

Subject cc Master

CONFIDENTIAL

DCAANB
cc Lord/Chanc.



10 DOWNING STREET

From the Private Secretary

28 October 1985

BANKING SUPERVISION

The Prime Minister today discussed banking supervision with the Chancellor of the Exchequer and the Governor of the Bank of England. The Economic Secretary, Sir Peter Middleton, Mr. Cassell, Mr. Blunden, Mr. Galpin and Professor Brian Griffiths were also present. The meeting had before it the Chancellor's minute to the Prime Minister of 15 October, the Governor's letter of 24 October, your letter to me of 25 October and the Economic Secretary's minute of 25 October reporting his visit to the United States.

The Chancellor said his paper set out proposals for improving banking supervision. The aim was for legislation in 1986/87. He had it in mind to publish a White Paper in December. The starting point for the proposals was that the system of supervision followed in the UK was in many ways superior to that in other countries, but it needed to be strengthened. Action was being taken to strengthen staffing and the system itself needed to become somewhat less informal. The proposals drew on the lessons learned from the JMB affair, but changes would anyway have been needed. There was a wide measure of agreement between the Treasury and the Bank. The only significant difference was on the Treasury's proposal for a Banking Commission.

The meeting then discussed in turn the eight areas described in the Chancellor's minute to the Prime Minister of 15 October.

(i) The role of bank auditors

It was agreed that this was a key area. The present inhibitions on direct contacts between supervisors and auditors should be removed. The exceptional

CONFIDENTIAL

circumstances in which auditors would discuss a bank's affairs with the supervisors without the bank being present, against its wishes or without its knowledge, needed to be further discussed. The Head of the Government Accountancy Service, Mr. Wilson, had this in hand. The result should probably be included in a code of practice rather than in legislation. The Chancellor would report further when, he hoped, agreement had been reached.

(ii) Banking inspection

Agreed.

(iii) Two tier system of supervision

Agreed.

(iv) Reporting requirements

Agreed. It was however recognised that fines for late or inaccurate reporting would not be an alternative to on-site inspection. Fines might be effective in relation to small deposit takers. Visits by supervisors would be more effective against the larger institutions.

(v) Individual large exposures

Agreed.

(vi) Duty of supervisors

It was agreed that the new legislation should impose a more general duty in addition to the protection of depositors which was the basis of the 1979 Act. However the Chancellor and Governor would reconsider the wording of the proposed new duty, perhaps along the lines that the supervisors would "have regard to" the soundness and integrity of the banking system, rather than "maintain" it. The supervisors could not in practice be expected to fulfil so uncompromising an obligation, and to state it in that way could perhaps leave them open to legal action.

(vii) Improving professionalism

Agreed.

(viii) Banking Commission

The Chancellor explained that in many countries the duty of banking supervision was carried out by an

organisation other than the central bank. This helped to avoid problems arising from the conflict of objectives. However the Chancellor accepted that it was undesirable to have two separate bodies here and such a change would in the UK context suggest a lack of confidence in the Governor and the Bank. The intention of the proposed Banking Commission was to build upon the existing system, whilst bringing conflicts of objectives fully into the open and giving added weight to the task of banking supervision.

The Governor spoke along the lines of his letter to the Prime Minister of 24 October. He shared the Chancellor's aims. However he was anxious that the proposed Banking Commission would produce too hybrid a system. An advisory body would avoid the blurred lines of responsibility which would be produced by setting up a Banking Commission. There could be difficulty in attracting people of adequate quality to the Commission. The problem of conflicts of objectives was not in practice substantial and indeed the lack of separation of the tasks was helpful, for example in providing a source of understanding of new banking instruments. To set up a Banking Commission would undermine the Bank's international role. It could also, by leading to a more overt system for payment by banks of the cost of supervision, pave the way to legal claims against the Bank when supervision failed. If the Government decided to pursue the proposal it would be necessary to prepare the way by discussions with the British Bankers Association and others.

The Prime Minister suggested that the extent of disagreement between the Treasury and Bank was perhaps not very large. She invited the Chancellor and the Governor to discuss the proposal further with a view if possible to arriving at an agreed view. In the meanwhile drafting on the other matters discussed in the meeting should go ahead with all speed.

The meeting briefly discussed the Chancellor's minute to the Prime Minister of 25 October about the proposal for a Building Societies Commission. The Economic Secretary explained that this was a freestanding proposal, and that the Building Societies would welcome the extension of responsibility for supervision from a single person to a Commission, though this was no reflection at all on the way in which the Registrar had carried out his responsibilities. The Prime Minister agreed that the Chancellor could proceed with an announcement as he had proposed.

Closing the discussion, the Prime Minister said the policy on conveyancing by Building Society solicitors needed to be decided before the Building Society legislation was

introduced. The Government had made a clear pledge on this, which should be fulfilled.

I am copying this letter to John Bartlett (Bank of England).

cc Lord Cynic.

(David Norgrove)

Mrs. Rachel Lomax,
HM Treasury.