

## Papers submitted to the Wilson Committee

*The five papers which follow were submitted in July to the Committee to Review the Functioning of Financial Institutions (the Wilson Committee) in connexion with the second stage of its inquiry.*

### Regulation in the City and the Bank of England's rôle

#### The forms of regulation

1 The regulatory arrangements which govern the manner in which financial institutions in the City are conducted do not rest simply on statute, but are a blend of both statutory and non-statutory provisions.

2 Statute law establishes by act of Parliament rules which are intended in all stages of their application to be interpreted and enforced by the courts. In appropriate cases the statutes prescribe sanctions and maximum penalties for non-observance. The power of statute law lies in the general willingness of society to obey the law enacted by Parliament and in the sanctions which the State is prepared to enforce. From this it follows that statute law does not seek to impose ideal standards; it contents itself with providing sanctions for a failure to adhere to minimum standards. Furthermore, the very nature and power of the law makes a change of the law a serious matter not to be undertaken too frequently. It is also often a time-consuming matter. The result is that statute law tends to be slow to adapt to changing circumstances or new developments. It is also an inherent feature of statute law that it tends to be its letter, not its spirit, which the courts interpret and enforce. For these reasons, statute law, particularly where it relates to administration or regulation, is sometimes framed in a manner which gives some degree of discretionary authority to a person or body designated in the statute as responsible for the administration or regulation in question. But the manner in which that discretionary authority may be exercised is normally fairly closely circumscribed, and may still be challenged in the courts. Building societies and insurance companies are subject to this type of statutory/discretionary regulation.

3 Non-statutory regulation, which is interpreted and enforced by the courts only in cases of manifestly unfair application, seeks to do more than the law can properly be asked to do. As well as prescribing specific rules, which might equally be enshrined in a statute, it is concerned to lay down ethical criteria for behaviour, which a statute could not easily embrace.

4 In the context of financial institutions in the City, such non-statutory regulation is of two distinct types. The first consists of the exercise by the Bank of their traditional powers as the central bank of the United Kingdom in controlling and supervising generally the banking system and money markets. These powers, which were confirmed in general terms in the Bank of England Act 1946, are exercised informally by means of recommendations and requests, which despite their informality are treated by the market as effectively mandatory.

5 The second type of non-statutory regulation normally originates in the realisation by a group of individuals or institutions that regulation of their activities is desirable in the common interest, and their acceptance that rules for the performance of functions and of duties should be established and enforced. Typical of such arrangements are those to which members of professional bodies subscribe in order to establish appropriate standards of professional conduct and competence. In some cases the enforcement of such standards is entrusted to a committee of a profession or of practitioners in a market. Frequently, however, the enforcement of the regulations may be entrusted to an authority outside the group, which is or becomes customarily recognised and obeyed and which may also become the initiator of new regulations; much of the non-statutory regulation of the securities markets takes this form. In both cases the system can be described as self-regulation, the first intrinsically so, the second by common consent.

6 The success of self-regulation involves the scrupulous observance of rules, and depends in large part on the belief of those concerned that the rules are drawn up by a responsible and acceptable representative body or authority and that obedience to the rules is in their own best interests. Thus, listed companies sign an agreement with the Stock Exchange because they wish to see their shares quoted in a market place with established rules which give the public the confidence to invest in the securities which are quoted on it. But other factors affect the acceptability of an authority formulating and enforcing rules. The legitimate exercise of the powers disposed of in non-statutory regulation requires that it should be undertaken with primary regard for the public interest in general and not only in the interests of those who submit to it. In particular, this means that regard must be had to the need not to discourage competition, notwithstanding that unrestrained competition between financial enterprises carries its own particular potential hazards. It is these considerations which have given the Bank, by virtue of their public position, a special rôle in the areas of the City's activities subject to non-statutory regulation.

7 The pattern of regulation differs markedly from one sector of the City to another, reflecting differences both in historical evolution and in the specific character of individual markets. Experience shows that structural changes in markets, development of new market instruments, etc. may require changes to be made from time to time both in the pattern of regulation and in the rules applied. This underlines the need for the regulatory system to be capable of ready adaptation to changing circumstances.

## The development of regulation and the Bank's evolving rôle

**8** As the City grew into a major international trading and financial centre, the spirit grew up among those operating there that they should conform to generally accepted and prescribed standards of behaviour or suffer the consequences in terms of their business reputation and, ultimately, their ability to do business at all. Thus developed the City's tradition of regulating its own affairs. The authority for this was derived not from statute but from the determination of those concerned to uphold the standards and reputation which had been acquired and which themselves served to enhance the growth of the City. This remains the predominant mode of regulation, but, over time, statutory regulation has come to play a significant part in certain fields, notably through the operation of successive Companies Acts, the Prevention of Fraud (Investments) Act, the Insurance Companies Acts, the Protection of Depositors Act, the Consumer Credit Act and the Exchange Control Act.

**9** The Bank's rôle in the City has been determined as it has grown up among the institutions and markets which constitute the City, and it continues to evolve with them. The Bank's central banking functions—notably as adviser to the Government and executor of domestic monetary and exchange rate policy—give them traditional and unquestioned responsibility and authority over banks and money markets, while at the same time inevitably involving close working relations with City institutions in general. To a considerable degree, therefore, Bank Governors have been able to play the rôle of confidant and arbiter of the City and guardian of its standards. The Bank's rôle was accepted the more easily because players could feel that, as referee, they were both independent of faction and understood the game, while being at the same time able to keep in view the wider issues.

**10** The Bank, however, do not stand in the same relationship to each type of financial institution. In some cases the Bank will take an active rôle in monitoring and guiding all important aspects of regulation. In other cases the Bank are content to play a more passive rôle, available if necessary as referee in the event of a serious dispute or policy decision, but generally content to allow the members themselves to govern their own affairs. In appearance, the style is in all cases one of government by consensus, because this has proved over many years to produce the most satisfactory results. In essence, however, the banking system and money markets fall under the traditional regulation of the Bank and as such are effectively controlled by them.

**11** The nationalisation of the Bank under the provisions of the Bank of England Act 1946 brought a formal change in the status of the Bank. The Bank had, however, for a long time regarded their responsibility and duty as directed to the national interest and always subject to the ultimate authority of government. Furthermore, although the Act provided a contingent statutory basis for the exercise of the Bank's authority over banks (and thus indirectly over those financial markets in which banking companies predominate), the Bank in practice have continued to exercise their authority in these fields without radical alteration of their method of operation—which had proved both effective and flexible, and which rested on its long-established custom and use in acting as central bank and controlling money markets, and not on the power to issue directions in closely defined circumstances.

**12** In the case of exchange control, the Bank exercise statutory powers as agents of the Treasury. The purpose of the control is to protect the reserves and assist the balance of payments. In these two respects, the Bank's involvement in exchange control regulation is different from their involvement in other types of regulation. Exchange control has been in force since the outbreak of war in 1939 and the legislation on which it is based was consolidated in the Exchange Control Act 1947. The Act is comprehensive in its scope and, in administering the regulations made thereunder, the Bank have inevitably extended their contact with and involvement in the City's institutions and markets far beyond what had been customary before 1939. This applies particularly to the banks, the securities markets and the commodity markets, but also to the insurance and shipping industries.

## The current system of regulation

**13** The major sectors of City business can be broadly categorised under the following six heads: banking, money and foreign exchange markets, securities markets, commodity markets, insurance, and shipping. The Bank have supervisory responsibilities in varying measure over the banking sector, money and foreign exchange markets, securities markets and commodity markets: these are explained in detail in four separate papers, each covering one of these sectors.

**14** Supervision of the *banking* system and of money and foreign exchange markets is a customary and accepted rôle for a central bank. The Bank have for a long time accepted responsibility for the soundness of the banking system in the City. This responsibility developed out of the nineteenth century banking crises, the successful handling of which by the Bank demonstrated that it was not necessary to have statutory powers to make regulation effective. Supervision of the primary banking sector rests with the Bank and has been operated on a non-statutory basis. There are, however, certain statutory provisions relating to banking institutions, notably the Exchange Control Act 1947, Schedule 8 to the Companies Act 1948 and the Protection of Depositors Act 1963 (as amended by Section 127 of the Companies Act 1967). Current legislative proposals are designed to extend the exercise of the Bank's responsibility beyond the primary banking sector to encompass all deposit-taking institutions not otherwise regulated by statute and to give it a statutory basis. The proposals are outlined in a separate paper submitted by the Treasury.[1]

**15** The Bank are equally concerned to see that *money and foreign exchange markets* operate not only in an efficient, orderly and proper manner but also in accordance with high standards of business conduct. In the small and specialised bullion market the Bank have a close relationship with the relatively few institutions regularly operating there. In the foreign exchange markets the Bank have taken the lead in the organisation of the Foreign Exchange and Currency Deposit Brokers' Association and in maintaining ultimate and effective control of the application of its rules and procedures. In the sterling money markets the Bank have very close relations with the discount houses, who perform a central rôle in the system. More recently the Bank have chaired a working party looking into the possible structuring and organisation on a similar basis of a Sterling Brokers Association for brokers operating in the sterling money markets.

[1] Current proposals for legislation governing banks and other deposit-taking institutions, draft clauses and EEC obligations.

**16** The Bank's interest in the *securities markets* is less central than it is in the banking system and in the money and foreign exchange markets, and is more in the nature of general surveillance. Consistent with their general approach to financial markets, the Bank have an interest in seeing that high standards and sound market practices are observed. The domestic securities market is important both for the effective channelling of domestic savings to meet the needs of government, industry and commerce and as an important constituent of the range of markets which make London an international market-place. Through its detailed rule book the Stock Exchange has over a long period developed and sustained high standards which go well beyond those required under the provisions of the Companies Acts and the statutory rules for licensed dealers in securities under the Prevention of Fraud (Investment) Act 1958 administered by the Department of Trade. The Bank's special interest is in the conduct of the market in government securities, both because of the key rôle of debt management in monetary policy operations, and because the effective functioning of the securities markets is essential to the meeting of the Government's borrowing needs, a process greatly helped by the extent and depth of the secondary market in government debt. The Bank's general interest in securities market matters has developed progressively over the post-war period in response to the growing need for more comprehensive regulatory arrangements and rules of conduct, as the significance of these markets for public policy has increased. One consequence of this closer interest was the initiative taken by the Bank leading to the formation in 1968 of the City Panel on Take-overs and Mergers. A more recent example has been the Bank's initiative in the establishment of the new Council for the Securities Industry.

**17** In the *commodity markets* the rôle of the Bank is also mainly one of surveillance; but exchange control responsibilities require a degree of direct involvement with the London Metal Exchange and the London Commodity Exchange. The re-emergence of these markets after the Second World War was dependent on specially devised exchange control schemes for firms operating in them, based on Memoranda of Understanding between the Bank and the relevant market associations. In addition to the conditions imposed to meet exchange control requirements, the Bank have encouraged the development of procedures for the prudential ordering of the markets. Regular liaison meetings have been established between the Bank and the markets. A system of regular returns of the business being undertaken in the markets has been introduced, and regular informal contacts are maintained by the Bank throughout these markets. Following the devaluation of sterling in 1967, the Bank in furtherance of their oversight of these markets gave financial assistance in the form of loans to firms who found themselves in difficulties, which helped some of these markets to weather a difficult period and emerge with their effectiveness undiminished.

**18** The Bank's relationships with the *insurance industry* have been less close, although there have been increasingly frequent contacts in recent years, reflecting the major rôle of this industry as institutional investors and the consequent impact of this rôle on other markets. Regulation of the insurance industry has been effected by statute from the middle of the nineteenth

century, and responsibility for its implementation rests with the Department of Trade. The Bank have no hand therefore in the prudential supervision of this industry. Contact with the *shipping industry*, other than on exchange control questions, has also been limited and intermittent and has been related more directly to the physical side of trade than the financial.

### Relations between the City and government

**19** The significance of the contribution of City institutions and markets to the economy has given relations between the City and government a particular importance. In this the Bank have always had a major part to play. The Bank have three kinds of regulatory rôle, each of which carries with it the need to serve as a bridge between the City and government: first, as the authority to whom the operation of exchange control is delegated; secondly, the exercise of public authority over the banking system and financial markets generally; and thirdly, general oversight in the public interest of non-statutory regulatory arrangements operating within different sectors of the City, including those applied by special bodies like the Take-over Panel.

**20** In all of these activities the Bank maintain close contact with government. The principal link is through the Treasury, but given the regulatory responsibilities of other government departments the Bank have established appropriate relations with those departments, notably the Department of Trade and, in the field of restrictive practices, the Department of Prices and Consumer Protection. At the same time, the Bank recognise that there needs to be a range of contacts between City institutions and various parts of government. The intermediation of the Bank, however, can contribute to the resolution of problems or to the reduction of an unnecessarily large number of channels of communication. A practical example of co-operation and co-ordination between the Bank, the City and government can be found in the arrangements agreed between the Department of Trade and the Bank in 1976 for monitoring together the statutory and non-statutory elements of securities regulation—described particularly in the Department of Trade evidence to the Committee. [1]

**21** The Bank have also sought in a number of ways to help the City develop its own capacity to examine critically its own procedures and organisation and to represent its views on organisational and regulatory questions to government. The City Liaison Committee (originally formed to provide back-up to the City members of the National Economic Development Council in 1965) was revived and extended in the early 1970s to review matters of this kind, as well as other wide-ranging issues of public concern on which the City may have views to express. At the same time specialist committees associated with the City Liaison Committee were established, and much of their work has covered regulatory questions. The City Capital Markets Committee produced the main City response to the Department of Trade's examination of the regulation of securities markets in 1974. The City Company Law Committee has been closely involved in study of prospective company law legislation of a regulatory nature affecting the financial and commercial community, including EEC company law directives, the government discussion paper on contents of corporate reports, insider dealing and loans to directors. The City EEC Committee has been closely concerned with the EEC harmonisation proposals on regulation

[1] *Supervision of the Securities Market: the statutory framework and specific controls.*

of banks and certain aspects of securities markets business, and with the development of a non-statutorily based code of conduct for stock exchange transactions within the EEC.

### **The future course of regulation**

**22** The Bank consider that the best way to regulate the activities of the City is likely to remain a blend of statutory and non-statutory arrangements. The nature of the mix will vary over time and depend upon the particular activities involved, their evolution and public attitudes towards them. In particular areas the Bank would favour statutory arrangements. For instance, the Bank would endorse the widely held view in the City that there should be an attempt through statute to make certain securities dealings undertaken with the benefit of 'insider' information a criminal offence. The Bank also believe that in the area of supervision of deposit-taking institutions the enactment of legislative provisions in relation to non-bank deposit-takers is necessary to support the Bank's existing methods of supervision.

**23** There are, however, many aspects of market regulation where non-statutory control has proved more appropriate and flexible than statutory control and is likely to remain so. Systems which rely on law and specific regulation as the sole guide to behaviour in commercial affairs may lead to any conduct being regarded as permissible if it satisfies the legal requirements, whereas in the systems which rely on self-regulation, and in some cases discretionary powers, more attention can be concentrated on the intentions, both ethical and practical, which underlie the provisions. Moreover, non-statutory processes are often quicker to introduce and modify than processes prescribed by law, and speedier in execution, as a direct result both of the congestion of the legislative timetable of Parliament and of the heavy work load of the courts. Thus, non-statutory elements form a vital part of an effective regulatory régime for commercial markets, where the extremes of rigidity inherent in a statutory framework must be avoided and in which the revision of the letter of the law never in practice keeps pace with those determined to flout its spirit.

**24** The changing blend of statutory and non-statutory regulation is likely to be influenced increasingly by international considerations. London's development as an international financial centre has drawn to it representatives of a wide number of countries operating in a variety of financial functions. Among the attractions of London is the flexibility and efficiency of its regulatory system. But the newcomers bring with them different business traditions and methods. The markets are no longer nationally bound—they are part of an international market linked to different countries operating under different sets of rules and laws.

**25** In particular, the United Kingdom's membership of the EEC has made an important body of external law directly relevant to UK financial markets. Since the approach of much of continental Europe to regulatory matters has traditionally leaned heavily on statute, one might expect our own mixture of statutory and non-statutory arrangements to sit uneasily with their approach. In the five years of its membership of the Community, however, the United Kingdom has won considerable support within the Community for ways of moving ahead on joint regulatory efforts which recognise the validity of an approach seeking to combine the merits of statutory and non-statutory measures, particularly in the fields of banking and securities markets regulation.

**26** Despite their respective merits, all methods of non-statutory regulation will remain acceptable only if they are seen to be effective in the protection of the public interest. In addition, self-regulation will only remain so if it continues to be administered in a manner which is generally believed to be justified by those to whom it is applied. In the general conduct of regulation of the banking system and of the City's markets it is the Bank's view that non-statutory regulation has been a major factor in sustaining the probity and efficiency of the operations of the City of London. While it is clear that the interplay of statutory and non-statutory régimes should be kept continually under review, the Bank believe that non-statutory arrangements combined with statutory provisions will continue to provide an effective and flexible system of control.