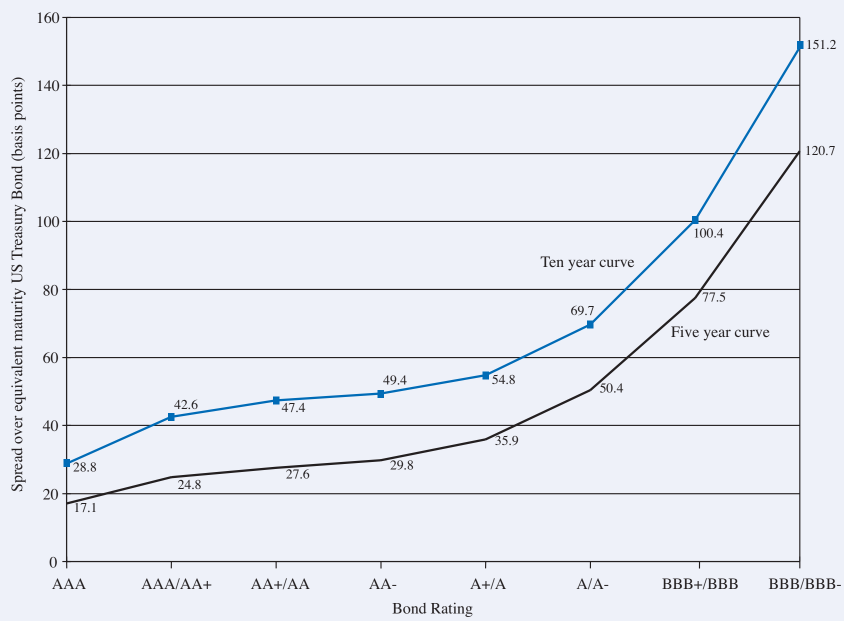
The ten-year cumulative default rates — the chance of a default within ten years of the paper being rated at that rating level, even if it is later sharply downgraded — are shown in Chart 1. Within each rating category, ratings are graded by plus or minus (in the case of S&P and IBCA) or by 1, 2, 3 in the case of Moody's: thus Moody's A1 is equivalent to S&P's A+.

Differences in ratings

Not all agencies, however, speak the same rating language. An article published in 1994 by the Federal Reserve Bank of New York showed that the average rating level, comparing entities rated by various agencies, is similar for IBCA, Standard & Poor's and Moody's. Currently, on sovereign ratings, the average difference is insignificant but Moody's are the lowest, with IBCA next and Standard & Poor's the highest. However, some agencies — notably the Japanese, but also the smaller American companies — assign ratings which are on average higher than those of other companies.

This does not mean that the assessment of risk is faulty: their rank ordering of risk may still be correct. They may also simply take the view that the world is less risky than the other agencies believe. But it may mean that the relationship between ratings and default probabilities is different from that employed by the big international agencies. The Hong Kong Monetary Authority, for example, accepts paper as collateral for its liquidity facility which is rated A– /A3 by IBCA, Standard & Poor's and Moody's but insists on a minimum rating two notches higher (A+) for paper rated by the Japan Bond Rating Institute.

Chart 2: Eurodollar credit spreads by rating



Source: HSBC Markets

... default rates and ratings are broadly reflected in the pricing of bond issues worldwide

Ratings and spreads

These default rates and ratings are broadly reflected in the pricing of bond issues worldwide: Chart 2 shows the premium above the yield on a US Treasury bond that issuers at different rating levels have to pay to borrow in the eurodollar market. These spreads vary over time, reflecting the market perception of overall risk and the supply and demand for funds.

Another important caveat is that spreads on non-investment grade sovereigns tend to be more volatile than spreads on the market as a whole. Indeed, some analysts have argued that the markets consistently require a higher risk premium for a given rating accorded to a sovereign than they do for a rating accorded to a corporate, reflecting the markets' perception of the lack of track record of the rating agencies in the field of sovereign analysis compared with the track record in bank and corporate analysis.

It may also reflect the inherent difficulties of sovereign analysis compared with other forms of credit analysis. The most fundamental difference arises from the lack of effective legal remedies against sovereigns. If a bank or corporate is able to service its debt, it will do so, because its creditors can have recourse to the courts. In general, therefore, the business of assessing bank or corporate risk is about assessing the ability to pay.

Of course, sovereign analysis also involves examining the ability to pay, weighing such factors as the volatility and trend of foreign exchange earnings, growth trend of the economy, sustainability of the current account position, ratios of externally-held debt to exports and GDP and so forth. But in addition, the sovereign rating process inevitably involves subjective judgments about the political willingness to pay. In extreme circumstances, how much sacrifice would the political and social system be prepared to make to continue debt service?

Data deficiencies

In time, our econometric work on lead indicators of default may be able to reduce the element of analytical judgment. However, models do not yet give us clear answers. There are data deficiencies before the modern period, when there are large numbers of sovereign defaults. There have been many defaults since 1970. Some 40 per cent of all 72 countries with access to international markets have defaulted on foreign currency obligations. But many of the defaults in 1982 and soon after were the result of financial market contagion. They may therefore tell us more about the herd-like characteristics of financial markets than the individual characteristics of defaulting sovereigns.

Differences of opinion between rating agencies

		Moody's	S&P	IBCA
Two notches				
	China	A3 (A-)	BBB	NR
	Cyprus	A2 (A)	AA-	NR
	Czech Republic	Baa1 (BBB+)	A	A-
	Hong Kong	A3 (A-)	A	A+
	Kuwait	Baa1 (BBB+)	NR	A
	Qatar	Ba1 (BB+)	BBB	NR
	South Africa	Baa3 (BBB-)	BB+	BB
	Sweden	Aa3 (AA-)	AA+	AA-
	Taiwan	Aa3 (AA-)	AA+	NR
Three notches				
	Venezuela	Ba2 (BB)	B	NR

... the sovereign rating process inevitably involves subjective judgments about the political willingness to pay

There is, however, one consolation about sovereign default: although it may have been more frequent, it has also tended to result in lower ultimate capital losses. One of the largest capital losses inflicted on sovereign lenders since the 1982 debt crisis was by Poland, the net present value of whose Brady bonds were worth just half of the obligations and interest arrears they replaced. A more common discount was the 32 per cent for Argentina or 33 per cent for Brazil. But when banks or corporates fail, they tend to leave little behind them: the average loss for Moody's rated corporate bond debtors which fail is some 60 per cent.

Despite these uncertainties, there is substantial agreement between the main rating agencies about the broad level of sovereign risk. A three rating-notch difference is very rare, affecting only Venezuela. Of the current two-notch rating differences, shown in the table, perhaps the most understandable are the cases of countries that are undergoing a substantial regime change such as Hong Kong or South Africa, although there are some notable differences among OECD countries as well.

In low rated countries like Brazil virtually every entity that issues foreign currency debt is rated at the same level because the sovereign risk is judged to dominate all other risks

The sovereign ceiling

The most consistently controversial aspect of sovereign rating is that it acts as a ceiling for other issuers. In low rated countries like Brazil (rated unanimously B+, B+, B1), virtually every entity that issues foreign currency debt is rated at the same level because the sovereign risk is judged to dominate all other risks. Thus a bank may be a sound and efficient institution with a low probability of default on its obligations in its local currency, but its foreign currency rating will still be B+ (with an implicit default probability of a third over ten years).

This raises another important question about how credit officers use long-term foreign currency ratings. Although the sovereign ceiling may encapsulate the overall risk of a particular issuer very well, credit departments should clearly still prefer to have inter-bank lines to the better Brazilian banks. And the long-term foreign currency rating will not help them to discriminate. That is why the IBCA individual and legal ratings of banks, which respectively measure financial strength and the likelihood of support by a large shareholder or the central bank, are so widely used in the inter-bank market: Brazil's Banco Itau is rated a good B whereas Banco do Brasil is rated C/D. Yet both have the same long-term foreign currency rating at the sovereign ceiling: B+. Moody's has recently followed IBCA's practice by introducing a financial strength rating for banks.

The sovereign ceiling is not, though, immutable. One interesting recent case is the Mexican government's US$6 billion floating rate note issue, which was rated BBB–/Baa3, two notches above the Mexican sovereign rating of BB/Ba2 and on the lowest rung of the coveted investment grade ratings.

The reason for the rating — and price — enhancement was that the issue benefits from an elaborate system of special accounts, into which are paid oil revenues owing to PEMEX, the Mexican state oil company. However, this arrangement required some diligent legal work to ensure that the new issue did not breach the usual 'negative pledge' clause in sovereign bond contracts, which specifies that the sovereign will not create securities with a better claim on its assets or income flows than enjoyed by the current security.

The Mexican issue is therefore unlikely to create a precedent for existing sovereign bond issuers, although it might help new countries without existing borrowings (and hence operational negative pledge clauses) borrow on finer terms by attaching particular flows to the bond.

Banking is a relationship business, and syndicated credit terms may take account of all the other fees and commissions that a bank can receive from its client

There are some precedents in the private sector, where some Mexican, Brazilian and Venezuelan banks have issued dollar-denominated debt secured on the receivables sent to them (via an escrow account) by US banks. However, this is a zero sum game. If flows or assets are not available to support senior, unsecured debt, the overall sovereign credit rating applying to senior, unsecured debt is likely to be lower.

Private sector entities can occasionally achieve better pricing than their sovereign in the syndicated credit market: a recent example is Anglo-American, the mining house, in South Africa.

However, banking is a relationship business, and syndicated credit terms may take account of all the other fees and commissions that a bank can receive from its client. In the bond market, by contrast, transactions are more clinical. So corporate or bank borrowers are almost never able to borrow more cheaply than their sovereign.

Different considerations apply, however, with local currency ratings, which do not encapsulate transfer risk. The local currency rating of a sovereign government is usually higher than the foreign currency rating, reflecting the government's greater ability to control flows within its own jurisdiction and, in extremis, its ability to print the means of debt service. However, it does not follow that all local currency sovereign ratings are AAA: there are several instances of local currency sovereign defaults such as the alteration of the terms of indexation of debt by the Argentinian and Brazilian governments following monetary reform plans.

These defaults tend to be associated with hyperinflation, and there are therefore conceivable circumstances in which private sector entities might benefit from a higher local currency rating than their governments if they were able to withstand such circumstances better.

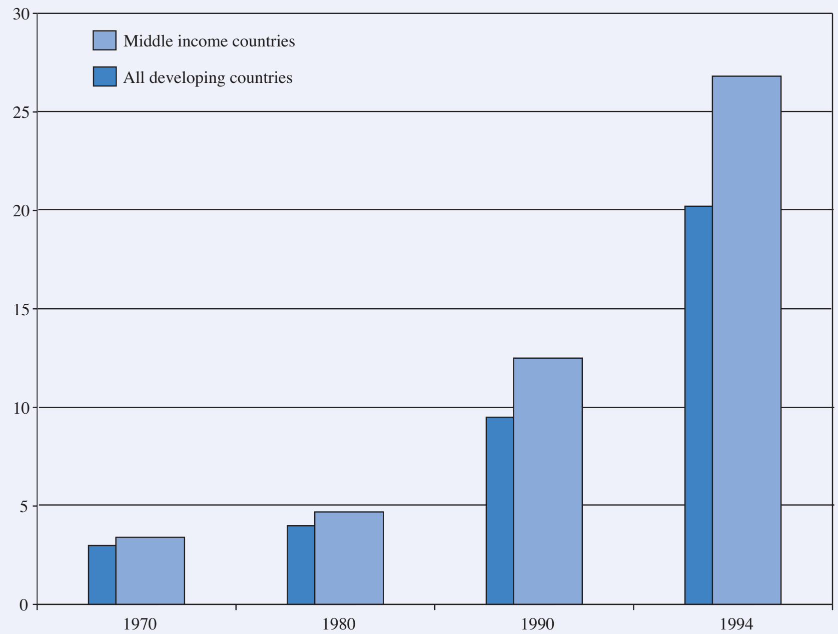
Bank debt and bonds

Apart from disagreements over the standing of individual countries, the big agencies also have some doctrinal differences. Perhaps the most important of these is Moody's view that bank deposits, including inter-bank credit lines, are inherently more risky than other forms of foreign currency obligation and therefore in many cases should have a slightly lower sovereign ceiling rating.

Thus Moody's bank deposit sovereign ceiling rating for South Africa is Ba1 whereas the bond rating is a notch higher at Baa3. Moody's justifies this view by arguing that an inspection of the history of sovereign defaults shows that countries are more likely to impose foreign exchange controls limiting inter-bank obligations than they are to default on foreign currency bonds.

Although this is supported by the historical record, there is a question mark about its relevance. The financial structure of countries' external debt is different today from what it was on the eve of the debt crisis in August 1982. Bonds were once insignificant (Chart 3). However, in the 1990s, bonds are simply too important to be spared from the stresses that might arise in sovereign default, just as they were too important during the bond defaults of the nineteenth century and the 1930s and 1940s. Neither IBCA nor Standard & Poor's distinguish between the ratings of bank deposits and bonds.

Chart 3: Proportion of bond debt in external debt (%)



... sovereign defaults are likely to increase, since the number of low rated sovereigns in the market is increasing

There are other rapid changes in the international environment which will continue to make history an imperfect guide to the future. Sovereign defaults are likely to increase, since the number of low rated sovereigns in the capital markets is growing rapidly. But the most encouraging development is the increasing willingness of investors to assess the individual credit strengths and weaknesses of sovereigns.

In 1982, Mexico's default was swiftly followed by virtually every country in Latin America, all of which were shut out of international capital markets for the better part of a decade. In 1994, Mexico's near-default caused a 'tequila effect' that was much more temporary, and Mexico itself rapidly regained access to the markets. That willingness by investors to assess individual credit strengths, rather than succumb to market panic, reduces the likelihood of a widespread sovereign debt crisis such as 1982.

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DEPOSIT PROTECTION AND BANK FAILURES IN THE UNITED KINGDOM

By Patricia Jackson, Regulatory Policy, Bank of England

Payouts from the UK Deposit Protection Fund have been small, compared with those in some major centres such as the United States and Japan. This partly reflects the less generous scheme in the United Kingdom. But it is due mainly to the relatively small number and size of banks that have failed. Reasons for failure varied. But traditional banking concerns of asset quality and liquidity almost always featured.

In the 14 years since the introduction of the Deposit Protection Scheme, 29 UK-authorised banks have been placed either in administration or in liquidation, and Johnson Matthey Bankers (JMB) and National Mortgage Bank (NMB) were purchased by the Bank as part of support operations. But in all but five cases (JMB, NMB, BCCI, British and Commonwealth and Barings) the banks were relatively small. At the start of the period there were about 350 banks incorporated in the United Kingdom.

The relatively small size of most of the banks which have failed is reflected in the size of the total payments from the Deposit Protection Fund. Since 1982 these payments to depositors have amounted to only £144 million gross and £88 million net, after the recovery of funds from the liquidation or administration. It is likely that the Fund will recover a significant amount of even this net figure.

In contrast, the cost of failed banks to the Federal Deposit Insurance Corporation in the United States over the past ten years (1986-1995) is estimated to have amounted to $30.6 billion, or the equivalent of £19.5 billion (at today's exchange rate). In Japan the current banking problems have substantially reduced the Deposit Insurance Fund which stood at the equivalent of £5 billion two to three years ago.

Even adjusted for the relative size of the different economies (using 1995 GNP) there would still be a substantial difference. The US economy is six-and-a-half times as large as that of the United Kingdom, and the Japanese economy is four-and-a-half times as large. The size of payouts in Japan and the United States is also influenced by the relative generosity of the schemes compared with the United Kingdom.

There is full deposit protection in Japan and depositors are fully covered for deposits up to $100,000 in the United States. The UK scheme is less generous than arrangements in many other countries. This reflects concerns that full cover would reduce the incentives for depositors to take a view on the soundness of individual banks and therefore reduce

THE UK DEPOSIT PROTECTION SCHEME

Under the original scheme set up in 1982 each depositor could receive up to 75 per cent of sterling deposits up to £10,000. In 1987 this was increased to 75 per cent of sterling deposits up to £20,000, and in 1995 was increased again to 90 per cent of deposits (in EEA currencies or Ecus) up to £20,000 equivalent (or the sterling equivalent of 22,222 Ecus whichever is the greater). The scheme is funded by banks authorised in the United Kingdom (excluding branches of banks from other EEA countries unless they have topped-up the cover under their domestic schemes using the UK scheme) according to their holdings of deposits in EEA currencies and Ecus.

DEPOSIT PROTECTION ARRANGEMENTS ELSEWHERE

In the **USA**, deposit insurance is administered by the Federal Deposit Insurance Corporation (FDIC) with separate funds for banks and savings institutions. In contrast to the UK system, where no depositor is fully insured, depositors at member institutions are fully insured up to $100,000. A risk-based charge (reflecting their capital and perceived supervisory risk) is levied on the member's assessment base (basically domestic deposits) and additional income comes from the investment of the surplus of the Bank Insurance Fund in government securities. This contrasts with the UK scheme where institutions are levied generally only after a failure according to the amount of insured deposits. In the past ten years (1986-1995), the total cost to the FDIC of failed banks was $30.6 billion, net of recoveries (£19.5 billion at current exchange rates).

In **Japan**, deposit insurance is provided by the Japanese Deposit Insurance Corporation (DIC) which covers deposits with banks and various other deposit-taking institutions. The DIC has in practice been used to finance mergers and take-overs rather than to compensate depositors, largely because no Japanese institution has been allowed to fail in the conventional sense. Under the DIC law there is a payout ceiling of Yen 10 million per depositor but this has in practice not been enforced. The scheme is funded by a flat percentage (recently raised to 0.048 per cent) of deposits levied on the member institutions annually. In addition, a temporary special levy (at 0.036 per cent) has recently been set to cover payouts above the ceiling. Funds provided to facilitate mergers and takeovers have substantially reduced the DIC fund, which stood at the equivalent of £5 billion one or two years ago.

The banking problems in some Scandinavian countries in the early 1990s were dealt with mostly through government support (either with capital injections or guarantees) and therefore not related to deposit protection arrangements. Support arrangements are estimated to have amounted by end-1994 to some £6.5 billion in **Sweden**, £6 billion in **Finland** and £2.5 billion in **Norway** (of which £0.8 billion came from bank-financed 'safeguard' funds).

In **France**, there has been a mixed picture of state rescue packages for large high profile banks (for example Credit Lyonnais and Credit Foncier de France) and some failures which have led to calls on the deposit protection arrangements. The deposit protection schemes vary according to the nature of the credit institutions.

For mutual co-operative banks as well as savings and provident banks the central supervisory body of each group is responsible for ensuring prudent conduct and also the continuing existence of its institutions. To this end it takes all the necessary measures, in particular to safeguard the solvency and liquidity of each of these institutions and of the network as a whole, giving de facto 100 per cent protection to depositors. In most cases the firms contribute, ex ante, to a central fund for the support of institutions in difficulty.

Commercial banks (members of the Association Francaise des Banques) participate in a system which collects funds ex-post and covers deposits (in full) up to FFr 400,000. Each year, a member can be called to make contributions to the scheme up to a maximum of 0.3 per cent of its deposits. Institutions can also be required in any year, if necessary, to contribute uncalled contributions from the previous two years and contributions which could be called in the following two years.

Deposit protection schemes in **Germany** are also organised by the banking associations. The three largest schemes are operated by the Association of German Commercial Banks, the Association of German Savings Banks and the Association of German Cooperative Banks. The scheme for the commercial banks is very generous, compensating non-bank depositors in full for deposits up to 30 per cent of the bank's capital.

The depositor has no legal entitlement to this compensation but the association's by-laws state that the obligation will be honoured.

All savings banks and Landesbanks, as public law institutions, have a guarantor obliged to take whatever measures are appropriate to ensure operational viability of the banks. In order to reduce the exposure of the guarantor, the regional savings banks' associations have established deposit guarantee funds. These, along with the Landesbanks' contingency reserves, form a joint liability scheme which can be drawn on to provide support for an institution to prevent it from failing.

For co-operative banks there is a mandatory deposit insurance scheme aimed at preventing banks from collapsing. In addition to these schemes the Association of Public Sector Banks established a scheme in 1994 for banks not already members of one of the existing schemes.

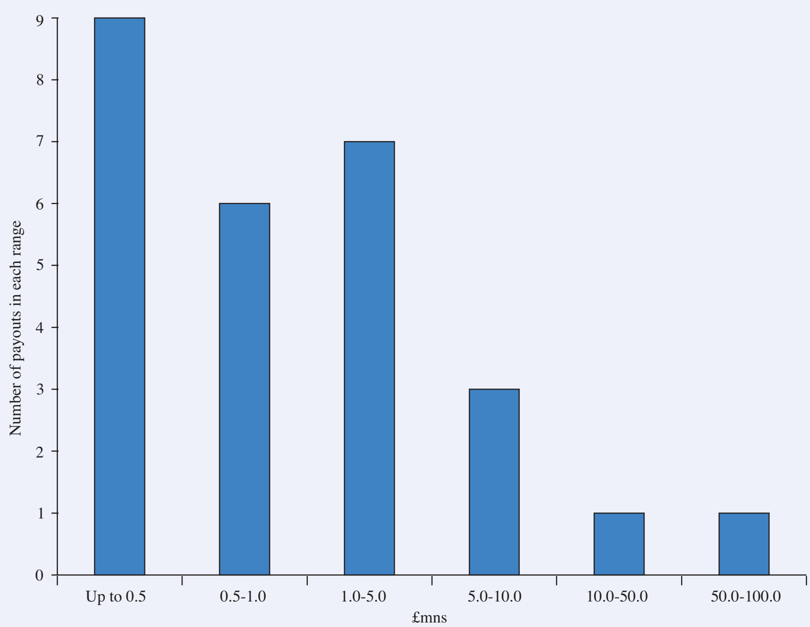
market discipline on bank managements.

Of the five larger UK authorised banks to get into severe difficulty in the period only two, BCCI and British and Commonwealth Merchant Bank, led to calls on the Deposit Protection Fund. The gross payout to BCCI depositors, which has represented the largest call on the Fund, was less than £100 million.

To date, depositors in BCCI have not made claims in respect of a substantial proportion of what would appear to be eligible deposits (others were not eligible to claim because their deposits were in foreign currency). The next largest gross payout was to depositors in British and Commonwealth Merchant Bank. But in this case the bank was finally wound up with no losses, leaving no net call on the Deposit Protection Fund.

... in most cases the total payout to the depositors in the bank concerned was less than £5 million

Chart 1: Distribution of gross payouts per failure



Two of the other three cases — Johnson Matthey Bankers and National Mortgage Bank — did not lead to calls on the Deposit Protection Fund because they were acquired by the Bank as part of support operations. Barings was purchased by ING, which meant that depositors with the authorised bank (although not holders of bonds issued by the group) suffered no loss.

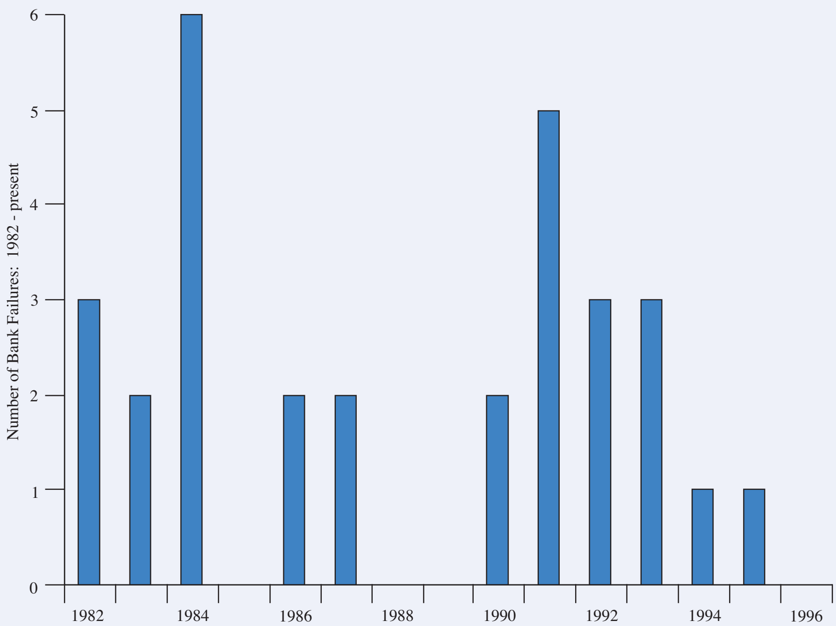
The distribution of the total size of gross payouts, per failure, is shown in Chart 1. The net figure would be substantially lower in some cases. As can be seen, in most cases the total payout to depositors in each bank concerned was less than £5 million, due largely to the predominantly small size of the banks which have failed.

Chart 2 shows the distribution of failures between the various years. It includes Johnson Matthey Bankers, which was purchased by the Bank. National Mortgage Bank is not included but the Bank supported it from 1991 and then purchased it in 1994.

There are two spike years — 1984 and 1991 — with six and five failures respectively. The first coincided with the difficulties in Johnson Matthey Bankers but was unrelated to it. It came despite strong economic conditions. The second included BCCI and to an extent reflected fallout from that case. It also coincided with a sharp downturn in the economy that exacerbated the problems in some already weak small banks.

Before 1979 the Bank exercised a degree of informal (and non-statu-

Chart 2: Distribution of failures over time



tory) supervision over a limited part of the banking system. The 1979 Banking Act gave the Bank, for the first time, statutory responsibility for supervising all banks operating in the United Kingdom. Every institution wishing to continue to accept deposits from the public had to apply to the Bank for recognition or a licence under the Act.

The closure of a number of small banks in the period following the introduction of the Act (including the spike in 1984) in part reflected an increase in information available to the Bank on such matters as the fitness and properness of directors, controllers and managers. In addition, low quality lending and poor systems and controls in some banks led to their failure.

The 1991 spike reflected difficulties in the small bank sector. The failures of first British and Commonwealth and then BCCI led to pressure on the wholesale funding on which most were dependent. Because the small banks had traditionally been heavily involved in the property market the problems were compounded by the fall in property values as the recession deepened.

The Bank kept 40 small banks under particularly close review and worked closely with them to help them reorder their affairs, or wind down in an orderly fashion. For a few small banks the Bank provided some liquidity support in mid-1991 designed to prevent the problems developing into a wider systemic disturbance. The banks which did fail had a combination of problems. They were affected by the reduced confidence in small banks but also suffered from poor asset quality and

The 1991 spike reflected difficulties in the small bank sector … problems were compounded by the fall in property values in several of the cases there were elements of fraud.

Bank problems

We have looked at 22 cases of banks which failed or were in severe difficulty since 1984. Of these, 13 were banks which became unviable and the remaining nine were a sample of banks with severe problems which proved tractable. We categorised the problems in these banks as follows:-

The results in summary:

Poor asset quality	16
Mismanagement	18
Dealing losses	2
Group structure/contagion	4
Liquidity	9
Fraud/concealment	7

Poor asset quality — This was present in 16 of the 22 cases. This encompassed a number of different, and often overlapping, elements.

(a) ***over concentration*** — where the failure of one loan, or a small number of loans, placed the bank in jeopardy (five of the 16 cases);

(b) ***specialisation*** — where there was a concentration of the loan book in one sector, region, or to a group of individuals (10 of the 16 cases);

(c) ***poor risk selection*** — where the bank made loans without correctly pricing the risk (13 of the 16 cases).

Institution	Problems					
	Poor asset quality	Mismanagement	Dealing losses	Group structure/ contagion	Liquidity problems	Fraud/ concealment
1		✓	✓			✓
2		✓		✓		
3	✓	✓		✓		✓
4	✓	✓				✓
5		✓	✓			✓
6	✓	✓				
7	✓	✓			✓	✓
8				✓	✓	
9	✓	✓			✓	
10	✓	✓			✓	
11	✓	✓			✓	✓
12					✓	
13	✓	✓			✓	
14	✓	✓			✓	
15	✓	✓				
16	✓	✓				
17	✓	✓				
18	✓				✓	
19	✓	✓				
20	✓	✓				
21				✓		✓
22	✓	✓				

... traditional banking concerns of asset quality and liquidity were at the forefront

Mismanagement — This was to a degree evident in most cases (18 of the 22). It also encompassed several different factors:

(a) ***poor strategy*** — 11 of the 18 cases

(b) ***poor systems and controls*** — 17 of the 18 cases

Dealing losses —These were significant in only two of the 22 problem banks: Barings and Adam and Co (in both cases a trader had taken a large and speculative position).

Group structure or contagion — Difficulties in the bank were caused by problems elsewhere in the group. This was a factor in four of the cases, most notably British and Commonwealth which was undermined by problems in its computer leasing sister company, Atlantic Computers.

Liquidity problems — These were a factor in nine cases. In most, this was due to a dependence by smaller, property-based banks on wholesale funds, although two small banks also suffered a more general loss of depositor confidence. The nervousness in the wholesale markets resulted from the failure of British and Commonwealth and BCCI, and coincided with the 1991-92 slump in property prices.

Fraud/concealment — This was a factor in seven cases, including both cases which involved dealing losses, in all of which the losses were concealed.

We have not shown the macro-economic cycle as a specific element in any failures. But in a number of cases the macro-economic environment provided an important part of the backdrop to failure for particular banks. In effect, it exposed management or strategy weaknesses, such as over-lending to a sector (particularly property) during a boom which was followed by difficulties as asset prices fell sharply.

Weak economic conditions also exacerbate confidence or domino effects. A boom, encouraging over-lending by some banks to certain sectors, increases the likelihood that several banks will experience the same difficulties in the downturn.

Another relevant factor, but one which is not highlighted, is size. All banks are affected by macro-economic conditions. But smaller less-diversified banks do appear — not surprisingly — to be generally more vulnerable to changes in market conditions than large banks which are diversified across a number of sectors and income sources.

Almost all the cases of problem banks examined involved a combination of several factors. But, as the table shows, in most cases the traditional banking concerns of asset quality and liquidity were at the forefront. ■

INTERNATIONAL REGULATORY CO-OPERATION

By Clifford Smout, Bank of England, and John Barrass, the SIB

Recent events have demonstrated the importance of effective co-operation between regulators from different jurisdictions in the supervision of internationally active financial groups. What practical steps should be taken to ensure that international regulatory arrangements for banking and securities business keep pace with changes in global finance?

Banking has for many years been an international business, not least as a result of its role in financing international trade. With these opportunities for profit there has come — as always — risk. Indeed, when Barings got into difficulties in 1890 its problems stemmed from its exposure to Latin America. Banks carrying out activities in other countries have often sought to establish branch presences, to enable them to make the most effective use of their capital, although domestic regulations have sometimes precluded them from doing so.

Where branches have been allowed, supervision in the host country has taken into account the work of other regulators; after all, in most countries insolvency legislation means that in practice a branch does not have its own capital, and the 'host' supervisor therefore depends on the head office being sufficiently well-capitalised to guard against risks elsewhere in the organisation.

But even where subsidiaries have been established, it is clear that events elsewhere in the group can damage the local firm, reinforcing the need for active collaboration between supervisors.

Given this background, when the Basle Committee on Banking Supervision was set up at the end of 1974 (see box), the initial focus of its work was to define the role and responsibilities of home and host supervisors of internationally active banks. These were set out in the 1975 Concordat, which was revised and expanded in 1983, and which established — as a matter of best practice — how supervisory responsibility for banks' foreign branches, subsidiaries and joint ventures should be shared between host and parent supervisors.

This work was updated in 1992, when a number of these principles were reformulated as minimum standards. These were as follows:

- all international banks should be supervised by a home-country authority that capably performs consolidated supervision;
- the creation of a cross-border banking establishment should be subject to the prior consent of both host and home supervisor;
- home supervisors should be able to gather information from overseas establishments;
- if the host supervisor believes any of these standards are not met it can impose restrictive measures or prohibit the establishment of banking offices.

Since then, the members of the Basle Committee have been working closely with banking supervisors from other countries on the implementation of these standards, not

INTERNATIONAL REGULATORY CO-OPERATION

Basle Committee on Banking Supervision

The Basle Committee was established by the central bank governors of the G10 countries at the end of 1974, following serious disturbances in international currency and banking markets, including the failure of a German bank, Bankhaus Herstatt, part way through the trading day. The Committee's members come from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States, and are typically the heads of supervision or senior executives of the central bank and other authorities with formal responsibility for banking supervision.

The Committee's conclusions have no legal force, but rather represent broad supervisory standards, practices and guidelines which individual authorities use to implement detailed arrangements best suited to their own national circumstances. The key objectives of the Committee are to strengthen international co-operation by improving the overall quality of banking supervision worldwide, and to ensure that no foreign banking establishment escapes supervision.

The Committee is best known for its work on capital adequacy. In 1988 it published the Basle Capital Accord, which established a measurement framework and minimum standards which are followed not only in all member countries, but in virtually all other countries with internationally active banks. Those standards have been revised on a number of occasions, most recently to incorporate the market risk stemming from the trading activities carried out by international banks. The Committee was also responsible for the Basle Concordat, which has helped to define the respective roles of home and host country supervisors in the supervision of internationally active banks. This framework was developed into a set of minimum standards in 1992.

The International Organisation of Securities Commissions (IOSCO)

IOSCO started life in 1974 as the Inter-American Association of Securities Commissions, but in 1983 became a 24-strong international organisation. By the autumn of 1996, IOSCO had 136 ordinary, associate and affiliate members from all parts of the globe, with its members including all the main developed and emerging markets. The ordinary members comprise the chief statutory or governmental competent authorities responsible for the regulation of securities and derivatives markets in more than 70 countries. Other members include additional regulatory organisations, and international bodies with an interest in securities regulation.

IOSCO's key role in facilitating international communication and co-operation between regulators is achieved through its range of Committees, its various supporting Working Parties concerned with specific regulatory issues, and its Annual Conference. As with the Basle Committee, conclusions reached by IOSCO are not legally binding, but represent standards which may be reflected in the national regimes and practices of individual member countries.

IOSCO's agreed objectives include: to co-operate together to promote standards of regulation, in order to maintain just, efficient and sound securities markets; to unite efforts to establish standards and effective surveillance of international securities transactions; and to provide mutual assistance to promote the integrity of markets by rigorous application of the standards and effective enforcement against offences. Specific issues covered by Working Parties include multinational disclosure and accounting, the regulation of secondary markets, the regulation of intermediaries and capital adequacy, enforcement and exchange of information, and investment management.

… securities business is nowadays undeniably an international activity, requiring closer links between regulators, markets and the industry

least through the network of regional groupings of bank supervisors which has been put together in recent years.

Securities supervisors also have a long tradition of international co-operation, including arrangements for information sharing and mutual assistance in enforcement. IOSCO (see box) has proved itself a facilitator of this process, and securities supervisors have chosen to reinforce co-operation arrangements with formal bilateral agreements. For example, since 1987, the SIB, the Treasury and other UK authorities have entered into a series of Memoranda of Understanding, and more detailed Financial Information Sharing Memoranda of Understanding, with numerous overseas regulatory authorities.

Nevertheless, a few years ago it might have been argued that securities supervisors were focused primarily on issues of domestic investor protection, with less common ground internationally. Perhaps there was also, in some jurisdictions, a focus on the regulation of the marketplace and of individual exchanges — including domestic standards for ensuring the efficiency and integrity of markets — rather than on non-bank investment firms themselves. This is all changing as securities business is nowadays undeniably an international activity, requiring closer links between regulators, markets and the industry.

Changes in global finance

These developments are not confined to the securities industry. Both banking and securities businesses are

The BIS building in Basle, home of the Basle Supervisors' Committee

becoming more globalised, reflecting the huge advances in communications technology seen over the past 20 years. These have enabled much greater centralisation of trading and control structures, with 'centres of excellence' serving customers in many more locations than was previously possible.

At the same time, governments have been removing barriers, such as exchange controls, which were originally set up in an attempt to impede the free flow of capital. International competition in this, as in other areas, can provide significant benefits to consumers.

There has been some blurring of what used to be a clear distinction between banking and securities business. In many countries, of course, universal banks have long carried out both activities. Even in Japan and the United States, where a split between the two is mandated by domestic legislation, these restrictions do not apply to overseas subsidiaries.

But the growth of the over-the-counter derivatives industry, with the potential it offers to manage market risks more precisely, may have led to more long-term credit risk for securities house groups using these instruments, while conversely many banks have stepped up their trading activities. Coupled with the growth of securitisation, this means that relatively liquid trading assets now account for a significantly higher proportion of banks' assets, and contribute more to profits, than was the case even five years ago.

But banks and securities houses remain distinct in many important respects. In particular, illiquid assets still form a far higher proportion of banks' balance sheets. Nonetheless, overlapping product lines, and increased focus by firms and their regulators on underlying risks rather than particular products, means that there is now a need for regulators to co-operate not only within but also between disciplines.

The first step is for each to understand the objectives of the other, typically set out in separate statutes. Once this has been done, it is clear that there are many spheres where a co-operative approach is not only desirable but essential to both.

Crises in large financial groups now almost inevitably have an international dimension. It is crucial to ensure that the original problems, whether related to inadequate controls, insufficient capital or other causes, are not exacerbated by a failure of supervisors to work together.

As businesses become more global, and distinctions between 'banking' and 'securities' products become less clear, the ways in which firms manage themselves are also beginning to alter.

Increasingly, management is being conducted on a functional basis, with business lines, controls and risk management carried out from the centre, but with local managers also having a role (so-called 'matrix management'). In some cases, this has led to a streamlining and improvement of controls in the group.

Firms now consider their risks on a portfolio basis and can more easily exploit the benefits of diversification as well as recognising potential concentrations of exposure. But they have typically not overhauled the legal structure of the group, which is often perpetuated by other considerations, such as tax or regulatory restrictions.

This can lead to a mismatch between legal and management structures. The legal structure of a group can have supervisory implications, particularly in an insolvency. Profits in one firm may not always be available to meet losses in another in the same group. As a result all regulators of a group need to be satisfied that the legal entity for which they are responsible is properly controlled, whatever the overall management arrangements. Nevertheless, it would be prohibitively costly and duplicative to do so in a way which took no account of the work of others. There must therefore be more proactive sharing of information,

Crises in large financial groups now almost inevitably have an international dimension. It is crucial to ensure that the original problems ... are not exacerbated by a failure of supervisors to work together

and greater co-ordination between the various regulators. It is important not only to establish a better framework of co-operation in preparation for any emergency, but also to be able to address potential issues before they become more serious.

The official response

The importance of international regulatory co-operation is now widely recognised. At the G7 summit in Lyon at the end of June, the heads of state observed that "better prudential regulation and supervision in the financial markets are essential elements in preserving the stability of the international monetary and financial system".

They welcomed the work accomplished in the area of regulatory co-operation since the previous summit. But they called for "maximum progress" in the following twelve months — ahead of the Denver Summit in June 1997 — on "enhancing co-operation among the authorities responsible for the supervision of internationally active financial institutions, importantly by clarifying their roles and responsibilities".

In their joint paper ahead of the Lyon summit, Basle and IOSCO announced a joint initiative to strengthen co-operation between the regulators of diversified financial groups. This will seek to improve understanding of the roles, powers and responsibilities of each regulator and help facilitate access to the information each needs to fulfil its responsibilities, "including making meaningful assessments of the risks to the relevant entities within the group and to those entities taken together".

Basle and IOSCO will also look at whether additional co-ordinating arrangements to facilitate information exchange, in both normal and emergency situations, should be set up, and the extent to which existing provisions of national law might need to be amended to support this objective. Any such change would not, however, affect the responsibilities of any authority responsible

... Basle and IOSCO announced a joint initiative to strengthen co-operation

G7 heads of government at the Lyon Summit in June

under national law for supervising the different parts of a group.

The report referred to the work of the Joint Forum of banking, securities and insurance supervisors which has been set up to pursue practical means to facilitate information exchange, as well as other issues associated with the supervision of international financial conglomerates.

The Joint Forum will also examine the possibility of establishing criteria to identify a lead regulator, and its role and responsibilities. Suggestions for the latter include: enabling information to be passed more efficiently to relevant supervisors within a group in normal circumstances; taking a more proactive role in a crisis; carrying out risk assessments of the group as a whole; and, in the longer term, considering how far supervisory efforts could be better co-ordinated when looking, for instance, at a group's controls, particularly when these cover activities in different jurisdictions.

Solutions are also needed to some of the practical issues raised. For instance, one question is the most efficient means whereby information can be shared. One possible model — which has been described as the Internet model of supervision — would involve every regulator talking to every other. This is not a particularly appealing concept for a group which has presences in 60 or 70 countries, and involves both banking and securities (or insurance) activities.

Another would be to have all contact channelled through one of the home supervisors, which could lead to other types of inefficiency. Whatever model is adopted, it is in the interests of all to make it effective and efficient.

In some cases parts of the group may not be subject to any oversight. Supervisors then need to decide how they can most effectively acquire any relevant information from the head office itself, or from other parts of the group.

Steps taken to improve co-operation are also occurring within disciplines. For instance, in June the International Conference of Banking Supervisors endorsed a report by a working group of the Basle Supervisors' Committee and Offshore Group of Banking Supervisors on practical problems arising from the Basle Minimum Standards of supervision. In particular, the group identified practical arrangements to enable supervisors to overcome impediments to information flows in carrying out effective consolidated supervision.

A similar exercise on non-co-operative jurisdictions has also been carried out by IOSCO and is currently being followed up by a self-assessment exercise to identify where particular problems might exist. Moreover, many supervisors are pushing ahead bilaterally to enhance the flow of information from countries in which their own banks or securities firms are active (or for which they are the 'host' supervisor), to ensure that both parties understand the nature of the information which is

The Windsor Declaration … set out a clear forward agenda for securities regulators to address issues relating to the safety and soundness of derivatives

required in such cases and how best to avoid either gaps or duplication in supervision.

Following the failure of Barings, multilateral co-operation between securities supervisors was strengthened by a meeting at Windsor, which can be seen as something of a milestone. Co-chaired by the US Commodity Futures Trading Commission and the SIB, it involved regulatory bodies from 16 countries responsible for supervising the world's major derivatives markets.

The meeting focused on the regulatory issues highlighted by that collapse, in particular the implications of the increasing volumes of cross-border trading on international futures and options exchanges which have become linked by common members and similar products. Discussions focused on four sets of issues: co-operation between market authorities; protection of clients' positions, money and assets; default procedures; and regulatory co-operation in emergencies.

The Windsor Declaration which was published at the end of that meeting set out a clear forward agenda for securities regulators to address issues relating to the safety and soundness of international derivatives markets. Much of the follow-up work programme has been taken forward by IOSCO. This includes developing best practice on the treatment of customer positions, money and assets; the monitoring and exchange of information about large positions on derivatives markets; measures to improve the supervision of firms; and measures to strengthen cross-border information sharing by regulators. A final report has been published recently by the SIB and CFTC.

A further significant, and related, development was the signing in March this year of two agreements between 49 futures exchanges and clearing houses, and between 14 of their supervisory bodies, in Boca Raton. The signatories committed themselves to share information on unusually large positions taken by exchange members or their customers.

This was the first multilateral agreement of its kind, and has already proved useful in the recent copper market situation.

Active collaboration

This paper has focused almost exclusively on issues relating to information sharing and the supervision of groups, as this is at the core of the present debate on international regulatory co-operation. But there is also a wide range of other issues on which progress is being made in Basle and IOSCO. The papers prepared for the Lyon Summit noted six other areas in particular:

- work on internal management control systems, not least the papers issued by Basle and IOSCO on risk management of derivatives activities;
- capital adequacy, including the work on market risk carried out by the Basle Committee (which for the first time will allow banks to use proprietary 'value at risk' models as a basis for measuring market risk);
- reporting and disclosure, where Basle and IOSCO have issued a series of joint papers designed to promote market transparency;
- operational and settlement systems, including the Windsor Declaration and the work of the BIS Committee on Payments and Settlement Systems;
- improvement of supervision throughout the world;
- work on market emergencies.

In addition, important initiatives have been taken in recent years by both organisations to address the problem of money laundering, and to deal with issues such as netting and IT questions. Many of these topics have fundamental implications for the future of supervision and are likely to form a core agenda for banking supervisors and securities regulators in the months ahead. ■

CREST: ITS RECOGNITION AND APPROVAL

By Brian Smith, the Securities and Investments Board

London's new equity settlement system, CREST, launched on 15 July 1996, allows electronic holding and transfer of shares. It was urgently needed to replace a system using 1970s technology and mountains of paper. The launch came just three years after the Bank of England had set up a task-force on securities settlement, in the wake of the collapse of the TAURUS project. In addition to the work on project design and implementation, CREST posed issues for regulators.

The CREST project was begun because the London Stock Exchange had abandoned its comparable TAURUS development in March 1993. TAURUS had seriously over-run its budget and its planned development timetable and was judged to be fatally flawed.

In response to the cancellation of TAURUS, the Bank of England set up the Task Force on Securities Settlement, on which the Securities and Investments Board was represented. The Task Force's report in June 1993 stressed the need to keep the design of a new equity settlement system simple and stable. This would avoid 'design creep'— whereby new features are added during the development phase — and minimise the need for legislative changes. The successful development of CREST owes much to the early identification of, and adherence to, these principles.

The 'go live' date was fixed for the second half of 1996. It was decided that the Bank of England should play a significant role, drawing on its experience with settlement systems, for example in the Central Gilts Office. But a separate company, to be made independent of the Bank on start-up, should be set up to run the new system. This company is called CRESTCo.

A great deal hung on the successful development of CREST. The abandonment of TAURUS had been a considerable shock to the City and a blow to its confidence. Many firms had suffered substantial financial losses and wasted systems effort.

The existing Talisman system, which CREST was to replace, had been based on 1970s technology and the use of mountains of paper. It needed replacing urgently if the UK was to offer settlement services that met modern international standards, such as delivery versus payment and a three-day settlement cycle. Without these improvements, there was a risk that business in the UK equity market might move elsewhere.

CRESTCo and its services

CREST is not just a settlement system. It allows 'dematerialised' holding and transfer of shares. That is why new regulations were needed. CREST's services include:

- responding to electronic messages from members to transfer stock between their accounts;
- checking the electronic authentication of the message and comparing the instructions input by the buyer and the seller, and storing the correctly matched version;
- checking the availability of stock and cash in the CREST members'

accounts on the settlement day, and moving the stock from the seller's account to the buyer's;

- facilitating the borrowing and lending of stock and cash in order to provide collateral;
- notifying the stock's registrar;
- transferring certificated shareholdings for those wishing to retain shares in paper form;
- maintaining records of dematerialised shareholdings; and
- handling cash distributions, dividends and other stock events.

CREST also provides for the reporting of transactions to the relevant exchange, and accounting for stamp duty. Its participants include members, sponsors, registrars and payment banks. Each of these categories of user has a different place in its structure and has different needs of the system.

Members, such as market makers, custodians and investors, can hold stock in dematerialised form via CREST, and may send and receive electronic instructions to and from the system to effect settlement.

Sponsors input instructions on behalf of 'sponsored' members — members who have decided not to have a direct connection.

Registrars update their registers on instructions from CREST. They also act for companies in such matters as take-overs or rights issues.

Payment banks receive information continuously about the amounts payable on behalf of members as a result of CREST processing. These amounts are paid net between the payment banks and between a payment bank and each of its customers at the end of each working day under an assured payments agreement between these banks and CRESTCo.

The CREST services are provided by means of a computer system (with facilities managed by Hoskyns), and secure communications networks (provided by SWIFT and Syntegra) which connect users online. A central courier and sorting service (provided by TNT) handles certificates being deposited or withdrawn. CRESTCo is responsible for the overall structure of CREST, and for the services provided by its subcontractors, Hoskyns and TNT.

Public policy issues

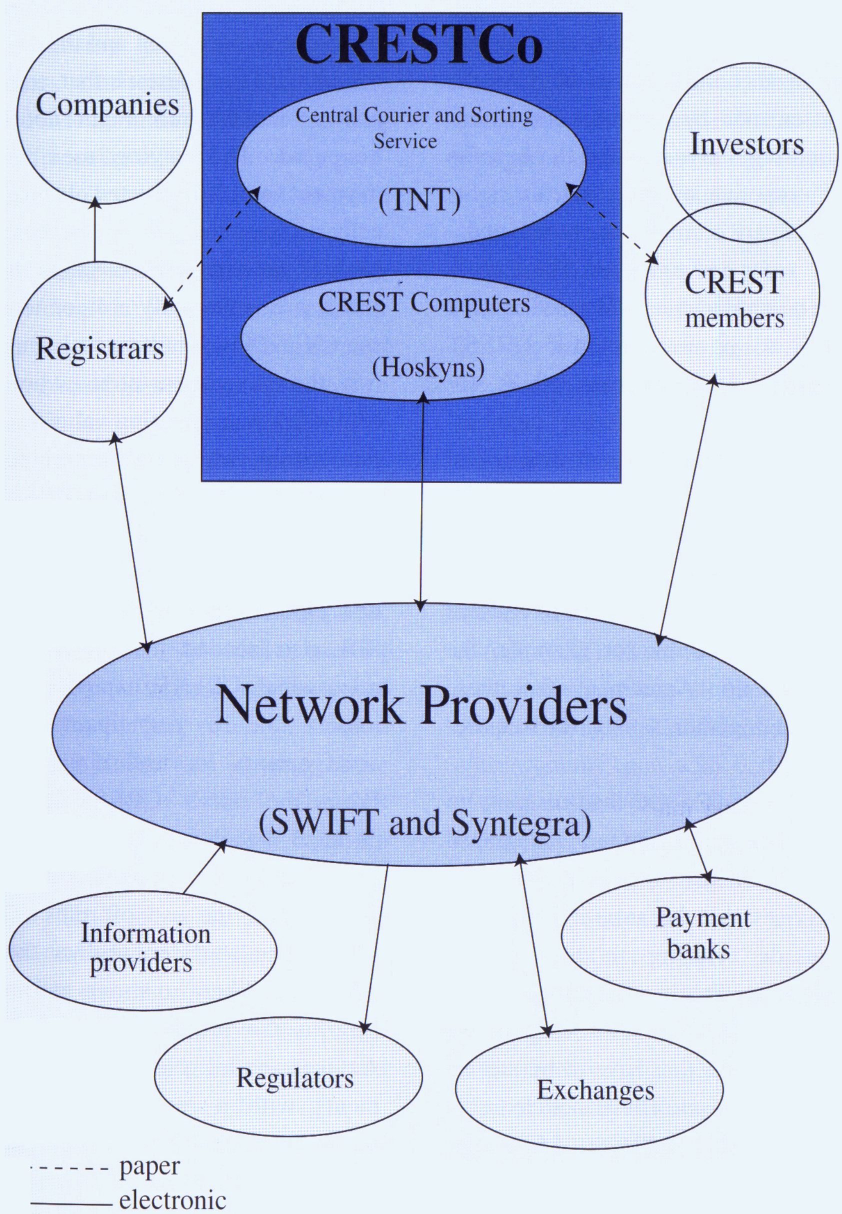
The system provides for legal ownership of securities to be transferred electronically without a written instrument of transfer. This innovation gave rise to new legal concepts which called for new legislation to spell out the requirements for a system to transfer legal title electronically, taking into account the need to protect investors.

The scope for loss from fraud, negligence or default should be minimised as far as possible. If such loss does occur, there must be adequate means to find the cause and provide redress. Furthermore, existing rights conferred on registered shareholders, such as their rights to receive dividends and company reports, should not be prejudiced. In particular, wider share ownership should not be discouraged.

With these issues in mind, the SIB, working with CRESTCo and

CREST provides for legal ownership of securities to be transferred electronically without a written instrument of transfer

Structure of CREST



the DTI, helped the Treasury to develop the Uncertificated Securities Regulations. These became law in December 1995 and the Treasury delegated to the SIB its powers under the regulations to approve the operators of systems to settle and transfer stock ownership electronically.

Regulatory approval

CREST needed to gain regulatory approval under these new rules to become an operator of a 'relevant system' (a system for electronically transferring legal title to securities). To do so, it needed to satisfy the SIB that it met certain technical requirements under the following headings:

(a) ***using a third party to operate part of the 'relevant system'.*** CRESTCo proposed to use two network providers initially. The SIB needed to be satisfied that both the contractual arrangements between these two firms and CRESTCo and the latter's own procedures for monitoring network performance would enable it to meet its obligations under the regulations;

(b) ***system security.*** This was particularly important from the aspect of investor protection, and the SIB paid special attention to CRESTCo's proposed solutions. The SIB needed to be satisfied, for example, that instructions were properly authenticated so that only valid instructions from bona fide users could be accepted by the computer system;

(c) ***systems capabilities.*** A number of specific requirements fell into this category, such as the maintenance of adequate records of instructions sent

From the outset, CRESTCo had declared that it was "a service, not a regulator" and sought therefore to minimise the use of rules

by the system and the amendment of registers of securities. It was also necessary to ensure that the system could handle the volumes of transactions generated;

(d) ***operating procedures.*** These are designed to ensure, for example, that errors are notified and corrected; that stock account balances held on the system and by registrars are reconciled regularly; and that the benefits of corporate events (such as rights issues) are correctly attributed; and

(e) ***rules and practices.*** These specify particular rules and practices that need to be in place for CREST members, registrars and others, for example, on terminating membership, withdrawal of securities, and record-keeping. The SIB needed to be satisfied here not only that CRESTCo's rules met these requirements but, where these rules referred to obligations in, for example, the Membership Agreement, that these would together satisfy the requirements.

CRESTCo also had to apply to the SIB to become a recognised clearing house under the Financial Services Act because it wished to provide clearing services to the London Stock Exchange. The Financial Services Act sets out the requirements that have to be met by clearing houses. These include:

(a) ***having sufficient financial resources.*** CRESTCo's proposals for raising capital, generating revenue and securing insurance needed to be considered alongside the risks to which CRESTCo was exposed, and their financial implications.

Unlike the London Clearing House, CRESTCo does not act as central counterparty for transactions outstanding in the event of a default of a participant, but instead has an assured payments agreement with banks. This reduces CRESTCo's requirement for capital and the associated risk to investors that transactions entered into might not be honoured. The buying member's payment bank is instructed electronically to pay the selling member's bank at the end of the business day, and is unconditionally obliged to do so. CRESTCo simultaneously notifies the stock's registrar, who is committed to registering valid transfers within two hours of receiving notice of the electronic transfer;

b) ***having adequate arrangements and resources for the monitoring and enforcement of its rules.*** The SIB also needed to consider the rules which CRESTCo proposed to impose on its participants, and arrangements for enforcing them. From the outset CRESTCo had declared that it was "a service, not a regulator" and sought therefore to minimise the use of rules. The SIB had to consider whether these rules were likely to prove satisfactory in the provision of clearing services under clearing arrangements with a recognised investment exchange. Where these rules required members to have agreements with a settlement bank, a network provider, and with CRESTCo itself, the emphasis of the SIB's scrutiny turned to the agreements themselves;

(c) ***being able and willing to promote and maintain high standards of integrity and fair dealing, and to co-operate with regulators and others in the sharing of information.*** The SIB needed to consider CRESTCo's proposals for formalising its relationship with others (for example, by entering into Memoranda of Understanding with regulators, or by issuing guidance to members), together with internal procedures and culture;

(d) ***being able to provide clearing services to a recognised investment exchange which would enable that recognised investment exchange to satisfy its own Financial Services Act requirements for recognition.*** CRESTCo's ability to meet this requirement was an important issue for the London Stock Exchange, and also for LIFFE and Tradepoint, which needed to make use of CREST's settlement services and wished to continue to use the London Clearing House as a clearing house interfacing with CREST. The SIB needed to be satisfied that CRESTCo had satisfactory agreements in place with the London Stock Exchange and the London Clearing House to provide clearing services. It was necessary to establish how the procedures for settling transactions would work in practice.

What would happen if the settlement process was delayed because of insufficient stock or credit? Or if it could not be completed because a registrar refused to register a stock transfer (known as a 'bad delivery')? Or where procedures had to be used to correct errors?

Arrangements for monitoring and enforcing settlement performance standards (for example, requiring trades to be reported and settled within given times, with consequential penalties for failures) also had to be considered. Here the question at issue was whether the recognised investment exchange would itself make these arrangements or would rely on CRESTCo.

Handling the applications

The applications were received by the SIB in early 1996, as planned, and final decisions on them were taken on 11 July. The period from January to July 1996 was particularly intense for the SIB and even more so for CRESTCo. Anticipating this, the SIB created a dedicated CREST team of four staff: one with many years of previous experience at the London Stock Exchange on Talisman and other systems; one with both Bank of England and investment industry experience; an experienced lawyer with a background of working with exchanges; and a specialist in systems and security matters.

The process of considering these applications involved detailed and extensive discussions with a number of key institutions as well as with CRESTCo. In addition to the investor protection issues outlined above, there were legal, technical, contractual and commercial dimensions to these applications which made them unusually complex.

What would happen if the settlement process was delayed because of insufficient stock or credit ... or could not be completed ... known as a 'bad delivery'?

For investor protection reasons, the Financial Services Act also had to be changed to require the authorisation of any person inputting instructions to CREST on behalf of another. This catered, in particular, for the provision of sponsored membership. All those proposing to provide sponsorship services needed to be authorised when CREST went live to avoid being in breach of the Financial Services Act. The amending legislation was passed by Parliament in late May 1996, leaving seven weeks for Self-Regulating Organisations to invite firms to apply for authorisation and for their applications to be considered.

Central to the SIB's consideration of CRESTCo's applications was whether the system would work satisfactorily. The regulations are very specific about what a relevant system must do, concerning both overall performance and demonstrating specific functions. CRESTCo translated these requirements into computer programs, hardware, system manuals, procedures, rules, contracts and agreements with system users and service providers.

The SIB kept in touch with CRESTCo's early work on developing the system to avoid wasted effort later when the applications were received and considered.

Trialling of parts of the system began in January 1996. These trials became progressively more sophisticated and comprehensive, leading to full trialling from April to June. CRESTCo was open about progress of the trials, publishing regular bulletins, and admitting the difficulties encountered. The SIB monitored progress closely and had full access to CRESTCo staff and to data on the problems. New errors were monitored, as well as the rate at which they were being resolved.

Trialling of parts of the system began in January 1996. CrestCo was open about progress of the trials, publishing regular bulletins, and admitting the difficulties encountered

By early July the SIB was satisfied that the performance and robustness of the system were sufficient for it to go live. Making such a judgment is never easy, particularly where some errors remain — as they always do in any new system development — but it was felt that these did not pose a significant risk, and that CRESTCo staff were capable of dealing with them.

The relevant regulations, however, impose much more stringent requirements than this 'general readiness'. Each was translated by the SIB into a series of specific tests or procedures that had to be met. In almost all cases the SIB was eventually satisfied that each requirement or test was met, but in a small number it agreed to accept commitments by CRESTCo to have particular functions or features in place by given dates, mostly in 1996.

As well as the technical requirements, it was necessary to consider the contractual and legal arrangements before the applications could be granted. To reach a considered view on whether CRESTCo's applications met the statutory requirements, the SIB had to consider the relevant law, CRESTCo's rules and detailed procedures, and the agreements between CRESTCo and various parties. The relationship between CRESTCo and the network providers gave rise both to commercial issues and regulatory concerns, and sometimes the two interacted (for example, the terms on which insurance would be provided).

It proved particularly difficult to reconcile the different objectives in constructing the Membership Agreement between CRESTCo and members. The last contractual agreements were only finally settled on the morning of 11 July, very shortly before the SIB's Executive Committee met and took the decision in favour of recognition and approval. Without these agreements, the application could not have been granted.

The need for the Stock Exchange to enter into an agreement with CRESTCo to use its clearing services to retain its recognised investment exchange status raised a number of issues about who would monitor and enforce settlement performance standards, and how firms would report their transactions.

This was resolved when CRESTCo agreed to provide the Stock Exchange with a daily feed of all the transactions to be cleared and settled on CREST, enabling the latter to dispense with its proposals for trade reporting.

This was welcomed by firms because it avoided double reporting. CRESTCo's agreement with the London Clearing House to provide services that would enable it to settle certain LIFFE and Tradepoint trades took longer to resolve, and was not finally signed until the morning of 11 July.

The SIB worked with other regulators to examine the impact of CREST on their rules and to take steps to consult and make changes where necessary. In fact, though the SIB decided that no changes to its rules were necessary, other financial regulators chose to make changes to accommodate the new sponsorship activity. The Securities and Futures Authority took particular steps to monitor its member firms' readiness to become CREST users.

Phased approach

The process of taking decisions on CRESTCo's two applications was tailored to reflect the particular circumstances of CREST. Since a key factor was whether the system was ready to operate live, and since this was a judgment that could not be made until close to the inauguration date, the SIB Board decided to adopt a phased approach in considering the applications, over the period from May to July.

> Delivery of such a system within the planned timetable and only marginally outside the original budget was a considerable achievement

The SIB was given leave by the Treasury to recognise and approve CRESTCo's applications, following the advice of the Director General of Fair Trading that CRESTCo's rules did not pose significant problems for competition. All outstanding issues concerning the applications were resolved on 11 July. CREST was inaugurated on 15 July.

The system is now up and running and the SIB's focus has turned from the intensive approval process to the more everyday task of supervision of CREST.

Delivery of such a system within the planned timetable and only marginally outside the original budget was a considerable achievement by all concerned.

The Chancellor and Deputy Governor inaugurate CREST

BANCASSURANCE: EUROPEAN APPROACHES TO CAPITAL ADEQUACY

By David Raikes, Supervision and Surveillance, Bank of England

'Bancassurance' — the linking of banking and insurance products and businesses — has expanded rapidly in many European countries. Banking supervisors have to address a number of difficult issues when considering how to treat banks' investments in insurance companies for capital adequacy purposes, and European countries have adopted a variety of approaches.

... the types of business and risks that banks and insurance companies face are very different

There are several reasons behind the rapid growth in bancassurance. First, there is a considerable degree of complementarity between banking and insurance products: for example, when providing services such as mortgages, banks will often require their customers to insure themselves against some of the standard risks which could threaten their ability to repay. By offering the customer an insurance product themselves, or by marketing the services of an associated company, banks can increase the revenue (and in particular the fees) that they can earn from these types of financial transaction.

Second, faced with high fixed costs within their retail branch networks, banks have sought to use their resources more productively by applying them to a wide range of activities, gaining economies of scope.

Third, banks have felt they can gain a competitive edge by offering customers the widest possible range of financial services, including insurance products.

Last, banks have responded to the longer-term shift in the pattern of retail savings; in most European countries insurers have been taking a growing share of retail savings.

In some cases, banks have developed bancassurance through joint marketing arrangements, whereby they sell an insurance company's products through their retail network.

However, in many cases banks have either acquired insurance companies outright, or sought to cement a joint venture by taking an equity participation in the insurance company.

This in turn has presented banking and insurance supervisors with the difficult question of how to treat such investments when calculating the capital adequacy of the entities linked in this way. The difficulty arises because, despite the complementary nature of the two types of product, the nature of the business and risks that banks and insurance companies face are very different. As a result, bank and insurance supervisors have different definitions of capital, and different solvency and liquidity requirements.

The supervision of banks and insurance companies is conducted by different bodies in most European countries. The development of bancassurance has greatly increased contacts and the exchange of information between banking and insurance supervisors, both within a domestic context and in multinational fora.

Supervisory issues

Bancassurance arrangements can take a variety of forms, but where the

Banks tend to have assets which are difficult to value, whereas insurance companies have uncertain liabilities

links involve equity participation there are two main types of structure to consider. The first is where a bank has a direct holding in an insurance company. The second is a holding company structure, where the holding company has equity participations in both the bank and the insurance company. The structure of the group will have a bearing on two fundamental questions:

- if the holding is less than 100 per cent, what proportion of the capital should be subject to common treatment? If the holding gives the parent direct or indirect control, supervisors may expect the parent to take responsibility for the solvency of the subsidiary, in which case all of the capital should be subject to common treatment;
- to what extent might the parent's capital in one part of the group be available in practice to support the operational needs of other parts?

The Second Consolidated Supervision Directive (2CSD) requires all authorised credit institutions to be supervised on a consolidated basis, 'downwards' where the institution owns 20 per cent or more of another financial institution, and 'upwards' where the institution's parent is a non-bank financial institution, or where the parent owns a group whose activities are mainly financial in nature.

However, the 2CSD does not include insurance companies in its list of 'financial' businesses which require consolidation. This reflects the different types of assets and liabilities held by banks and insurance companies. Banks tend to have assets which are difficult to value, whereas insurance companies have uncertain liabilities.

Capital treatment

In 1995 a tripartite group of banking, insurance and securities regulators from the G10 countries under the chairmanship of Mr Tom de Swaan, an executive director of the Nederlandsche Bank, produced a report entitled 'The Supervision of Financial Conglomerates'. Also in 1995, a technical expert group produced a report for the European Commission, which produced similar conclusions.

The principles discussed in these reports have a wider application. Financial conglomerates are defined in the reports as groups which are engaged mainly in providing financial services via at least two of the following types of institution — credit institutions, insurance undertakings, and investment firms.

The main problem relating to capital is that it is possible for the entities in a group to fulfil their capital requirements on an individual basis, but for the group as a whole to have less 'own funds' than the sum of its parts. This arises if capital is used more than once — for example, where the capital used to support business in a parent company is used also to support the activities of a subsidiary, or subsidiaries. This is usually referred to as *double gearing* (or excess gearing).

There are two basic ways in which supervisors can seek to obtain a view of a financial group as a

Rules developed for one purpose ... cannot be easily applied to another

whole: by consolidated supervision, or by solo-plus supervision. Under consolidated supervision, the focus is initially on the parent, or the holding company of the group. The assets and liabilities of the individual companies are consolidated, normally using the rules of the parent's supervisor. The result is compared with the group's capital. The overall evaluation of the capital adequacy of the group needs also to take qualitative factors into account, besides the arithmetic of the consolidation exercise itself.

Under solo-plus supervision, the focus is initially on the individual companies in the group, once again complemented by a general qualitative group-wide assessment of capital adequacy by the supervisor whom, it has been agreed, should act as the 'lead regulator' of the group.

Typically, *accountancy-based consolidation* is used to assess capital adequacy in homogeneous banking groups. This method of consolidated supervision is not, however, well suited to heterogeneous activities, since rules developed for one purpose (eg banking) cannot be easily applied to another (eg insurance).

Instead the tripartite group identified four quantitative techniques which can be used to assess capital adequacy:

building block prudential approach — where the consolidated balance sheet of the group is split into blocks according to the types of business involved (ie banking, insurance etc). Capital requirements are calculated by each supervisor and added together. The total capital required is then compared with the aggregated own funds across the group;

risk-based aggregation — where the solo capital requirements of group companies are added up and then compared with group capital. The technique is very similar to that employed in the building block approach, but by starting with the capital requirements of the individual companies, it can be used when consolidated accounts are not available. Risk-based aggregation does not automatically net out intra-group exposures, with the result that it can produce a stricter capital requirement. A more prudent form of risk-based aggregation involves the aggregation of the maximum regulatory capital requirement for each subsidiary. This in turn is taken to be the greater of the subsidiary's actual regulatory capital requirement or the investment by the group in that subsidiary;

total deduction — of the book value of all investments in subsidiaries from the parent's own capital. The advantages of this technique are that it is conservative and simple to apply. On the other hand, it does not produce an overall measure of risk at the group level. Nor does it allow any credit for holdings of capital in subsidiaries which are surplus to the solo capital requirements;

risk-based deduction — like risk-based aggregation, this method begins at the level of the individual companies in the group. But instead of adding up the solo capital requirements and comparing them with the own funds of the group, the capital requirement of each subsidiary is matched directly against the own funds of that subsidiary. Surplus funds can then be used to augment capital at group level, subject to tests to ensure that the capital would indeed be available to support other parts of the group if the need arose. Unlike the total deduction method, the parent can therefore be allowed to take account of its share of capital surpluses in subsidiaries.

The building block prudential approach, the simple form of risk-based aggregation, and the risk-based deduction method can, in principle, both eliminate double gearing and give a picture of the risks carried by the group. The total deduction method, and the more prudent form of risk-based aggregation, deal effectively with double gearing but do not seek to give so much information on risks.

Capital treatment

In practice, European supervisors are still adopting a range of supervisory practices. In the *UK*, the Bank of England's treatment of bank investments in insurance companies is based on the deduction approach.

In the Bank's view it is inappropriate to consolidate the books of an insurance company subsidiary with those of its parent bank using accounting-based consolidation, because the risks in an insurance business are very different from those in banking.

So as far as banks' consolidated reporting is concerned, investments in insurance companies are treated as investments in unconsolidated subsidiaries and associates, and deducted from the group capital base.

In *Germany*, the Banking Law requires capital charges to be applied on a consolidated basis for credit institutions and financial institutions. However, insurance companies do not fall within this definition and, at present, banks' investments in insurance companies incur only the normal risk assets capital charge of 8 per cent. This reflects the difficulties in consolidating insurance risks with banking risks. The German authorities have suggested that the risk-based deduction approach could be used as an alternative.

Similarly, neither *Italian* nor *French* insurance companies are treated as financial companies for the purpose of consolidated supervision. As a result, investments in them are also usually risk-weighted. The French authorities' contribution to the de Swaan annex states that the supervisory authorities' approach "incorporates qualitative elements beyond strict calculation, which are particularly important if technical difficulties are experienced in consolidating certain entities of a group". Looking ahead, they favour the consolidated assessment of capital within banking and insurance company groups.

In the *Netherlands*, a joint supervisory protocol drawn up between the Nederlandsche Bank and the VZK (the insurance supervisor) requires that a holding company should have an amount of capital, reserves and

In the Bank's view it is inappropriate to consolidate the books of an insurance company subsidiary with those of its parent bank using accounting-based consolidation

subordinated loans which is at least equal to the sum of the funds required by the central bank and the solvency margins imposed by the VZK; when looking at the adequacy of the capital of the holding company for the activities of their entity, each supervisor will then deduct (or disregard) the capital required to support the other subsidiary. This is the case, for example, in the ING Group, where ING Bank and Nationale Nederlanden Insur-ance are separately supervised, with additional supervision of the group as a whole carried out by both supervisors.

Where a bank has acquired an insurance company subsidiary in the Netherlands, the central bank has ascertained the insurance company's solvency margin from the VZK and deducted it from the bank's capital.

In *Spain*, a Royal Decree was approved in December 1995 on the supervision of financial conglomerates. It stipulates that the own funds requirements of a conglomerate should be the sum of the own funds requirements of each part of the group.

Actual own funds of the group are calculated by a technique which

SOME SIGNIFICANT LINKS BETWEEN BANKS AND INSURANCE COMPANIES IN THE UK

BANK	SUBSIDIARY/ASSOCIATE	NATURE OF BUSINESS	NATURE OF LINK
NatWest Bank	NatWest Life NatWest Re	Life assurance and pensions Reinsurance	100% owned by NatWest Bank “
Barclays Bank	Barclays Life	Life assurance & pensions	100% owned by Barclays Bank
Lloyds TSB Bank	Lloyds Abbey Life [includes Abbey Life; Black Horse Financial Services; and TSB Life]	Life assurance & pensions	62% owned by Lloyds; remaining 38% is widely owned
Royal Bank of Scotland	Royal Scottish Assurance Direct Line Group Ltd: owns Direct Line Insurance and Direct Line Life insurance Bankinter Aseguradorea Directa SA	Life assurance & pensions Motor & household insurance Life assurance Motor insurance	80% owned subsidiary by RBS; remaining 20% held by Scottish Equitable Link 50% owned by Direct Line
Abbey National plc	Scottish Mutual Abbey National Life Carfax insurance Baker Street Insurance Abbey National General Insurance Abbey National Health Life assurance and pensions	Life assurance and pensions “ “ General Insurance Motor & household insurance Life assurance and pensions	100% owned by Abbey National “ “ 100% owned by Abbey National Joint venture with Commercial Union Joint venture with Norwich Union
HSBC/Midland	Midland Life Midland Captive	Life assurance and pensions Captive insurance	78% owned by Midland Bank 100% owned by Midland Bank
Halifax	Halifax Life Clerical Medical	Life assurance & pensions Life assurance & pensions	100% owned 100% owned by Halifax

is on the lines of the risk-based aggregation method.

In *Switzerland*, the regulations were amended in December 1994 to require a 100 per cent deduction from capital of a banks' investment in an insurance company (even if it was structured via a holding company). However, recognising that this is not yet a Europe-wide practice, and following representations from the banking industry, the amendment will be withdrawn from 1 July. Switzerland will revert to its former practice of requiring a risk weighting — which will be set at 500 per cent, and will apply to both holding company structures and direct investments.

It is clear that there is considerable variation in supervisory practice throughout Europe

Conclusions

It is clear that there is considerable variation in supervisory practice throughout Europe. The UK currently operates a policy of capital deduction, for both direct holdings and holding company structures, and Switzerland has indicated that it favours such an approach.

Most other countries tend to favour adopting one of the other three approaches, but progress in doing so differs between countries, reflecting the difficulties involved in consolidating the balance sheets of banks and insurance companies.

Unfortunately, the alternative — a risk-weighting of banks' investments in insurance companies — cannot measure the risks in the insurance company itself, and therefore offers a less precise estimate of the risks faced by the investing bank.

In implementing the Capital Adequacy Directive, which came into effect at the beginning of this year, the Bank of England has used a form of risk-based consolidation for groups which included banking and investment businesses. Although technically difficult, this has been successful in finding a way to resolve the problem posed by the different nature of the balance sheets of these two businesses.

Attention is now turning to ways in which other types of business should be treated. The de Swaan Group, which produced the 1995 report on financial conglomerates, is now reconvening in a reconstituted form as a 'Joint Forum on Financial Conglomerates'. Its terms of reference are considerably wider than the question of capital treatment (and its membership includes a number of non-European supervisors). But it may well also provide some further guidance on how best to tackle the issues involved in the supervision of bancassurance.

REGULATORY DEVELOPMENTS

Compiled by the Bank of England and the Securities and Investments Board

UK SUPERVISORY DEVELOPMENTS

Banking Supervision

The Bank's review of supervision

In July, the Bank announced a restructuring of its Supervision and Surveillance divisions, following a review conducted with the help of Arthur Andersen. The Bank's review of supervision is described in the box on page 8.

Post-BCCI Directive

This Directive ('Directive to reinforce prudential supervision within the European Union following the collapse of BCCI') was implemented by statutory instrument in the United Kingdom on 18 July. It covers European Economic Area (EEA) credit institutions and investment firms, insurance companies and UCITs. It has four main provisions: first, it requires supervisors to refuse authorisation where group and ownership links prevent effective supervision; second, it requires financial undertakings to have their head office in the same Member State as their registered office; third, it widens the range of gateways to disclose information; and fourth, it requires Member States to place a duty on auditors and experts appointed by supervisors to report concerns to the supervisory authorities. In the United Kingdom, auditors have had a statutory duty to report relevant information to supervisors since May 1994.

Large exposures – changes post-Barings

The Bank's large exposures reporting form (Form LE) and accompanying reporting instructions have been revised to address the recommendation on the flow of funds to connected counterparties in the Board of Banking Supervision's (BOBS) Report on Barings. The instructions have been clarified to ensure that banks exercise care in identifying the counterparty with whom they have entered into a contract, particularly where that company is trading on an exchange both for its own account and on behalf of clients. The new package includes some changes related to underwriting and holdings of securities eligible for 'soft limits'. These have been necessitated by the Capital Adequacy Directive. Reporting banks have been required to use the new form (Form LE2) since the end-September reporting date.

For further information contact: Bank of England Regulatory and Supervisory Policy Division (0171 601 5997).

Bilateral netting

Since the end of April, UK authorised banks have been able to report the current exposure element of the counterparty risk arising from forwards and OTC derivatives on a bilaterally netted basis if they have satisfied the requirements of the relevant Policy Notice (S&S/1996/3). Draft reporting instructions have been sent out to banks which are netting and to banking associations for comments. The final instructions will be available in early November.

For further information contact: Bank of England Regulatory and Supervisory Policy Division (0171 601 5997).

Liquidity reporting

Following publication of its review of supervision in July, the Bank has launched a project to review the information collected on banks' liquidity mismatches for those banks to which the mismatch regime is applied. At present, five forms are used to collect liquidity data; it is hoped that, among other things, the review will reduce this number.

It is also envisaged that the scope and coverage of liquidity data measurement will be brought more closely into line with the way it is analysed by institutions. Off-balance-sheet and credit-card cash flows, for example, are not adequately captured by the present returns, even though they may constitute a material element of banks' cash flows.

The Bank is also examining the basis upon which returns should be completed (consolidated or unconsolidated), the measurement of liquidity mismatches in individual currencies, and the use of accruals and inclusion of interest payments and receipts. In designing a revised framework, the Bank is liaising with the British Bankers' Association to consult institutions about their methods of liquidity measurement and management.

Reporting foreign exchange exposures

The Bank will also be working in the coming months to replace its current Form S3 and foreign exchange guidelines with a more precise approach to monitoring foreign exchange risk, based on a combination of prudential returns and banks' internal limits. The intention is that the new approach to monitoring foreign exchange risk will eventually be extended to other types of risk, such as that related to interest rate movements.

For further information contact: Bank of England Regulatory and Supervisory Policy Division (0171 601 3155).

Internal controls

The Bank is currently considering the means by which it gains comfort on the adequacy of banks' internal controls. A further review of the Section 39 regime is under way; this is separate from the changes which were made in the three Policy Notices issued in April and summarised in this year's Banking Act Report.

For further information contact: Bank of England Regulatory and Supervisory Policy Division (0171 601 5536).

Securities and investments regulation

Disciplinary action against Robert Fleming and Jardine Fleming companies

The Investment Management Regulatory Organisation (IMRO) announced on 29 August that it had taken disciplinary action against four firms in the Robert Fleming and Jardine Fleming groups, imposing fines totalling £700,000 and terminating the authorisation of one firm. This action arose from an investigation into investment management activity carried out in Hong Kong by Jardine Fleming Investment Management Ltd (JFIM), to which the four IMRO-regulated firms had delegated fund management. IMRO's charges related to breaches of the SIB's Principles 2 (skill, care and diligence), 9 (adequate compliance arrangements) and 10 (keeping a regulator informed), as well as breaches of a number of specific IMRO rules.

Equity market developments

The London Stock Exchange continues to develop plans for new electronic trading services, including a public order book. Following two consultation papers earlier this year, the Exchange has recently published a detailed service specification and draft rules. Comments are requested by mid-November.

The Exchange expects to commence electronic order book trading in FTSE 100 stocks by the final quarter of next year. While it intends that the order book should account for a significant proportion of trading and be the focal point for price formation, its plans also provide for trades away from the order book. The Exchange hopes that its new services will offer investors a greater choice in trading and lead to a reduction in the spread between the best bid and offer prices.

In a parallel development, the Treasury has been considering the future of the current market maker exemption from stamp duty. In May the Chancellor asked the SIB for advice on the role of liquidity providers in the new trading structure. In response, the SIB issued a consultation paper — Maintaining Enhanced Market Liquidity (CP.97) — and subsequently advised the Chancellor that stamp duty relief should be granted to all exchange firms acting in an intermediary (as opposed to end-investor) capacity. The Chancellor accepted the advice and proposes to introduce in the 1997 Finance Bill a new stamp duty relief for all exchange intermediaries in respect of their equity purchases. It is also intended that stamp duty relief will be granted for stock borrowing and lending and equity repo agreements conducted under on-exchange arrangements. The Chancellor invited representations from interested parties on the further suggestion that the new intermediaries relief might be limited to purchases offset by sales within a specific period.

CP.97 also contained a revised version of an earlier draft standard on market integrity. This sets out high-level principles for trading practices on recognised investment exchanges. The SIB intends to finalise this standard shortly.

For copies of this and other SIB Consultative Papers contact SIB Publications Unit (0171 638 1240).

Custody

Providing custody of customers' investments is not currently an activity which requires authorisation under the Financial Services Act (FSA) in its own right. However, custody is crucial to investor protection and, in response to developments in the industry, the SIB published a consultative paper in August 1995. The paper requested comments on the SIB's provisional view that custody should be authorisable under the FSA, and on its proposed standards of regulation.

Most respondents favoured authorisation of custody and, on the SIB's recommendation, HMT announced in May its intention to make custody an authorisable activity. This would extend the FSA regulators' jurisdiction to cover 'third party' custody and, in the event of a firm defaulting, investors could make a claim on the Investors Compensation Scheme. HMT are currently finalising a draft amendment to the Act.

Respondents viewed the SIB's proposed standards for the regulation of custody favourably, believing that they codified existing good practice. The standards relate to all UK firms which provide custody, and cover: responsibilities of custodians and owners; segregation of customers' investments; protection against loss and identification and periodic checking. The final standards were issued in August 1996 as guidance for the FSA regulators to implement. The rules implementing the standards are expected to be in place by early 1997, thus allowing the FSA regulators time to consult on the rule changes needed.

Foreign exchange dealing services

In a Consultative Paper (CP.89) issued on 1 February 1996, the SIB expressed the view that speculative dealing services in the 'spot' foreign exchange currency markets (sometimes called 'rolling spot forex') are activities which constitute investment business under the FSA. Unauthorised firms providing such services were given until 1 March 1996 either to apply for authorisation (via membership of the Securities and Futures Authority) or to cease trading. The SFA is currently processing a number of applications from such firms. The SIB is monitoring the situation to ensure compliance with the guidance and has taken appropriate enforcement action where necessary.

Responsibilities of senior executive officers

In early September, the SFA published a consultative Board Notice proposing changes to its rules and guidance which, if implemented, would seek to ensure that the Senior Executive Officer of an SFA-regulated firm could be held directly responsible and accountable for both ensuring that control structures are in place and that they are working effectively in the firm. The SFA proposes that the Senior Executive Officer of a regulated firm must ensure that all employees act so as to avoid serious financial or reputational damage to the firm; and that, if damage occurs, and the SFA believes failure of management controls caused or contributed to the damage, it shall be presumed that the Senior Executive Officer has failed to comply with that duty, unless it can be shown that he has taken all reasonable steps to avoid such damage.

The SFA also proposes to add to its guidance on compliance with regulatory requirements an explanation of what it would regard as reasonable steps for a Senior Executive Officer to take to comply with the proposed rules. The guidance covers, for example, clarity of responsibilities, effectiveness of internal controls and the need to follow up identified concerns. The SFA's proposals reflect its experience with Barings, and are consistent with its policy of taking action against registered individuals directly responsible for breaches. These proposals make clear that the SFA will consider the Senior Executive Officer to be the person primarily accountable for management failures.

Copies of SFA Board Notices are available from the SFA (0171 378 9000).

EU SUPERVISORY DEVELOPMENTS

Amendment to the Capital Adequacy Directive

Since the publication of the Basle Committee's market risk amendment to the 1988 Basle Accord in January of this year, EU Member States have begun considering possible amendments to the Capital Adequacy Directive (CAD). Article 14 of the CAD allows for it to be revised within three years of implementation if there are "developments in international fora of regulatory authorities".

The two main departures from the CAD approach in the Basle framework are the scope it gives supervisors to allow value-at-risk (VaR) models to be used to calculate the market risk requirement for a trading portfolio, and the introduction of a framework for allocating capital to commodities risk. The European Commission has held a number of meetings to discuss the outline of the draft Directive, and discussions are likely to continue in an EU Council Working Party.

Calculation of add-ons

Two draft Directives to amend the Solvency Ratio Directive are being negotiated in Brussels; the first will introduce a new methodology for calculating credit equivalent amounts for derivative contracts. This methodology will be based on the factors to be applied to calculate the potential future exposure on such products (the so-called 'expanded add-ons matrix') agreed in Basle.

The new Directive also allows banks and investment firms to net these add-ons when calculating their credit equivalent amounts. At present, under EU law banks and investment firms may only net the mark-to-market values arising from such derivatives business, not the add-ons.

For further information contact: Bank of England Regulatory and Supervisory Policy Division (0171 601 4261).

Commercial mortgages and mortgage-backed securities

The second amending Directive being discussed allows supervisors to lower the risk weighting to be applied to commercial mortgages (currently weighted at 100%). The United Kingdom has expressed reservations about the prudence of reducing the capital requirement against commercial mortgages, as some evidence appears to show that such business carries more risk than residential mortgages. This Directive would also confirm the United Kingdom's existing treatment of mortgage-backed securities.

For further information contact: Bank of England Regulatory and Supervisory Policy Division (0171 601 4261).

The Investment Services Directive

Six European Economic Area (EEA) Members have fully implemented the Investment Services Directive - Belgium, Denmark, Ireland, The Netherlands, Sweden and the UK. The position of other EEA Members is as follows:

Austria	New draft law expected to go before Parliament in October 1996. Full implementation expected in early 1997.
Finland	Primary legislation came into force in August 1996. Work in hand on a few outstanding points.
France	Primary legislation passed in July 1996, including changes to the regulatory framework. Full implementation expected this year.

Germany	Some aspects already implemented. Full implementation expected by end 1996.
Greece	Primary legislation passed in April 1996; further secondary measures are in hand.
Iceland	Primary legislation passed in March 1996.
Italy	Legislative decree came into force in September 1996; work on secondary measures is in hand.
Luxembourg	'Regulated markets' aspects implemented. Legislation to achieve the remainder before Parliament.
Liechtenstein	Not yet implemented.
Norway	Primary legislation passed in June 1996. Work on additional secondary measures in hand. Implementation expected by end 1996.
Portugal	Implementation expected by end-1996.
Spain	Bill still before Parliament. Implementation expected by end 1996/early 1997.

Implementation in the United Kingdom was achieved through a combination of legislative changes (in particular, amendments to the FSA), changes to the rules of the SIB, the SROs and relevant UK exchanges, and changes to the s43 regime operated by the Bank of England. The ISD has also required changes to the operation of, and access to, regulated securities markets in Member States. One effect is to enhance opportunities for remote access to screen-based European exchanges. The SIB is responsible for designating and maintaining a list of UK 'regulated markets' for ISD purposes. It published the current list in its Annual Report for 1995/96.

DEVELOPMENTS IN OTHER INTERNATIONAL FORA

Basle/IOSCO work on regulatory co-operation

A joint statement from the two committees also outlines a new initiative, designed to enhance the supervision of groups which offer a range of financial services on a global basis. This will look at the need for additional arrangements to improve the exchange of information between the various regulators of a group, and the legal and other obstacles which have to be overcome for this to happen. The initiative is intended to support the work of the Joint Forum of banking, securities and insurance supervisors, which is developing principles for the future supervision of financial conglomerates. The Joint Forum is also examining a number of issues relating to information-sharing, including the possibility of establishing criteria to identify a lead regulator or convenor for this purpose.

At their Lyon meeting, heads of government welcomed the steps which had been taken so far, but stressed the need for further progress in the coming year.

The subject of international regulatory co-operation is explored further in the article on 'International Regulatory Co-operation' on pages 44-50.

Multilateral netting

In April, the Basle Supervisors' Committee issued its views on how the Basle Capital Accord should treat the exposure of banks to multilateral clearing houses for forward value foreign exchange contracts. The paper recommends two elements of capital requirement: first, in respect of the current credit exposure resulting from the mark-to-market value of forward foreign exchange transactions; and second, in respect of the potential future exposure arising from the volatility of these forward transactions. The industry supported the basic principles set out in the Committee's interpretation, which has now been confirmed. The Bank has adopted this method for UK banks' exposure to multilateral clearing houses, such as ECHO.

'Interpretation of the Capital Accord for the multilateral netting of forward value foreign exchange transactions.' Basle Committee on Banking Supervision, April 1996.

International Conference of Banking Supervisors

Every two years, banking supervisors from some 140 countries meet to discuss issues of common interest. The latest meeting took place in Stockholm in June. As well as discussing how best to improve domestic supervisory methods, it also endorsed a report by a working group drawn from members of the Basle Committee on Banking Supervision and the Offshore Group of Banking Supervisors. This paper looked at a number of practical issues relating to the implementation of the Minimum Standards for the supervision of cross-border banking. The group identified a number of practical arrangements which could enable supervisors to carry out effective consolidated supervision whilst at the same time respecting customer confidentiality. The paper was published on 8 October.

'The supervision of cross-border banking'. Basle Committee on Banking Supervision and Offshore Group of Banking Supervisors, October 1996

REGULATORY DEVELOPMENTS IN OTHER COUNTRIES

United States

Proposed changes to Section 20 rules

Representative Jim Leach's bill, which aimed to increase the powers of commercial banks to engage in securities and insurance business, stalled in the US legislative process and was finally given up in June. The Federal Reserve Board subsequently issued proposals to amend the conditions under which Section 20 subsidiaries of bank holding companies are allowed to underwrite and deal in securities. The key proposal would increase from 10% to 25% the proportion of its total revenue that a Section 20 subsidiary can derive from 'ineligible' securities activities. These are defined as securities activities that a member bank may not underwrite or deal in, such as corporate debt and equity, municipal revenue bonds, mortgage-backed securities and consumer-receivable-related securities. The second part of the Fed's proposals would amend or eliminate three firewalls imposed on the operation of Section 20 subsidiaries. Whilst the debate on these proposals continues, the Fed have announced that interest earned on securities held for a company's own account will not be treated as revenue from underwriting or dealing in securities for the purposes of Section 20. This change will be effective from 12 November.

Regulation Y

The Federal Reserve Board have issued proposals that affect a variety of banking and non-banking powers of banks in the United States. These proposals are designed to reduce bureaucracy at the application stage and to enhance supervision of institutions once they are approved. The proposed revisions to Regulation Y would make it easier for well-managed and well-capitalised foreign banks to expand in the United States, particularly in non-banking activities, whilst also making this expansion cheaper than is currently the case. Streamlined application procedures would make it easier for bank holding companies which have passed the Fed's standard for comprehensive and consolidated supervision, to buy banks and carry on permissible non-banking activities with the filing of a short letter 15 days in advance. The Fed are also proposing to allow shelf registration, thus abandoning the current one-year time-limit on approvals to carry on de novo non-banking activities, and to revise and expand the list of permissible non-banking activities.

New approach to supervision of foreign banks

Following its announcement last year of a new supervisory rating system for foreign banks in the United States- the ROCA system, covering risk management, operational controls, compliance and asset quality - the Fed has been implementing the new system in its examinations of banks. The key innovations are a greater emphasis on consideration of management processes and an assessment of the 'strength of support' provided by a foreign bank parent to its US operations. In a parallel move, the Fed and Office of the Comptroller of the Currency are also formalising their assessment of risk management and internal controls in a supervisory rating for all domestic banks, which will be used as a basis for determining the overall management rating assigned under the CAMEL system.

Canada

1997 Review of financial sector legislation

The 1997 Review, published in June, makes limited changes to the Canadian regulatory regime, but does not propose more far-reaching reform. The main benefit to foreign banks is that they will be permitted to opt out of membership of the Canadian Deposit Insurance Corporation, and the requirements that accompany it, as long as they do not carry out retail business. But there is no relaxation of the requirement for foreign banks to operate in Canada through subsidiaries rather than branches nor, more generally, any expansion of banks' insurance or leasing powers. Such issues are to be referred to a Task Force, whose recommendations will shape the next revision of Canadian financial legislation in 2002.

Japan

New banking supervisory guidelines

In June, the Japanese Ministry of Finance published new guidelines on banking supervision and banks' internal management controls. These were produced partly in response to the problems which had come to light the previous year in respect of the New York branch of Daiwa Bank.

The guidelines contain wide-ranging recommendations aimed at strengthening Japanese banks' risk management practices. These include a requirement for overseas offices of Japanese banks to have an annual inspection by independent external specialists, looking in particular at trading activities, and for the larger of these overseas offices to set up an internal audit function which should report directly to head office. The MoF has said that it wishes to strengthen co-operation with overseas supervisors.

France

Parliamentary report on banking supervision

A Parliamentary report has been published, with a number of proposals affecting banking supervision. These include: greater use of external experts by the Commission Bancaire; a greater focus on preventative supervision, to be achieved in part by identification of key areas of risk and systematic follow-up of on-site inspections; and the establishment of a single deposit protection fund with ex ante contributions, from all credit institutions, weighted according to their deposit base.

Credit Lyonnais

Credit Lyonnais, a major French state-owned bank which ran into financial difficulties in 1994/5, has had to seek a further Ffr3.9bn of funding from the government. The latest problems arose mainly because of the structure of the funding of a 1995 rescue package; under the terms of that package some Ffr125bn of problem assets were transferred to a special purpose company funded, indirectly, by a loan from Credit Lyonnais on which the interest rate was set below market rates. As domestic interest rates in France fell, the cost to Credit Lyonnais of funding the loan — the difference between Credit Lyonnais' cost of funds and the return it received from the special purpose company — increased.

As part of the rescue package, the government has increased the interest rate payable to Credit Lyonnais on its loan to the special purpose company to the level of market interest rates: this, when backdated to 1995, accounts for most of the Ffr3.9bn transfer. The transfer enabled Credit Lyonnais to report a small profit (Ffr66mn) for the first half of 1996.

Like the previous rescue package, the latest injection of funds has had to be approved by the European Commission under the terms of the state aid provisions of the Treaty of Rome. The Commission approved the package under its emergency procedure, but indicated that it would wish to look again at the restructuring plan. It is expected that this will focus on plans for the privatisation of the bank. Credit Lyonnais' chairman, M. Peyrelevarde, has indicated that he hopes that the bank might be ready for privatisation in mid-1998 — although he also suggested that a further recapitalisation of the bank, of up to Ffr12bn, might be necessary as part of the process.

Credit Foncier de France

In May, Credit Foncier de France, a partly government-owned bank which specialises in property finance, announced losses of almost Ffr11bn in 1995. The losses arose because of difficulties in the French property sector and increased competition following the removal of Credit Foncier de France's monopoly in the distribution of interest-free housing loans. After trying to find a buyer, the government announced in July that the state-owned Caisse des

Depots et Consignations would mount a take-over bid on behalf of the government. Ownership will eventually be transferred to a new public institution, Caisse Nationale du Credit Foncier.

Germany

Proposed financial services legislation

The Government has published a consultation document setting out plans for new financial services legislation. The proposed legislation will implement the Capital Adequacy, Investment Services and Post-BCCI Directives . It will also extend the regulatory framework to cover activities such as electronic money and bureaux de change. The draft legislation requires the approval of the Cabinet before it can be discussed by Parliament, and it is unlikely that the measures will become law before mid-1997.

Italy

Restructuring of Banco di Napoli

A restructuring plan is being developed for Banco di Napoli, which earlier this year received a bridging loan of Lira 2.36 trillion from the Italian state and a consortium of banks after suffering heavy losses in 1994-95. It is now envisaged that about Lira 10 trillion of the bank's problem loans will be transferred into a specially-created bad loan entity. The authorities are aiming to privatise the bank by the end of the year and, as preparation for this, it will receive a cash injection of about Lira 2 trillion from the Treasury. The European Commission has indicated that it will examine the proposed cash injection. Meanwhile, Banco di Napoli is continuing to rationalise its operations to allow it to focus on its core lending business in the south of Italy.

Hong Kong

Regulation of stored-value cards

In May, the Hong Kong Monetary Authority (HKMA) published the draft Banking (Amendment) Bill 1996, which included proposals on the treatment of stored-value cards. Whilst it does not propose to regulate single-use stored-value cards (eg phonecards), the HKMA takes the view that the issuance of a multi-purpose stored-value card is akin to taking a deposit. Licensed banks which are already authorised to take demand deposits will also be allowed to issue multi-purpose stored-value cards without further specific approval. Companies set up specifically for the purpose of issuing multi-purpose cards will be subject to the same authorisation criteria as deposit-taking authorised institutions under the Banking Ordinance. The Bill also gives the HKMA powers to issue guidelines on the regulation of stored-value cards.

There are two rival stored-value card systems being developed in Hong Kong: Visa Cash (launched in August 1996) and Mondex (to be launched in Q4 1996).

Singapore

Banking Act amendments

The Singapore government has amended its Banking Act to allow foreign supervisory authorities to conduct inspections of banks under their supervision, subject to the approval of the Monetary Authority of Singapore (MAS) and undertakings on confidentiality. The amendments allow foreign supervisors to inspect branches' loan books and internal controls (and also other matters, subject to MAS approval). MAS will retain powers to impose conditions on how the inspection is conducted and what information made available. The amendments refer to the inspection of branches only, and do not apply to subsidiaries.