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PRIME MINISTER

BANKING SUPERVISION

The purpose of the Seminar on Monday should be to arrive at decisions regarding the substance of the forthcoming White Paper on Banking Supervision.

The papers by the Chancellor and the Governor raise four major issues:

a. the responsibility of auditors to report to supervisors;

b. the terms of reference for the supervisory body;

c. the method of supervision (inspection, staffing, disclosure, statutory requirements, reporting);

d. the organisation of supervision.

A fifth subject, which is mentioned en passant but not developed, is:

e. the prosecution of fraud.

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The Need for Perspective

It is important to remember that, by and large, banking supervision in London has a good record, and is greatly favoured by international banks over systems in other countries, largely because it is flexible and participative (variously described by George Blunden in the mid-Seventies as comparable to the Catholic confessional or marriage guidance counselling!). JMB revealed the system to be too casual and too dependent on the goodwill of individual bank management. Changes are needed, but the danger is to over-respond with too rigid and bureaucratic an approach.

Two useful tests which should be applied to any proposed change are:

1. If it had been in place at the time of JMB, how would the outcome of that affair have been different?

2. Would the proposed change drive business away from London?

The Proposals for Change

a. Responsibility of Auditors to report to Supervisors

Legal restriction on communication between auditors and supervisors must be removed. But if auditors are required to report to supervisors without the presence (and knowledge?) of management, there is the real danger that a lack of frankness might develop between auditors and management. **Perhaps auditors should be given initial responsibility to report matters to the banking clients' Audit Committee of Non-Executive Directors before reporting to the supervisors. How are the exceptional circumstances in which dialogue between auditors and supervisors should take place to be defined?**

b. Terms of Reference for the Supervisory Body

The proposal is to change this from "the protection of depositors" to "maintain the soundness and integrity of the banking system". The former is precise and readily understandable; the latter is general and vague and open to many different interpretations. **I should press the Chancellor as to why it needs to be changed.**

If, as I suspect, it may be to cover other non-deposit institutions, they should be included specifically, rather than by changing the terms of reference.

c. Methods of Supervision

The changes concerning banking inspection, two-tier system of supervision, individual large exposures, and improving professionalism of this supervision all seem reasonable.

Imposing fines for late reporting seems rather petty. **Why not send supervisors to the institution concerned with power of inspection or, for repeated lateness, revoke the licence?**

d. Organisation of Supervision

On this subject, I believe that the Chancellor's proposal is half-baked and messy, as well as a step on the road to a fully independent Banking Commission, which would some day include supervision of the building societies.

The reason for separating the monetary policy side from the banking supervision side of the Bank of England is a presumed conflict of interest. You may ask that these conflicts of interest should be elaborated, and examples given of when they have produced inadequate supervision.

If there are fundamental conflicts of interest, they will not be removed by organisational change. The only difference will be a change in the individual or body resolving the matter. Under the present system, the conflict is resolved by the Court of the Bank, which means in practice the Governor. If the Banking Commission were to be independent of the Bank, then it would be the Chancellor. If, as is proposed, supervision is the responsibility of the Commission, but the Governor is the Chairman of the Commission, then the conflict will still be resolved by the Governor. In other words, the changes do not achieve their intended result.

Most of the benefits of the proposed Banking Commission (raising the status of supervision and giving greater responsibility and power to outsiders) could be achieved just as well in the Bank's proposal for a Banking Supervision Advisory Board or Council, provided:

a. it had a majority of non-Bank members; and

b. if the Court chose to overrule the recommendations of the Commission, then the matter would automatically be reported to the Chancellor.

e. Prosecution of fraud

Great damage is done to the City, the market economy and the Government's image by fraud. Is there any evidence that the Fraud Investigation Group is proving a success? **Press the Treasury and Bank to be more** positive and less relaxed about this matter. There used to be (I think) a special court in the City of London dealing with complex financial matters, with a jury drawn from the City. Could this be resuscitated?

Conclusions

I would recommend the following:

Responsibility of Auditors to report to Supervisors

1. Auditors should be given initial responsibility to report matters to the banking clients' Audit Committee before reporting to the supervisor.

2. Press the Chancellor to define in the White Paper "the exceptional circumstances" in which dialogue between auditors and supervisors should take place.

Terms of Reference for the Supervisory Body

3. Press the Chancellor as to why the terms of reference need to be changed.

4. In place of fines, get supervisors sent to the institution concerned if it is late in reporting.

5. Reject the Treasury Banking Commission. Accept the proposed Banking Supervision Advisory Board, provided

a. it has a majority of non-Bank members; and

b. if the Court chooses to overrule the recommendations of the Commission, then the matter would automatically be reported to the Chancellor.

Fraud

6. Press the Treasury and the Bank to be more positive and less relaxed about fraud.

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