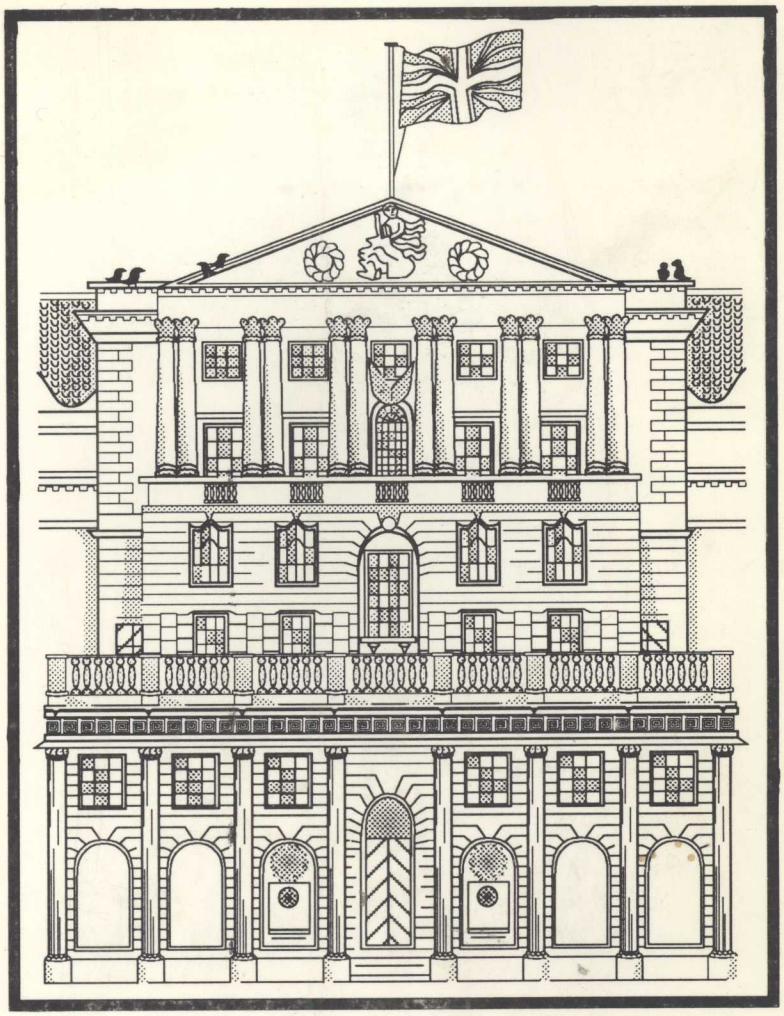
The Touche Ross Guide to the Regulation of Banks in the United Kingdom



A Eurostudy Special Report

Written by Peter Andrews and Brian Smouha

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FOREWORD

The City of London is the financial centre of Europe. Some voices in the City continue to express pride in its probity and in its free and open "self regulating" market for financial services. Indeed, at the time of "Big Bang" in 1987 there was much talk of deregulation. At this stage, however, the impression is gaining ground that the City is under threat from a burden of regulation which is creating expense and bureaucracy without controlling determined wrong-doers. In view of the apparent consensus that the City should continue to police itself, one is entitled to ask a question: how can it be that such an important and generally reputable industry as UK banking now finds itself confronted by regulatory requirements of unprecedented size and scope?

Whatever the answer to the question may be, the question itself bears witness to the existence of a major business problem: the Banking Act, the Bank of England's notices, the Financial Services Act and its related rulebooks, the relevant directives of the European Communities and the statements of the Bank for International Settlements together add up to thousands of pages of detailed rules. All of these rules need to be considered and many of them need to be followed by every bank operating in the UK.

The challenge for management is to operate competitive and profitable institutions without compromising compliance. This is not simply a matter of minimising compliance overheads. There is also a need to maximise the benefits which can arise, for example in terms of control over the conduct of business. The object of this Guide is to provide information and ideas to help management meet the challenge head-on. In something over two hundred pages the Guide aims to identify, describe and make sense of all significant aspects of the mountain of regulation facing the UK banking sector.

The Guide is divided into four main parts, the first three of which describe and comment on the key areas of bank regulation. Part one deals with the Banking Act, 1987. Part two deals with the Financial Services Act, 1986. Part three deals with other regulations affecting UK banks, including in particular the requirements of the European Communities. The fourth part addresses some of the regulation based issues facing bankers today. Wherever appropriate, detailed materials have been relegated to the extensive appendices to be found at the rear of the Guide.

The Guide describes the regulatory structure in place in late 1989. By common consent this structure is costing the City at least several tens of millions of pounds per annum. It is already clear that 1990 will bring a number of significant developments in the structure. These include the coming into force of the Companies Act 1989, which will amend the Financial Services Act 1986 by increasing the powers of the Securities and Investments Board. Also, within two years various directives of the European Communities will have been finalised and the single financial market will be in place. A vital issue for those involved in planning the business of banks is whether these further developments will cost yet more money. From the strictly UK perspective the omens are not good.

It appears that the UK intends to continue with its plethora of supervisors and with its blanket system of regulation of investment business. Under this blanket no distinction whatsoever is made between major international banks and self-employed life assurance advisers. It also appears that the new powers of the Securities and Investments Board to issue statements of principle and designated rules may well undermine institutions' hard won experience of the Financial Services Act regime. The statements of principle may possibly create uncertainty by operating in the informal and imprecise manner now abandoned by the Bank of England. The designated rules are likely to change significantly rulebooks with which some familiarity has at last been achieved.

The picture is not entirely gloomy. The UK regulators know that a balance must be struck between maintaining UK institutions at the highest levels of reliability and keeping the City competitive. In addition, there is an increase in regulation elsewhere driven by well publicised frauds and bank

collapses. Something approaching the much discussed ideal of equivalent regulatory regimes across the world may therefore been seen. In any event the City may be able to offer a competitive level of profitability to international institutions without losing its integrity. It would then remain a location from which such institutions cannot afford to be absent.

At the moment, it has to be admitted that the most encouraging regulatory sign for banks operating in the UK appears to be the coming of the single European Banking Licence. This will permit banks to undertake throughout the European Communities a wide range of activities, including investment activities. One wonders how many readers of this Guide will conclude that from 1992 the interests of their organisations would be served best by head-quartering European operations in, say, Luxembourg and reducing UK operations to branch status. If such decisions are taken, it may be said that the City buckled under the yoke of regulation.

Stephen Almond

Part One

The Banking Act, 1987 and the Bank of England's Regulations

CHAPTER ONE

OVERVIEW OF BANKING REGULATION

1.1 THE NEW ENVIRONMENT

The introduction of the 1987 Banking Act marked an important stage in the dramatic development of the regulation of banks in the United Kingdom in recent years. There is no doubt that the burden of supervision is increasingly onerous and, indeed, is likely to become heavier yet. Apart from the Act itself other recent developments include:

- International convergence of supervision;
- the establishment of a new supervisory regime for the wholesale markets;
- increasing use of investigative accountants;
- specific control over large credit exposures;
- more stringent requirements for sovereign debt provisioning; and
- a shift towards consolidated supervision of groups containing banking companies.

These are simply some of the tangible features of a more general shift in the style of supervision. The Bank of England ("the Bank") maintains the same role of protecting public depositors and monitoring the overall stability of the financial markets, but the centre of attention is shifting away from the scrutiny of reported historical data within the hallowed halls of Threadneedle Street. Today, the regulators appear to be much more pro-active in their approach, and are concentrating more on getting inside the banks in the UK to make on-site assessments of the quality of management, business, and information and control systems.

The development of legislation to protect the public investor, as embodied in the FSA, presents banks in the United Kingdom with a whole new area of regulatory requirements developing alongside and, to some extent, overlapping with this increasingly pro-active approach to the traditional area of banking supervision. Bankers are now faced with a bewildering and, to some extent, still evolving structure of regulations. The scale of regulation today is such that it must form an important element of bankers' strategic and transaction planning, with particular consideration given to liquidity and capital requirements, systems development and information and staffing needs.

On a more positive note it is hoped that international convergence of supervision will simplify international banking operations in the sense that a broadly similar regulatory regime will be found in each of the world's major financial centres. Moreover it is expected, at least in the UK, that international convergence of supervision will not necessitate simultaneous adherence to more than one regime: rules made under the mechanisms established by the Bank for International Settlements ("BIS") will be implemented by the Bank of England in replacement, where appropriate, of its own rules; rules established by the European Community ("EC") will, depending on their nature, be implemented by the Bank, where it is able to do so under an existing power or, where the Bank has no such power, by UK Act

of Parliament or by direct effect in the UK.

There remains the possibility that EC requirements may conflict with BIS requirements but it is understood that strenuous efforts are being made to avoid such conflicts. Should they arise - or should the Bank's own requirements conflict with those of the EC or the BIS - the position would probably need to be resolved at a political level, although, as already noted, certain EC requirements are of such nature that the UK has a legal obligation to implement them (and they could in theory be enforced in the European Court).

The new environment is typified by increasingly intense regulation of the conduct of banking business involving a wide range of statutory and non-statutory supervisors. These include:

Body	Source of Authority
Bank of England: Banking Supervision Division Wholesale Markets Supervision Division Gilt Edged Division Foreign Exchange Division Money Market Operations Division	Banking Act 1987 Bank of England Act 1946
The Securities and Investments Board and the Self Regulating Organisations	Financial Services Act 1986
Recognised Investment Exchanges	Financial Services Act 1986
Office of Fair Trading	Consumer Credit Act 1974
Data Protection Registrar	Data Protection Act 1984

In addition, there are guidelines and recognised codes of practice established by business associations and other bodies responsible for specific areas of activity.

These include:

Activity	Source of Guidance
Securities issuing	International Stock Exchange
Trade finance	Uniform Customs and Practices
Consumer lending	Finance Houses Association
Bond dealing	Association of International Bond Dealers
Primary capital markets	International Primary Markets Association
Interest rate and currency swaps	International Swap Dealers Association
Futures trading	LIFFE

1.2 BACKGROUND

Statutory regulation of banks arrived very late in the United Kingdom. Reliance continued to be placed upon an informal system long after most major industrialised countries had introduced statutory regimes. As a result, the Bank has decades of experience of supervising through discreet persuasion rather than strictly defined rules. Indeed, one of the interesting distinctions between the Financial Services Act and the Banking Act is the less strict definition of statutory arrangements in the latter leaving greater scope for the Bank to continue to utilise its pragmatic approach to supervision.

Having said that the statutory approach was only recently adopted in the UK, mention should be made of the Bank of England Act 1946, which empowered the Bank to issue directions to any banker, with the specific prior approval of the Treasury. It was never clear, however, whether these powers were really intended for supervisory purposes and, in any case, they were never used in practice. Certainly, there was no comprehensive system of regulation, nor were there any rules regarding such things as conduct of business and quality of management and systems. There was a rather intricate, layered system of recognitions covering specific areas of business activity, which were administered by various different bodies. The Bank stood at the centre on the monitoring side, whilst the direction of operations was largely left to a small number of major banks.

It was only when structural changes emerged in the market place towards the end of the 1960's that this rather loose arrangement began to show its limitations. Credit controls on the primary banks led to the establishment of subsidiaries beyond the scope of those controls and enabled new fringe players or "secondary banks" to compete effectively. These new players were able to grow very rapidly and fuelled the expansion of the interbank market. The subsequent crash of the early 1970's brought the Bank very much to the forefront again, as it directed the "lifeboat" operation to support the secondary banks through mobilising the deposit resources of the primary banks. It is generally recognised that the Bank acquitted itself very well during this crisis period, but the market place had outgrown the existing supervisory arrangements and a more coherent and far-reaching system was needed, supported by statutory powers.

This was the domestic background to the Banking Act 1979. That Act also addressed the international perspective and met the United Kingdom's obligation under the First Co-ordination Directive on Credit Institutions issued by the European Communities (EC) in 1977, which required a system of prior authorisation for credit businesses involving certain minimum criteria.

One of the problems in formulating the 1979 Act was that English law contained no clear definitions of the terms "banks" or "banking". That Act, therefore, did not focus upon credit facilities but rather on the funding sources. The legislation concentrated on the protection of the interests of the public depositors of funds.

It did not concern itself directly with the ways in which those funds were put to use. The emphasis on protection of the public reflects an assumption similar in principle to the assumption underpinning the FSA that professionals do not need statutory protection against poor or unethical investment advice.

When the Johnson Matthey affair exploded, however, the scandal and the debate did not focus upon the fate of the ordinary depositors. The question asked was: how could it be that a major institution, supervised by the oldest regulator of them all, was allowed to sink into such an apparent state of mismanagement that collapse became inevitable, without any whistles being blown? It is worth noting that the action taken by the Bank owed more to its experience during the secondary banking crisis than to its statutory powers under the 1979 Act. The Bank orchestrated the mobilisation of the resources of the UK's major banks, and, as with the lifeboat operation, public deposits were thereby preserved.

In the aftermath of this affair, a committee of enquiry was set up under the chairmanship of the Governor

of the Bank to consider the system of banking supervision. The committee, known as the Leigh-Pemberton Committee, reported in June 1985. It commented that Johnson Matthey's lending systems and their operation had proved to be completely inadequate. The committee's report laid the foundations for what was to become the Banking Act 1987.

The scope of the new Act is virtually unchanged - the Bank's primary duty is still the protection of depositors' interests but it does appear that the Bank was badly stung by the Johnson Matthey affair into a recognition of the public's perceptions of its responsibility for the stability and adequacy of management not only of the banking system as a whole but of the individual participants. The new Act does give the Bank more explicit powers of investigation, and the supervisors have made very clear their intention of getting closer to the internal workings of all banks in the UK, irrespective of the level of deposits held.

1.3 COMPARISON OF THE 1979 AND 1987 ACT

At the heart of the 1979 Act was the two-tier system of authorisation, whereby institutions were either licensed deposit takers or recognised banks. This system proved rather difficult to operate; the distinction puzzled both observers and participants, and absorbed much of the supervisors' resources to administer. Recognised status was sought by many institutions on the grounds of prestige rather than need, and the wide range of banking services which the Act required of recognised banks was quickly made out-moded by the emergence of expert and highly regarded institutions with rather narrow specialisms. Consequently, the 1987 Act does away with the two-tier regime.

Regulatory control over the ownership of banks is one of the key areas in which the support of statute has become recognised as a necessity. No such support was provided by the 1979 Act. In practice, the Bank continued to exert its non-statutory authority with great success, but there was an increasing awareness that the Bank was poorly armed to prevent a determined predator from bludgeoning its way through the traditional barriers. The 1987 Act gives the Bank statutory power, supported by criminal sanctions, to prevent anyone acquiring in an authorised institution a controlling stake, which is defined as 15 per cent or more of the voting power exercisable at any general meeting of the institution.

The 1987 Act recognises more fully the very considerable extent to which the supervisors are dependent upon the provision by the authorised institutions of timely and accurate information. As with the 1979 Act, most supervisory information is provided on a voluntary basis, but failure to provide information and provision of false or misleading information are now criminal offences.

A more important development under the 1987 Act is the removal of constraints which previously precluded exchanges of information between the supervisors and the auditors of the authorised institutions. The Bank is building upon this by requesting annual accountants' reports on accounting and other records and internal control systems, supported by regular routine meetings with the auditors and reporting accountants.

One of the problems with the 1979 Act was the limited courses of action available to the Bank in dealing with an intransigent or a troubled institution. The only statutory power was that of revocation of licence, which was often too extreme a remedy to be applied. The 1987 Act provides more flexible powers of intervention, particularly the power to restrict rather than revoke a licence in instances where the criteria are no longer met but outright revocation is considered inappropriate or unjustified.