The role of the banking supervisor

The Head of Banking Supervision, ***Mr W P Cooke****, describes*[1] *the conduct of banking supervision as it has developed in the United Kingdom, particularly since the Banking Act, 1979. He describes the relationship between the supervisor and bank auditor, goes on to discuss the supervisory implications of the spread of international banking, and concludes with some remarks about the need for a common and realistic approach to provisions for bad and doubtful debts.*

I shall begin by saying a few things about the general role of the supervisor, particularly how we see that role in London. My remarks will inevitably reflect the attitudes and systems we have adopted in this country but, while our approach in certain important respects differs from that in other countries, I believe my colleagues abroad would agree with most of what I have to say. Over recent years working in the field of international co-operation in banking supervisory matters, it has been heartening to find an increasing degree of agreement on principles even if practices and techniques may differ.

The conduct of supervision

To single out banks as a special category of institution requiring the attentions of a supervisor implies no special lack of confidence in the capacity of bankers to manage their own affairs. Rather, it arises from the unique fiduciary responsibility which bankers assume when they accept other people's money for safe keeping. That is why in this country, when introducing legislation in the late 1970s, we took the view that the important activity which would be the trigger for statutory control was the act of deposit-taking. But in addition to this micro-level concern for the interests of individual depositors, there is also a macro-economic dimension which needs to be constantly in the supervisor's view. Banks have a central intermediary role in sustaining economic activity, and the maintenance of a sound banking system is essential for the fruitful development of both the national and the international economy.

Supervision has evolved from a voluntary system . . .

In this country, as indeed in most advanced economies, supervision has grown out of the market. But while it has always been a feature of the Bank's approach to supervision to sail with a fairly light rudder, it is always necessary to be mindful of the Charybdis of prudential laxity across the channel from the Scylla of overbearing regulation. There has been some tendency, at least over the past few years, to characterise the supervisory stance of the Bank as less flexible and more regimented than in the past. I believe this to be only to a very limited extent true, and in so far as it is so more a consequence of increased scope than changed style. The extent of the Bank's supervision has grown over the past decade in two particular directions. The first, as a consequence particularly of the secondary banking crisis, but also EEC developments, has been the widening of the Bank's supervision to include institutions not traditionally under its control and to give that supervision statutory backing. The second has been the stretching of the Bank's supervisory horizons to embrace in a more comprehensive way than in earlier times the totality of British banks' activities no matter in which country they take place.

. . . but now has a legal setting . . .

I shall come back to talk about the international dimension of the supervisor's role later on in my remarks. First some comments about the domestic scene. The widening of the Bank's role in recent years was given added momentum by the passage of banking legislation in 1979. The Banking Act of that year invested the Bank for the first time with a statutory responsibility for the supervision of deposit-taking institutions. That responsibility had up till then been carried out on the basis of custom and usage and the Bank's long-standing authority in the City.

But it is important to emphasise that although the Bank's role in this area of its activities is now statutorily underpinned, the day-to-day fulfilment of that role is still handled without recourse to detailed legal provisions. The framework of the regime and the general principles of supervision to which the Bank must have regard are set out in the statute, but the application of those general principles are left to be handled in a way which can be responsive to the particular features of individual institutions and developments in the market-place.

It may perhaps not be readily appreciated what a wide diversity of institutions come within the ambit of the Bank's supervision under the Banking Act. They range from the major clearing banks—among the world's giants—and the many branches here of all the other major banks of the world, to licensed deposit takers with a much narrower and more specialised constituency to serve like, for example, the Methodist Chapel Aid Association and the Hardware Federation Finance Company. Within the United Kingdom the geographic spread takes us from the City of London to the Mull of Kintyre, and the character of business ranges

(1) In a speech to a conference on banking organised by the Institute of Chartered Accountants, in London on 4 November 1982.

from the most blue blooded merchant banks to small businesses wrestling with the gritty world of used-car finance or second mortgages.

... which is operated flexibly...

Now you may say this flexible response to individual institutions, justified by their diversity, is all very well but surely some common rules are possible, at least for groups of institutions in the same area of business and of similar size. Indeed it is the Bank's practice to engage in peer group analysis—checking particular judgements of adequacy of balance sheet and profit performance against similar institutions. At the same time there is no wish on the Bank's part to stamp all our variegated institutions with a standard range of supermarket categorisations, each group clearly distinguished from each other, with identical labels for capital, liquidity, overall size or area of activity. So, as the Bank has sought to build on the basic framework for the supervisory regime set out in the legislation, we have concentrated on outlining our approach to the measurement of certain aspects of a bank's business rather than specifying the absolute levels to be maintained in applying that system of measurement. This approach was most clearly manifested in the three discussion papers we have issued since the Banking Act—on capital adequacy,[1] liquidity[2] and foreign exchange.[3] These papers, all now issued in their definitive version after extensive discussions with the banking community, address themselves to general prudential principles and the basis on which those principles should be applied to individual institutions. They are no more than a framework. They are not a comprehensive blueprint and I am conscious that there will always be a balance between an appropriate quality and depth to the professionalism of the analysis and the wish to avoid introducing excessive rigidity into the system.

... through dialogue with bank managements

Another aspect of the Bank's approach to supervision which should be highlighted is the process of dialogue which is at the heart of the system. The papers just referred to were initially issued—as I said—as discussion documents for we believe that, certainly in the long term, but more often than not also in the short term, the interests of bank managements and of those concerned with the prudential soundness of banks are the same. Furthermore, the disciplines which a market imposes on its members home in, often rather quickly, on institutions operating imprudently, whether the problem is overtrading, excessive risk-taking with consequential impact on the profit and loss account, or generally sloppy management. Indeed it is judgements about management which are at the heart of our supervisory process—not only from the evidence of the balance sheet and the profit performance but from face to face discussions with senior management of all supervised institutions. The Bank's system is designed to enable the supervisor to sit alongside management, sharing in his thinking. Although we have no wish to be directly involved in management we certainly regard it as of crucial importance to have a good understanding of the thrust of management in a business. I do not need to tell this audience that banking is all about confidence. Banks in whose management the market has confidence, even when times are rough and hard, will normally weather the storms, while banks whose managements are suspect can well run into difficulties, even if their conventional ratios are at the conservative end of the range.

Occasionally firm rules are needed...

I should make it clear, however, that notwithstanding this emphasis, and in my view the very proper emphasis, which we put on flexibility and letting managements manage, there will always be a point at which the supervisor must be the final arbiter. Hopefully this only arises infrequently and when there is no alternative. It is also important that the arbiter's ruling should be readily accepted. That is why the Bank as an institution has always set out to be closely involved in the market. The professionals must be prepared to accept the referee's decision. There will always be some aspects of supervision where there can be no absolute or objective basis for applying judgement. Capital adequacy is perhaps the most obvious example. In this area particularly there will be occasions when the supervisor has to say you may go no further. It has been interesting recently to note several cases where banks who have previously chafed at a regime required by the Bank have subsequently come to settle without complaint within the guideline applied as circumstances have changed.

Ultimately of course the market will provide its own correction of a bank which goes gung-ho for lending at any price or ignores prudential standards generally, but there will of course be time lags and in extreme cases these may be at the expense of the depositor. That is why, in addition to a legally based supervisory regime, it was judged right to introduce a degree of depositor protection in the legislation. Not so much, I think it is fair to say, to back-stop the short-comings of the supervisor but rather to build in some consumer protection arrangement for the small depositor.

... but ultimately management quality counts

One final aspect of the supervisor's role should be mentioned. I have touched on Capital adequacy, Management quality, Earnings (or profitability)—the dynamic of the business—and Liquidity: four fifths of the 'CAMEL' which is the standard check list of all supervisors. The missing item is Asset quality. It is generally, although far from exclusively, the case that most of the losses incurred by banks arise from their lending. And it is in this area that the system of supervision in this country gives rise to the most questioning. How, one is asked, can the Bank supervise effectively without a system of inspection or examination of the books of the banks and

(1) The measurement of capital; issued on 5 September 1980 and reprinted in the September 1980 *Bulletin*, pages 324–30.
(2) The measurement of liquidity; issued on 20 July 1982 and reprinted in the September 1982 *Bulletin*, pages 399–402.
(3) Foreign currency exposure; issued on 24 April 1981 and reprinted in the June 1981 *Bulletin*, pages 235–7.

in particular the credit files. Our response to this is that we rely on proven management quality, historic loan loss experience and the monitoring of management's own view of evolving profitability and major problem loans through the year, together with regular returns of the sectoral and country breakdown of lending and the largest exposures. This we believe gives us at least as good an overview of the quality of the assets of a bank as sending in a team of inspectors to look at the loan documentation. We of course have to rely on management baring their soul to us several times a year, but find in practice that it gives us at least as good a picture as a sampling of lending which is the common feature of most inspection systems. We also learn rather quickly whose soul baring we can depend upon. Now I would not claim that this aspect of supervision is not capable of improvement, but in general we believe it serves us rather well. Of course this system can be abused, but happily setting out to hoodwink the supervisor is not a popular bankers' pastime in this country; if it were so the system would have to be modified. In particular cases, however, we can always mount special investigations of all and every aspect of a bank's business if we feel this is necessary.

The relationship between supervisor and auditor

The pros and cons about physical examination of the banks' prime records by supervisors leads me into the second aspect of the supervisor's work on which I would like to dwell for a few minutes—the relationship between the supervisor and the bank auditor. For the auditor of course an examination process is central. Indeed I think it may be said that one of the main reasons why in this country we have managed to maintain a system of supervision which does not involve an examination procedure is because of the reliance we can place upon the auditor's work.

The auditor's first duty is to shareholders . . .

Let me note first a difference of emphasis in the two roles. For the supervisor the primary responsibility is to a bank's depositors; for the auditor it is to the shareholders. Both share a duty to form an opinion on the condition of a bank. The auditor's task is to report on the information presented by directors in the company's accounts (perhaps with a formal disclaimer if it appears unsatisfactory) so that the shareholders can make an assessment on which they may themselves act as they deem fit. The depositor on the other hand merits a more active protection, and the supervisor has thus not only to form his own judgement of a bank's condition but also to undertake whatever action appears necessary to protect depositors' interests. The auditor, one may say, is concerned primarily with establishing the truth of facts presented to him by management and the appropriateness of the judgements made in relation to those facts, while the supervisor's concern extends to the implication of those facts and judgements for the future viability of the business. This reflects the different character of shareholders and depositors. The shareholder knowingly undertakes a risk activity which may involve loss; the depositor reasonably expects to get his money back, an expectation now partially reinforced by statute.

. . . but he must also consider depositors

While an auditor's first duty is to the shareholders, however, he will also be aware that the accounts he reports on are likely to be read and acted upon by third parties. Furthermore, in the case of banks, the existence of the depositors will have a particular impact on the way the auditor views and discharges his responsibility; they are unsecured creditors, a financially dependent group meriting special protection, and the volume of their unsecured claims in relation to the capital of the bank is enormously greater than would be expected in any other type of company. This means that the auditor needs to be especially careful to investigate the condition of a bank in depth and ensure the accuracy, the 'truth and fairness' of information presented.

The need is all the greater because there are probably a greater range of areas of high risk associated with banking than with companies in general; for example, interest rate risk, foreign exchange risk and country risk. In order to assess these factors accurately, it is likely that an auditor will need to acquire at least some degree of specialised knowledge and closer links between bank auditors and supervisors may well be useful in this regard.

Supervisors depend on the auditor's assessment . . .

Links between auditors and supervisory authorities are not as close in the United Kingdom as in most other countries because the Bank does not insist that prudential returns should be audited. However, considerable reliance is placed on auditors by the Bank because of the absence of regular inspection as part of the supervisory process. To a considerable extent, the Bank depends on the bank's auditors to verify valuations of assets, liabilities and reserves, and relies, to a degree at least, on their judgement of the adequacy of internal control systems.

. . . which places added responsibility on him

To date we have seen no reason for changing this practice. We are fortunate in this country that auditing standards are extremely high. I should note, however, that we have identified isolated cases recently where the auditors of a supervised institution have apparently allowed themselves to be misled. The Bank's reliance on audited accounts was thus misplaced and it has been necessary to commission special investigations by reporting accountants. Isolated as these cases were, I should emphasise how important it is that shortcomings of this kind do not occur in the auditing of those special categories of institutions which are entrusted with the deposits of the public. Both supervisor and auditor in their complementary roles, owe the depositors the duty of total vigilance. Unlike comparable legislation in other countries, the Banking Act does not have a specific provision which empowers the Bank to appoint auditors or to change auditors approved by shareholders, (although we can appoint accountants to carry out a special audit if this seems necessary). Auditing deficiencies have not proved to be a serious problem in the administration of the Act and I believe they are unlikely to do so, but this will depend on the accounting profession taking care that standards are maintained. Bank auditing is a specialist task and not all firms are equipped to carry it out. Individual firms and the profession itself owe themselves as well as their clients a duty to review very carefully their capacity to carry out such responsibilities and to pursue them with all due diligence.

One final aspect of the auditor-supervisor relationship in this country which deserves a special mention is the fact that under our present system not only is there no mechanism for a bank auditor to convey unease to the supervisory authorities (unless it is concrete enough to merit a qualification in the accounts) but such exchange of information could be in conflict with the auditor's duty of confidentiality. A quite different situation obtains in some other countries, for instance in Switzerland and Holland, where banking law actually requires auditors to pass any relevant information to the banking supervisory authorities. Although again I do not believe serious problems have arisen as a result of the constraints within our system, I believe that the workings of such arrangements abroad may merit closer examination here.

The international dimension of supervision

I should now like to turn to some of the international aspects of supervision; in particular the growth in recent years of co-operation between supervisory authorities, which has developed alongside the growing international character of major banks' operations and has led to the growth of a whole new dimension to the supervisor's role.

The growth of international banking . . .

The expansion of a bank beyond national frontiers poses immediate supervisory problems. A different legal system and supervisory regime will impinge on those activities. The supervisors of the bank proposing to expand, the parent bank, will want to be assured that its operations abroad can be properly conducted. As they are not physically on the spot to supervise those activities themselves, they need to assure themselves of the adequacy of supervision of foreign establishments by the relevant authorities receiving branches or subsidiaries of foreign banks within their own territories. These host authorities will have similar concerns. Failure of a foreign bank operating in their country could cause losses to local depositors and might damage confidence in the local banking system. They will wish, therefore, to investigate the quality of the home country supervision of a bank seeking to expand into their market.

. . . requires fully and clearly allocated responsibilities . . .

The first major problems then, which arise for the supervisory authorities whose banks are involved in international banking business, are the allocation of supervisory responsibilities and the closely related need for supervisors to have access to information on an international level. It is, I think, now generally recognised that at the beginning of the 1970s supervisory authorities had not addressed themselves sufficiently to these questions, and that techniques of supervision had lagged behind developments in international banking business and the growth of euromarkets.

The events of 1973–74 after the first oil shock and the spectacular failure of two international banks highlighted this lacuna in a dramatic way. They led to the establishment by the governors of the central banks of the Group of Ten major industrialised countries and Luxembourg and Switzerland of a standing committee of banking supervisory authorities. The first task of the Committee was to address itself to the division of supervisory responsibilities among its members for international banking business. The understandings which resulted from these discussions led to the document which has come to be known as the Concordat and which sets out the respective responsibilities of the parent bank's supervisory authority and the supervisory authority of the country in which a branch or subsidiary of that parent bank operates. The basic objectives were to ensure that no foreign establishment of a bank operating internationally escaped effective supervision and, to that end, that there was a clear understanding between the different authorities—parent and host—about the nature of the supervisory responsibilities borne by each in respect of international banking activities undertaken in their territories.

. . . with parent and host authorities jointly supervising . . .

Supervision was deemed to be the joint responsibility of parent and host authorities, with both having a duty to ensure that surveillance of banks' foreign establishments was adequate. The supervision of liquidity was seen as the responsibility of host authorities in the first instance (on the grounds that foreign establishments generally have to conform to local rules on liquidity management). The solvency of branches, which are an integral part of the parent bank, was seen as primarily a matter for parent authorities, while that of subsidiaries fell rather to the host; though it was recognised that parent supervisors, in their supervision of the parent bank, needed to take account of its foreign subsidiaries and joint ventures in view of its moral commitment in their regard.

A later recommendation of the Committee, which developed out of the Concordat, was that supervision of banks' international business should be carried out on the basis of consolidated data, in order to provide a global picture of a bank's activities. This tended to reinforce the perception of an overall supervisory duty of the parent authority to monitor the totality of a bank's international operations, including both branches and subsidiaries.

. . . banks on a consolidated basis . . .

The principles of the Concordat and the technique of consolidation, as applied in major countries, now forms the framework within which the supervision of banks' international business is undertaken. At the risk of playing an overworn record, I must here stress yet again that these arrangements, worked out between the major industrialised countries and increasingly accepted and applied by other supervisory authorities round the world, relate to *supervisory* responsibilities not *lender of last resort* responsibilities. It is thus wrong to say that the recent events surrounding the demise of the Banco Ambrosiano demonstrate the ineffectiveness of the Concordat understandings. In any event, as a number of others commenting on that situation have indicated, there can be no guarantee that any authority will automatically undertake to stand behind any banking institution in all circumstances, especially where it appears that fraud is involved. Actually, whatever the arguments may be concerning the actions of the Italian authorities—and it would appear that we may not yet be at the end of the story—one may reflect that it is rather ironic that the full gravity of the Ambrosiano situation in fact came to light as a result of the Italian authorities' moves to implement more fully the principles of consolidated supervision. All this is not to say that there are not some unsatisfactory features about this affair, and it would also be fair to say that the particular circumstances of this case have pointed up one or two aspects of the Concordat to which the supervisors should give further attention.

... and exchanging information

In the course of building up the apparatus of supervisory co-operation in recent years, a great deal of importance has been attached to the improved flows of information both within banking groups and between banking authorities. These flows have of course to be subject to the requirements of banking secrecy provisions in different countries, but these are not nearly as constraining as might be supposed. In my view there are very few cases where effective consolidated supervision is frustrated by an inability to supply information on grounds of banking secrecy. Secrecy regulations operate stringently most particularly in respect of the details of individual depositors' business. They do not normally impede aggregated liability data, and information on the assets side of the balance sheet important for judgements of risk. It has been a notable development in recent years that legislative provisions have been introduced in a number of countries, including in our own Banking Act, to temper banking secrecy constraints on information flows. In particular cases, such provisions authorise supervisory authorities to disclose information to other supervisory authorities where it is judged such disclosure would be of assistance to those authorities in the exercise of their responsibilities.

The resulting co-operation and improved techniques ...

So over recent years there has grown up an international framework of supervision and the means to give effect to it through co-operative endeavour and exchanges of information. But there has also been a by-product in this process—a general improvement in supervisory techniques as a common perception of best practice emerges. This has been one of the significant benefits of discussions in Basle and in other groups like the EEC Contact Group of European Community supervisors, the offshore supervisors group, as well as in the two major international conferences of supervisory authorities in London in 1979 and in Washington in 1981. We have all learnt a great deal about each other's systems and I can think of a number of cases where in this country we have improved our techniques by borrowing some of our colleagues' better ideas. Others too I believe have learnt something from us.

It is not surprising that these movements in the supervisory field have been paralleled among the accounting profession in moves to develop a capacity to expand the international co-ordination of their business practices through such bodies as the IASC and the IFAC. The Basle Committee has maintained contact with both these bodies in so far as banking and related matters are concerned, and I hope very much that this contact may be sustained and developed in our mutual interest in the years ahead. Indeed it seems highly likely, certainly in the European context, that the supervisor and the accountant are going to become involved in a fairly major debate on matters of mutual interest, notably the issue of hidden reserves for banks, as the debate in the EEC on the bank accounts directive gathers momentum.

... must be harnessed in this difficult period ...

But before concluding these remarks I would like to touch briefly on another topic which is a particularly live issue at the moment—that of provisions by banks against bad or doubtful debts. This is a very large subject and I can do no more than deal it a glancing blow today. This is the season when most bank managements, due to the mind concentrating incidence of impending annual accounts, are turning their attention to this issue. For the normal process of risk analysis in the domestic sector, corporate and personal, well proven procedures will be undergone and decisions reached. But this year the international lending of many banks is posing new problems, at least in degree.

Bankers, auditors and supervisors are all having to wrestle with the difficult issue of deciding what if any provisions should be made against banks' international portfolios, particularly in relation to indebtedness in cases where problems have arisen or are imminent in meeting capital and/or interest payments on outstanding lending. At one extreme, some may say that this is not a problem—countries don't go bust, they say. Ultimately it will all come good, so provisions for capital at least are not required. Others may say that for countries X and Y there appears to be no prospect of repayment of their borrowing over what to bankers would appear to be a reasonable time horizon, so we should write it all off. The reality and the practice, as so often, no doubt lies somewhere between these two extremes and I have no magic formula to offer today. I would however make one or two observations. First, there can be no doubt, and I have found no bankers to contest it, that over the last two or three years the quality of assets in many major banks' portfolios have undergone some deterioration. Second, it cannot be denied that different loans to the same sovereign borrower have the same quality, albeit perhaps different maturities, no matter in which bank's balance sheet they appear. In an ideal world it would seem reasonable to treat such assets in the same way. Third, managements of banks do in practice view such identical or almost identical assets differently and there is considerable diversity of treatment. At the same time, there is a marked reluctance among most supervisory authorities to take action which deprives management of their responsibility as the prime judges of the quality of assets in their book.

. . . and a common approach adopted to asset quality

So we find ourselves in a situation where there has been a deterioration of assets generally but no structured system by which international banks in general, or even within the same country, can react to this situation along the same lines. Some will argue strongly that consistency does not matter too much apart from purist arguments about equalising competition which are unrealisable in the real world. My present view is that, if it is right that world economic growth is in the doldrums and unlikely to emerge from them very quickly, it must be right for banks affected to consider carefully the need to take some action to reflect in their balance sheets any deterioration of asset quality, and I know my colleagues in other countries have this very much in their minds too. Banks would be well advised to act in good time and in appropriate degree to bolster their capacity to sustain themselves through difficult times. They will need to consider prudent provisions, general or specific, according to the judgements in particular cases to deal with deteriorating asset values. They will also need to consider the appropriateness of the maximum possible retention of profit to reinforce the capital resources of the bank, if necessary at the expense of excessively liberal distribution policies. As far as decisions about provisioning policy are concerned, I recognise that auditors (not to mention tax authorities) as well as bank managements have difficult judgements to make. There will need to be wide discussion—among bankers, between bankers and auditors, between bankers and supervisors and between different supervisory authorities. Out of these, hopefully, some reasonable and sensible consensus will emerge. In this process the supervisor, while allowing bankers and auditors to make their judgements may have to be prepared to make his judgements on their judgements in the light of the overall picture as it emerges and to react as necessary in the supervisory assessment of the individual institution.

We will need . . . a flexible and responsive system

In conclusion then I think it can fairly be said that banking supervision has come of age over the past decade. To some extent it has had to grow up fast. The supervisor is faced, like the bankers themselves, with the consequences of the macro-economic environment, both at home and on the wider international canvas; the world has become, in many aspects of banking business, a single market. This feature is more marked in London than in most countries and it presents us with formidable challenges. Ultimately success in managing these markets will depend upon the supervisors maintaining a broad community of interest with bankers and vice versa. We will need to sustain a flexible and a responsive system. A supervisor cannot afford to be too purist: also, unlike a scientist, he cannot afford to test his theories to the point of destruction. At the end of the day in that slightly quaint, rather demure and faintly Victorian sounding system that we call prudential supervision, it is judgement not arithmetic that counts. Bankers, auditors and supervisors will need to exercise good judgement in the period ahead and work to maintain the dialogue nationally and internationally in order that we may all play our part in sustaining the soundness of the system.