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CEB
for banking supervision
meeting
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Treasury Chambers, Parliament Street, SW1P 3AG

PRIME MINISTER

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25 October 1985

VISIT TO WASHINGTON AND NEW YORK : 22 - 28 SEPTEMBER

As background to your meeting on banking supervision on 28 October, you may find it helpful to have some impressions I formed during a recent visit to the United States.

The purpose of the visit was to study the American system of banking supervision; its place in the broader regulatory framework for financial institutions; and its impact on banks. This is highly relevant as we put the final touches to the Building Societies Bill and consider our policy on banking supervision.

In Washington, I saw Chairman Volcker, and senior officials of the Federal Home Loans Bank Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Treasury, and the Securities and Exchange Commission; and the staff of the House and Senate Committees on Banking. In New York, Hurricane Gloria notwithstanding, I called on Merrill Lynch, Burnham Drexell Lambert, Citibank, Chemical Bank and J.P. Morgan. I also addressed the British-American Chamber of Commerce, and met members of the British banking community.

I am most grateful to the Ambassador and the Consul-General in New York for the full and interesting programme they assembled, and the efficiency of all their arrangements.

There are profound differences between the American and British



banking systems, with which I need not trouble you. These stem from our widely different constitutional, political and financial conditions. There are, nevertheless, lessons to be learnt from developments in the United States, which are relevant to our own legislation.

(a) Codification vs flexibility

I was not attracted by the detailed codification of banking supervision practised in the United States. I detected considerable envy of our flexible system, and I remain convinced that we must maintain its fundamental character. An excess of statutory provision merely leads to observance of the letter of the law.

I also felt, however, that there were certain statutory elements which the Americans took for granted, and which we can usefully incorporate into our own legislation. The American supervisors and bankers whom I met were without exception amazed to discover that under our present banking legislation it does not constitute an offence to file late or inaccurate supervisory statistics with the Bank of England supervisors. They were also surprised at the absence from our legislation of a statutory obligation to report to the supervisors large exposures to single and related borrowers. One or two statutory benchmarks of this kind would underline the importance which Parliament attaches to compliance with supervision. They would not impinge materially on the flexible way in which the law is applied to individual institutions.

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(b) De-regulation v supervision

At the political level in the United States, the use of slogans has led to a damaging conceptual confusion. Under the Reagan administration, "deregulation" has been a prime political objective. This means, of course, removing obstacles to competition, and creating "level playing fields" (a phrase we often hear in this country) for disparate financial institutions.



But Congress has not perceived that increasing freedoms to provide services competitively implies the need for a more effective supervisory system. "Supervision" has been equated with "regulation", and the supervisors have accordingly found it difficult to obtain a political hearing.

The twin problems of over-rapid "deregulation" and inadequate supervision are illustrated by the problems of the savings and loan institutions, or "thrifts", which are the nearest equivalent to our building societies. These institutions suddenly found themselves facing bankruptcy because high market interest rates forced Federal Government to remove the artificial limit on the interest rates payable on deposits, whilst their mortgage portfolios were almost invariably at fixed interest rates which were low compared with those currently prevailing. To help the thrifts make profits from other activities, legislation was rushed through enabling them to provide a wide range of services without adequate prudential checks. As a result, there have been several serious thrift failures, and literally thousands of these institutions are technically insolvent.

I draw two conclusions. First, I am reinforced in the view that our plan to allow only a gradual evolution of the building societies into more sophisticated financial institutions is right. And secondly, it is important - as we are proposing in the Building Societies Bill - that prudential powers should be correspondingly strengthened to cope with greater diversification by the supervised institutions.

(c) The dangers of deposit protection

Almost all banks and savings and loans in the United States must contribute to federal deposit protection funds. All deposits of up to \$100,000 are insured, and in many cases protection extends to even larger sums. Brokers in any case split up large deposits into smaller units, so that they are in effect fully protected. There is no reason to think that



normally prudent institutions have been tempted into unwise decisions by the existence of 100 per cent deposit protection. But it is undoubtedly true that irresponsible institutions, or those facing possible ruin like certain thrifts, have pursued reckless growth confident that at the end of the day the depositors will not lose out. As a result, the Federal insurance scheme covering thrifts will almost certainly become seriously insolvent, and even the Federal Deposit Insurance Corporation (FDIC) now looks far from sound, particularly since the rescue of Continental Illinois. The Americans see no political possibility of resiling from 100 per cent deposit protection, but strongly impressed upon us the dangers of moving in their direction.

Our own scheme under the Banking Act 1979 provides for up to 75 per cent of a maximum of £10,000 to be protected in the event of a Bank failure. I believe that we should stick to the principle of only partial protection of deposits, and keep the ceiling low, so that the scheme should be confined to its primary function of protecting small depositors. We propose to introduce proposals for building societies very similar to those for banks.

(d) Multiplicity of supervisors

For historical reasons, the responsibility for supervising banks is split amongst a large number of independent supervisory agencies. They have made only moderate progress towards full co-operation with each other, and compete with each other for influence, staff, and other resources. The result is wholly bad. The Americans are well aware of this, and urged us to avoid any unnecessary proliferation of institutions in our new supervisory legislation generally.

(e) Supervision of financial conglomerates

The Americans face the same problem as we do of making sure that financial conglomerate groups can be properly supervised. It is not sufficient for their various activities to be separately



supervised by the relevant supervisors. An overall view of the risks faced by the organisation has to be taken. They impressed upon us the need to take advantage of new legislation to make adequate arrangements, and to ensure a central role for the banking supervisor in respect of any group which includes a material deposit-taking business.

(f) Staffing of supervisory bodies

Most of the American supervisors complained of rapid turnover of staff, and of the difficulty of attracting staff of a calibre adequate to keep pace with new financial instruments and with much more highly qualified commercial bankers, who were very substantially better remunerated. I was also struck by the frankness with which top management in the banks we visited admitted to not understanding fully the risks involved in many of the new off-balance sheet instruments.

We too face the problem of finding enough suitable human resources for our supervisory agencies. Both the Banking Supervision Division and the Registry of Friendly Societies are taking active steps to overcome it.

Inspection

The American supervisors found it astonishing that our own arrangements for banking supervision made no provision for on-site inspection. They all found this an invaluable aid to understanding how a bank worked, and forming a view of its reliability and financial standing. I was not persuaded that a fullscale system of inspection on the American model was efficient or desirable. But I was persuaded that our own supervisors should conduct considerably more on-site visits than they have done in the past.

I am copying this minute to Leon Brittan, in view of his interest in supervisory questions, to Her Majesty's Ambassador in Washington, and to the Governor of the Bank of England.

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