

## Supervision of banks and other deposit-taking institutions

1 This paper outlines the development of the Bank's rôle as supervisory authority over banks and certain other deposit-taking institutions in the United Kingdom and describes current philosophy and practice in the conduct of that supervision.

### Background

2 There are at present no specific legal requirements governing the establishment of a deposit-taking business in the United Kingdom, but, once established, there are limitations on the banking services which it can provide. Until the Second World War these limitations were mainly market-determined. Some facilities, like the granting of bankers' payment facilities by a clearing bank, were granted only when a company had acquired sufficient standing within the banking community; other facilities, like the Bank's willingness to discount a company's acceptances at the prime rate, were in the Bank's own gift, but the Bank took note of market opinion. These limitations still apply but are now less significant than legal requirements; for since the War various requirements have been placed by statute upon banks or on banking business. A list of these Acts of Parliament, showing the restrictions each of them imposes on deposit-taking institutions and the government departments responsible for their administration, is given in the appendix. The most important are the Exchange Control Act 1947, which confines the provision of a full range of foreign exchange services to authorised dealers, and the Protection of Depositors Act 1963, which imposes conditions upon advertisement for deposits.

3 A number of these statutes required the establishment of lists of companies recognised as banks for the statutory purposes in question. Such lists were necessary because of the absence of any overall legal definition of a bank, and in some cases the task of establishing these lists was initially undertaken exclusively by the government department concerned. In due course concern over the ambiguities of status which resulted and over the potentially conflicting criteria being adopted led to the Bank being consulted in the administration of all the various statutory recognitions. In giving advice the Bank drew both on their own evaluation of the applicant and on their assessment of market opinion. The amalgam of the market-based and statutory recognitions resulted in what may be described as a status ladder, with a series of rungs represented by individual recognitions, up which companies could progress as their reputation and expertise developed. But only those which had acquired the highest recognitions were regarded by the Bank as banks in the full sense of the word—at the present time this effectively means authorised banks under the Exchange Control Act 1947 and banks recognised by the Department of Trade as exempt from the provisions of the Protection of Depositors Act 1963 under Section 127 of the Companies Act 1967.

4 In no case did the statutes give departments powers of prudential supervision over the banking institutions recognised by them. So there was no overall supervision of deposit-taking institutions as such. On the other hand, it had long been

accepted that the Bank had a supervisory rôle in relation to the fully-recognised banks. The acceptance by the Bank of responsibility for supervising banks implied in turn a capacity for being informed about them, and, within the Bank, this task fell to the Discount Office, a rôle first acquired during the nineteenth century when so much banking business was transacted by bills of exchange. The Discount Office continued to fulfil this rôle as the 'eyes and ears' of the Bank, but with the passage of time it became concerned with a wider range of UK-based banks, and later with the branches and subsidiaries of foreign banks. The number of banks it was required to watch over thus increased, and particularly so from the mid-1960s with the arrival of many branches of foreign banks and the formation of London-based consortium banks. The business conducted by UK banks also became steadily more complex.

5 The degree of supervision exercised by the Bank varied greatly according to the type of bank concerned. It was most highly developed in respect of the members of the London Discount Market Association and the Accepting Houses Committee with which the Bank traditionally had very close operational links. Apart from holding meetings throughout the year on individual problems, the Discount Office maintained regular and formal contact with the senior management of each of the discount and accepting houses by annual discussion, based on the Bank's analysis of the annual balance sheets, at which past performance and future plans were reviewed. The Bank also maintained regular and close contact with senior management of the clearing banks, but it was not the practice to hold discussions specifically related to their balance sheets, although if examination of them threw up matters for special discussion (e.g. capitalisation) these would be discussed at one of the regular meetings. The treatment of other UK-registered banks involved the analysis of all annual balance sheets, and most analyses were followed up by interviews with senior management, certainly so if the analysis disclosed grounds for concern. The Bank did not maintain any formal or regular contact with companies which did not fall within the banking sector proper, seeking to develop such relationships only when a company became a serious contender for full recognition as a bank.

### Developments since the secondary banking crisis

6 The secondary banking crisis of 1973-74 and the consequent establishment of the support operation, familiarly referred to as the 'Lifeboat',<sup>[1]</sup> demonstrated the need for intensification and extension of existing supervisory arrangements. It was apparent that the operation of the Protection of Depositors Act 1963 had not adequately alerted depositors to differences in status and risk between the various companies which were seeking to attract deposits from the general public. Some part of this confusion was due to the introduction in the 1967 Companies Act of the Section 123 certificate, which could be granted by the then Board of Trade to companies satisfying them that they could properly be treated for the purposes of the Moneylenders Acts 1900 to 1927 as *bona fide* carrying on the business of banking. The criteria used in judging applications for such certificates (which were

[1] These events are more fully described in the Bank's background paper 'The secondary banking crisis and the Bank of England's support operations' published in the June *Bulletin*, page 230.

sought by those wishing to avoid uncertainty as to their ability to sue for recovery of money lent created by the Moneylenders Acts) were purely functional and involved no test of the quality of the business in question. Extension of supervision was necessary in particular because of the development of wholesale money markets, which had linked banks and other deposit-takers more closely together, with the consequent danger of the contagious spread of any trouble that might arise.

**7** In the crisis atmosphere of 1974, the Bank moved rapidly to fill this gap. Deposit-taking institutions which a year or two earlier might have resisted any intrusion by the Bank into their affairs now positively welcomed it. The Bank were therefore able to bring them immediately within an enlarged and intensified supervisory system inaugurated in the summer of 1974. The functions of the Discount Office, which had involved some fifteen people, were absorbed into a new and considerably larger Banking and Money Market Supervision Section, under the direction of a senior official with the status of Head of Department. The section now numbers some seventy people. All banks registered in the United Kingdom (except the clearing banks and the British overseas banks) are required to submit quarterly returns revealing the main components of their business and to attend interviews at the Bank to discuss and elaborate on the position revealed in the returns. About 100 banks were covered. Some 60 non-bank deposit-taking companies (including members of the Finance Houses Association) were also required to participate on a similar basis. These companies initially comprised all those known to the Bank to hold sizable deposits from the public. The composition of this group of supervised institutions has changed slightly in the intervening period as additional deposit-taking companies have, as appropriate, been brought within the net; and some companies have been absorbed into other supervised companies.

**8** The intensification of the Bank's supervisory procedures has taken place in a number of areas. For the 160 or so institutions now involved, returns are submitted and reviews undertaken at least once a quarter. These returns break down the balance sheet into its components, display the maturity structure of liabilities and assets both in sterling and in other currencies, provide details of large deposits and loans (together with those made by or to others with whom the company or its directors have a connexion) and of bad loan provisions, and provide a breakdown of the purposes and country destination of loans. In addition, information on profitability is received on a regular basis. All these returns are analysed within the section to bring out the main characteristics of the business (e.g. its nature and spread, concentration in particular areas, and dependence on connected business) and certain key ratios are derived, covering capital adequacy, liquidity and the matching of maturities of liabilities and assets in sterling and euro-currency. The resultant analysis is seen as the essential first stage in the Bank's understanding of the underlying nature of the business and is used as the basis of the regular interviews with senior management of the individual institutions.

**9** The interview is the cornerstone of the Bank's system of supervision. While it is based on the analysis of the most recent information, it can and does range far wider. The prime aims of the interview are to build up within the Bank an intimate picture of the institution, its business and its objectives, and to

assess the capabilities of its management to control the business and fulfil the objectives. This emphasis on qualitative assessment has been born of experience, as management problems and inadequacies have typically provided the first sign of difficulty. It is because the assessment of an institution is made on both quantitative and qualitative grounds that no one indicator of performance is given special prominence; the various factors are allotted their due weight according to the Bank's understanding of the individual business and the capabilities of its management.

**10** The supervision of the clearing banks and of the British overseas banks with large foreign branch networks has taken a somewhat different path. This is because of the greater scale and complexity of their operations and the security provided by their greater resources. A working party met in 1975, which established the principle of annual reviews—the precise methodology was set out in an article in the *Bank of England Quarterly Bulletin* for September 1975. [1] These banks are supervised on the basis of an annual cycle, with more detailed statistics and several interviews, each dealing with a particular aspect of their operations. The Bank have always had very close contact with clearing bank management and this, together with the greater need for formal administrative procedures within highly structured large companies like these banks, entails emphasis being placed on the examination of control systems and reporting and auditing procedures.

**11** The extension and intensification of supervision by the Bank was entirely non-statutory. Subsequently it has been agreed with the Government that there should be a new statutory framework for supervision, with the Bank being recognised as responsible for the supervision of all private sector deposit-taking institutions other than building societies. Such a framework would conform with the EEC Banking Directive adopted in December 1977 'on the co-ordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions', which requires the United Kingdom to set up formal arrangements for licensing deposit-taking institutions in the United Kingdom.

#### **International aspects of supervision**

**12** The position of London as an international banking centre has enhanced the complexity of the Bank's function as a banking supervisory authority. London's position as a leading international centre with large and sophisticated money and capital markets has made it attractive as a place for foreign banks to have branches or subsidiaries and for banks to combine in order to establish specialist consortium banks. The Bank have consequently developed a special interest in monitoring international market developments, in encouraging the development of a similar interest by other national bank supervisors and in ensuring that adequate consultation takes place between national supervisors to keep abreast of developments world wide and, most importantly, to ensure there is a proper understanding between national supervisory authorities of where responsibility rests. The Bank established a general acceptance of the principle of a parent company's responsibility, going beyond that of legal liability, for the operations of deposit-taking subsidiaries and affiliates in other countries. In pursuit of this principle, in September 1974 the Bank sought comfort letters from banks which were

[1] Page 240.

shareholders in banking companies established in this country, acknowledging formally a moral commitment to support their associate or subsidiary if it ran into difficulties. The willing provision of these comfort letters by all concerned did much to allay the anxieties then present in the international banking community. Also at that time the Bank took the lead in the establishment of a Committee of Banking Supervisors, under the aegis of the Group of Ten countries and Switzerland, for which the Bank have continuously provided the chairman. Through the Committee, contacts have also been developed, and are being extended, with the authorities in other countries. The Bank are also represented on an informal group of bank supervisors from the EEC countries, which meets regularly to discuss in confidence matters of common interest.

**13** More recently, the Bank have started holding prudential discussions with branches in London of overseas banks in order to ensure a systematic understanding of their operations. From the legal point of view, branches are integral parts of their parent organisations, so that the responsibility for their supervision formally rests with the supervisory authority of their parents. But the Bank recognise that there should be some responsibility on the part of the host country's supervisory authorities for keeping abreast with the affairs of branches situated in its territory. These discussions are intended to complement that prime responsibility of the parent's supervisory authority by bringing to bear the Bank's on-the-spot experience of institutions operating in London markets. The positions taken by all banks, including foreign bank branches, in the London foreign exchange and euro-currency markets have for long been the subject of

detailed reports to the Bank, enabling immediate enquiry to be made into any unusual activity. The closer contact with the branches of foreign banks, of which some 180 now have branches in the United Kingdom, will further extend the Bank's understanding of the influences affecting the international markets in London.

### **Legislation**

**14** The existing pattern of banking supervision has major elements which, in the Bank's view, have proved their worth within the structure of the UK financial system, and it is intended that the proposed new statutory framework should enable them to be preserved. The description which best illustrates these qualities is that the system is progressive, participative and personal. The proposed framework will recognise a progressive element among deposit-taking institutions while doing away with the confusions in the public mind which had arisen from the former multiplicity of recognitions. It will continue to encourage the participation of the banking community in the development of appropriate supervisory practices and to pay due regard to the market's judgments of those participating in it. It will remain a personal system both by the maintenance of the style of personal dialogue between companies and the Bank and by the Bank continuing to have regard to the individual structure and circumstances of each deposit-taking company, rather than seeking a standard level of conformity through detailed ratio controls. The Bank believe that such a supervisory system within a statutory framework is appropriate to present circumstances and will maintain the spirit of trust and co-operation that has been built up over many years.

References to banks and banking in the statutes (excluding Northern Irish legislation)

1 Principal banking recognitions

- Exchange Control Act 1947  
 Except with HM Treasury consent (given on the advice of the Bank of England) no person other than an authorised dealer (known as an authorised bank) may deal in foreign currency or open accounts for non-residents of the United Kingdom.  
 The list of authorised dealers is not closed: banks are added to it as appropriate.
- Companies Act 1948  
 Schedule 8 empowered the Board (now Department) of Trade to exempt recognised banking or discount companies from certain of the provisions relating to the disclosure of information in a company's balance sheet; principally an exempted company need not disclose the size of its hidden reserves. A revised form of this schedule is contained in Schedule 2 of the Companies Act 1967.  
 No new names have been added to the list of exempted banks since 1967. The London and Scottish clearing banks and certain others have relinquished exemption: the status is now confined to members of the Accepting Houses Committee and the London Discount Market Association, and a few other banks.
- Protection of Depositors Act 1963  
 Restrictions on advertising for deposits do not apply to those banking and discount companies which are recognised for this purpose by the Board of Trade under Section 127 of the Companies Act 1967. Prior to 1967, exemption was given only to banking and discount companies with existing Schedule 8 exemption.  
 The list of exempted banks is still open: it is maintained by the Department of Trade on the advice of the Bank of England.
- Companies Act 1967  
 Section 123 empowers the Board of Trade to issue certificates stating that a person can properly be treated for the purposes of the Moneylenders Acts 1900 to 1927 as being a person *bona fide* carrying on the business of banking.  
 This list is effectively closed: virtually no new names are being added to it, pending the repeal of the licensing provisions of the Moneylenders Acts and their replacement by the licensing sections of the Consumer Credit Act 1974 (it is not known when that will take place).
- Income and Corporation Taxes Act 1970  
 Under Section 54 only a company which is recognised by the Inland Revenue as carrying on a *bona fide* banking business in the United Kingdom is authorised to pay annual interest gross on deposit accounts and to receive annual interest gross on advances to UK borrowers.  
 This list is open: it is compiled by the Inland Revenue after consulting the Bank of England.

2 Other statutes

- Bank Charter Act 1844  
 Regulates the issue of bank notes by bankers in England and gives the Bank of England certain privileges relating to the issue of promissory notes.
- Bank Notes (Scotland) Act 1845  
 Regulates the issue of bank notes in Scotland by bankers.
- Stamp Act 1853  
 Provides that drafts on bankers payable to order on demand and endorsed by payees are sufficient authority for payment.
- Bankers' Books Evidence Act 1879  
 Subject to the provisions of this Act, a copy of any entry in a banker's books shall in all legal proceedings be *prima facie* evidence of such entry.
- Bills of Exchange Act 1882 and Cheques Act 1957  
 Codify the rights and obligations of bankers relating to cheques and certain other instruments.
- Agricultural Credits Act 1928  
 Enables English and Welsh farmers to create a charge on farming stock and other agricultural assets in favour of a bank approved by the Minister of Agriculture. At present the Minister recognises as banks institutions which are authorised under the Exchange Control Act 1947, are exempted from the provisions of the Protection of Depositors Act 1963 or are exempted from the provisions of the Moneylenders Acts.
- Agricultural Credits (Scotland) Act 1929  
 Allows the three Scottish note-issuing banks to grant loans secured on agricultural land to farmers in Scotland.
- Bank of England Act 1946  
 Empowers the Bank of England to request information from and make recommendations to bankers and, with approval of HM Treasury, to issue directions to bankers to obtain compliance with any such request or recommendation. Section 4(6) defines a banker as 'any such person carrying on a banking undertaking as may be declared by order of the Treasury to be a banker for the purposes of this section'.
- Building Societies Act 1962  
 Section 59 empowers the Chief Registrar of Friendly Societies to designate by order, made with the consent of HM Treasury (who consult the Bank of England), those banks which are authorised to hold the funds of building societies. Authorisation is limited to certain of the institutions holding one or more of the principal banking recognitions, the National Girobank, the National Savings Bank and the trustee savings banks.
- Solicitors Act 1974  
 Allows solicitors to keep client accounts or trust accounts only with the Bank of England, with banks exempted from the provisions of the Protection of Depositors Act 1963, or with trustee savings banks.