Supervision and central banking

*The **Deputy Governor** discusses[1] the interrelationship between the Bank's traditional role as central bank and its newer role as banking supervisor within a statutory framework.*

The Bank's supervision developed from its operational role as a central bank. The extension of this role, as a result of the part it was able to play in the secondary banking crisis in 1974, was subsequently confirmed and formalised by the statutory powers conferred on it by the Banking Act 1979. Even in the new statutory framework of the Banking Act 1987, the Bank's supervisory activities will continue to reflect its position as central bank as well as its statutory powers; and its supervision—with its emphasis on flexibility and consultation—is still strongly influenced by its traditional, informal approach.

*The **Deputy Governor** argues that the Bank's authority as central bank is distinct from its statutory authority as supervisor and is a source of additional strength in its supervision. He illustrates this contention by considering the Bank's role in support operations, in dealing with international debt difficulties and in ensuring proper standards of behaviour in corporate finance activities. He concludes that there have been significant advantages—in the United Kingdom at least—in combining supervisory and central banking roles, and expresses the hope that the financial community will continue to accept the non-statutory authority which the Bank is able to use alongside its legal powers.*

When I last spoke to the Lombard Association, some twelve years ago, I talked about the supervision of the UK banking system. It was then nine months after our Banking Supervision Division—and our new wide-ranging system of supervision—had been established and was the first occasion on which anyone from the Bank had spoken on that subject, publicly or semi-publicly. I gave much the same talk shortly afterwards at a seminar in London organised by Jack Revell of Bangor University and it was subsequently published in the Bank's *Quarterly Bulletin.* It described the new system and how I saw it developing; and became, for some years, a source document for those interested in banking supervision.

It is tempting tonight simply to try to update that speech and create a new source document. But I think that that would be otiose. Many of you have had years of education in and experience of our systems, and we for our part now speak much more frequently and freely about them. Our powers and methods have been exhaustively debated, especially since the publication of the Government's White Paper in December 1985—reaching a crescendo during the parliamentary scrutiny of the new Banking Bill.

So I thought I might instead use this platform to say something about my personal view of the interrelationship between the Bank of England's traditional role as central bank and its newer role as banking supervisor within a legislative framework. These roles often complement each other; sometimes conflict; and on occasion are indistinguishable. But the traditional role has greatly influenced the way the newer, statutory, role has developed.

The central banking origins of the Bank's supervision . . .

The beginnings of our statutory role as supervisors date back to the secondary banking crisis in 1974. Until then, our attention as supervisors—though that was a word I never remember hearing used in the Bank before 1974—was confined almost exclusively to the members of the discount market and to the accepting houses, two groups of institutions which were central to the day-to-day functioning of the money markets and to our operations in them. These operations are, as you know, designed both to oil the wheels of the payments system and at the same time to influence interest rates in a way that helps the Government of the day to achieve its policy objectives—traditional, central banking, functions.

We allowed the discount market the privilege of access to the Bank, and the accepting houses that of eligibility of their bills, in order to facilitate those operations. In return we had to assure ourselves of their continuing soundness and so expected them to allow us to maintain a close watch on their business—much as any bank would wish to do with those to whom it is most committed. For their part, they were prepared to accept our requirements as the price for their close commercial relationship with us and

(1) In a speech to the Lombard Association, on 8 April.

the privileges they enjoyed. Incidentally, this type of arrangement still survives in our relationship with the gilt-edged market makers: we have no particular statutory backing for our supervision, but they too are prepared to accept it as a necessary condition of their special market relationship with us.

The rest of the banking system was until 1974 virtually unsupervised, though that did not of course mean that banks were wholly exempt from legal constraints. There were various Acts which recognised banks as a distinct kind of institution for particular purpose. But each Act defined a bank in the fashion appropriate to its purpose, so there was no single, simple legislative definition of a bank. And no Act gave us or any other body powers to carry out what we now think of as supervision.

... and the development of the Bank's statutory powers

Originally, then, our supervision was very narrowly focused on our operational needs as a central bank. Indeed, the need for wider-ranging supervision was not generally appreciated—either by the Bank or by the banking community—until the secondary banking crisis. This had a decisive effect on attitudes, both within the banking community and outside it, and made the case—stronger than any intellectual argument could do—for the need for formal supervision on a much wider scale. In particular, it led to a wide public and political recognition that depositors needed more protection than was given by the Protection of Depositors Act 1963—which effectively controlled only advertising for deposits.

We responded to that change of attitude and circumstances by introducing in August 1974 a voluntary system of supervision for nearly all deposit takers, both for most fully-fledged banks and for many of the so-called secondary banks. We in the Bank were able to respond because we could act quickly and on our own initiative: the DTI—which had previously been responsible for the protection of depositors—could not have acted without legislative sanction. In the immediate aftermath of the crisis, this initiative was widely accepted. Those in the Lifeboat hoped that public awareness that they were being supervised by us would help them regain the confidence of depositors, especially depositors in the interbank market; and others, who were under pressure but not yet in the Lifeboat, hoped that it would keep them out of it. Yet others, who were—like the consortium banks—under pressure but who were not eligible for the Lifeboat, also gladly accepted our move as a restorer of confidence.

But it is doubtful if this degree of acceptance would have survived once the crisis had receded; and still more doubtful whether the largest banks, who were exempted for a year or so from our new reporting requirements, would voluntarily have accepted our supervision if Government had not very soon afterwards made it clear that they intended to legislate to give our unofficial arrangements statutory backing. This process was not completed until early in 1979, when the promise of legislation was nearly four years old; but that had been sufficient in the meantime to give us the backing we needed.

So we became supervisors of the banking system not as a result of careful consideration and public debate but as a result of a spontaneous reaction to a crisis which we, as central bank, were able to respond to. Supervision, though, is by no means universally accepted as a function of the central bank. In only three of the eleven leading economic countries is banking supervision carried out entirely by the central bank: in five it is conducted by another government agency and in three it is shared between the central bank and other bodies. Even in the last two years, in the early stages of the debate leading up to the formulation of the new Banking Bill and after we had been conducting supervision for over a decade, there were voices advocating that responsibility for it should be taken away from the Bank. I am glad, however, that those voices did not prevail and that banking supervision in this country will continue to rest with the central bank. I shall try to explain why later.

As I said just now, the Banking Act 1979 was designed to put our extended involvement in supervision on a firm statutory footing. It conferred on the Bank functions 'with respect to the control of institutions carrying on deposit-taking businesses' and created the Deposit Protection Board. The objective of supervision explicit in the Act was to safeguard depositors and its focus was individual banks. It was not—and is not—directly concerned with the soundness of the overall banking system or with the protection of shareholders, though both can have a bearing on the protection afforded to depositors and so need to be borne in mind by our supervisors.

While the 1979 Act certainly met many of the intentions of its drafters, it did not prove wholly satisfactory: experience of working within its constraints soon demonstrated that improvements to it could be made, and the speed with which the markets themselves were developing made other changes advisable. But once again it took a crisis—in this case, the JMB episode—to make legislative changes a high priority. The shortcomings demonstrated by that crisis—many of which we had already identified but had been unable to remedy without legislation—provided the necessary impetus for a thorough-going revision of the 1979 Act, which is reflected in the new 1987 Act which will come into force later this year. This retains the same fundamental objective as its predecessor, but gives the Bank greater powers—for example, in obtaining information from banks and from auditors; and removes the distinction between licenced and recognised institutions, which was an obstacle to effective supervision of the latter.

The further contributions to our supervision . . .

But it is important to remember that this legislation, even in its latest form, does not fully define our supervisory relationship with the banking community; nor does it specify—except in one or two instances—the prudential standards to be applied. There is, in short, much more to our system of supervision than can be found in the legislation. Second, while the legislation adds to the powers we have at our disposal, it should not be thought of as replacing the natural authority we derive from our role as central bank. Rather, the legislation provides the additional backing we have needed to extend our authority into areas in which it did not naturally run.

. . . of the Bank's supervisory style . . .

That the Banking Act says little about the standards we require banks to observe is deliberate vagueness. To specify in legislation the way in which capital and risk should be measured; how various financial instruments should be treated; the control systems banks should use; the amount of capital they should have; and so on: all that detail would be both clumsy and inflexible. In some minds, of course, flexibility is only one step away from weakness and inconsistency. We remain convinced, however, that flexibility is essential to effective and fair supervision. To apply capital ratios, exposure triggers and all the other tools of supervisory control in a rigid, mechanical fashion, with no regard to the particular balance of each bank's business or the experience of its management, would be to impose on banks an inappropriate degree of regimentation. What is more, it could also do damage to the banking system as a whole: too great a degree of uniformity would tend to create a banking community less well able to withstand systemic shocks, just as a genetically homogeneous population can be vulnerable to disease. So, while the principles we follow and the measurement techniques we use are now applied equally to all banks, we do not regard uniformity in their precise application as a desirable objective. Banks are individual and should be treated as such.

Because the Banking Act leaves us with a substantial degree of discretion, and therefore considerable flexibility to develop our supervision without recourse to Parliament for amending legislation, we can consult widely with those who will be most affected or those best able to advise us from their own practical experience. Thus we draw on City expertise to refine proposals and to help us respond in a timely fashion to changing market practices. Were statute to become more prescriptive as to the details of what we do, we would be less able to adopt so participative a style. I do not think it would be to the banking community's advantage.

Participation has a broader aspect, of course. We are no less conscious than we always were that we are not commercial bankers, and that we need to maintain close contacts with those who are, so that our knowledge of what is going on remains accurate and up-to-date. We make strenuous efforts to consult the banking community on policy questions, both through consultative papers and in less formal discussions. We have much increased our use of secondments, both inward and outward, to add to the practical experience of our supervisors. And the Board of Banking Supervision, set up a year ago and now formally enshrined in statute, brings practitioner experience to bear at the highest level on the decisions we take—both on policy and on individual cases. That Board has already proved its worth. All these features of our supervision are aspects of participation, and they are valuable to us.

A final key element in our non-statutory armoury is that we rely greatly on personal contacts with—and knowledge of—management. We do not have the resources to operate a system which relies predominantly on inspections. And we would not want to, because we are convinced that regular interviews and face-to-face contact contribute information that would not emerge from any examination of statistical returns, however thorough, or from inspection of the books. Analysis of statistical information has its place; so too do systems checks, which we now use more frequently. But the prudent running of a bank relies, in the end, on the quality of its management.

When action is required of a bank to remedy deficiencies, we again rely on a personal approach in the first instance, and not on formal directives: the use of the Banking Act provisions is very much a last resort. We have found that, by discussing problems with management, we can bring our influence to bear in a way which enables us to deploy a much wider range of response, and to bring about necessary changes more discreetly, than would be possible if we had to rely on the less personal and more legalistic approach that is dictated by our formal powers. We tend to reserve those only for the most serious cases and only after informal channels have been tried and have failed.

. . . and its authority as central bank

Let me return to my main theme: the relationship between the Bank's authority as supervisor and its authority as central bank. When we are using the formal powers given to us in the Banking Act, the nature of our powers and the basis of our authority are quite clear. Indeed, should a bank fail to implement changes we are seeking to enforce under those powers, various legal remedies are available to us. But in many cases, probably by far the majority, we ask for action to be taken without explicit reference to the powers we have at our disposal under the Banking Act. It is then often assumed that this informal authority derives solely from the possibility that it can if necessary be backed up by use of formal powers; and therefore that it too is derived from the Banking Act. On this view, our traditional authority as central bank seems to play no part, and has become subsumed in our recently acquired authority as supervisor.

That view is, I think, mistaken. What I have been saying about our style of supervision demonstrates how our

traditional approach as central bank has influenced our approach to our new statutory responsibilities. And we continue to act in this field with an authority which derives not only from statute—both directly and indirectly—but also from our position as central bank. On occasion, it can be difficult to disentangle the two. But, even in supervision, we still derive strength from being also a central bank and by having at our disposal that additional authority.

I will illustrate this contention by three examples, which help to clarify the authority we derive from our separate capacities: sometimes working together, sometimes separately and conceivably even in opposition. My first example is one where our central banking role goes beyond our supervisory one, but where this is not always clearly perceived: responsibility for support operations.

(i) Support operations

One thing wholly absent from the new 1987 Banking Act—as it was from its predecessor—is any reference to the Bank's traditional concern for the systemic health of the banking system. Superficially, this might seem to be a curious omission: after all, was not the rescue of JMB—which to some extent prompted the new Act—justified precisely on such systemic grounds?

On this aspect of the Bank's relationship with the banking community, there should be no doubt—though there is often confusion—about the distinction between the Bank's responsibilities as banking supervisor and its responsibilities as central bank. Banks can—and do—fail from time to time, and there is no presumption whatsoever that they will not be allowed to do so. Our supervision is directed, as I said earlier, to the objective of safeguarding depositors, not shareholders. Where a deposit-taker becomes insolvent, the Deposit Protection Fund steps in; it has done so in fourteen cases since 1979. Indeed, banking failures can be healthy, both in removing from the system banks which are not able to operate successfully and as a reminder to others that the supervisory regime does not guarantee survival for all. There may even be circumstances where the supervisor's desire to see the lesson of failure being taught conflicts with the central banker's desire to minimise systemic damage. I see JMB as such a case.

There will be cases where the supervisors are able to foresee solvency difficulties for a particular institution and decide that depositors can best be protected by persuading management to pre-empt failure, by finding a stronger institution with which to merge or by which they may be taken over. In such cases, the supervisors may use their good offices to help bring about such a change of ownership. This of course applies normally to the smaller, less well established deposit-takers. There have been a number of such cases since 1979. I can conceive too that the supervisors could on occasion feel that they could best protect depositors by helping to organise liquidity support for a deposit-taker which was clearly solvent but illiquid, though I do not think we have yet done so as supervisors: for one thing, it is by no means easy—except with the benefit of hindsight—to discriminate between illiquidity and insolvency, so those circumstances will only arise very infrequently.

In either of these cases, the supervisors would be performing a function which has traditionally been the preserve of central banks but need not be so. Indeed, it is conceivable that the Lifeboat in December 1973 could have been organised by our Banking Supervision Division, if it had then existed. For the Lifeboat never supported an insolvent institution.

Salvage of an insolvent institution for systemic reasons is, however, entirely a central bank function. We have had to do it on a handful of occasions over the last 120 years, but never with the intention of protecting shareholders in or owners of the insolvent institution and often at a cost to them over and above their stake in the business; and usually also with the removal of senior management responsible for the disaster. JMB is the latest example: taken over and kept going by the Bank as central bank, not by the Bank as supervisor, but with the help of other interested banks, primarily in order to preserve the London Gold Market. In the 1970s we—again as central bank—took over the banking part of the Slater Walker empire when, if we had not done so, a group containing a UK bank could have become the first defaulting borrower in the euromarket, with grave systemic risks for the British banking system.

But even though support operations for systemic reasons are a central bank function and have no place in the job specification of supervisors acting under legislation designed to protect depositors, it cannot be said that the Bank, as banking supervisor, ignores systemic issues: far from it. Supervisory standards are set not only with an eye to what is required to protect depositors with individual institutions, looked at in the narrow context of their own operations, but also with an eye to protecting them from problems which could be created by wider, systemic, developments. A bank may consider a course of action it wishes to take to be acceptable—as it may well be in a limited context. But the same course might, if widely copied by other banks, have unfortunate effects on the banking system as a whole. It is part of the supervisors' job to take that wider, systemic view and sometimes to curb practices which even prudent banks might, if left to themselves, regard as safe.

A very clear example of the part this thinking can play is the treatment we require for banks' holdings of other banks' capital. Such holdings give no net addition to the capitalisation of the banking *system,* so we deduct them from the individual holding banks' capital. By this means, we discourage the holding of capital which affords the banking *system* little protection against unexpected losses—even though, when viewed from the perspective of the individual institution, such holdings strengthen, not weaken, their own position.

(ii) International debt

I now turn to the international debt difficulties of the past few years, which have been held to illustrate the possibility of our supervisory role and our central banking one pulling in different directions and the risk of the signals we send to the banking community appearing confused. We have always as a central bank looked beyond purely domestic concerns, to the international dimension of issues: this has been essential from the days when London was a major port, with trading links around the world and an indigenous banking community which helped to finance not only our own trade but also that of many other countries; right up to the more recent arrival in London of so many nationalities of bank, and so great a volume of euromarket business. We have, therefore, been all too aware of the threat to the international financial system which the debt servicing problems—first of Poland, then of much of Latin America and now also of many other third world countries—have posed.

For this reason, our central banking interest has hitherto been to lend support to the strenuous efforts which have been made, and continue to be made, to avert a major default. We have played our part in bridging operations and have made efforts to ensure that the international institutions and governments respond constructively to requests from the debtors for assistance. Equally, we recognise the importance of continuing commercial funding for the debtors and, so long as the financing packages seem to us to offer a realistic chance of promoting renewed growth in the debtor countries (their best and only prospect of avoiding the painful consequences of default), we have done what we can to encourage our banking community to play their part. That task of persuasion and prodding has so far not had all the results that might have been hoped for it; but it has not been a wasted effort, nor one which it is improper for a central bank to engage in. It is much like the role of 'honest broker' which we have played domestically for many years, helping companies in financial difficulties to arrive at workable solutions to their problems.

Wearing our supervisory hat, however, the picture has looked rather different. We see banks with substantial exposures to countries which are having difficulties meeting their commitments. Our concern for the protection of depositors leads us to take a close interest in the way those exposures are treated in banks' balance sheets and in the extent to which they have allowed for the possibility that the debtors may not continue to service their loans. We have not so far—as some other countries have—insisted on a certain level of provisions in certain clearly-defined circumstances: provisioning is normally a task which only banks' managements and their auditors are properly equipped to do. But we have had cause from time to time to question the decisions they have taken, and to urge them to consider very carefully whether the provisions they have made adequately reflect the risks of non-payment. We have also looked increasingly for the added reassurance of better capitalisation.

Our desire as supervisors to see better capitalisation and higher provisions may seem to sit slightly awkwardly with our desire as central bank to encourage banks to continue to lend. The conflict is one which we cannot avoid, wearing our two rather different hats. But it is a conflict which is more apparent than real. It is in fact a situation familiar to commercial bankers: the need to maintain a prudent level of provisions, lest the worst should happen; while, by continuing to lend and to seek remedies for a borrower's difficulties, doing all that can be done to ensure that it does not.

(iii) Corporate finance activities

My third example is also very current and is an illustration of the way in which supervisory and central banking concerns can point to the same response. It may, as a result, be difficult to distinguish which source of authority we are drawing on when we intervene; but the fact that they pull together much reinforces the pressure we can bring to bear.

There has recently been much concern in the City and in industry about takeovers, and the practices which participants—advisers as well as bidders and targets—have used to secure their objectives. More broadly, the whole question of business ethics has become a lively topic of debate: competitive pressures in the City have encouraged in banks a tendency to have less regard to traditional standards and instead to use every inch of latitude the law allows. At the same time, many long-standing practices have themselves come under scrutiny for their acceptability in today's markets—even though they have been accepted without question for many years.

It must be said that, hitherto, the supervisors have not greatly concerned themselves with corporate finance activities. But it is now clear that misdemeanours in that part of a bank could lead to such a risk of loss of reputation and of confidence that a bank's other business might be threatened and even its ability to fund itself might be weakened; and so the security of its depositors could in turn be threatened. So now our supervisors cannot but be concerned with the behaviour of those responsible for banks' corporate finance activities, and must ensure that those involved are recognised as being fit and proper in the full sense of those words. Looking further ahead, they now see the need to be much better informed about corporate finance departments and to be assured that proper standards are being maintained; hence the recent very detailed questionnaire directed to all banks with corporate finance departments.

All this concern is shared by the Bank as central bank. But in that capacity our concerns go further. As central bank we have traditionally been guardian of the standards of probity and responsibility shown by City institutions. This concern goes wider than the confines of fitness and properness required under the Banking Act. We expect an ethic which respects the spirit of the law and not just its

letter; and we are convinced that senior management must take responsibility for any actions by their staff which go beyond what is acceptable. So our recent interventions have sometimes relied on our legal powers as supervisors but at other times on our customary and informal authority as central bank. That informal authority is a powerful instrument, even today. We do not use it lightly.

Peroration

I referred earlier to the fact that in only three of the eleven major industrial countries is the central bank entrusted with full responsibility for banking supervision. So we are in a clear minority, despite the significant advantages we at least have found in having both roles. But in a country with no written constitution, it is perhaps not surprising that the central bank's authority does not rely wholly on statute. I would not wish to claim that what works well in London would be equally effective in countries where a different arrangement has been chosen.

A question I would like to leave you to ponder is whether our traditional authority will retain its strength and vigour. It relies, as all informal authority must do, on the skill and expertise of those who wield it; on their powers of persuasion; and on the stature of the institution they represent. But it depends equally on the preparedness of those over whom they have that authority to accept it, even when their own narrow interest may be to disregard it or when they have no legal obligation to comply. We have been fortunate in having had in London a banking community that has readily accepted that there is, at times, a wider interest to which they must have regard. But there have been signs of late that the ethos of the City is changing.

The openness of London to foreign participation brings to the City the great benefits of a wide range of expertise, contacts and outlook. But it also means that many in its financial community are unfamiliar with this sort of non-statutory relationship, uncertain how to react to it; and by inclination, perhaps, tending to think more in terms of rights than of duties. The pressure of competition is undoubtedly encouraging indigenous banks to start to think in the same sort of way. Statute is already playing a greater role in financial affairs, the Financial Services Act being the most recent example. This too creates a tendency to view what is, by comparison, so ill-specified an authority as that we have as central bank with a degree of unease, if not disrespect.

A further test will come shortly when we introduce arrangements for supervising the wholesale markets which will rely only indirectly on statute. It will be interesting to see if they can survive without the direct statutory backing which some already feel they will inevitably need.

There must be a danger that the many pressures on the structure of the City and its central institutions will yield—both in the wholesale markets and elsewhere—to a still more legalistic regime in which informal authority no longer has a role to play. I am sure we would all gain by it being otherwise; and I hope that the value of informality will continue to be properly recognised by the financial community and that the limitations of legislation do not become generally considered, still less accepted, as inevitable.