# Supervision and competitive conditions

*The **Deputy Governor** addresses[1] the issues raised by inequalities of supervisory treatment and their impact on competition, and in particular the possible effects on UK-incorporated banks of the measures recently taken, or proposed, by the Bank on off balance sheet business and large exposures. He emphasises that, while the Bank will try to avoid placing locally-incorporated banks at a competitive disadvantage, this will not be done by imposing a laxer regime than prudence dictates. The Bank will seek to ensure that branches of foreign banks in London do not engage in imprudent risk-taking, will continue to press for international agreement on broadly common standards and will encourage other countries to follow its lead in seeking to bring the full range of banks' activities within their supervisory framework. But absence of comprehensive agreement will not diminish the Bank's determination to ensure that UK banks remain adequately capitalised and conduct their business prudently.*

London remains an attractive centre for foreign banks, and I am glad that this is so: the openness of the City to participants from other countries is one of its strengths, and helps to foster its global outlook as well as providing a competitive spur to indigenous firms.

Indeed, the Bank of England has itself helped to contribute one new name to your number: that of Mase Westpac, who are taking on the core of the business of Johnson Matthey Bankers. I am very pleased that the London Gold Market has welcomed their new colleague so wholeheartedly. It confirms that soundly managed and experienced foreign firms can find a place at the traditional heart of the City's operations; many other financial centres could not make a similar claim.

The sale of the core of JMB is the most important stage in our salvage of the sound parts of that business. The Bank can now look forward to recovering the whole of its £100 million investment. And we are confident that our efforts to minimise the losses from the loan book will continue to meet with success, so the eventual cost of the indemnity to the Bank and to its co-indemnitors will be substantially less than the first firm estimate of nearly £70 million. Indeed, by last December the figure was already down to just over £50 million and it continues to fall as recoveries proceed. We are sure that the eventual cost will be significantly lower.

We will never be able to judge whether the rescue was justified in simple cost terms since we can never know with any precision how extensive would have been the damage to the Gold Market and to the City more generally, had we stood back and allowed matters to take their course. But when I take intangibles like 'reputation' into account, as must of course be done for a proper assessment, I remain convinced that we were right to act as we did. I find it ironic that much less will have been expended in this operation—which has been widely condemned—than in some of those which were considered necessary a decade ago and which were so universally acclaimed. It is however very gratifying to us, though also a little saddening, that throughout the last year and a half the foreign banking community has shown greater trust in our judgement than have some domestic commentators.

Let me now turn to my main theme today, which is the sensitive topic of equality of supervisory treatment, frequently encapsulated in that quaint, somewhat Edwardian, expression 'level playing fields'.

Many British bankers, I know, suspect that the Bank of England's supervisory regime bites much harder in some respects on locally-incorporated banks than on those whose home base is abroad and so inhibits their ability to compete. Overseas banks established in London, of course, have to meet the same criteria as indigenous ones, for the Banking Act 1979, which remains the statutory basis for our supervision, makes little distinction between banks of different nationalities; and the changes to that Act presently under consideration are not intended to alter this. In many other ways too, the Bank treats overseas and UK banks equally. But for some aspects of the business of British branches of overseas banks, the Bank of England looks to the home supervisors of the parent banks to ensure that prudent standards are being met. That applies particularly to standards of capital adequacy, especially relevant now in relation to off balance sheet business, and to large exposures. In these areas, British banks often think that their competitors are subject to standards less onerous than those demanded of them.

It is not just you, the foreign banks, who present a competitive challenge to them. The rapid pace of institutional and structural change in London at present, and the general shift in lending towards forms of

(1) In a speech at the Financial Times/Banker Lunch for Foreign Bankers, on 6 May.

intermediation akin to securities business, have brought the banks under pressure from non-bank financial intermediaries too, both domestic and foreign. Just as we, as supervisors, are very much aware of the need to develop our supervisory regime to take account of these changes in banks' activities, so too are British banks correspondingly conscious that their ability to thrive in the more open structure of the City and to retain their prominent position in international markets will in part depend on the restrictions within which they operate. I do not, therefore, find it surprising that concern has been expressed about the effects on competition of some of the measures recently taken, or proposed, by the Bank to regulate the UK banking system.

But such threat as there is to their competitive position—and I suspect that it is less than some of them think—is not a reason for us to impose a laxer regime than prudence dictates. Nevertheless, we will do all we reasonably can to avoid placing them at a competitive disadvantage in their business. We shall do this not by being less strict in what we require of them but by rigorously examining what you, the foreign banks and other potential competitors, are up to, and by taking action when this seems necessary.

Let me take off balance sheet business first. We became concerned about the rapid growth of banks' underwriting of the various types of note issuance facilities because they led banks to take on off balance sheet commitments which were not captured within our normal capital requirements. So the Bank announced last year that it would require capital cover for such commitments; and we were the first supervisors to do so.

Subsequently, we initiated a full review of the range of off balance sheet risks to which banks are now exposed. Our findings were published during March, in the form of a consultative paper, only a few days after the publication by the Basle Supervisors' Committee of a paper on the same subject. The Bank's paper is likely to lead, after consultation, to a much wider range of off balance sheet business featuring in our assessment of the adequacy of banks' capital.

Once again these changes will probably come into effect before many overseas supervisors have implemented their own policies in this area. UK-incorporated banks may thus be affected before branches of overseas banks in London and foreign banks operating outside the United Kingdom. The Bank will, however, seek to ensure that overseas banks' branches in London do not involve themselves in imprudent risk-taking through excessive exposure to off balance sheet risks. Where we consider that they are doing so, we will seek to restrain them and to ensure that both the head office of the bank and its home supervisor are aware of what is going on.

We obviously hope that other supervisors will soon bring off balance sheet business within their own supervisory frameworks. Indeed, the publication of the Basle supervisors' paper is intended to facilitate constistency in the approach adopted by different supervisory authorities. I make no apology for the fact that the Bank was the first to take action to tighten its approach to these risks: financial markets are changing and we must keep pace with these changes. And it is encouraging to see that some other supervisors have already announced measures, broadly similar to ours, for capital cover for note issuance facilities.

The Bank is also concerned about the risks involved in large exposures. Our view—endorsed by the Government in its recent White Paper on banking supervision—is that a bank should not normally take on an exposure to a non-bank customer or to a group of associated customers which exceeds 10% of its capital; and that a 25% concentration of risk should be a limit exceeded only in very exceptional circumstances.

Here again UK banks may feel that they are being restrained more than banks from other countries. But I think their concern about this is exaggerated. The Bank will expect branches of foreign banks to have asset profiles which are prudent. Where we see large exposures which we regard as excessive, and when the London branch does not reduce them, we shall again take the matter up with the head office of the bank concerned and with the relevant banking supervisor. The 25% figure is, admittedly, somewhat lower than that currently applied in a number of countries; but other supervisors, too, have been reviewing their policies and there is a general move towards stricter guidelines or limits. Indeed, the European Commission is presently considering a draft Council Recommendation on large exposures which, if adopted, will encourage a number of countries to adopt stricter policies.

Our new requirements will have to take account of UK banks' legitimate interest in the underwriting of securities issues. Many are long established as lead managers of such issues and will need to continue to take on large exposures for a brief period if they are to compete for such business. The credit risk at the time of underwriting is relatively low; but, once the paper is issued, holdings carry a credit risk little different from other exposures. The treatment we adopt will need to reflect this.

Similarly, in the management arrangements for sterling commercial paper which were announced last week, we have tried to adopt an approach which will provide a level basis for competition between firms subject to different regulatory arrangements. We have indicated that, initially, we would want issues of this type of paper to be managed by UK-incorporated banks. But it is not our aim, in any protective way, to exclude other firms from this role: indeed, we are already in discussion with a number of them to explore ways in which they might participate on a basis that is consistent with level competition. I do not pretend that it will be easy, or that in the end we will find a perfect solution. But with understanding on both sides

I am sure that we can go a long way towards flattening out the major bumps in the pitch.

In conclusion I can assure you that the Bank will continue to try hard, through its membership of the Basle Supervisors' Committee and in other ways, to reduce the inequalities between national supervisory policies and to achieve agreement on broadly common standards. Absence of comprehensive agreement between the principal supervisors will not, however, affect the Bank's determination to ensure that UK banks remain adequately capitalised for the business they undertake, and are otherwise prudently regulated.

I am sure that UK banks as a whole will derive benefit from undertaking business in a banking centre in which best practices are seen to be applied and maintained; and I hope that others will follow our lead in seeking to bring the full range of banks' expanding activities within their supervisory framework.