

# **UK Banking Superv**

## **Evolution, Practice and Issues**

Edited by

**Edward P. M. Gardener**

*University College of North Wales*

London  
**ALLEN & UNWIN**  
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**Allen & Unwin (Publishers) Ltd,  
40 Museum Street, London WC1A 1LU, UK**

Allen & Unwin (Publishers) Ltd,  
Park Lane, Hemel Hempstead, Herts HP2 4TE, UK

Allen & Unwin, Inc.,  
8 Winchester Place, Winchester, Mass. 01890, USA

Allen & Unwin (Australia) Ltd,  
8 Napier Street, North Sydney, NSW 2060, Australia

First published in 1986

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#### **British Library Cataloguing in Publication Data**

Gardener, Edward P. M.

UK banking supervision : evolution, practice  
and issues.— (Studies in financial institutions  
and markets; 2)

1. Banks and banking — Great Britain — State supervision

I. Title II. Series

332.1'0941 HG1778.G7

ISBN 0-04-332102-X

---

#### **Library of Congress Cataloging-in-Publication Data**

UK banking supervision.

(Studies in financial institutions and markets ; 2)

Includes index.

1. Banks and banking — Great Britain — State supervision

Addresses, essays, lectures. I. Gardener,

Edward P. M. II. Series.

HG1778.G7U37 1986 332.1'0941 85-15717

ISBN 0-04-332102-X (alk. paper)

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Set in 10 on 11 point Plantin by Grove Graphics, Tring  
and printed in Great Britain by Billing and Son Ltd, London and Worcester

# **UK Banking Supervision**

*Studies in Financial Institutions and Markets*

*Edited by J. R. S. Revell*

*Emeritus Professor of Economics*

*University College of North Wales, Bangor*

**1 THE GILT EDGED MARKET**

Jeremy Wormell

**2 UK BANKING SUPERVISION: EVOLUTION,  
PRACTICE AND ISSUES**

Edward P. M. Gardener

## **Preface**

The 1970s marked a watershed for British banks and their regulatory authorities, particularly the Bank of England. Rapidly escalating inflation, high and volatile interest rates, fierce competition, and growing risks and crises were among the factors which evidenced the growing fragility of the financial system. This environment of risks and risk-taking was not unique to Britain's financial institutions and markets. Many other developed banking systems, including the international banking system, had started to come under severe pressure. The world was changing. Comparative stability had given way to a new era of turbulence in world banking and financial systems.

In late 1973, the British banking system faced its severest test in modern history – the so-called fringe (or secondary) banking crisis. The Bank of England and the core banks responded quickly to contain the crisis. One immediate result of these experiences was the realization that more comprehensive prudential regulation and bank supervision were necessary consequences of the new and evolving bank markets. Regulation covers legal and administrative measures which apply to all banks. Supervision is a process of monitoring individual banks to ensure that they obey regulations and do not behave imprudently. Important new supervisory measures were initiated in 1974. Throughout the 1970s, increasing concern and resources were directed towards bank supervision in the UK. The Johnson Matthey affair in the Autumn of 1984 and the bank's 'rescue' by the Bank of England were a timely reminder of the challenges faced by modern supervisors.

Alongside the new risks and the trauma of crisis, other forces were also operating to help shape the rapid growth of UK bank supervision. These included the EEC movement towards the harmonization of bank regulation and a growing acceptance by governments of the consumerism philosophy. As the bank supervisory function has grown, however, economists have continued to argue generally for less regulation. Market discipline, the 'unseen hand' of the market, is favoured by many economists as a more efficient regulator of bank resource decisions than legal prescriptions. Little wonder, then, that bank supervision has already produced a host of theoretical and practical problems. These problems are compounded in that supervision is often the partial product of political and social forces, besides economic and legal influences. In the UK, the more institutional problems of banking supervision have been largely ignored by mainstream economists.

This book draws attention to some of the main problems – theoretical

and practical – associated with banking supervision in the UK. It sets out to introduce and analyse the UK bank supervisory process, and it raises some important questions. The main emphasis is on the process and historical context of supervisory development, and some of the most pressing problems engendered by supervision. One question addressed early on in the book is whether supervision is necessary; much of the supervisory debate has tended to accept supervision as a necessary fact of life. Attention is then directed at methods and styles of supervision. At the same time, several associated issues are raised.

Besides documenting related developments, this book attempts to identify and explore some of the fundamental questions about supervision. Nevertheless, the book is still very much selective, rather than comprehensive. Areas like international banking supervision, capital adequacy and competition could never be covered comprehensively in one volume. With these constraints in mind, the emphasis of the book is on domestic banking supervision. The objective is to explain and consider some of the distinguishing features of UK bank supervision. This also provides the background for a more detailed study of selected aspects of important problems, like capital adequacy and deposit insurance.

This text is not intended to be any kind of reference book or supervisory manual. It does not attempt to detail the minutiae of the UK supervisory process. An excellent account of the purely institutional structure and development of the UK supervisory system is contained in *The Management and Regulation of Banks* by John Cooper referred to on several occasions in Part A. In one sense, this collection may be seen as a complement to John Cooper's study. It has a different objective, and this is reflected in the scope of the collection of readings. Nevertheless, some background to the UK system and the general process of supervision is provided in Part A. These four opening papers by the editor are designed to set the scene for the later readings, besides raising and discussing some matters not covered elsewhere in the book.

The selection of readings in this book was made on the basis of several criteria. One rather obvious criterion was that the contributors should either be distinguished practitioners or serious students of supervision. Some emerging UK supervisory problems also occur in other countries, and they are much better documented and more rigorously debated in these countries. This has led to a number of papers in the book from contributors abroad. Although the book is designed to have a UK bias, it seemed unwise to ignore the realities of the market. Marco Onado was invited to write Chapter 9, and the whole of Section E is contributed by distinguished US scholars.

Another criterion was that the contributions should be current and topical. Again, this requirement is obvious enough. A final criterion was to introduce ideas and perspectives which may not be generally available to the wider audience sought by this collection. On the one hand, this has led to several

especially commissioned papers, and some papers not previously published. On the other hand, it has led to invited papers which introduce perspectives from other economic fields and different branches of social science. Examples include Jane Sargent's paper in Chapter 7 and Les Metcalfe's contribution in Chapter 8.

This book is intended for a wide audience. At the most general level, the interested layman and social scientists from other disciplines should find it of some interest. British banks, banks operating in the UK and bank supervisors generally will find the collection both informative and, hopefully, provoking. Bankers in countries other than the UK should also find the book of interest. With the growing internationalization of banks and the increasing globalization of many banking markets, knowledge of the practice and issues associated with supervision in different countries becomes more relevant. Students of banking, monetary theory and financial economics will find that the book gives some new perspectives and offers avenues for further research. There has been a marked tendency to segment academic sub-disciplines in recent years. This has been one result of increased specialization. Banking supervision and regulation generally are areas which benefit from a greater cross-fertilization of ideas. Students of applied economics in banking and finance should find that this book improves their understanding of the regulatory forces that help shape financial systems.

The book is divided into five main sections as follows:

- Part A Supervision – a Perspective
- Part B Evolution and Practice
- Part C Related Issues
- Part D Capital Adequacy
- Part E Deposit Insurance

Part A by the editor provides a general background to regulation in general and UK bank supervision in particular. It sets the scene for the rest of the book. Part B comprises four invited papers on different aspects of the growth and operation of supervision in the UK. The remaining three sections contain three papers apiece. Part C looks generally at selected areas, like competition and the problems associated with setting supervisory objectives. Parts D and E are devoted to specialist considerations of two fundamental areas of supervision, capital adequacy and deposit insurance. A great deal of US academic literature has grown around these areas, but they have not been so rigorously debated in the UK. Nevertheless, they are matters of topical concern, and they have stimulated increasing interest and debate.

Several acknowledgements are in order. First, to all the contributors who allowed me to present their views. All the copyright holders must also be



thanked for allowing the reprint of these articles. It should be added that there is no implication that a contributor necessarily supports or opposes the views of another in this volume. In this sense, each paper is mutually exclusive of the others in the book. I am grateful to Jack Revell who stayed with the idea of this book and encouraged its completion. His contribution to this whole academic area is particularly great. At the same time I thank the publishers George Allen & Unwin who both fostered the project and provided a strong 'devil's advocate' role. I must also thank my secretary, Sue Potter, who toiled through the many drafts of the manuscripts. Jill Anker also provided considerable help in the typing. Finally, I must thank my wife, Anne Christine, and our children – Michael, Emma and John – for their continual support. Any errors or omissions are assumed, of course, by the editor.

*Institute of European Finance*  
*University College of North Wales*  
*November 1984*

Edward P. M. Gardener

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## PART A

# **Supervision – a Perspective**

This opening collection of four papers sets out to provide a perspective on bank supervision in general, and UK supervision in particular. The starting point is a survey of some of the major structural changes and banking risks which emerged in the 1960s and 1970s. These were part of the general chain of events that helped lead up to the celebrated fringe (or secondary) banking crisis in Britain. It was these experiences which exposed the inadequacy of the 'old-style' Bank of England supervision, and thereby helped to shape the current UK approach. Chapters 2 and 3 examine supervision in the context of regulation generally, and explore some major supervisory conflicts and issues. Many of these areas are developed further in the specialist contributions which begin in Chapter 5. Chapter 4 finally sets the scene by outlining the evolution and structure of banking supervision in the UK.



# 1 Banking Crises and Risks

Some time during the 1970s the longest period of continuity in economic history came to an end. At some time during the last ten years we moved into turbulence.

Peter F. Drucker (1980), *Management in Turbulent Times* (London: Heinemann).

## Introduction

A marked and disturbing feature of the 1970s and early 1980s has been the periodic emergence of problems, failures and crises in many different banking systems worldwide. The world banking system as well has experienced severe and continuing tests of its resilience. British bankers at the start of the 1970s found themselves at the dawn of a new epoch characterized ominously by increasing risks and uncertainties. Instability had replaced the previous ordered pattern of events. The banking crises and new banking risks that were spawned stimulated – and in many instances demanded – growing interest in banking prudence and its supervision.

Subsequent UK supervisory developments were in large measure a reaction to such pressures. Later contributions will explore these developments, together with their historical context and associated issues, in some detail. Our first task, however, must be to set the scene for a study of the supervisory function in general, and UK supervision in particular. To this end, our journey starts off with a consideration of those developments which helped lead up to the phenomenon of modern banking crises and the emergence of potentially greater risk exposures for banks. Although there were certainly other important forces at work in the development of UK supervision, increasing risk in the system was probably the single most important influence.

## Background to Crises

### *Changes in the banking system during the 1960s*

The British banking system is currently living through a period of marked, some would emphasize dramatic, change. Over the past twenty years or so many important developments emerged which radically transformed UK and world banking markets. The process continues today, and no one knows where it will end. Faced with keener competition, increased opportunities

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and threats, and growing uncertainty, British banks have responded in many ways. New products and more complex forms of banking organization have appeared. Sophisticated management skills and new technology are currently being harnessed. Theories that did not recognize banks as individual, adaptive firms in their own right, and the shorter-term, often harsh realities of the market, illustrated the widening gap between academics and practitioners. At the same time, some traditional banking and regulatory policies became increasingly suspect under the pressures of innovation, rapid change and growth.

The more stable and protected pre-1960 days of British banking are probably now gone forever. From the late 1950s in the UK, the political and economic climate was more encouraging towards new financial enterprises. The Conservative government of the day sought to restore the economy towards normality after the pressures of wartime and postwar restrictions. Credit controls were eased, for example, and borrowing regulation through the Capital Issues Committee finished. Dismantling these kinds of barriers, coupled with a rising standard of living, opened up the way for new and more aggressive profit-seeking enterprises in the UK financial sector. Competition began to increase and some of the newer, smaller financial operators failed; others did not remain very long in business. The new face of British banking had started to emerge. Subsequent events virtually transformed the traditional and cosy UK banking market.

The 1960s developed as a period of major structural innovations in the UK banking and financial system. These brought with them new opportunities and risks. One of the most significant structural developments was the growth of the so-called secondary banking system, together with its associated money markets, or parallel money markets. A part of this new secondary banking system – the so-called fringe – later became a source of the biggest upheaval in modern British banking. Although it is very difficult to classify them neatly because of their wide-ranging activities, the rapidly growing secondary banks had several distinguishing features. One common element was that they did not compete directly with the clearing banks – the deposit or primary banks – for payments transmission business. The secondary banks dealt mainly in the wholesale side of banking where the deposits and loans are typically for large amounts. Most of their deposit and lending business was for a fixed maturity (term deposits and term lending) and in foreign currencies. Agreements on rates between secondary banks were rare. Competition for business was fierce and this part of the banking sector grew rapidly.

In the present context, potential confusion has arisen over the term 'secondary banking', which is still widely used in the UK banking literature. For example, the expression secondary banking crisis is often used to describe the 1973–5 crisis sparked off by the troubles of the fringe banks. The fringe banks, however, were only a small part of the secondary banking

system. In order to avoid this confusion, Revell (1973) introduced the use of the term secondary banking. He refers to the fringe banking crisis in order to describe the troubles of 1973-5. In this more specific use of terms, a fringe operator is one who engages in more risky business within any sector of the financial system. The original sense of the term secondary banking is rendered by terms like 'wholesale banking' or 'non-deposit banking'. We shall adopt this convention, and the term wholesale banking is now a common one in the UK banking literature. In adopting this convention, however, it would be as well to emphasize that fringe banks and the predominantly wholesale banking sector also engaged in some retail banking activities.

The phenomenal growth of the wholesale banks and their new mix of business militated against the development of suitable guidelines for prudential management. A new and virtually unexperienced risk : return trade-off problem had arisen for bankers and nobody knew the rules. Although more prudent bankers accepted that the maturity matching of deposit and loan maturities was the basic principle of wholesale banking, the extent of permissible maturity unmatching, the usual banking practice, was not obvious or well researched. The rules of traditional, fractional-reserve banking had developed through many decades of trial and error. Wholesale banking reached early maturity without the benefits of any such tested rules. In retrospect, there had to be a price paid for such a meteoric and largely unimpeded growth.

The parallel – now also more usually called wholesale – money markets evolved alongside the new wholesale banking system and contributed in large measure to its growth. Just as the discount market was the traditional money market of the primary banks, so the parallel markets emerged as the money markets of the fast-growing wholesale banks. The birth of these new markets can be traced back to 1955 when UK local authorities were no longer able to borrow at will from the Public Works Loan Board. At a time of apparent high interest rates, local authority treasurers went out to secure short-term, or temporary, money in the market. Banks began to bid for deposits to on-lend to local authorities, and the market in local authority deposits had begun. In 1957 we saw the emergence of the eurodollar market. The 1960s witnessed the start in London of several new important markets, including the inter-bank and certificates of deposits (CDs) markets in dollars and sterling. Some idea of the broad composition and structure of the main parallel markets at the end of 1970 is given in Table 1.1.

These new markets brought with them the innovative banking technique of liability management, or endogenous deposit determination, first developed in the US during the early 1960s. A bank short of funds could simply go out on to these new wholesale money markets and bid for deposits. No longer did banks have to wait for deposits to flow in before they could



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Table 1.1 *Parallel Markets' Resources*

	<i>End 1970</i> <i>(£ million)</i>
Eurocurrency, etc. deposits	5,400
Local authority deposits	1,800
Inter-bank sterling deposits	1,700
Dollar CDs	1,600
Sterling CDs	1,100
Finance-house deposits	700
Total	12,300

*Source:* Adapted from Revell, 1973, p. 270.

expand their lending volume. The banks that employed liability management effectively threw off the liquidity shackles of traditional deposit banking. They became potentially 'advances driven', rather than 'deposits driven'. Loans could be made in anticipation of the bank being able to go out and buy in the necessary supporting deposits on the inter-bank or CD markets. Later experience in the 1970s, however, demonstrated that banks driven through liability management could be exposed to significant dangers – particularly funding and interest rate risk exposures – where they grossly unmatched the maturities of their assets and liabilities. The wholesale markets are still predominantly short term with the majority of deposits being under six months maturity. Unlike the traditional discount market, the wholesale money markets have no lender of last resort, there is no direct intervention by the authorities, and all loans are unsecured.

The UK clearing banks, therefore, found themselves having to face up to a new competitive, aggressive and innovative operating environment during the decade of the 1960s. The distorting effects of being virtually the sole recipient sector of monetary controls made themselves felt on the clearing banks during this period. The recurring sterling crises over this time resulted in the reimposition of controls and the use of direct lending ceilings. Because they (and not the wholesale banks) were subject to cash and liquid assets ratios, for example, a direct participation in the parallel money markets by the clearing banks was less profitable for them. They were also subject to long-standing operating conventions, like the interest rate cartel, which constrained their direct activities in the new money markets. Nevertheless, they operated indirectly in wholesale banking, at least in a limited fashion, through subsidiaries and associate companies – the so-called 'clearers' cheaters'.

In the retail sterling market, the clearing banks also faced major