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CONFIDENTIAL

The Governor

Bank of England

London EC2R 8AH

24 October 1985

The Rt Hon Margaret Thatcher MP
10 Downing Street
London SW1

Dear Prime Minister,

with DRN?

BANKING SUPERVISION

The Chancellor has sent you a note covering a paper by the Treasury ahead of the meeting scheduled for 28 October to discuss banking supervision. As he says, my officials and I have been consulted in the preparation of these papers and I am happy to say I am content with their broad thrust and most of the individual proposals. There are still a number of differences between us which I hope we can resolve in further discussion either between us or at your meeting. But there is a major point on which I wanted to write to you ahead of the meeting.

I fully share the Government's desire to improve, and in many ways tighten, the supervision of the banking system. The Review Committee set up by the Chancellor in the wake of the JMB affair, which I chaired, made a number of recommendations to this end which are incorporated in the present Treasury paper. As the paper points out, we are also engaged in a major increase in and enhancement of our supervisory resources in the Bank; and we are actively seeking to increase the professionalism of our supervisors by inward and outward secondments, more training etc. So much is common ground. But it is important that, in all this endeavour, a fundamental point is not lost. This is that the JMB affair, though extremely damaging, was an isolated event. It revealed a number of shortcomings in our supervision to which it is right and necessary for us to react. But equally it is important that we do not overreact to this isolated failure. The Bank of England's supervision of the banking system in London is widely regarded, by those who have experience of other more dirigiste regimes, as better than that practised anywhere else.

Our supervisory approach is certainly one of the reasons why the world's best banks continue to be attracted to do business in London. The main reason for the success of the present supervisory system would probably be regarded as its participative nature. The essence of the Bank's approach has always been to involve the banks themselves in responsibility for the supervisory process. A striking testimony to the effectiveness of this approach is that over the past two years, non-scheduled interviews with our supervisors - that is to say, interviews at the instigation of the institution itself rather than the Bank - have been as frequent as the regular scheduled interviews. Were the banks to stop coming to us to discuss proposed actions and developments, and simply wait until we could prove they had transgressed our regulations, our system would be greatly weakened. We should be much less well placed to identify potential problems before they had become actual.

This means that tightening regulations, introducing penalties and more statutory obligations will not necessarily bring unambiguous improvements in supervision. One must take account of the risk of a deterioration in the underlying relationship between the supervisor and the supervised; and of the risk that the supervised will be more inclined to stand on the letter of the law rather than comply with its spirit. This concern underlies a number of our differences with the Treasury paper. Some of these are only of emphasis, but one is of such importance that I have felt it necessary to put to you a separate submission on it.

This is the proposal for a Banking Commission. I sympathise with a number of the aims that underly the proposal; but I believe that, as formulated, it is fundamentally misconceived. It would trench on the authority of the Court; would blur lines of executive responsibility; and would detract, internationally as well as domestically, from the standing of the Bank and of the supervisors themselves. As we have indicated in the attached paper, it would be possible to achieve the Chancellor's main objectives by the creation of a body which was advisory rather than executive.

Yours ever,

Robin

THE PROPOSAL FOR A BANKING COMMISSION

1 A number of things might be looked for from a Banking Commission: increased practitioner involvement in the supervisory process at the top level; greater public visibility and clearer accountability for banking supervision; and some degree of separation of the supervisory function from the other activities of the Bank of England.

2 The first two aims have the Bank's strong support. On the third, different views can be held in principle. It is certainly possible to carry out banking supervision through an organisation quite separate from the central bank. This is the practice in a number of important industrial countries where it does not lead to insuperable difficulties - though equally it has not led to better results than our present approach. There can in principle be conflicts between the demands of monetary policy, or macro-economic policy generally, and the obligations of the supervisors. In practice, however, these conflicts are less frequent and less difficult than is often thought. Moreover, our experience in this country and our observation of others suggests that any such conflicts are resolved better in a debate within the central bank rather than between different institutions.

3 There have, in our view, been a number of important advantages in having banking supervision as an integral part of the Bank of England. In the operation of monetary policy and the assessment of the significance of overall monetary developments we benefit greatly from the detailed knowledge of the banking system that comes from the supervisors. At the same time, the supervisors draw on the authority and standing of the Bank. The high regard for the Bank of England in this field has meant that we have from the start held the vital role of Chairman of the leading group of

supervisors and have provided from our staff or ex-staff the Secretary of the group. As a result, on matters of great importance for the coherent supervision of international banking such as parental responsibility and the consolidation of accounts throughout banking groups, our views have carried the day. With Chairmen and Secretaries from other countries, much less might have been done. If the Bank were dismissed as the supervisory agency here, our influence internationally would be bound to diminish.

4 There is also the practical point that, whether or not we should wish to set up a separate supervisory organisation if we were starting from scratch, we have to start from where we are. We have a large cadre of banking supervisors within the Bank of Engand and none outside. Any new body would have to be predominantly staffed by the people who do it now. For all these reasons we and the Treasury are in agreement that it would be wrong to try to take the whole of banking supervision out of the Bank.

5 If this is accepted, the question arises whether it would be possible to get some of the perceived benefits of separation from setting up a new executive banking commission to whom the existing supervisory staff would in some way be responsible. We believe the answer to this question is no.

6 A statutory executive supervisory commission of the kind suggested would result in a damaging, if not administratively impracticable, blurring of lines of responsibility. It is not clear to us what could be the relationship between this body and the Court on the one hand and Banking Supervision Division on the other. If commissioners were appointed with executive responsibility for supervisory policy decisions, they would have to concern themselves with the whole business of supervision - including the staffing and management of Banking Supervision Division. It is hard to see how a part-time body could properly fulfil that function; or to see how the Governor could be chairman of both Court and the commission without reinstating the

conflict of interest which it is the objective of the proposal to remove. The commission would in some sense be in charge of an important section of Bank of England staff up to and including the level of Executive Director; but that is a responsibility of the Court which they cannot waive while the supervisors remain an integral part of the Bank of England's staff. They would be required to serve two masters.

7 While we therefore oppose the creation of a new statutory executive supervisory body, we share the Treasury wish for greater senior practitioner involvement in, and a greater public visibility of, the supervisory function.

8 We believe these aims could be furthered by a new body which was advisory rather than executive. A Banking Supervisory Advisory Board or Council could be set up (and this could of course be done straight away without waiting for legislation). The membership would be much as envisaged in the Treasury paper: Governor as Chairman, Deputy Governor and the Executive Director in charge of supervision as ex officio members, and say up to six other members, two of whom would be a lawyer and an accountant. The others would be recently retired commercial bankers or former executives who were now non-executive members of their bank's board or its parent's board. This number would allow for experts from other fields to be co-opted if at any time there were accretions to the types of business for which Banking Supervision was required to take responsibility.

9 This body would meet regularly - perhaps monthly - and would review such matters as:

(a) all the policy initiatives and documents that were to be put out by the Bank of England on supervisory questions;

(b) regular reports on problem cases, developments in particular areas of the banking system and so on;

(c) the procedures and techniques, training and recruitment etc of Banking Supervision Division.

On all such questions the other members of the Council would tender the advice to the Governor. The advice would not be binding; but if the Governor decided not to accept it the question would have to be put to the Court for a final decision.

10 In this way there would be both in substance and in presentation a major input of experienced practitioner views on the whole range of supervisory questions. But the lines of responsibility for staff, management and decisions would clearly run through up to the Governors and the Court.