

# The Bank of England's role in prudential supervision

*Mr Brian Quinn, an Executive Director at the Bank, explains <sup>(1)</sup> the supervisory role of the central bank. He also discusses a range of related topics, including the distinction between regulation and supervision; the objectives of banking supervision; and the principles which inform decisions on the provision of financial support to troubled institutions. Finally, he explores how these issues may be affected by social trends and associated developments in the financial system.*

*Mr Quinn concludes that the existing arrangements we have in the United Kingdom for supervising banks have worked well and that, although improvements need to be made from time to time, occasional and exceptional episodes do not justify radical change, as the Bingham report confirmed. Although he does not conclude that supervision must be conducted by the central bank, he stresses the close and inextricable links between the core responsibilities of central banks and the supervisory function—links which are well forged and tempered in the United Kingdom. However, given that the primary objective of the central bank is the stability of the financial system and not the protection of the consumer, Mr Quinn suggests that changes taking place in society and in the financial system may point to the need for reconsideration, in due time, of the precise definition of the Bank of England's supervisory role.*

## Introduction

The topic on which I am asked to speak to you today is well chosen. I say this not only because of recent events but also, and more interestingly to my mind, because the issue of the role of the central bank and, in particular, its role in supervisory matters has become the subject of debate in a number of countries. I will not speculate on why that should be so. But I make the point in order to stress that we in this country are not alone in raising the question; our circumstances and our thinking are not as unusual as we may think. I also make the point so that those who hear my remarks will not consider that I make them from a defensive position. There is a lively debate going on and a good thing too if it leads to a better informed and more sophisticated understanding of the issues.

The fact is that the question of the role of the central bank in supervision is being discussed in the United States, South Africa, in several other European countries and in New Zealand. Let me also add that the discussions leading to the adoption of the Maastricht Treaty and to the draft statutes of the European Monetary Institute and of the European Central Bank addressed the question of the principal tasks of these institutions. What emerged from that process is very illuminating.

In my remarks I should also like to say something about some other subjects, including the distinction between regulation and supervision; the objectives of banking supervision; the principles which inform decisions on the provision of financial support to troubled institutions; and, finally, some observations about how these issues may be affected by social trends and associated developments in the

financial system. Each of these subjects is, I believe, sufficiently interesting in its own right but there are important linkages between them too, as I shall try to demonstrate.

## Regulation and bank supervision: objectives, content and style

If you will allow me a little digression, but one that I believe is relevant, I think the wording of the subject I am asked to speak about is also just right. In fact, I would probably have spoken about 'prudential supervision' even if the subject set had been the Bank's role in regulation. On that subject, I would have had little to say since in the area of banking supervision the Bank does not act as a regulator. Regulation, as the word indicates, is about rules and about the precise formulation and policing of those rules. In respect of financial services it calls for the codification of a corpus of strictly defined and detailed rules relating to particular activities, products and services. It entails specialised techniques of monitoring and enforcement and is usually accompanied by sanctions which are equally precise in their nature and in the circumstances of their application. This is what is appropriate when protection is being given to the individual investor or policy holder. Fair, equal and open treatment are of the essence in these matters. So far as the bank depositor is concerned, the product on offer is generally less complicated and more homogeneous and disclosure, partly as a result, has a lesser part to play.

Supervision is different, both in content and in style: the law sets the framework within which authorised companies may operate, rather than prescribing in detail how the relevant goods and services should be provided. Within that context,

(1) In a speech to a conference organised by Westminster and City programmes 'Re-examining City Regulation'. London, Wednesday 24 March 1993.

the companies providing those goods and services are, broadly speaking, left to make their own business decisions. The particular requirements applying to individual institutions such as capital adequacy or liquidity ratios may, and indeed usually do, vary.

*Prudential* supervision of banks makes the object of the exercise clear: it is concerned with the safety and soundness of the institution. That is not to say that prudential considerations do not arise for regulators of other financial institutions. Plainly they do, although the principal form that they take is usually different and applies product by product, or transaction by transaction. Nor would I wish it to be thought that supervision is indifferent to the quality of the goods and services offered or to the way in which the institution conducts itself in pursuing them: for example, failure to achieve satisfactory standards could, in the extreme case, cause serious reputational damage to the institution and create risk for its depositors. But the main difference is that the protection of depositors is best pursued by setting requirements that apply bank by bank rather than product by product or transaction by transaction, such that the institution remains able to meet the demands of depositors as their claims fall due.

I make the point, perhaps somewhat laboriously, because it seems to me that the role of the banking supervisor is in increasing danger of being misunderstood, on two quite separate counts. The first relates to the growing awareness of consumer interests and influences. This has led customers of banks, on both the lending and deposit sides, to believe that the banking supervisor is there to protect them from every deficiency they experience—or perceive—in the service they get from their bank. On this, I have to say that the role of the banking supervisor is to seek to enforce prudent conduct by banks, not customer satisfaction.

Second, the supervisor's task is not to look after the interests of shareholders or of borrowers. Recent press comment has implied otherwise in stating that the lending excesses of the large commercial banks in the last decade, both to domestic borrowers and to less developed countries, should have been stopped or curbed by the supervisors. Had they done so, the argument runs, banks would not have had to write provisions for loss, their ability to lend would not now have been constrained and they would not have had to increase their margins and charges as they have. All of these arguments, whatever their merits, fail to observe the fact that, although some of those banks may have suffered a sharp reduction in profits or even recorded losses in certain years, depositors themselves have suffered no loss. I cannot speak for the others, but the UK supervisors did give warnings, both publicly and privately, about the dangers of excessive concentration in the relevant sectors at the time. Intervention over and above what was actually done would, in my view, have been misdirected. The prudential criteria that set the limits to banks' activities in these episodes had the intended effect: to allow bank management to exercise their commercial judgment but within a framework which seeks to limit the risk to depositors.

You will note that I say 'limit' and not 'eliminate'. Even if a bank had failed as a result of imprudent lending, it does not necessarily follow that the banking supervisor would have failed in carrying out his responsibilities. I say this in order to point up a crucial element of the system, both here and in all countries that have a market economy. At one extreme, banking systems in which no bank can be allowed to fail and depositors face no risk of loss lack the vital ingredient of market discipline and breed management and depositor recklessness. At the other extreme, systems which rely only on market discipline court unnecessary bank and, possibly, systemic failure and avoidable loss to depositors. Somewhere between these extremes lies the right balance; and it is the joint responsibility of the banking supervisor, the deposit insurer and the central bank to find and apply it.

### Should the central bank conduct banking supervision?

This brings me back to the question of the role of the central bank in prudential supervision. This issue is usually discussed at the level of principle, where absolutes tend to reign. It is argued that a number of conflicts of interest arise when a central bank combines the role of central monetary authority and banking supervisor. And so they do. What is far from clear to me is that these conflicts are so severe that they must or can be avoided.

For example, it is suggested that a central bank will be induced to compromise on its conduct of monetary policy if, as banking supervisor, it is faced by the possibility of failure either in one of the banks it supervises or, *a fortiori*, in the banking system more generally. It is also argued, contrariwise, that the central bank—or indeed any agency that exercises both functions—might use instruments intended for the protection of bank depositors to carry out its monetary control activities because the conventional tools have shown themselves to be either ineffective or too painful in their effects on the economy.

Other kinds of conflict, it is argued, arise from the central bank's role as supplier of liquidity to the banking system through its monetary operations: in providing support to an institution experiencing exceptional funding difficulties; or in conducting banking business as principal or agent. The knowledge available to the central bank as supervisor, it is argued, can place it in an unfairly advantageous position. Finally, there is the proposition that perceived supervisory failures can damage the central bank's reputation and authority to the extent that compromises its ability to conduct monetary policy to full effect.

I do not deny that these arguments have force; but I believe that they are overstated—or even misconceived—and, more important, fail to acknowledge that synergies, as well as conflicts, should be taken into account in seeking an optimal solution.

It is undeniable that a tension can develop between the conduct of monetary policy and the safety and soundness of

the banking system. But that tension can exist whether or not the functions are combined in the central bank; allocating them to different institutions does not remove the tension. The question then becomes one of efficiency rather than one of principle: how is the problem best resolved—by addressing it within a single agency or by asking two (or more) institutions to find means of dealing with the very complex matters that fall to be dealt with in these circumstances? Who determines the priorities when a conflict exists? These questions still need to be answered.

The central bank has an interest of the first order in ensuring the soundness of the banking system; otherwise the conduct of monetary policy could be frustrated or even made impossible. This basic fact is recognised in all developed countries. Much is made of the independence of the Bundesbank and its separation from banking supervision, which is conducted by the Aufsichtsamt in Berlin. But the facts do not fit the perception. Although the Aufsichtsamt authorises and regulates banks, its decisions are made after consultation with the Bundesbank; and prudential policies are agreed jointly. Even more important, certain inspections of the authorised banks are conducted by Bundesbank employees working at the Landeszentralbanken. The Bundesbank is therefore directly and immediately—and I emphasise both words—in possession of all the information it needs to discharge its responsibilities for the stability of the currency.

Let me elaborate a little on that observation. Monetary policy cannot be carried out effectively unless the infrastructure and institutions through which operations are conducted are stable and secure. The infrastructure includes the payments system and, in particular, the wholesale payments mechanism. Whatever the ownership arrangements—and these vary from country to country—the central bank, as the bank of final settlement, must be in a position to satisfy itself that the payments system and the participants in it are, together, likely to be robust under strain. It is for that reason that the attention paid by central banks in many countries to the risk characteristics of their domestic payments systems has risen sharply in recent years.

The most obvious risk would be the failure of a settlement bank. Such a development would affect not only the other banks in the payments system but also the central bank itself as the bank of final settlement. The central bank therefore must take a close interest in the financial condition of its actual counterparties as well as in the design and operating features of the payments system. This is reflected in the work currently going on, not only in individual countries to improve payments systems, but also in international committees of central banks both in the G10 and in the European Community which are currently examining these matters.

Clearly what is important is that the central bank must have the information necessary to put itself in a position to anticipate and judge how it should deal with any weaknesses in the infrastructure or institutions on which it relies for the conduct of monetary policy. So in the context of conducting

its monetary operations no conflict arises from the central monetary authority acting also as banking supervisor. Once again, this seems to me to be primarily a matter of efficiency rather than of principle. It can, of course, be done by separating the supervisory function from the responsibility for the conduct of monetary policy. Arrangements can be made for access to the information relevant to the stability of banks and, indeed, are made in those countries where the functions are separated. But if they are already combined in a single institution, as they are here, are the other arguments for separation sufficiently strong to support the proposition that a change is necessary, or even desirable?

I do not believe so. The conflict of interest that may arise from being both the ultimate supplier of liquidity to an institution in difficulties and its supervisor is no different, in principle, from that arising for any financial company that has multiple functions; similarly when the central bank is acting as principal or agent in its banking operations. Arrangements have to be put in place and observed to ensure that information, when received for supervisory purposes, is not abused or misused; and machinery has to be established to ensure that senior and qualified people both know all that is going on and can strike the correct ethical and legal balance. The Bank of England has identified where such arrangements have to exist and observes them scrupulously.

On the other hand, I do accept that the damage to the authority of the central bank that can flow from supervisory failures, real or alleged, can be a problem. How great a problem I am less sure. Certainly the noise level can be fairly deafening and the central bank's judgments on matters of monetary policy are less likely to go unchallenged. Perhaps the worst thing is the diversion of time and energy which supervisory problems demand, particularly if they occur at a time when issues of monetary policy are themselves problematic. Part of the answer may lie in ensuring realistic expectations of what banking supervision can and should deliver.

At an earlier point I mentioned the draft statutes of the EMI and the European Central Bank. They bear looking at. The principal tasks are the stability of the currency, of the payments system and of the financial system. The last task is not defined in terms of operational supervision of financial institutions; under the principle of subsidiarity that is left to member countries. The EMI has instead a consultative role in supervision; but, under Article 105(6) of the ECB draft statutes, it is recognised that the European economy and financial system may evolve to the point where direct supervisory powers should be granted to the ECB. So, from a standing start, as it were, all EC countries—and not just central banks—have acknowledged the close interest of the central bank in the supervision of banks.

### **The roles of lender of last resort and banking supervisor**

I have already indicated that I see no unmanageable conflict between the roles of the central banks as lender of last resort

and as supervisor of banks. Indeed, I see a great deal of synergy. I define lender of last resort here as the provision of liquidity support in circumstances where either the system or individual institutions are experiencing funding difficulties of an exceptional nature—and not simply daily operating pressures. In such circumstances, the central bank has to decide whether to intervene with support or to allow the affected institutions to fail. In my opinion, that judgment is made less difficult if the central bank also has the information customarily obtained from conducting supervision. Knowledge of the financial condition of an individual institution, the background to current problems, the relationship between the institution and the payments system and the role it plays in the wider economy are all vital if an accurate assessment of the potential for systemic contagion is to be made. Of course, that assessment does not depend only on the combination of functions in the central bank. But it is more easily and more speedily made if the central bank has an operational role in supervision.

Systemic contagion is a function of the homogeneity of assets and of liabilities in banks' balance sheets. To give an example, if a bank which is funded primarily from specific wholesale lenders and lends primarily to a particular sector comes under threat of failure, the central bank's decision whether to provide support will be better informed if it has detailed and up-to-date information on all banks with similar balance sheet structures. Sometimes speed is absolutely essential in such circumstances. Separating the functions introduces a risk that communication of the important information will be in some way imperfect.

### **Principles of lender of last resort**

Gerry Corrigan, President of the Federal Reserve Bank of New York, is famous for, among other things, having coined the expression 'constructive ambiguity' when asked to comment on the attitude of the central banker towards the provision of financial support to troubled banks. A definitive statement of the circumstances in which such support would be forthcoming in the United Kingdom would be tantamount to showing the cat the way to the dairy. But that does not mean that we do not have regard to certain principles in making a decision. Six in particular are worth elucidating.

Central banks provide support to prevent systemic failure. The first and most important question is whether a failure would be solitary or would generate significant problems for other banks or the markets. Even here the judgment would have to take account of the likely extent of any spread of the problem; the wider the ripple the greater the case would be for intervention. There is no 'too big to fail' doctrine in the United Kingdom. There is a 'too important to fail' principle, but importance is a function of the particular bank at a particular time in particular circumstances.

Central bank resources are not risk capital. Support might be given in the face of liquidity difficulties but not, ordinarily, to assist a bank facing problems of solvency. Of course, it is often far from clear whether the problem is one

of liquidity or of solvency; and what begins as a genuine liquidity problem can become one of solvency if asset values should deteriorate, with continuing difficulties either in the wider economy or in the sector to which the troubled institution has significant exposures. For those reasons, central banks may have to make provisions for loss just like any other bank. I see nothing particularly disturbing about this. The free capital and reserves of a central bank are available for this purpose.

Central banks do not provide working capital. Assistance should be given in support of a clear and finite objective and not as an open-ended exercise. Given the paramount importance of the central bank in the financial system, there should be a clear exit for it in the terms of any facility or guarantee provided. That exit may take the form of the return of the affected institution to funding on normal commercial terms; but it may also take the form of a plan to run down the business in an orderly way in cases where no viable future seems likely.

Central banks are not in business to provide public subsidies to private shareholders. The support provided should be structured so that the shareholders of the recipient institution do not receive any benefit from the terms of the facility. Any losses should fall first on the shareholders and any benefits should accrue first to the central bank. In saying this one has to remember that a troubled bank has the option of voluntary liquidation or administration and may not be mindful of, or interested in, the wider repercussions of its actions. The terms of any support also have to strike a balance between giving management and shareholders an incentive to dispense with the support as quickly as possible, on the one side, and precipitating the problem we are seeking to avoid, on the other.

Central banks have to act with discretion. To advertise the difficulties of an individual institution is not only to place its own prospects of recovery in jeopardy, but also to focus the attention of the markets on other prospective casualties. In circumstances where failures occur depositors, especially wholesale depositors, play safe and seek the most secure haven. I recognise the argument that the public has a right to know at some point about the commitment of public funds for support operations but that should ideally be done when the danger of systemic difficulty has passed and the cost to public resources has therefore been contained to the minimum necessary.

Central banks should be parsimonious in their intervention. Their concern is the health and stability of the financial system. They must be mindful therefore of the risks of intervening too often to prevent failures. The disorderly collapse of a bank can threaten other viable institutions, but repeated rescues can lock in excess capacity and help to undermine the whole structure, making it more vulnerable to shocks.

### **Changes in the financial system**

It would be wrong of me to imply that the views I have expressed today about the role of the Bank of England in

prudential supervision represent my final thoughts on the matter. As much as any other institution, central banks do not exist in a policy vacuum. Their functions have to take account of developments in the environment in which they operate. I will mention only two such developments here which raise important issues of public policy.

The first arises from the coming together of the broad social trend which I earlier labelled consumerism and the changes taking place in the products and services provided by banking groups. As banks' traditional franchises have become steadily less profitable, they have diversified into other activities more into the fields of investment, securities and insurance. These products and services are eminently suitable for regulation, not supervision. Even banks' deposit products, with the introduction of TESSAs, are taking on some of the characteristics of investment goods. There appears to be a mismatch between the services provided by banks and the allocation of supervisory and regulatory responsibilities that seems bound to grow. Given that a primary objective of the central bank is the stability of the financial system and not the protection of the consumer, there is therefore a question whether the current arrangements may not, at some point, have to be reconsidered.

The same evolution in the financial system raises the second issue: whether the central bank's lender of last resort facilities should not be extended to non-banks, given the greater integration and closer links between all parts of the financial system. This idea overlooks two fundamental

facts: only banks' liabilities are very liquid and highly mobile; and only banks supply the ultimate means of payment—money. Those features are what make banks different and candidates for central bank financial support, but only when the relevant conditions are met.

### Conclusion

I have covered a great deal of ground this morning but my conclusions will be brief. I believe we have arrangements for the supervision of banks in this country that have worked well. In saying this, I am anxious not to appear—or to be—complacent. Problems do occur and changes do have to be made to achieve improvements in our supervisory arrangements. We are doing just that at present and, at some later point, we will want to set out precisely what we have done. It would, in my view, be wrong to see occasional and exceptional episodes as the justification for radical change. Bingham took the same view.

I do not argue that supervision *must* be conducted by the central bank. It is done differently and perfectly adequately elsewhere. However, in saying this, that should not be allowed to obscure the point that there are very close and inextricable links between the core responsibilities of central banks and the supervisory function. Those links are well forged and tempered by experience in the United Kingdom.

But we must also pay regard to changes taking place in society and in the financial system. Those changes may point to the need for reconsideration in due time of the precise definition of the Bank of England's supervisory role.