

Chapter 1

The Regulation of Banking – An Introduction

John Tattersall

Partner

PricewaterhouseCoopers LLP

1.1 Background

The regulation of banking in the UK has a history of reaction to crises and disasters in the banking sector. It has not arisen through proactive design, though there have been plenty of opportunities to reform it. Even today the FSA's approach to the regulation of banks is complex and far from ideal, but it is certainly a significant improvement on the approach of 30 or even 50 years ago.

Legislation such as the Banking Acts 1979 and 1987 was a direct response to banking failures. The secondary banking crisis in the early 1970s, when a number of new fringe banks which had been set up in the heady days of the 1960s collapsed as a result of incautious or even cavalier management styles, led to the establishment of a lifeboat by the Bank of England and subsequently to the enactment of the Banking Act 1979. Prior to 1979 there had been no statutory backing for banking supervision. Banks, in the gentlemanly tradition of the City of London, had obediently responded to guidance from the Bank of England. The new secondary banks were not so responsive, nor were they prepared to operate as members of the City club in the way that the inner circle of clearing banks had done in the past.

The Banking Act 1979 did not necessarily change the way that the Bank of England operated. However, it did provide statutory backing for banking supervision. The Bank of England, which was still then the sole banking supervisor in the UK, commenced an early form of risk-based supervision by distinguishing banks from licensed-deposit takers, with closer scrutiny for the latter category, which essentially included the secondary banks. The traditional banks were not only allowed to use the

word "bank" in their corporate name but were also trusted with a more hands-off system of supervision.

It took the subsequent failure of one of those institutions entrusted with the word "bank", Johnson Matthey Bankers, for the Bank of England to realise that the management of traditional banks can go wrong in just the same way as the management of secondary banks. Johnson Matthey Bankers had been lending money in an injudicious way with concentration of lending in excess of that permitted by the Bank of England. However, the lack of regular supervision of the institution and the lack of audited returns on matters such as concentration of lending or large exposures meant that the Bank of England was not warned in time of these ill-judged lending practices.

The Banking Act 1987 was the consequence: the two-tier system of supervision was abolished, with the same focus of supervision on institutions irrespective of the length of time that they had been lending money or operating in markets. The new legislation also provided power for the Bank of England to request institutions to commission reports on their prudential returns, as well as on their systems and control, from reporting accountants. Typically, the accountants used were their auditors, but this was not necessarily the case. More generally, the Bank of England had wider powers to investigate banks, to communicate with overseas banking supervisors, and to investigate the controllers or shareholders of banks.

Alas, even these new powers and the new vigour with which the Bank of England banking supervision division approached their task was not sufficient to prevent the collapse of Barings or the Bank of Credit and Commerce International (BCCI) in the early 1990s. Both of these collapses were rightly blamed on the failure of the management of those institutions. In the case of Barings, senior management that did not fully understand the complexities of derivative trading failed to detect the unauthorised trading activities of Nick Leeson, who became known as the archetypal rogue trader. In the case of BCCI, the failure of corrupt management, and their fraud upon the depositors and shareholders of the bank, was not identified either. It was clear that something needed to be done to improve the quality of banking supervision and this led to a review of the Bank of England's approach to banking supervision under the auspices of the Board of Banking Supervision.

The new approach was to be much more risk-based. The mnemonic RATE was coined, relating to risk assessment, tools (of supervision), and

evaluation. Banking supervisors were to spend far more time assessing risk, based on detailed interviews with management of the institutions, to give a better chance of identifying those institutions which were most at risk of failure or of creating instability in the banking system. They were to use the supervisory tools available to them in such a way as to increase the chance of detecting weaknesses and of rectifying them. Finally, the evaluation process was designed to evaluate the success of the regulatory approach adopted and determine the approach for the next supervisory cycle.

1.2 Development of the Financial Services Authority

It may seem unjust to supporters of the Bank of England that no sooner had a sophisticated risk-based approach to banking supervision been developed than the new Labour Government announced that it was to take the Bank of England's powers in relation to banking supervision away from them and give them to a new authority, subsequently named the Financial Services Authority or FSA. In fact, the official announcement in May 1997 led commentators to believe only that the self-regulating organisations, established under the Financial Services Act 1986, were to be merged into the new authority. It was seen as a real blow to the authority of the Bank of England that its own powers were to be given to the new authority. However, the goal of one-stop regulation, established by the new Government, was too attractive to resist.

One crucial element of the regulation of banks, namely the way in which banks dealt with their customers, was to be excluded from the new regime. Historically, the Banking Code had been a voluntary regime, and the establishment of the Banking Code Standards Board gave a greater degree of formality to the code. Nevertheless, the new board only took powers of naming and shaming and did not seek to fine or punish banks which breached its code in any other way. It has been seen by many as an unfortunate omission from the new regime.

In fact it has taken the establishment of the Banking Ombudsman, part of the Financial Services Ombudsman service, to provide more teeth in respect of the enforcement of this banking code. The ombudsman investigates only specific cases and does not provide general interpretation. To many, his powers of investigation and inquiry are seriously limited leading to some dubious judgements that irritate bankers. Nevertheless, his power to make awards up to £100,000 to customers who have been

disadvantaged does provide a serious incentive for banks to comply with the Banking Code.

Four-and-a-half years after the initial announcement by the new Labour Government of a changed regime for the regulation of the financial services sector, a new Act, the Financial Services and Markets Act 2000, was implemented. Details of this Act are set out in Chapter 2, and its implications, particularly the detailed objectives that it sets for the FSA, are spelled out in subsequent Chapters. The Act, like its predecessors, was drafted with past disasters, crises and the need to avoid repeats in mind. However, there are conflicting goals for government and the new regulator.

While the Act represents the most recent legislative change to the underpinning of banking supervision in the UK, the detailed rules have been changed by the FSA's implementation of the Capital Requirements Directive. This Directive, which itself is based on the updated Basel Accord issued by the Basel Committee of Banking Supervisors (Basel 2), has introduced a more risk-sensitive approach to the determination of capital requirements for banks. It is a major part of the European Commission's Financial Services Action Plan, dedicated to the creation of a single market in financial services throughout the EU. Many of the Directives which form part of this plan are mentioned in this guide, and their proliferation has to a significant extent determined the look of the regulations now governing banks in the UK.

1.3 The conflicting pressures for the FSA

The FSA continues to face several conflicts:

- (a) pressure from politicians to minimise the risk of failure of banks and to maximise the protection available to their depositors and other customers;
- (b) pressure, also from politicians, to maximise the availability of banking facilities and products for customers, including those less financially literate and who have not hitherto made appropriate use of other services of banks and financial institutions;
- (c) pressure from banks themselves to minimise the cost of regulation, whether the amount that they are required to pay to the FSA itself or their own internal compliance costs;
- (d) pressure from financial institutions and, indeed, from government to do nothing to damage the competitiveness of the UK in

- international markets, for example by imposing requirements which are not imposed in competing territories;
- (e) pressure from international bodies, including the European Commission and the G10 group of banking supervisors meeting in Basel under the auspices of the Bank for International Settlements, to conform to international standards of banking supervision and regulation;
 - (f) pressure both from international bodies and government to fight financial crime, and in particular to minimise the use of the UK financial system for money laundering;
 - (g) pressure from government and the consumer lobby to maximise competition within financial services markets;
 - (h) finally, pressure from the consumer lobby to maximise protection from consumers; essentially this results in a move away from the philosophy of *caveat emptor* and places greater pressure on the FSA to improve the education of consumers in respect of financial products.

These pressures are articulated in the statutory objectives and Principles of Good Regulation imposed on the FSA, which are described further in Chapter 4, together with an analysis of the FSA's approach to the supervision of banks and to the management of the risks that they represent. However, it is important to understand the interaction between British banking supervision and the international bodies which impose standards and this is described further in Chapter 3.

In practice, achieving a balance between all of these points requires careful management as well as a sound system of governance at the FSA, which is enforced by the FSA's Board of Directors. The current chairman of the FSA, Sir Callum McCarthy, and his chief executive, John Tiner, have achieved a significant reputation for monitoring and restraining the costs of regulation and putting much of the burden back onto the management of the institutions that the FSA seeks to regulate. Nevertheless, there continues to be much dissatisfaction with the cost of compliance among banks and other financial services firms.

1.4 The FSA's approach

The rest of this Guide provides details about the approach that the FSA has adopted and the second edition has been updated to reflect the implementation of the Capital Requirements Directive (or Basel 2) and other directives. Chapter 5 spells out the way in which the FSA has

pushed responsibility onto senior management, identifying that area as the key to a sound commercial services sector. Most of the crises and disasters, which contributed so significantly to the structure of banking supervision, were undoubtedly the fault of senior management. To the extent that senior management relied on guidance from the Bank of England or, subsequently, the FSA, they can no longer be under any illusion that it is upon them alone that the management of their institution depends. The approved persons regime allows the FSA to take action against individual members of management who are considered to be culpable in respect of banking failure.

Chapters 6 to 9 set out the major risks to which banks are subject, and the FSA's approach to monitoring the way in which management controls those risks. Chapter 6 focuses on market risk and the supervisory treatment of banks' trading books. Chapter 7 tackles the principal impact of the Capital Requirements Directive which is on the determination of capital requirements to cover credit risk, though one chapter can scarcely cover fully the very complex regime which is now being introduced, and readers may wish to read further details in the Practitioners' Guide series publications on the Basel Accord and on securitisation.

The FSA has also rightly placed emphasis on operational risk, the risk that the systems on which a bank depends will prove unreliable when needed most, and this is covered in Chapter 8, together with the approach specified in Basel 2 and the Capital Requirements Directive to Operational Risk.

The FSA and the Bank of England before it had always recognised the key role in ensuring that financial markets remain liquid, and in particular the banks needed to hold a stock of liquid assets in order to meet unexpected pressure from depositors whilst maintaining the confidence of depositors and counterparties. In Chapter 9 James Wise spells out the FSA's approach to liquidity risk. All of these Chapters show how reliant the FSA is on proper risk control by the management of institutions.

Chapter 10 provides a detailed analysis of the FSA's approach to prudential requirements for banks varying with the amount of risk taken by the institutions concerned, pulling together some of the detailed requirements spelt out in the chapters on market, credit and operational risk. That Chapter also comments on the requirements for adequate records, systems and controls in banks.

Regulation would not be effective if it did not prevent inadequately managed or resourced institutions from being authorised in the first place. Chapter 11 provides a guide to the steps that a newly established institution needs to go through if it is to obtain authorisation to accept deposits or provide other banking services. The same rules apply for the most part to institutions based overseas that want to set up branches or subsidiaries in the UK or to provide services from overseas to customers based in the UK.

Chapter 12, written by Brian Harte, an experienced director of compliance, provides a more detailed guide to the way in which the FSA supervises individual institutions and to the interaction that a bank might expect with its regulator. Chapter 13 explains what happens when things go wrong, and provides a guide to the enforcement and disciplinary processes established under the new Act.

Chapter 14 addresses the topical issue of the prevention of money laundering and the use of the financial system either for laundering the proceeds of crime or for providing finance for terrorist activities. This area is both a matter of public policy in the UK and an area which is the subject of significant international agreement, particularly in the wake of the outrage on 11 September 2001 in New York.

Finally, Chapter 15, written by David Strachan, a director at the FSA, explains the continuing joint role of the Bank of England and the FSA in ensuring systemic stability in the UK and provides a useful conclusion to this Guide by explaining the way in which financial regulation, properly applied, can contribute to stability in the financial system.

