ABSTRACT

This thesis examines the development and present state of U.K. banking regulation. Banks were formally unregulated in the U.K. up through the 1970s, and de facto control over them was ensured by the Bank of England ("the Bank") through informal mechanisms of so-called "moral suasion". In contrast, since 1979 banking regulation is conducted on a statutory basis, regulatory processes have been formalised, and banking institutions are required to conform with a growing body of substantive prudential standards in order to remain authorised to conduct deposit-taking business.

Various factors, including market developments necessitating increasing refinement of the statutory framework, the rapid growth of E.C. banking legislation, and the maturation of English administrative law, are found to contribute to the increasing formalisation of banking regulation, whose legal structuring is also assisted by the elaboration by the Bank and promulgation in quasi-formal guidance notices of detailed prudential policies, especially regarding financial requirements for banking institutions.

Although the responsiveness of the regulatory régime to the requirements of legal formality and transparency has increased considerably, the transformation is by no means complete. In a number of key areas of prudential policy, the Bank retains a very wide measure of discretion. The strategic character of these clusters of retained discretion enables the Bank to exercise a substantial degree of influence over the conduct of deposit-taking institutions. Moreover, despite the formal availability of opportunities for appeal or judicial review, the absence of specific substantive legal criteria - upon which the courts, or the special Banking Appeal Tribunal of the Banking Act, could rely for assessing, and ultimately overturning, the Bank's regulatory decisions - sets strict limits to the practical ability of potential complainants to obtain a remedy. Similarly, the non-transparency and secrecy surrounding the Bank's individual regulatory assessments and decisions hinder public accountability and control over the operation of regulatory policy.

Further formalisation of the regulatory process through the crystallisation of regulatory policies into fully operative legal rules appears necessary. Since a consistent and complete framework of rules in the area is unlikely to occur through primary legislation, the promulgation by the Bank of precise rules in its administrative pronouncements should be encouraged and such rules should find clear legal recognition.
ACKNOWLEDGEMENTS

This thesis, which is submitted in satisfaction of the examination requirements of the Ph.D. programme of the Faculty of Laws of University College London, is the fruition of long research and of all the support I received from many friends along the way. In particular, the patience and support of my supervisor, Prof. Graham Penn, during all these years were instrumental for its completion. The work has benefited tremendously from his perceptive - and often rather critical - comments. My engagement with the issue of banking regulation owes much to the advice of my good friend Panayotis Gennimatas, currently Vice-President of the European Investment Bank, and of my erstwhile supervisor, Dimity Kingsford-Smith, of the University of Sydney. Prof. Dawn Oliver, of University College London, and Prof. Eva Lomnicka, of King's College London, kindly accepted to read different drafts of Chapter 4, in the final form many of their comments have been incorporated. Prof. Jeffrey Jowell, of University College London, commented on an early draft of Chapter 6. Prof. Richard Dale, of the University of Southampton, commented on a long background chapter on the law-and-economics of banking regulation, which has only been omitted from the final thesis for reasons of length. My friends and colleagues Mads Andenas, of King's College London, George Walker, of Queen Mary College, Douglas Arner and Christopher Olive have all given valuable advice regarding both the content and the writing style and presentation of the thesis. During the late stages of my research, Prof. Joe J. Norton and the Centre for Commercial Law Studies at Queen Mary College have provided a great working environment and a unique opportunity to test my theories on banking regulation in the classroom. A large part of the actual writing took place in the U.S., while I was enjoying the hospitality of Paris and Fani Katsoufis.

I thank them all.

I would also like to express my gratitude to the Alexander S. Onassis Public Benefit Foundation, whose generous scholarship supported me during the early stages of my research.

My last thought and most profound thanks, however, go to my parents, Demetrios and Daria Hadjiemmanuil, without whose unflagging backing and understanding this intellectual adventure would not have been possible.
Table of Contents

Abstract .................................................................................................................. 2
Acknowledgements ............................................................................................... 3
Table of Contents ................................................................................................. 4

Introduction ........................................................................................................... 7

Chapter 1
The Evolution of U.K. Banking Regulation ............................................................ 19
1. Banking and monetary policy in the years 1944-70 ........................................ 21
   (a) Bank of England Act 1946 ........................................................................ 22
   (b) Prudential standards and statute law .......................................................... 27
   (c) The impact of macroeconomic controls ..................................................... 32
   (d) Competition, market structure and merger policies .................................. 38
   (e) Early plans for statutory regulation of deposit-taking, 1955-58 .............. 43
2. The rise of statutory prudential regulation ....................................................... 46
   (a) The secondary banking crisis .................................................................... 46
   (b) Regulatory overhaul and the enactment of the Banking Act 1979 ......... 52
   (c) The separation of banking regulation and macroeconomic policy ...... 58
   (d) The regulatory system after 1979 ............................................................... 63
3. The international and European regulatory convergence processes ............. 75
   (a) The work of the Basle Committee ............................................................. 77
   (b) Harmonisation of banking regulation in the E.C. ...................................... 94

Chapter 2
Authorisation and Supervision of Deposit-Taking Institutions under the Banking Act 1987 ................................................................. 102
1. The authorisation requirement .......................................................................... 104
   (a) Meaning of "banking" in common law ....................................................... 105
   (b) The prohibition on unauthorised deposit-taking ....................................... 110
   (c) The statutory definitions: rationale and shortcomings ........................... 116
   (d) European credit institutions .................................................................... 121
   (e) Banking names and descriptions ............................................................. 129
   (f) Representative offices ............................................................................. 131
2. The authorisation process .................................................................................. 132
   (a) Grant of authorisation: application and criteria ....................................... 133
   (b) Revocation and restriction of authorisation ............................................. 141
   (c) Procedural protections ........................................................................... 147
   (d) The appeal mechanism .......................................................................... 153
   (e) A residual role for judicial review? ......................................................... 163
   (f) The Bank's internal decision-making process and the Board of Banking Supervision ................................................................. 170
3. Continuous supervision and enforcement ....................................................... 173
   (a) Collection of supervisory information and powers of investigation .......... 177
   (b) Financial returns of authorised institutions, limits on the public disclosure of supervisory data and the duty of regulatory confidentiality ....................................................188
   (c) The Bank's relationship with auditors and reporting accountants . 200
   (d) The Bank's role in prosecutions and enforcement proceedings under the Banking Act ................................................................. 209

Chapter 3
Regulatory Policies and Residual Discretion of the Bank of England ................. 214
1. The legal status of the Bank's policy pronouncements .................................. 215
2. Capital and liquidity standards .............................................................................228
   (a) Absolute minimum capital requirements .............................................229
   (b) The assessment of capital adequacy ....................................................229
   (c) Consolidation ..................................................................................... 249
   (d) Large exposures ................................................................................. 254
   (e) Provisioning ....................................................................................... 263
   (f) Liquidity requirements ........................................................................264
3. The regulation of bank ownership, control and management ............................269
   (a) Fitness of bank owners and directors as a criterion of authorisation ............272
   (b) Bank mergers and acquisitions ......................................................... 289
   (c) Separation of banking and commerce .............................................. 294
   (d) Reciprocity ............................................................................................296
4. Conduct-of-business regulation ........................................................................ 298
   (a) Fraud .................................................................................................. 300
   (b) Money laundering .................................................................................301
   (c) Deposit advertisements ........................................................................304
5. The Bank's role in the termination of authorised institutions ............................306
   (a) Restructuring policies, bank rescues and regulatory incentives ................. 307
   (b) Insolvency proceedings against banking institutions ................................ 311

Chapter 4
The Bank of England's Regulatory Activities outside the Banking Act ....................... 319
1. The reform of the securities industry and investor protection under the Financial Services Act ("F.S.A.") ..................................................... 320
   (a) Market reform ..................................................................................... 321
   (b) The regulatory framework of the F.S.A ............................................ 326
2. F.S.A. and the regulation of wholesale markets by the Bank of England 335
   (a) Statutory definition of "investments" and "investment business" 335
   (b) Regulation of wholesale money market activities ............................ 339
   (c) Regulation of the discount and gilt-edged markets ............................ 345
3. The legal status of the Bank's de facto regulatory activities 353
   (a) The "private" legal capacity of the Bank ........................................... 356
Chapter 5
The Question of Liability for Regulatory Decisions ........................................ 382
1. Statutory immunity from liability ................................................................. 384
2. Liability for negligent regulatory decisions:
   the question of the duty of care ................................................................. 387
   (a) Pure economic loss .............................................................................. 390
   (b) A duty to rescue? .................................................................................. 395
   (c) Public-policy immunity from liability ................................................... 398
   (d) Banking supervision and the duty of care ........................................... 402
   (e) Breach of statutory duty ....................................................................... 411
3. Misfeasance in public office and other intentional torts ............................ 414
4. Liability for breaches of Community law ................................................... 420
5. Compensation under the Deposit Protection Scheme ............................... 425
6. Regulation and compensation: policy considerations ............................... 434

Chapter 6
The Bank of England and Public Accountability .......................................... 438
1. Non-departmental regulatory agencies and public accountability ............. 440
2. Openness and accountability in the operations of the Bank of England ...... 446
3. Accountability and prudential regulation .................................................. 457
4. Regulatory confidentiality as an impediment to accountability ................. 463

Conclusion ..................................................................................................... 469

Bibliography
1. Official publications ...................................................................................... 478
2. Books, articles, pamphlets, research papers ............................................... 490
Introduction

The last two decades have witnessed dramatic changes in the legal environment in which banks operate. Banking business was formally unregulated in the United Kingdom up through the 1970s. Governmental control was ensured in practice through a combination of selective legal restrictions on certain banking activities and the Bank of England's de facto control over the structure and operation of banking markets. The Bank pursued its policy objectives by use of "moral suasion", but ultimately compliance with its will was guaranteed by its dominant financial position. Prudential concerns played at most a marginal role in banking policy. However, the secondary banking crisis of 1973-74 turned the containment of risk-taking into the predominant concern of banking policy. This brought banks under an increasingly detailed framework of prudential controls. Under the Banking Acts of 1979 and 1987, the unauthorised conduct of deposit-taking business has been prohibited, and the Bank of England has been formally entrusted with the authorisation and prudential supervision of deposit-taking institutions.

In the years since the inception of the statutory system, banking regulation has clearly evolved in the direction of greater transparency and formality. Nonetheless, the delegation to the Bank of England of very wide discretionary powers remains one of its most fundamental characteristics.

The discretionary aspect of the present regulatory régime is accepted to a remarkable degree as legitimate, even indispensable. Acceptance of the Bank of England's role in this area commonly rests on belief in two interlinked propositions. Firstly, that discretionary regulation is necessary for the achievement of safe and sound banking. Secondly, that, as an institution, the Bank possesses special expertise and professional skills which allow it to perform its functions as regulator successfully.

It has been observed that administrative processes can only be considered to be legitimate if they appear to meet certain standard requirements, including that they: (a) implement the will of a constitutionally legitimate legislature, as expressed in a clear legislative mandate; (b) are characterised by procedural fairness, including the
recognition and representation of the interests of potentially affected parties; (c) are subject to mechanisms of control and accountability providing appropriate opportunities for the scrutiny and correction of inappropriate decisions; (d) involve the delegation of decision-making responsibility to professionals with the appropriate qualifications and expertise for solving problems of the relevant type (presupposing that this requires the exercise of "technical" - rather than "political" or "value" - judgement); or (e) are efficient, yielding satisfactory substantive results. While different persons may disagree on the relative value of these characteristics, generally speaking a particular administrative process will be more likely to gain acceptance if it displays any of them in strong form, and even more if it combines several of them.

In the case of the Bank of England, the legitimacy of its regulatory functions would be based predominantly on the last two grounds, that is, the Bank's expertise and professionalism and the efficiency of the manner in which it performs its regulatory role. In contrast, the imprecision and open-endedness of the Bank's legal mandate makes legitimation of its regulatory activities on the first basis questionable. Its decisions are the product of discretion and their substantive outcome cannot be claimed to be prescribed by express and unambiguous legislative provisions.

The Bank of England has built an expertise in matters affecting banking and finance unique among all governmental departments and agencies, and serious doubts do not seem to exist regarding the professionalism and high ethical standards of its officials. On certain occasions, the Bank's widely publicised inability to prevent the failure of significant banking institutions (first, of Johnson Matthey Bankers in December 1984; more dramatically, of Bank of Credit and Commerce International in July 1991; and, finally, of Barings in February 1995) has raised questions regarding the efficiency of its monitoring and enforcement procedures, triggering public perceptions of regulatory "crisis". It should be noted, however, not only that the lessons of these incidents have been utilised by the Bank in ongoing efforts to improve the mechanisms of banking supervision, but also that the significance of isolated bank failures for the overall quality of the Bank's regulatory work should not be exaggerated. It would be unreasonable to expect total and continuous success from any regulatory system. The expansion of regulatory requirements generally

---

2 All decision-making bodies enjoy in practice a certain margin of residual discretion, insofar as they are responsible for the making of findings of fact, the legal classification of these findings and the concrete application of rules to them. This form of residual discretion becomes more trivial as the precision and semantic entrenchment of the relevant legal rules increases. However, as will be shown in the following pages, the discretion of the Bank is much more explicit and significant: it does not stop at the interpretation and application of externally imposed rules, but extends to the identification and elaboration of the substantive regulatory criteria themselves.
3 Asked before a parliamentary committee whether these two failures in combination were not proof of the Bank's gross negligence in performing its regulatory functions, the then Governor of the
involves increasing costs and diminishing marginal benefits. This makes the total elimination of bank failures undesirable. Beyond a certain point, the costs of reinforcing the regulatory and supervisory system, in terms of additional administrative and compliance expenditures, pervasive intrusions in banks' business decisions, or the stifling of competition, become disproportionate to any expected benefits in terms of safety.  

Nonetheless, even though it may be argued that the Bank's overall performance satisfies the requirements of expertise and efficiency, the legitimacy of the discretionary regulatory régime on these grounds is not secure. Two important questions are left unanswered: first, whether an equivalent level of regulatory performance could not be achieved by use of public rules of general applicability; and second, whether the regulatory process is subject to appropriate procedural protections and mechanisms of outside control and accountability.

Generally speaking, rule-bound processes display certain clear advantages when compared to discretionary ones. Discretion creates uncertainty and ample opportunities for potential abuses, and makes difficult the assessment and outside control of administrative performance. In the past, the delegation of broad discretion to expert agencies was advocated as the best way for isolating the administrative process from the supposedly "corrupting" influence of political life and achieving solutions to the complicated problems of modern industrialised society. The ideal of government by expert agency, however, rested on certain totally unjustified assumptions; namely, that the public interest is an objective precept, and that its concrete expression and implementation in each instance is an unambiguous matter of technical judgement; and that this should better be assigned to disinterested agencies, possessing the necessary technical skills for achieving the goals of public administration, than by political decision-makers.

In fact, the concept of the public interest is inherently contestable. Its crystallisation in authoritative legal norms and official decisions can be seen as the result of political competition between various interest groups, pursuing mutually

---

4 In a recent speech, the Governor of the Bank, Eddie George, observed that "if society demanded a largely risk-free financial system, then one could indeed be produced. But it would constrain financial intermediaries to such an extent that they would not be able to provide anything like the range of services they do now"; E. George, "Protect the banking system but not individual banks", The Times, 27 Oct. 1995, 29.

5 See the classic advocacy of independent administrative agencies and the discretionary, "managerial" approach to the problems of the modern state by J.M. Landis, The Administrative Process (1938).
incompatible versions of the public interest, each reflecting the supporting group's subjective material or ideological preoccupations. For this reason, the technical "effectiveness" and professionalism of administrative action is often less important that the issue of control over the substantive policies pursued by the administration.

The delegation of discretionary decision-making power to bureaucratic agencies always raises questions of constitutionality, because it entails a loss of effective public control over the relevant governmental activities. The act of delegation vests the agencies with the responsibility to articulate the purposes and forms of public policy. In performing this policy-making role, the bureaucratic decision-makers in the agencies have a freedom to pursue subjective notions of what is appropriate and desirable, possibly influenced by their own interests and those of the regulated industry, or other pressure groups. These notions do not necessarily coincide with the public interest as it would be defined through the political process or by reference to broadly accepted normative principles. As a consequence, policy-making can be distorted in a subtle but systematic manner, leading potentially to the capture of the regulatory process by special interests. Whether this is a real danger or not, will depend on the degree of coincidence between the potentially affected interests and of social acceptance of common definitions of the public interest, as well as on the extent to which administrative performance is measurable against transparent public standards.

Discretionary decision-making powers always entail the danger that certain individual cases will be treated in an unjust and oppressive manner. This is another important reason for caution when the delegation of discretion is concerned. This necessitates the protection of the subject by means of ex ante legal fetters on the decision-makers' discretion and of appropriate mechanisms for the review and redress of offending decisions.

For these reasons, the legitimacy of administrative action should be evaluated primarily in terms of the specificity and clarity of the legislative mandate under which the relevant functions are entrusted to an agency, the openness and transparency of the agency's decision-making process and the effectiveness of the mechanisms of political, legal and managerial control and accountability. In particular, formal legal constraints are desirable to ensure that the delegators, i.e. the public as represented by the legislature, remain in the position to exert effective substantive control over the delegated functions. In the words of F. Schauer:

"A decision-maker instructed to make decisions according to a set of rules is thereby instructed not to consider certain facts, certain reasons, and certain arguments. We now understand that such instructions to ignore the otherwise relevant are usefully seen as withdrawals of decisional jurisdiction, with any of a number of arguments supporting that withdrawal. All those arguments, however, are premised on a reluctance to have some class of decision-makers
take on some category of decisions. [...] And although fear of error in the
exercise of that jurisdiction is one frequently valid reason for denial of
jurisdiction, it is by no means the only one. In political decision-making, for
example, questions of role allocation are often determined by issues of
legitimacy.6

In a regulatory context, the legal formalisation of substantive standards and the
setting of constraints to the effective autonomy of regulators may serve to limit the
danger that disproportionate influence on regulatory decisions may be exerted by
special interests or unrepresentative value-judgements and concepts of the public
interest. Even with regard to the treatment of individual cases, formalisation
provides objective and transparent criteria for the evaluation of the manner in which
specific regulatory problems are resolved. This makes the review of unfair or
discriminatory decisions feasible, contributing to the elimination of potential
arbitrariness.

Discretionary assessment of the adequacy of management procedures and
financial resources of banking institutions is claimed to be an indispensable aspect of
prudential supervision by the Bank of England. Two reasons are usually cited: firstly,
assessing banks' safety on the basis general rules would not do justice to the
individual characteristics of each institution, as risks often depend on intangible and
unquantifiable factors; secondly, a rule-bound system's lack of flexibility would make
it possible for regulated institutions to comply with the letter of the rules only, while
attempting to avoid their spirit by bringing their business outside the regulatory net
by means of innovative rearrangements of their formal legal characteristics.
Discretion is also claimed to be necessary concerning the Bank's responses to
identified problem-cases, as a means of ensuring that the regulatory interventions are
tailored to the concrete situation.

The ideal of the current regulatory system is the authorities' "vicarious
participation" in banks' management of risk.7 The essential characteristics of this
ideal have been described by E.P.M. Gardener as follows:

6 Playing by the Rules: A Philosophical Examination of Rule-Based Decision-Making in Law and
in Life (1991), pp.158-159. For an early defence of rule-bound decision-making, as a means of
achieving, not only certain instrumental values, such as public reliance, certainty and operational
efficiency, but also political control over the administrators, see H.J. Friendly, The Federal
Administrative Agencies: The Need for Better Definition of Standards (1962), especially pp.19-
25.

7 This aspect of the Bank's regulatory approach was first stressed by J. Revell, Solvency and
Regulation of Banks: Theoretical and Practical Implications (1975). See also G. Blunden, "The
supervision of the U.K. banking system" (1975) 15 B.E.Q.B. 188, where the regulatory approach
was described as: flexible, without rigid patterns; personal, with each institution being assessed
on the basis of its distinctive individual characteristics; and participative, taking into
consideration the opinions of other market participants.
"The basic idea of vicarious participation is that the prudential authorities do not lay down any inflexible mandatory prescriptions applied unequivocally to all banks. [...] Instead they should supervise and monitor that all banks are managed in a prudent fashion, undertake certain prudential tests and generally employ a suitable risk management methodology within their overall financial planning and control. [...] Of course, this suggestion presumes that the monetary authorities are also competent and responsible. In short, the real safeguards to the system lie in the abilities and professionalism of both the monetary authorities and bank managements. [...] The authorities should also have some form of control over the entry of new banks into the system; this implies some form of licensing or chartering of banks. [...] The prudential system outlined attempts to reconcile the need for flexibility with the desirability of some type of prudential regulation. [...] The authorities should be provided with several clearly defined powers of redress against recalcitrant or imprudent managements. [...] Needless to say, it is envisaged that such powers would be applied competently, consistently and with great forethought by the authorities. Also, the authorities should be given the flexibility, or discretion, to tailor their actions to meet the particular situation."

Gardener notes that this approach does not obviate the need for "government by law". However, once it is accepted that the Bank can be legitimately entrusted with the "managerial" responsibility for assessing the situation of individual banking institutions on an *ad hoc* basis, the legal fetters on the performance of this responsibility will necessarily be very limited, since deference to the Bank's professional judgement has been ensured in advance, while the development of transparent and independent general criteria, against which the substantive merits of its individual determinations might be measured, has been excluded.

A critical question is whether discretionary prudential regulation ensures benefits unattainable under a more rule-bound system of risk control. It is significant that, in practice, administrative decision-making invariably tends to crystallise in rule-like patterns, which are applied with limited regard for idiosyncratic factors. This process takes place despite the claims made by discretionary decision-makers that they approach each case on its individual merits. Accordingly, the real importance of legal discretion in regulatory processes may not lie as much in the provision of opportunities for individualised decision-making, as in its operation as a lever which increases the effective autonomy and policy-making influence of regulators.⁹

---

⁹ This affects not only the position of regulators relative to the central mechanisms of the state, but also their relationship with the regulated population: as long as regulators retain a power of reconsidering their stance in matters affecting their regulatees' right to conduct business, competitiveness or profitability, the latter will be ready to conform to the regulators' preferences, in order to ensure more sympathetic treatment. This increases the prestige and ease of action of regulators, the respect for their policy priorities, *etc.* Conversely, under a system of formal rules,
In the present context, it is indisputable that over the years banking regulation has gradually evolved in the direction of increasing legal structuring and formalisation. The role of Community law has been very important, with each new addition in the fast-growing body of E.C. banking legislation expanding the number of formal regulatory rules which must be implemented as such by the U.K. But equally significant have been the purely domestic developments, which have frequently anticipated those at Community level. The rapid growth of English administrative law has indirectly affected this area also, especially insofar as procedural safeguards and the reviewability of regulatory decisions are concerned. From a substantive point of view, regulation has become increasingly structured, partly as a result of statutory developments, but mainly of the elaboration and promulgation by the Bank in quasi-formal guidance notices of detailed prudential policies, especially regarding financial requirements for banking institutions.

Overall, the emergence of an increasingly detailed corpus of regulatory requirements suggests that the job of prudential regulation may be done equally well by use of rules. Nonetheless, the Bank still retains very wide discretion in a number of key areas of prudential policy. The strategic character of these clusters of retained discretion enables the Bank to exercise a substantial degree of control over the conduct of deposit-taking institutions without being particularly concerned that its decisions may be overturned as a result of appeal or review proceedings. The absence of specific substantive legal criteria upon which the courts, or the special Banking Appeal Tribunal of the Banking Act, could rely for assessing, and ultimately overturning, the Bank's regulatory actions sets limits on the prospects of success of potential complainants. This reduces the practical effectiveness of the existing mechanisms of review. Similarly, the lack of transparency in connection with the Bank's specific decisions hinders public control over the operation of regulatory policy.

The purpose of the present work is to critically examine the development and current state of the law, in order to identify the scope of the Bank's decision-making power, the legal fetters on its discretion, and the adequacy of the existing mechanisms of review and accountability.

Chapter 1 examines the historical development of U.K. banking regulation from 1944 to the present. The discussion identifies the fundamental differences between, on the one hand, the restrictive, largely informal, banking policies of the early post-War years, intimately linked to the conduct of macroeconomic policy and causing the regulatees can choose independently their strategies, with no regard for the regulators' subjective preferences.
very considerable market distortions, and, on the other hand, the system of prudential regulation put in place in the mid-1970s and given statutory expression in the Banking Acts 1979 and 1987. The development of the latter in more recent years is also outlined, stressing in particular the increasingly important role played by the efforts of the Group of Ten ("G-10") countries and the European Community to achieve convergence of national standards of prudential regulation.

Chapters 2 and 3 examine the statutory framework and practical operation of the current system of prudential regulation. Chapter 2 focuses on the formal authorisation of deposit-taking institutions under the Banking Act 1987 and the processes of banking supervision. Following the analysis of the statutory prohibition on unauthorised deposit-taking and related provisions, it discusses the authorisation process, the statutory criteria for the grant and revocation or restriction of authorisation and the rights of appeal provided under the Act to regulated institutions and their controllers, directors or managers against formal decisions of the Bank. The possibility of judicial review of the Bank's actions in relation to the performance of its statutory functions is also explored.

In the final section of Chapter 2, the Bank's statutory powers regarding the collection of information and the conduct of investigations as part of the continuous supervision of authorised deposit-taking institutions are analysed. The collection of comprehensive supervisory information is contrasted with the absence of policies aimed at increasing market transparency and at achieving financial discipline by requiring the public dissemination of accurate information regarding the financial situation of banking institutions. The Bank's relationship with bank auditors (who are used for supervisory purposes as surrogate bank examiners) is also critically examined.

Chapter 3 turns to the Bank's substantive prudential practices. It is observed that significant steps towards the formalisation of the regulatory régime have been made in practice by means of the promulgation in a series of regulatory statements and notices of general policies which guide the Bank's decisions in individual cases. Although policies pronounced in this manner do not have the legal effect of formally sanctioned secondary rules, they do play a very important role in regularising regulatory practice, and the courts show willingness to recognise their legal significance in appropriate cases.

On the other hand, closer examination reveals that the Bank's current policies leave certain key issues open for determination at the point of their application. To be dispositive (whether fully or only \textit{prima facie}) of an agency's caseload, even an unsanctioned administrative rule needs to have a sufficiently precise and objectively discoverable content. However, the Bank's regulatory pronouncements fleshing out the statutory authorisation requirements do not present this characteristic. While
these pronouncements set out precise frameworks for the calculation of the financial position (solvency, liquidity and large exposures) of deposit-taking institutions, they do not prescribe common mandatory financial ratios, but leave to the Bank the responsibility for determining what is an adequate level of financial resources for each individual institution, subject to certain uniform minimum financial ratios of Community-wide applicability. The fitness of bank owners, directors and managers is determined by the Bank on the basis of ad hoc evaluation, as opposed to the application of specific rules. The principles guiding the Bank's interventions in problem institutions, which are unable to meet their financial obligations or otherwise in breach of the authorisation requirements, are even less transparent. In such cases, the Bank has a wide discretion to decide what is the appropriate response. Depending on the case, the Bank may decide to encourage the implementation of programmes of remedial action, and even to provide last-resort lending; but it may also seek to terminate the activities of such institutions by withdrawing or restricting their authorisation or commencing insolvency proceedings. In all these respects, the regulatory system can hardly be said to have reached a sufficient degree of formalisation.

Chapter 4 examines the Bank's regulatory role in matters which are not covered by the Banking Act. The securities activities of financial intermediaries are regulated separately, under the Financial Services Act 1986. This enactment recognises the jurisdiction of the Bank regarding the regulation of wholesale money market activities. The Bank also operates special regulatory arrangements for those institutions (discount houses and gilt-edged market makers) with which it maintains direct dealing relationships in the context of its open-market operations. These arrangements are not explicitly supported by special legal provisions, and the Bank relies for their enforcement at least as much on tradition and on its dominant market position as on the availability of formal administrative sanctions. Generally, the Bank can rely on its private contractual capacity to influence market practices or to confer benefits (including financial support for ailing institutions) on a selective, and potentially discriminatory, basis. The legal position regarding the Bank's de facto regulatory activities is not entirely clear. There are unresolved questions of competition law, especially under Community law. The role of judicial review in this context is also uncertain, because the Bank's decisions may be lacking the public element necessary for bringing them under the High Court's supervisory jurisdiction. At any rate, the lack of clear substantive standards for these decisions gives cause for concern.

Chapters 2 to 4 indicate that challenging the regulatory decisions of the Bank of England in public law may be particularly difficult even for persons with genuine grievances. This raises the question whether compensatory remedies could provide
an appropriate and effective form of redress in this area. Chapter 5 explores the possibility of holding the Bank liable for damages attributable to its failure to perform successfully its regulatory functions. Two main types of potential claims can be identified: on the one hand, those by regulated persons alleging that their financial position, reputation or ability to engage in professional activities in the financial sector have been negatively affected by acts or omissions of the Bank relating to them; and on the other, those by depositors or other creditors of insolvent banks alleging that their losses would have been prevented if the Bank had exercised timely and effectively its supervisory responsibilities or powers of intervention. It will be shown that, both in common law and under the Banking Act, the possibility of recovery on these grounds is restricted. Currently, the Bank's civil liability for its regulatory actions or omissions seems to be confined to cases of intentional wrongdoing. A more liberal régime of civil liability for regulatory failures would appear to apply for breaches of Community law, but it is too early to make strong predictions in this connection.

Prescriptively, it is doubtful, whether a widening of the Bank's civil liability would be warranted. The imposition of liability for erroneous decisions could cause distortions to the Bank's decision-making environment and unnecessarily increase the costs of the regulatory system, without resolving the primary problem, that is, the lack of effective legal constraints and outside controls over the operation of this system. The solutions for this can only be found in public law.

Chapter 6 addresses issues of public accountability and political control over the Bank's regulatory activities. While a relatively high degree of openness and transparency has already been achieved in relation to the Bank's activities as a monetary authority, its accountability for regulatory matters remains limited. Once more, the absence of clear and precise statutory standards is the source of intractable difficulties, because it precludes assessment of the Bank's performance on the basis of objective and authoritative criteria. The Bank is required to divulge information of a general nature regarding the performance of its regulatory functions. However, the detailed operation of the regulatory system remains non-transparent. The existing lines of accountability do not ensure effective political control over the substantive direction of policy, and even less over the manner in which the Bank exercises its powers in individual cases. The prohibition under the Banking Act of disclosures by the Bank of confidential information relating to the affairs of its regulatees entrenches the prevailing practices of regulatory secrecy and makes public scrutiny of the Bank's real performance much more difficult.

The analysis recognises that over the years banking regulation has evolved from a fully discretionary system, relying to a considerable extent on the Bank's de facto power as a leading participant in the banking markets, towards a statutory régime
which operates at arm's length as a normal administrative process and which is increasingly responsive to the requirements of formality and transparency. The conclusion is, however, that the transformation is by no means complete. In a number of areas the Bank retains practically full discretion. Despite the formal availability of opportunities for appeal or judicial review, this sets limits to the ability of persons affected by the Bank's decisions to obtain a remedy, even when these have genuine grievances. Nor has full transparency of the regulatory system been achieved. This hinders public accountability and control over the Bank's regulatory conduct. Accordingly, further formalisation of the regulatory process through the crystallisation of regulatory policies into fully operative legal rules is necessary. Since a consistent and complete framework of rules in the area is unlikely to appear in the form of primary legislation, the encouragement of the Bank's function as an administrative rule-making body and the clear recognition of the legal status of its rules could be particularly important for this purpose.

The use of the term "regulation" in this dissertation to include the system of prudential requirements which is administered by the Bank of England under the Banking Act needs some explanation. Indeed, the Bank of England is always at pains to emphasise that its role is that of a "supervisor", not a "regulator". In the words of Brian Quinn, the Bank's executive director with responsibility for banking supervision,

"Regulation [...] is about rules and about precise formulation and policing of those rules. In respect of financial services it calls for the codification of a corpus of strictly defined and detailed rules relating to particular activities, products and services. [...] Supervision is different, both in content and style: the law sets the framework within which authorised companies may operate, rather than prescribing in detail how the relevant goods and services should be provided. Within that context, the companies providing those goods and services are, broadly speaking, left to make their own business decisions."\(^{10}\)

Thus drawn, the distinction between regulation and supervision serves to underline the flexibility of the Bank's approach and the limited nature of its interference with the business decisions of the management of banking institutions.

It should be noted, however, that the employment of the terms in this manner is neither binding nor so entrenched in the ordinary use of the language as to be the only (or even the most) natural one. A wider notion of the term "regulation" is employed in this thesis, to signify governmental interventions of a coercive character, regardless of their aims, which determine the outcome or control the operation of a private activity, restricting the free operation of markets. In this sense, regulation can consist either in precise legal rules or in administrative requirements supported by

the threat of sanctions, e.g. the withdrawal of an authorisation to conduct the particular activity. In contrast, "supervision" is used to refer to the associated or complimentary process of monitoring the behaviour of private parties, especially for the purpose of monitoring compliance with the regulatory requirements.

Finally, this dissertation is intended to reflect the state of the law as at 15 December 1995.
Chapter 1

The Evolution of U.K. Banking Regulation

The responsibility of the Bank of England for the maintenance of the good order of the U.K. financial system has been recognised since the late 19th century. Nonetheless, it was not until 1979 that the Bank's role as banking regulator was put on a statutory footing. Most commentators are of the opinion that the introduction of a statutory framework of banking regulation was a necessary policy response to profound transformations in the behaviour of the banking industry, and especially to new practices of aggressive risk-taking, which raised serious concerns about the safety and soundness of U.K. banks.

While this interpretation contains elements of truth, it has the defect of obfuscating the subtle interplay between public policy and market developments. Closer examination of the longer-term evolution of U.K. banking policy shows that the financial instability which triggered the transition to statute-based prudential controls was to a large extent the side-effect of prior public policies, corroborating F.A. Hayek's view that "[t]he 'necessities' of policy are generally the consequences of earlier measures".

---

1 A former official of the Bank of England, J.S. Fforde, "Competition, innovation and regulation in British banking" (1983) 23 B.E.Q.B. 363, pp.363-364, has suggested that, historically, most developments in the area of monetary policy and banking supervision, whether statutory or customary, consisted in adaptive reactions to changes in the structure of British banking caused by an underlying dynamic of financial innovation and competition. Fforde recognises that regulatory developments have exerted, in certain cases unwittingly, considerable influence upon the rate and direction of change. On the other hand, he appears to see innovation itself mainly as the result of straightforward improvements in the production of services. In reality, however, innovation often involves little more than techniques for avoiding regulatory distortions and barriers. On financial innovation as a market response to regulatory constraints, see E.J. Kane's remarkable series of articles on financial regulation: "Good intentions and unintended evil: the case against selective credit allocation" (1977) 9 J.M.C.B. 55; "Accelerating inflation, technological innovation, and the decreasing effectiveness of banking regulation" (1981) 36 J.F. 355, p.358; "Policy implications of structural changes in financial markets" (May 1983) 73:2 Am.Econ.R. 96; "Microeconomic and macroeconomic origins of financial innovation", in Federal Reserve Bank of St. Louis, Financial Innovations: Their Impact on Monetary Policy and Financial Markets (1984).

Until the early 1970s, U.K. authorities used the banking industry as a conduit for the implementation of the broader governmental economic policies through a system of credit controls. The subordination of banking policy to macroeconomic objectives impeded the domination of the regulatory process by the banking industry and its transformation into a source of economic "rents". At the same time, however, it caused a significant trend of innovation, whose specific aim was the avoidance of the more burdensome regulatory constraints (section 1).

After 1970, as the conduct of monetary policy shifted towards more neutral instruments, especially open-market operations, the direct controls on banking operations which characterised the previous phase were gradually dismantled. Nonetheless, the initial liberalisation measures, undertaken at a time when the previous policy régime had already caused considerable distortions in the structure of the banking industry, did not proceed smoothly or consistently enough. Instead, they became themselves a source of further distortions which, in combination with U-turns in monetary and fiscal policy, precipitated the collapse in 1973-74 of a large number of smaller banking institutions ("secondary banks"), funded predominantly with wholesale interbank deposits. The Bank of England reacted to the crisis by launching, with the participation of the clearing banks, a very costly "lifeboat" for these institutions.

These events triggered a radical overhaul of banking regulation, with an emphasis on prudential issues, culminating in the enactment of the Banking Act 1979. That statute subjected for the first time the business of banking to explicit licensing requirements, vesting on the Bank of England formal responsibility for the grant and withdrawal of deposit-taking authorisations. The new legislation expanded and legitimised the regulatory discretion of the Bank of England. At the same time, it erected a new barrier to entry in banking, preventing competition at the industry's fringe and reducing the contestability of the banking market, to the benefit of established institutions. Subsequent legislative and administrative reactions to perceived regulatory "crises" have tended to reinforce the Bank's regulatory powers in this area (section 2).

The development of regulatory policy over the past twenty years has been strongly influenced by multilateral efforts for the convergence of prudential standards. This provides a solution to a major policy dilemma faced by the national authorities, which, on the one hand, must set limits to banks' risk-taking in order to

---

3 "The burden of bank regulation increases the rewards for doing things differently per se [...] In an unregulated firm, an innovation can only be justified by its technical productivity [...] However, in a regulated firm, an innovation can be justified as well, or even instead, by its productivity in regulatory avoidance: its ability to release pent-up competitive pressure"; Kane, "Accelerating inflation...", loc.cit., n.1, p.358 (emphasis in the original).
counteract the perverse incentives created by their interventionist policies, but, on the other hand, cannot impose unilaterally regulatory burdens without harming the international competitiveness of their banking sector. The cause of convergence is promoted primarily in the Basle Committee on Banking Supervision, which brings together the banking regulators of the Group of Ten ("G-10") countries, and in the institutions of the E.C. In both fora, the U.K., whose large and internationally-oriented banking industry makes it particularly sensitive to competitive considerations, exercises a dominant influence (section 3).

1. Banking and monetary policy in the years 1944-70

In many industrialised countries the traumas of the international economic crisis of the 1930s created a climate of opinion favourable to comprehensive statutory controls on banking. The crisis also had a marked effect on U.K. economic policy, triggering a fundamental reassessment of its basic assumptions and leaving a legacy of pervasive interventionism and distrust of free markets. Nonetheless, as the crisis in this country did not involve banking failures, the new policies were not specifically concerned with the reform of the banking sector.

After the crisis, the paramount aim of economic policy was the achievement of growth at a rate that could sustain continuous full employment. This aim was pursued through a strategy of "demand management", involving the manipulation by various means, including in particular public spending, of the demand for investment and consumption, both in the economy as a whole and on a sectoral basis. A result of this strategy was the steady rise in public expenditure, as well as in the Public Sector Borrowing Requirement ("P.S.B.R."). Monetary and credit policy was also subordinated to the requirements of demand management, with nominal interest rates being kept at generally low levels, while the authorities tried to regulate the volume and direction of bank lending to the private sector by means of direct control ("liquidity management"). Price stability was only a secondary policy aim. It was pursued mainly through imposed restraints on prices and incomes. Monetary measures were not considered appropriate for this purpose, because the relationship between inflation and the money supply was not fully appreciated.

---


5 The servicing of the National Debt at favourable terms, with interest payments as low as possible, was a primary policy consideration. This led to extensive distortions in the monetary environment and to the substitution of credit rationing for the allocation of lending through the price mechanism. See M. Collins, Money and Banking in the U.K.: A History (1988), pp.462-465; and infra, subsection (c).
In the post-War years, the fixed exchange rates of the Bretton Woods Agreements constituted the major constraint on policy. From 1949 to 1967, the pound sterling remained fixed at U.S.$ 2.80. When a strong growth in demand was reflected in adverse movements in the balance of payments, putting pressure on the exchange rate, the growth objectives were reappraised and more restrictive policies adopted ("stop-go" policy). Further, the fixed-rate system was underpinned by strict exchange controls.

This economic strategy was pursued within a neo-corporatist institutional setting, favouring consensus-building and the open participation of the representatives of the organised interests of industry and labour in the public decision-making process, which took the form of extensive negotiations and bargaining. In most cases, the co-option of the main interest-groups made coercion unnecessary, thus avoiding the need for formal legal adoption of the relevant decisions.

The culture of informal negotiation was at least as evident in the financial sector as elsewhere. In this case, however, the involvement of the central government was less pronounced, trade unions were not represented in the decision-making process and the centre of power was occupied by the Bank of England. Banking policy was based on the traditional fragmentation of the City of London, where different groups of specialised institutions, in imperfect competition with each other, exploited particular niches in the financial markets. The top of the pyramid was occupied by the members of three highly exclusive clubs: the large clearing banks, which dominated retail banking; the discount houses, which intermediated between the Bank of England and the commercial banking sector; and the accepting houses, a group of strong merchant banks which, instead of extending credit outright, specialised in guaranteeing ("accepting") bills of exchange, thus increasing their creditworthiness and making them eligible for rediscount by the Bank of England.

This fragmented market structure actually simplified the work of the monetary authorities, since it allowed them to affect monetary conditions simply by controlling the lending activities of the clearing banks.

(a) Bank of England Act 1946. The nationalisation of the Bank of England took place only in 1946. However, the Bank's institutional role as the central bank of the

6 For a detailed historical account of the operation of neo-corporatism, see K. Middlemas, Power, Competition and the State (1985-91, 3 Vols.).
U.K. had been established much earlier. From the start of its operations as a private institution in 1694,\(^\text{10}\) the Bank was the government's privileged banker. A hundred and fifty years later it also secured an effective legal note-issuing monopoly.\(^\text{11}\) In the second half of the nineteenth century, it became increasingly evident that this monetary monopoly, which entailed the concentration of the nation's gold reserves in the Bank's vaults, carried with it new responsibilities of a public character. Thus, the Bank, whose obligations were in theory confined to managing the National Debt and ensuring the convertibility of its notes into gold under the Gold Standard, was now expected \textit{de facto} to act as the lender of last resort, by providing additional liquidity to the rest of the banking system in times of financial stringency, in order to ensure the orderly and smooth working of the money markets and avert financial crises.\(^\text{12}\) In this manner, the Bank assumed gradually the functions of a modern central bank.\(^\text{13}\)

Initially, this transformation did not put in question its institutional and operational independence, because strict adherence to the principle of convertibility isolated the supply of money from political interventions and prevented the subordination of its monetary responsibilities to other governmental aims.\(^\text{14}\) The outbreak of World War I, however, marked the beginning of the government's active participation in monetary affairs. The incorporation of monetary policy in the armoury of general economic policy was completed with the eventual suspension of gold convertibility and the rise of demand management. In the 1930s, the government's interventionism increased in pace with its rapidly mounting needs for finance. Although the Bank remained legally in private hands, its functional

\(^{10}\) Under the Bank of England Act 1694.

\(^{11}\) Bank Charter Act 1844. On the current legal basis of its monopoly of issue, see Currency and Bank Notes Acts 1928 and 1954 (as amended) and Currency Act 1983. The Bank Charter Act 1844 is a striking example of anti-competitive regulatory politics. All its main provisions were adopted on the suggestion of the Bank itself, \textit{i.e.} the prospective regulatee. The effect of the Act was to ensure the Bank's monopoly and to preempt political criticisms that it abused its dominant position by subjecting its note-issuing business to non-discretionary statutory rules. Opposition was deflected by "grandfathering" existing competitors into the new régime and insulating them from further competition by barring entry and freezing existing market positions. See L.H. White, \textit{Free Banking in Britain: Theory, Experience, and Debate, 1800-1845} (1984), pp.76-80.

\(^{12}\) W. Bagehot's great work, \textit{Lombard Street: A Description of the Money Market} (1873), was written exactly for the purpose of establishing this responsibility.

\(^{13}\) On the evolution of the Bank as a monetary authority from the 19th century to 1939, see Collins, \textit{op.cit.}, n.5, ch.6 and 9.

\(^{14}\) The degree of autonomy of the central bank is a function of the prevailing conception of the role of monetary policy. The central bank can be expected to be more independent when monetary policy is aimed exclusively at protecting the value of the currency, than when it is used as one of the instruments of general economic management. See F. Vicarelli, "Central bank autonomy: a historical perspective", in G. Toniolo (ed.), \textit{Central Banks' Independence in Historical Perspective} (1988); and G.E. Wood, T.C. Mills, and F.H. Capie, \textit{Central Bank Independence: What Is It and What Will It Do For Us?} (1993).
autonomy, as expressed in its capacity for independent monetary action, disappeared.

At the dawn of the post-War era, it was already beyond doubt that, as a matter of constitutional competency, the primary responsibility in monetary matters belonged to the Treasury and the Chancellor of the Exchequer (and, beyond them, to the Prime Minister and the Cabinet). From a formal legal point of view, however, the situation was anomalous. The Bank continued to be a privately-owned institution and, even though several of its specific functions, including its note-issuing activities, foreign-exchange operations, management of the National Debt and activities as banker to the government, were regulated under statute, its broader status as a monetary authority lacked formal recognition.

The general elections of 1945, which brought a new Labour government to power, marked the end of this situation. In its election manifesto, the Labour party had expressly promised the nationalisation of the Bank, as well as the regulation of commercial banking with a view to meeting the needs of the nation's industrial sector for investment financing. The manifesto pledge was made to accommodate the widespread animosity towards the Bank and the City within the party's ranks, which often found expression in calls for the nationalisation of the whole banking system. Nonetheless, the short bill presented by the government in pursuance of the manifesto pledge displayed little of these radical origins. In fact, an important contribution to the bill's drafting had been made by the Bank itself, which made no attempt to resist its nationalisation, but merely sought to ensure that the transition to public ownership would not threaten its operational autonomy.

The bill, which soon entered the statute book as the Bank of England Act 1946, contained provisions for the acquisition of the Bank's stock by the Treasury, for the adequate compensation of its erstwhile proprietors, for the future constitution of its Court of Directors and for the appointment of its members by the Prime Minister and for the power of the Treasury to give directions to the Bank in the public interest, after consultation with the Governor of the Bank. Virtually the only controversial clause was that vesting on the Bank the legal power to issue directions to the commercial banks. The first draft of this provision referred specifically to the

---


Bank's power to regulate the composition of commercial-bank assets. Under the pressure of the Bank, which objected to the formalisation of its functions, this reference was quickly dropped. Despite being redrafted in less specific terms, however, the clause continued to face opposition from the banking world and the press. To deflect any remaining fears that it might lead to the subjection of banking to direct government control, the government consented to its further amendment during the bill's passage through Parliament.

In its enacted form as Section 4(3) of the Bank of England Act, the provision entitles the Bank to request information from, and make recommendations to, "bankers", if this appears to it to be necessary in public interest. The Bank can also issue directions to secure implementation of such requests and recommendations, although such directions can be given only with the Treasury's authorisation and after an opportunity has been given to the banker concerned to make representations. A further safeguard is provided by the condition that "no such request or recommendation shall be made with respect to the affairs of any particular customer or banker". The provision is notable for its lack of precision and reliance on the criterion of "public interest". This makes possible its potential use for a variety of ends, even though the original legislative intent related to the control of lending. Significantly, the initiative for the exercise of the power lies with the Bank, which must form its own view on the requirements of the public interest. Any attempt by the Treasury to impose indirectly its own views would be ultra vires.

Whether this allocation of responsibility between the Treasury and the Bank was a confirmation of the Bank's historical predominance in the affairs of the City or merely a signal aimed at alleviating fears that behind the bill lurked the covert nationalisation of banking, is a moot point. What is certain, is that it entrenched the Bank's authority as effective regulator of the commercial banking sector. In terms of its direct utilisation, however, the Bank's formal power of direction was practically superfluous. The provision of Section 4(3) was never made fully operative and the power of direction was never actually exercised. The legislative intention had always been that the power should be used only as a reserve legal

---

19 It has been contended that the making of "recommendations" and "directions" in the section is ancillary to the power of the Bank to "request information", and is thus limited to statistical and other returns; E.C. Woods, "A banking myth" (1969) 119 N.L.J. 207. However, neither the wording of the enactment nor its legislative history provide support for this view.
21 By virtue of s.4(6), which stipulates that "banker" is limited to "any such person carrying on a banking undertaking as may be declared by order of the Treasury to be a banker for the purposes of this section", the provision's legal effect was made contingent on the making of secondary legislation. However, the order of s.4(6) was never made, condemning s.4(3) to a purely nominal existence.
weapon, to underpin the Bank's informal authority in the money markets. Its day-to-day use was not envisaged. The essential significance of the provision consisted in providing to the banking industry a signal that the authorities, while being happy with the prevailing informal practices, would be ready to resort to formal regulation if their wishes were ignored. Without eliminating the room for negotiation, this oblique threat made the banking industry more attentive to the government's point of view.

Clearly, the Bank of England Act did not fulfil the demands of the Labour party's left wing for the effective public control of banking. Whether it was simply an "electoral gambit", whose usefulness in appeasing the Labour electorate was exhausted at the moment it was enacted,22 or a purely symbolic move which "celebrated victories already won",23 is more doubtful. The exercise of closer control over bank lending and investment was indeed within the government's intentions. The Bank's power of direction, which was enacted in diluted form, was originally conceived with this purpose in mind.24 The government's willingness to regulate the direction of credit is demonstrated by the subsequent enactment of the Borrowing (Control and Guarantees) Act 1946.25 That Act complemented the Bank's control over bank credit by giving the Treasury the right to issue regulations regulating non-bank financing, including both borrowing from non-banks and securities financing. The Bank was spared the inconvenience of having to operate the direct controls on the allocation of credit under the new Act. The task was given, instead, to the Capital Issues Committee, a neo-corporatist body composed of bankers, brokers and industrialists and characterised by lack of enthusiasm in the exercise of its powers.

It cannot be disputed that, overall, the credit-control apparatus legislated by the Labour government proved to be particularly ineffectual. However, the reasons should be sought more in the actual practices of English neo-corporatism, with its preference for negotiated settlement over direct command-and-control intervention by the central state, than in the cynical enactment of an inherently and deliberately inadequate regulatory framework.

24 The power of the Treasury under s.4(1) to give directions to the Bank could be interpreted in similar terms as being intended to provide an additional legal guarantee that the Bank, as the spokesman of British capitalism, would not obstruct the policies of the socialist government. See A. Cairncross, "The Bank of England: relationships with the Government, the civil service, and Parliament", in Toniolo (ed.), op.cit., n.14, p.48.
25 Finally repealed by the Government Trading Act 1990, s.4 and Sch.2, pt.1.
(b) Prudential standards and statute law. Historically, the absence of legal controls of a prudential nature has been a notable characteristic of British banking. Over the second half of the nineteenth century, the Bank developed the technical skills that allowed it to act as lender of last resort to the City in times of crisis, without necessarily providing a safety-net for its individual competitors. Since the Bank's interventions appeared to be fully sufficient to combat any emergency and ensure stability, there was no particular demand for additional prudential regulation. In any event, the Bank's private ownership disqualified it from the assumption of formal regulatory functions over its competitors. To control the banking system, the Bank had to rely solely on its market power.

As the other banking institutions could not assume that they would be rescued on an individual basis in case of insolvency, they developed, and observed voluntarily, prudent business practices. More precisely, banks maintained cash reserves, usually at more than 10% of their total liabilities, as well a high proportion (around 30%) of liquid assets; they were careful to ensure a balanced distribution of their other assets between safe investments in government securities and risky loans or advances to commercial undertakings; they extended only short-term lending (normally of up to six months), preferably on self-liquidating assets, such as bills of exchange; they did not engage in real-estate business, security financing or position-taking in foreign currencies; and established internal controls, especially branch examinations. Despite the absence of any legal restriction, the banking sector's standard commercial practices assured in practice the strict separation of banking from commercial and security business. In short, British bankers conformed to the traditional prudential conventions, which required the segregation of activities and the concentration of banks on diversified short-term financing. The institutional structure of the securities markets reinforced this form of behaviour. In particular, until 1986 the Stock Exchange was organised as a cartel of its member

---

26 An early effort, in the Joint Stock Bank Act 1844, to regulate joint-stock banking, purportedly for prudential purposes, but more likely to protect the Bank of England, which had just ensured its monopoly of issue, was so evidently anti-competitive that it had to be repealed in 1857.

27 See Bagehot, *op. cit.*, n.12.


29 Until the early 1980s, the banking industry stayed out of the mortgage market, which was left to the building societies, a group of specialist credit institutions organised in mutual form. In later years this was probably a reflection of the anticipated disapproval of the authorities, rather than of the conservatism of commercial banks.


32 In the early post-War period the Bank obstructed certain attempts by the banks to diversify. But this policy was reversed in 1958, when the Bank accepted the clearing banks' entry into hire-purchase business. See Select Committee on Nationalised Industries, *loc.cit.*, n.8, para.79.
partnerships. The outside ownership of member firms was forbidden. This excluded banks from trading in listed securities.\(^{33}\)

The increasingly public character of the Bank’s functions as a monetary authority after World War I did not affect directly the nature of its relationship with other institutions insofar as prudential issues were concerned. Thus, in 1969 the Bank acknowledged two responsibilities in relation to "financial and other institutions":

"(i) The maintenance of the good order of the financial system and, in particular of the banking system.
(ii) The implementation of monetary policy by means other than intervention in the various financial markets."\(^{34}\)

More specifically, the Bank claimed that its primary concern under the first heading was "the financial soundness of British and foreign banks operating in the United Kingdom and the proper conduct of their activities."\(^{35}\) This, however, should not be taken to imply that the exercise of specific supervisory responsibilities. While the Bank monitored closely all market developments and was ready to intervene for the purpose of preventing disorder in the banking markets, it did not undertake the prudential supervision of individual institutions.

Until 1979, there was no explicit legal impediment to the starting up of a banking business. Only the Money-lenders Acts 1900 and 1927\(^{36}\) imposed a formal restriction on the operation of small credit institutions, by requiring the registration of money-lenders and threatening unregistered persons with criminal sanctions and the unenforceability of loans made by them; although "bankers" were exempted from

---

\(^{33}\) Today, the relative merits and drawbacks of the growing integration of banking and security markets are the subject of much discussion. Diversification resulting from fusion of the two types of activities can probably be a source of strength for most banks, but can also increase the vulnerability of risk-prone ones by providing additional opportunities for aggressive position-taking; see R. Dale, "Banking and securities business: the separation issue", in J.J. Norton (ed.), *Bank Regulation and Supervision in the 1990s* (1991); and R. Dale, *International Banking Deregulation: The Great Banking Experiment* (1992), particularly chs.2-3 and 10-11. In the latter work, after a detailed examination of moves towards the removal of regulatory barriers in a number of countries, including Britain, Dale, at p.181, reaches the conclusion that "there is a problem here without a solution. Policymakers may give precedence to the safety and soundness of the financial system by separating the banking industry from securities markets - with whatever loss of efficiency and competitiveness that such a division may entail. Alternatively, they can give priority to efficiency and the exploitation of economies of scope by allowing banks to engage freely in securities activities - while accepting a much greater potential for contagious financial disorders and a correspondingly larger role for the lender of last resort."

\(^{34}\) Select Committee on Nationalised Industries, *loc.cit.*, n.8, App.6 to the Minutes of Evidence, para.2.

\(^{35}\) Ibid.

\(^{36}\) Repealed by the Consumer Credit Act 1974, which requires the licensing of persons who provide credit up to a certain limit (currently £15,000) to individuals and regulates advertising methods, disclosure of information, contractual terms and rights of the parties in relation to consumer-credit agreements.
the relevant provisions, it was doubtful whether this exemption could cover smaller
institutions with a restricted range of business.\textsuperscript{37}

At the same time, the ability of new entrants to compete was restricted by
several provisions regulating special aspects of banking. In the post-War period, a
growing number of such provisions required the authorities to maintain lists of
institutions recognised as banks for particular purposes. The authorities were given
almost complete discretion with regard to the making of these recognitions. Each
type of recognition conferred on the institutions concerned a privilege or exemption
from legal requirements that was necessary for the conduct of specific banking
activities. Possession of certain recognitions implied a particular degree of
respectability. In this sense, the recognitions constituted a hierarchical "ladder". To
attract any significant amount of business, an institution had to climb at least its
lower rungs, while participation in the highest echelons made possible the
undertaking of the full range of banking functions.\textsuperscript{38}

The top of the ladder was occupied by institutions appointed by the Treasury as
"authorised dealers" or "authorised banks" for the purposes of the Exchange Control
Act 1947\textsuperscript{39} or recognised by the Board of Trade and the Bank as "bankers" for the
purposes of Schedule 8 of the Companies Act 1948. Before the abolition of
exchange controls in 1979,\textsuperscript{40} only authorised banks could deal in foreign exchange,
keep accounts in foreign currency for non-residents and carry out certain exchange-
control functions delegated to them by the Bank of England, while only so-called
"Schedule 8" banks were allowed to conceal their true profits in their published
accounts and maintain hidden reserves. Usually both of these first-tier recognitions
were obtained by the same institutions, especially clearing banks, British overseas
banks or merchant banks. Only those institutions which possessed at least one of
them were included in the Bank's list of "statistical banks" and were, accordingly,
required to submit statistical returns.

From the Bank's standpoint, only the statistical banks belonged to the banking
sector proper and were within its self-proclaimed jurisdiction. However, because of
the uncertainty surrounding the precise ambit of the exemption of "bankers" from
the provisions of the Money-lenders Acts, a third significant recognition came into
existence under Section 123 of the Companies Act 1967: in the period 1967-73, the

\textsuperscript{37} See infra, ch.2, section 1(a).
\textsuperscript{38} On the pre-1979 legal framework, see Inter-Bank Research Organisation, \textit{Prudential Regulation of Banks in the European Economic Community, No. 9: United Kingdom} (1975); and I. Morison, P. Tillett and J. Welch, \textit{Banking Act 1979} (1979), pp.4-20. The system of recognitions was
terminated by the Banking Act 1979, Schs.6 and 7.
\textsuperscript{39} Ss.36 and 41.
\textsuperscript{40} The Exchange Control Act was formally repealed by the Finance Act 1987, s.72(7) and Sch.16, pt.XI.
Board of Trade, acting in consultation with Bank, provided certification as a "banking or discount company" solely for the purposes of this exemption to at least 133 finance companies and fringe deposit-taking institutions lacking another banking recognition. These "Section 123 banks", some of which lacked experience or prudence, would play a central role in the banking crisis which erupted in 1973. Their official recognition as "banks" gave them an important psychological advantage and allowed them to participate fully in the emerging interbank market, facilitating the quick growth of a secondary banking system.

The psychological significance of the label "bank" had not escaped official attention. The solution chosen was aimed directly at protecting depositors from misleading advertisements, without setting new entry controls. Thus, the Protection of Depositors Act 1963 imposed a requirement to publish specified accounts on any company advertising for deposits, and also prohibited the use of banking descriptions in such advertisements. Initially, only Schedule 8 banks were exempted from these provisions. Later, other institutions, including in particular reputable foreign banks, became recognised for this purpose by the Board of Trade under Section 127 of the Companies Act 1967. Similarly, only these banks could be permitted by the Board of Trade\(^{41}\) to register a company name containing the words "bank", "banker", etc.\(^{42}\) Nonetheless, the restrictions on banking names and descriptions were not watertight. In particular, they could not stop a Section 123 bank from relying on its recognition to establish its "banking" status.

It is significant that the operation of the system of banking recognitions was formally entrusted to governmental departments - the Board of Trade and the Treasury - and not to the Bank. In practice, these departments normally consulted the Bank. There was nothing, however, to suggest that the Bank was considered to be responsible for every aspect of banking regulation. In fact, the supervisory functions of the Bank were limited.\(^{43}\) Until 1974, the Bank supervised closely only those institutions which played a role in its money-market operations and for which it had essentially assumed financial responsibility, namely the discount houses and the accepting houses. The latter accepted the Bank's supervision as the price for the privileges conferred upon them.\(^{44}\) The rest of the banking system was left largely unsupervised. The Bank would not intervene in the internal affairs of clearing banks.

\(^{41}\) Under the Companies Act 1948, s.17.

\(^{42}\) See Inter-Bank Research Organisation, \emph{op.cit.}, n.38, pp.14-16.

\(^{43}\) See Fforde, \emph{The Bank of England...}, \emph{op.cit.}, n.16, pp.749-760. The author remarks that "a banking disaster involving the use of [...] public funds would have raised all kinds of questions about the absence of supervision [...] But in the early post-war period the contingency of such a disaster was exceedingly remote and there was no need to spend time preparing for one.; p.759.

\(^{44}\) Only the discount houses had direct access to the Bank's discount window and only bills bearing the acceptance of an accepting house were eligible for rediscount by the Bank.
even though it maintained close contacts with them, and would only occasionally look into the activities of other "statistical banks". As for institutions possessing lesser recognitions, these were totally outside its regulatory horizon, even for monetary-policy purposes, and the Bank did not have any contacts with them.\(^{45}\) In contrast, the Bank was closely involved in certain other sections of the City, such as the securities and commodities markets.\(^{46}\) Again, however, the focus was on the orderly operation of the markets, not on prudential supervision of individual firms.

The regulatory control exercised by the Bank in relation to specific banking matters which did not affect monetary policy, such as mergers and take-overs or money-market transactions, were essentially of this character. The Bank's functions could, accordingly, be compared to those of the ruling committee of a securities exchange, which is mainly preoccupied with market organisation and transaction rules. The protection of depositors was not a direct concern of the Bank. Generally, during this period, the notion of investor protection was confined to matters concerning fraud and the provision of misleading information. Otherwise, investors had to take care of their own interests. "A fool and his money are soon parted": the maxim summarised the prevailing attitude.\(^{47}\)

On the other hand, it must be noted that in numerous instances the Bank provided support to failed financial institutions. There were probably about a dozen cases of rescues in the 1960s alone. They took the form of "temporary loans", which the recipients were not always able to repay - although total losses to the Bank were relatively low. The particular circumstances or the beneficiaries of the rescues are not known, but they were apparently aimed at preserving the order of the financial system as a whole, including non-banking markets, such as the commodity markets.\(^{48}\)

When in the late 1970s the Bank moved towards a comprehensive system of prudential controls for banking institutions, in an effort to play down the extent of the change, it insisted on the continuity of its regulatory arrangements, claiming that the new controls involved little more than an expansion and up-dating of a long-


\(^{48}\) Select Committee on Nationalised Industries, loc.cit., n.8, paras.91-94.
existing supervisory net.⁴⁹ In reality, however, until that time prudential supervision, in an exact and systematic sense, was simply not taking place. Instead, the Bank would gather information from the market as a means for the planning of its monetary operations and the exercise of informal influence on financial institutions through personal contacts. The limited scope of this exercise is illustrated by the fact that the Discount Office, which had responsibility for day-to-day contact with the money market, was also responsible for monitoring the City, although it had a staff of only fifteen persons.⁵⁰

(c) The impact of macroeconomic controls. The role of monetary and credit policy in the evolution of post-War U.K. banking was not neutral. In fact, the increasingly complex set of selectively employed controls, through which policy was conducted, caused serious distortions in the structure and operation of the banking industry.

By the turn of the century the Bank had already developed an effective instrument for affecting the price of money, the Bank Rate. Initially, this was merely the Bank's lending rate, which generally followed the prevailing market rates. With time, however, it became the leading price index in the money market. This was achieved through the trivialisation of the Bank's last-resort lending. Effectively, the Bank offered to accommodate on a day-to-day basis at Bank Rate any net shortages of cash faced by the banking system as a whole. In basic terms, since clearing banks did not borrow directly from each other or from the Bank, the accommodation was achieved through the discount market. Any banks with excess cash would place it at call with the discount houses, which would on-lend it to banks short of cash. Whenever there was a market-wide shortage, the discount houses would resort to the Bank, which was always prepared to offer accommodation on its own terms, taking as security bills bearing the acceptance of an accepting house.

The willingness of the Bank to provide day-to-day accommodation meant that the market was able to operate on narrower margins of liquidity than before. In this


Some information on the supervisory practices of the Discount Office was gathered in 1973-74 by J. Revell by means of correspondence and interviews with officials. Apparently, two ratios, one for solvency and one for liquidity, were regarded as significant for banking institutions. "It would seem that the ratios were regarded rather as internal screening devices for alerting the Discount Office to the possibility of overtrading. The real control was exercised in informal conversations with each bank's representatives when it submitted its accounts periodically to the Bank. [...] The signs of strain in this flexible system were already apparent in the 1960s because of the growth in the number of banks and the great increase in the number of people involved in directing the affairs of banks."; J. Revell, Solvency and Regulation of Banks: Theoretical and Practical Implications (1975), p.47.
manner, however, the Bank Rate, which was made more flexible and ceased to apply
to the Bank's other business, was transformed into an important factor in the
clearing banks' daily business decisions regarding their liquidity positions. This
increased sharply its effect upon the structure of market rates. The transmission
mechanism became more reliable with the gradual stabilisation of the cash ratio (*i.e.*
the ratio of coin, notes and balances with the Bank to total deposits) that was kept
by commercial banks for liquidity purposes. The stabilisation of this publicly
observable indicator was attributable to a broader stabilisation of market conditions,
but also to the banking sector's growing reliance on the Bank's liquidity lending,
which removed the incentive for keeping cash reserves above the conventional
minimum level.\footnote{On the origins of the Bank Rate, see R.S. Sayers, *Central Banking after Bagehot* (1957), ch.2.}

The transformation of the once prudential cash ratio into a rigid monetary-
control instrument was completed in 1946, with the administrative imposition of a
fixed ratio of 8\%. This constraint on the composition of the clearing banks' asset-
portfolio structure was aimed at increasing the leverage of the Bank's open-market
operations, whose impact on the demand for cash assets would be automatically
translated in proportional changes in the total monetary circulation.\footnote{This was envisaged by the Macmillan Committee, "Committee on Finance and Industry: Report" (Cmd. 3897, June 1931), para.71. Many years later, it was claimed in the pages of the Bank's *Quarterly Bulletin* that the cash ratio had no operational relevance and that it was justifiable only on prudential grounds; M.D.K.W. Foot, C.A.E. Goodhart and A.C. Hotson, "Monetary base control" (1979) 19 *B.E.Q.B.* 149, p.150. This claim must be received with caution. It is true that no attempt was ever made to restrict the exact quantity of cash available to the clearing banks. This, however, shows only that the ratio did not form part of a strategy seeking to contain monetary expansion through the introduction of absolute limits on the quantity of base money. On the other hand, the ratio did underpin the conduct of monetary policy by providing a fulcrum for the Bank's open-market operations, which were directed at the price, rather than the nominal quantity, of money. This possibility is not mentioned by the authors of the *Bulletin* article. An earlier article, "The management of money day by day" (1963) 3 *B.E.Q.B.* 15, to which they refer, does not contradict the present interpretation of the ratio as being essentially non-
prudential in intent.}

Alternatively, administrative variations in the numerator of the ratio could be used to control overall credit expansion, although reliance on this openly interventionist technique was not envisaged.

Contrary to the intentions of the authorities, the practical impact of the cash ratio
was minimal. The clearing banks were able to manipulate the ratio, because they
could discount Treasury Bills for cash with the Bank virtually on demand. This was
a deliberate policy choice of the authorities, whose main concern was the stability of
the Treasury Bill rate.\footnote{Radcliffe Committee, "Committee on the Working of the Monetary System: Report" (Cmdnd. 827, Aug. 1959), para.376.} In any event, at the time of the introduction of the cash ratio
the Labour government continued to pursue the policy of "cheap money" which

\footnote{33}
from 1932 onwards had kept rates at very low levels, rendering monetary policy almost redundant. The authorities relied instead on direct controls and fiscal measures to contain monetary growth.

Because of the superficiality of the cash ratio, a new devise had to be found in 1951, when the new Conservative government signalled a return to monetary policy. The Bank's solution was to adapt the flexible prudential convention of keeping around one-third of bank assets in highly liquid form into an explicit official requirement for the maintenance of liquidity (i.e. ratio of cash, money at call and short notice with the money market, Treasury bills and discountable commercial bills to total deposits) within a prescribed band of 28-32%. By 1957, a more rigid liquidity ratio of 30% had become the norm. The ratio was reduced to 28% in 1963. The liquidity ratio was probably higher than what would be required by commercial prudence. On the other hand, the Bank wanted to keep liquidity relatively close to the limit, so as to make clearing banks more sensitive to its operations. This shows that the attainment of the broadest possible safety margin was not a purpose of the ratio.

The liquidity ratio proved also to be less reliable than expected. Among the designated components of liquidity were certain liabilities of the private sector (bills), whose supply was beyond official control, as well as public liabilities held by the non-bank private sector, which could be purchased by the banks whenever their ratio came under pressure. The ratio itself was not rigid enough, as the banks were asked to operate normally above the minimum requirement, rather than at it.

The failure of the authorities to exploit in full the opportunities offered by the two ratios through active use of open-market operations was due, not only to the technical flows of the arrangements, but also of their fundamental unwillingness to accept all the implications of reliance on the classic, market-oriented instruments of monetary policy, i.e. the Bank Rate and the conduct of open-market operations in government securities. In particular, the authorities were reluctant to carry to its logical end the observation of the Radcliffe Committee that, in managing the National Debt, "the Bank is not a dictator but a market operator [...] It cannot choose both a rate of interest and the quantity of debt to be held at that rate". Thus, the primacy given to servicing of the National Debt at favourable terms and the authorities' reluctance to cause drastic changes in the prevailing rates -

56 Radcliffe Committee, loc.cit., n.53, para.375; the role of monetary instruments in controlling the liquidity of the economy is analysed in paras.368-380.
57 See supra, n.5.
apparently, for fear of placing disproportionate burdens on the shoulders of the private sector — impeded an effective market-oriented monetary policy. This raises the question whether the liquidity ratio, instead of providing a fulcrum for the Bank’s operations, operated in essence as a means of strengthening demand for Treasury Bills, an important component of liquid assets, so as to minimise the cost of public borrowing.

This necessitated reliance on direct credit controls. Qualitative "directives" on lending had been used frequently in the post-War period. They discriminated between different sectors and regions, by setting priorities that the banks should follow in their lending. Direct quantitative controls, in the form of "requests" to clearing banks to restrict the volume of their advances, were introduced for a short time in the late 1950s, in parallel with strict regulations on hire-purchase agreements which affected the non-bank financial sector.

With the end of the credit squeeze of the late 1950s, the policies of financial planning and controls on borrowing were essentially abandoned. In order to reassert monetary control, the authorities attempted to affect directly banking liquidity by effectively increasing the existing ratios by an additional fixed component. The new scheme was announced in 1958. Two years later, calls of "special deposits" from the clearing banks were first made by the Bank. Interest was paid on these deposits, but, unlike the operational accounts that bankers kept with the Bank, these did not count as liquid assets for the computation of the liquidity ratio. Although even the Governor of the Bank recognised that the measure was unfair to the clearing banks, calls for special deposits were made on several occasions during

59 The argument can, in fact, be generalised. The equally ineffectual cash ratio had a similar funding effect, since it increased the demand for non-interest-bearing balances with the Bank. Later on, the Bank’s calls for "special deposits" had the same indirect effect, since by placing special deposits with the Bank the banks made money available to the authorities at a lower interest rate than that prevailing in the commercial market for advances. Finally, the imposition of quantitative restrictions on lending to the private sector ensured greater demand, and thus lower rates, for public debt, which provided an alternative channel for expanding bank portfolios.

61 Hire-purchase controls were the legacy of wartime emergency powers. They were introduced by reg.55 of the Defence (General) Regulations 1939, issued under the Emergency Powers (Defence) Act 1939, s.1(1). They survived the War and were re-enacted by virtue of Sch.2 of the Emergency Laws (Repeal) Act 1959 and later of s.1 of the Emergency Laws (Re-enactments and Repeals) Act 1964. All remaining controls were brought to an end by the Control of Hiring and Hire-Purchase and Credit Sale Agreements (Revocation) Order 1982, S.I. 1982/1034.
the 1960s. This, however, did not prove enough. As the country entered a period of financial instability, the monetary authorities found it expedient to resort again to direct credit controls. These devices became a constant feature of their policy after 1965.64

Credit-control "requests" were probably the most controversial of that period's practices. From the perspective of the rule of law, the making of requests - also known euphemistically as "moral suasion" - raised serious concerns.65 There was something unsettling about the fact that the Bank communicated to the clearers the various requests of the authorities without even bothering to specify their actual source or legal status.66 Nor was there much comfort in the fact that the so-called "requests" were in reality underpinned by the implicit threat of de facto sanctions, in the form of administrative measures (e.g. withdrawal of an institution's recognition as an authorised dealer for exchange-control purposes) or the withholding of the facilities that the Bank provided as the bankers' bank under its contractual powers.67

Admittedly, this was the era of corporatism's intellectual hegemony, when few persons would approach the question in "legalistic" terms. The general feeling was that the practice was justifiable, or even superior, to the alternative of "inflexible" statutory measures.68 The direct credit controls were resented, if at all, on more mundane, substantive grounds. Compliance with their strict limits to the capacity of banks to expand their lending was particularly difficult. In one occasion in 1969, when it had become clear that soon the scheme would be abandoned, the banks actually disregarded the limit on their advances and were "fined" by the Bank, which halved the interest on their special deposits.69 More importantly, many objections were directed to the discriminatory effect of monetary policy, which, at a time when competition from other banks and non-bank financial institutions was growing fast, imposed a heavy burden on the London clearing banks. In particular, credit controls diverted lending business to unregulated channels. The Bank expanded gradually the

64 See, e.g., "Credit restraint in 1967/68" (1967) 7 B.E.Q.B. 164. See also Select Committee on Nationalised Industries, loc.cit., n.8, paras.69-81.
65 E.C. Woods, "The banks - harmony or control?" (1969) 119 N.L.J. 557 (pt.1) and 585 (pt. 2). See also "Banking regulation in Britain - by 'suasion', not statute" [Nov. 1967] Midland B.Rev. 12, pp.16-19; this article reveals the uneasiness felt by the clearing banks as the authorities became increasingly dependent on requests directed to an ever broadening number of institutions.
66 The notices issued by the Bank referred indiscriminately to "the Government", "the authorities" and "the Bank". In fact, the initiative belonged to the Treasury; see Radcliffe Committee, loc.cit., n.53, para.353.
67 Ibid., para.350; and Select Committee on Nationalised Industries, loc.cit., n.8, para.77.
68 Select Committee on Nationalised Industries, ibid., paras.76; but see App.30.
69 "Credit restriction" (1969) 9 B.E.Q.B. 145. "This was an unprecedented step, having been taken on neither a traditional nor a statutory basis"; Select Committee on Nationalised Industries, loc.cit., n.19, para.67.
net of its direct lending controls, directing its "requests" to a growing range of
institutions, whether "statistical banks" or even non-banks, especially the leading
finance houses. Nonetheless, it was obvious that these policies were causing
increasing distortions and were straining the Bank's traditionally close relationship
with the banking community, particularly the clearers.70 There was an evident need
for the overhaul of the methods of monetary control and proposals for a non-
discriminatory reserve requirement applicable to all banks alike were debated.71 The
demise of the system of direct credit controls was finally signalled by the advent of a
new Conservative government in 1971.

As has been explained, the conduct of monetary and credit policy in this period
relied on selective pressures on the clearing banks. According to M. Collins,
"[f]or the authorities, the clearing banks presented a convenient and
politically-acceptable channel through which to implement policy: only a
small group of very large banks was involved, banks with a tradition of
acting in unison and of co-operating closely with the central bank."72

Obviously, the discriminatory effect of policy implementation had serious side-
effects for the clearers' competitiveness. Why did they accept without protestation
this situation? The exercise of covert coercion, although hardly disputable, can offer
only a partial explanation.

If anything, the major banks, which might be expected to resent the selective
burdens placed upon them, generally expressed satisfaction about the existing
arrangements and their relationship with the Bank.73 One reason could be that they
accepted the demands of the central bank as an unavoidable aspect of modern
banking. Probably more important was the fact that the authorities were always
ready to consult them "both on operational matters and on questions of policy".74 In
view of their politically sensitive position, these non-transparent consultation
processes were very important to the banks, because they gave them an opportunity
to promote their broader interests without engaging in public debate. The paramount
consideration, however, for the major banks was that the authorities supported a
number of restrictive practices in which they engaged and which brought them
significant unearned profits.

On the other hand, in the longer term the official policies eroded the competitive
advantages that these banks enjoyed as a result of their dominant market position

---

71 "Control of bank lending: the Cash Deposits scheme" (1968) 8 B.E.Q.B. 166.
73 See Select Committee on Nationalised Industries, loc.cit., n.8, para.81.
74 Radcliffe Committee, loc.cit., n.53, para.354.
and generated incentives which precipitated the structural transformation of British banking.

(d) 

*Competition, market structure and merger policies.* The highly concentrated structure of British banking and its fragmentation along specialist lines were to a large extent, although not exclusively, the result of market forces. Over the years, however, a number of restrictive practices were built into the system with official approval, ensuring the entrenchment of the position of the established banking institutions and the cartelisation of banking markets.

For the British banking industry, the tendency towards increasing concentration had commenced in the nineteenth century, with the introduction of limited liability.\(^75\) After an initial expansion of the branch networks of the more successful banks, the trend was continued with a spate of amalgamations, which reduced greatly the number of joint stock banks, at a time when private partnerships all but disappeared as a force in banking. By 1918, it was felt that things had probably gone too far in that direction and that the latest mergers might have an anti-competitive purpose. Rather than involving the absorption of smaller local institution by large banks seeking to spread their branch network, amalgamations now took the form of mergers between strong institutions. This made possible the emergence of local monopolies and concerted practices. Although the report of the Colwyn Committee, which investigated the matter, contemplated the introduction of statutory merger controls,\(^76\) this did not happen. Instead, the Bank and the Treasury assumed *de facto* vetting powers with regard to proposed banking mergers. This put an end to the amalgamation movement.

By then, however, the dominant position of the clearing banks was firmly entrenched. New entry was discouraged by the fact that newcomers could not claim the legal privileges conferred on established banks. More importantly, the clearing banks had established a virtual monopoly in the area of money transmission activities, since access to the facilities of the clearing house was confined to the members of the Committee of London Clearing Banks, which owned it.\(^77\) This was a particularly important barrier to entry in the field of retail banking, because of the central role played by chequing accounts in the British payments system.

The entrenchment of the clearing banks allowed them to form a cartel, which set uniform bank rates for all members, both for term deposits (no interest was paid for

---


\(^76\) "Report of the Treasury Committee on Bank Amalgamations" (Cd. 9052, May 1918).

\(^77\) "In current accounts the existence of the jointly-owned and -managed clearing house is a clear barrier to entry"; Griffiths, *op.cit.*, n.59, p.18.
current accounts) and for standard loans and overdrafts, thus guaranteeing a comfortable profit margin. The cartel stayed in place in the post-War period, despite the fact that outside the financial sector restrictive practices and co-ordinated pricing were generally condemned as harmful and contrary to public policy. The monetary authorities, in particular, gave their full approval to the arrangements, because the clearers' dominance ensured stability in the banking system and simplified the implementation of monetary policy.

While, however, the banishment of price competition was conducive to the preservation of established market positions and the protection of profitability, the cartel could not ensure perennial "rents" for the clearing banks. Insofar as profitability was concerned, the cartel could not be exploited to the maximum, for fear of political retaliation. Moreover, the stifling competition in interest rates caused the intensification of competition in terms of service. To attract business from each other, the clearers were obliged to over-expand their branch networks and to offer a variety of incidental services to their clients. To the extent that these costly "improvements" in availability and quality of services did not respond to real changes in demand, but were only imperfect substitutes for more attractive pricing, they amounted to a tax on efficiency, consuming scarce resources which, for the absence of the price cartel, would be more profitably employed elsewhere.

At the same time, the need to follow the request of the authorities in matters of credit policy imposed a heavy burden upon the clearers. During the 1960s, it became increasingly evident that, despite the cartel, the selective credit controls were setting strict limits on their growth and profitability. Even worse, new competitive pressures were building up.

The almost exclusive focus of credit controls on the lending activities of the clearing banks created ample profit opportunities for outside competitors, who were eager to exploit the regulatory asymmetry and undercut the clearers. These competitors were able to fund their activities by offering deposit rates above the rates of the cartel. This fuelled the phenomenon of "disintermediation", i.e. the

---

79 See Griffiths, op.cit., n.59; and D.A. Alhadeff, Competition and Controls in Banking: A Study of the Regulation of Bank Competition in Italy, France, and England (1968), pt.3.
80 "Since the banks' powerful market position (including both their high concentration and their freedom to collude on anticompetitive agreements) is dependent upon government policy, the clearing banks are vulnerable to political retaliation (including nationalization) if the public should believe that the banks were 'abusing' their enormous market power. [...] In this kind of environment, the loan-rate formula is a useful device, for it moderates, (or at least does not exacerbate) the political risk"; Alhadeff, ibid., p.308.
81 See National Board for Prices and Incomes, "Report No.34: Bank Charges" (Cmnd. 3292, May 1967), ch.7.
substitution of the established channels of financial intermediation by "unofficial" ones. Increasingly, the clearing banks were losing new deposits to other banking institutions and building societies. The economic environment of the 1960s, which was characterised by a rise in the level of interest rates and increasing prosperity, was bound to boost the relative importance of interest-bearing deposit accounts, as the public sought to invest an expanding volume of savings in more profitable ways. However, the clearing banks did not modify cartel arrangements with a view to attracting more expensive deposits which, in any case, they could hardly use because of the strict quantitative lending restrictions. Instead, they chose to make the most out of their relatively cheap (non-interest-bearing, but carrying heavy operational costs, especially in the form of branch networks) transaction-oriented current accounts, generating so-called "endowment" profits that were immune to outside competition because of the clearers' privileged access to the clearing mechanism. Other institutions, mostly merchant and foreign banks, seized the opportunity to expand, sometimes by soliciting retail deposits from the public, but mainly by raising funds in the emerging wholesale money markets.

One factor which encouraged experimentation and innovation was the emergence, from around 1957, in London of a vast interbank market in currency funds, most of which were both deposited by, and on-lent to, non-residents. The rise of this market was precipitated by the exchange controls and reserve requirements of the U.S. authorities which, as they applied only to domestic transactions, created a strong incentive for American banks to relocate abroad some of their dollar activities, in particular those involving the financing of their multinational corporate clients. The choice of London as the centre of so-called "euro-dollar" market was based in part on linguistic factors and the City's long financial tradition. However, a consideration of at least equal weight was the absence of regulatory burdens on the cross-border transactions of foreign banks. The authorities were willing to leave the euro-markets virtually unregulated, because most of the underlying transactions were completely unconnected to the U.K., so that the volume of intermediated funds

83 Building societies, in particular, could potentially pose a major threat to the dominance of retail banking by the clearers. However, the legal constraints on such mutual societies, especially the restrictions on the composition of their assets, and their lack of access to the facilities of the clearing house did not allow them to exploit the opportunity.

84 On the reasons that dissuaded clearers from adopting a competitive deposit-rate policy, see Alhadeff, op.cit., n.79, pp.328-332; and Reid, op.cit., n.47, pp.28-29.

85 On the growth of non-clearing banks, see J. Grady and M. Weale, British Banking, 1960-85 (1986), chs.4-7.

had little impact on domestic monetary conditions. In the following decades, international banking in London soared, with cross-border and cross-currency transactions reaching almost three quarters of total lending.

The phenomenon was mirrored by the growth of a wholesale market in sterling interbank deposits and negotiable certificates of deposit outside the traditional discount market ("secondary" or "parallel" market). Transactions in this market were unsecured, short-term and very competitive. The market was funded with deposits of the non-financial private sector, but also with local-authority funds, foreign funds converted into sterling and, ironically, deposits placed by the discount houses, which were themselves funded with money lent to them at call by the clearers as part of the liquidity ratio requirements.

The wholesale market was not confined to the non-clearing banking sector. Many large corporations and local authorities participated actively in the market, with the lines between users and providers of intermediary services becoming often blurred. Even the clearers themselves joined the movement through subsidiaries. More significant, however, was the participation of a heterogeneous array of financial institutions of questionable banking status, especially finance companies. Unable to raise funds in the banking and capital markets because of the credit controls, these institutions, which were later to gain some notoriety under the collective description of "secondary banks" or "fringe banks", tended to rely almost exclusively on wholesale short-term funding to finance their business, which expanded rapidly starting with the temporary relaxation of hire-purchase controls in the period 1958-61. Limited certification as Section 123 banks was particularly useful to these institutions as a means of opening access to the money market.

The growth of the interbank market was not an unmixed blessing, because it signified a clear break with banking tradition, with its emphasis on conservative investments in self-liquidating, short-term assets. The availability of wholesale deposits changed the priorities of lending bankers: while in the past lending was constrained by the normal volume of available deposits, now banks were ready to exploit all attractive lending opportunities without considering their liability position, in the expectation that any potential shortage of funds would be covered for a modest price through the purchase of liabilities in the market for interbank deposits.

---

88 "From 1960 to 1971 [...] the proportion of discount houses' borrowed funds represented by the non-clearing bank sources steadily declined with the growth of rival money markets [...] The discount market found it necessary to participate in the new money markets that developed fast in the 1960s. With the declining importance of Treasury bills, and the possibility of capital losses on government stock, [...] the discount houses needed to find alternative sources of profit and these they found in the newer markets"; Grady and Weale, op.cit., n.85, p.86.
89 See supra, subsection (b).
In this manner, the new techniques of "liability management" resulted in considerable widening of the maturity mismatch between bank assets and liabilities, especially in the form of financing longer-term assets through the rolling-over of short-term liabilities.

In a pioneering description of the new "secondary banking system" which appeared in 1968, Jack Revell indicated a number of potential sources of risk:

"[M]ost secondary bankers aim to increase their profits by having assets somewhat longer than deposits because yields rise with maturity [...] The secondary banker [...] can arrange the loan first and then cast around for additional deposits to finance it [...] The bank which is placing a deposit with another bank - in fact, lending money to another bank - has lost control of the ultimate use of that deposit, and it relies completely on the discretion used by the 'borrowing' bank in lending that deposit. It would seem that a failure anywhere could ripple through the system in a way that would be impossible in the [retail] banking system [...] There is one particular danger associated with banking based on Euro-[currencies]: there is no lender of last resort." 90

Nonetheless, during this first period of rapid market growth, the institutions involved did not have a complete understanding and consciousness of these risks. This was achieved only with the eruption of the 1973 banking crisis.91

The rise of the secondary banking system put tremendous pressure on the cartel and damaged the effectiveness of selective credit controls. It has already been said that these controls created lending opportunities for unregulated institutions. The wholesale markets were the conduit through which their lending was financed. The result was that total liquidity was kept above the desired level, with part of the credit flowing to non-approved sectors. The efforts of the authorities to close the gaps in the credit controls were defeated by the adapting market. Indeed, even the expansion of direct lending controls to all "statistical banks" and the leading finance houses only served to further divert business to the new constellation of Section 123 banks.92

From their part, the clearers witnessed the loss of market share to their outside competitors, even though they attempted to tap the new lines of business by establishing specialist subsidiaries. Moreover, the Bank of England had started to question the anti-competitive aspects of their conduct.93 In 1967, the National Board for Prices and Incomes launched a devastating attack on their concerted pricing,

91 See infra, section 2(a).
92 The overhaul of monetary-policy instruments through the introduction in 1971 of a non-discriminatory reserve requirement for all statistical banks did not remove this asymmetry. See infra, section 2(a).
93 See quotation from Governor's speech of April 25, 1963, in Alhadeff, op.cit., n.79, pp.332-3
excessive reliance on the endowment effect of non-interest bearing deposits (which had become more striking as a result of rising interest rates), non-disclosure of certain charges and maintenance of hidden reserves.\textsuperscript{94} Thus, the writing was clearly on the wall for the price cartel, although neither the banks nor the monetary authorities could accept its final demise before new monetary arrangements had been put in place.\textsuperscript{95}

In the meantime, with the blessings of the Bank of England and the Treasury,\textsuperscript{96} a new wave of amalgamations between clearing banks took place, with the aim of rationalising branch networks. This was the most drastic structural change within the club since the time of the Colwyn Committee. The number of London clearers was reduced to six, while that of their Scottish brethren to three. In particular, the merger of the Westminster and National Provincial Banks to form the National Westminster meant that the dominant "Big Five" clearers became the "Big Four". On the other hand, a proposed similar merger between Barclays, Lloyds and Martins Banks, that would have resulted in the further reduction of leading high-street banks to three only, was refereed to the Monopolies Commission, which decided by a majority not to allow it to go through.\textsuperscript{97}

\textit{(e) Early plans for statutory regulation of deposit-taking, 1955-58.} A recently published continuation volume of the official history of the Bank of England, covering the years 1941-58, provides a detailed account of an episode which illustrates certain basic themes in the evolution of regulatory policy and foreshadows the enactment of the first statutory scheme of banking regulation in 1979.\textsuperscript{98}

The various post-War controls on the allocation of credit checked the growth of finance houses by restricting their ability to borrow from the banks or to raise funds in the capital markets. The controls, however, did not extend to deposit-taking; nor was there any restriction on advertising for deposits. Late in 1955, at the beginning of a three-year-long credit squeeze, the Governor of the Bank, who was concerned that hire-purchase financing was weakening the effectiveness credit controls, approached the Chairman of the Finance Houses Association ("F.H.A."), which

\textsuperscript{94} \textit{Loc.cit.}, n.81.
\textsuperscript{96} National Board for Prices and Incomes, \textit{loc.cit.}, n.81, para.154.
\textsuperscript{97} Monopolies Commission, \textit{loc.cit.}, n.94. At paras.48 and 218, the Commission noted that the communication by the Bank of England of the official attitudes towards mergers to the interested banks was so flawed, that the latter became aware that the Bank was willing to allow a merger among the "Big Five" only when their competitors, the Westminster and National Provincial Banks, made their own announcement.
\textsuperscript{98} Fforde, \textit{The Bank of England...}, \textit{op.cit.}, n.16, pp.761-779.
represented eleven large institutions controlling between them a considerable portion of the hire-purchase market, raising his objections to their advertising in the press for deposits. In his written reply, the Chairman of the F.H.A. pointed to the fact that there was nothing unlawful about advertising for deposits. In addition, he expressed the association's desire to see the removal of the funding controls and the confinement of regulation to contractual terms only, insisting that the funding controls were inequitable, because they had much greater impact on finance houses than on retailers offering hire-purchase credit and also because they encouraged the growth of small deposit-takers.

The Bank rejected the removal of the controls, since these were, in its opinion, necessary to restrain overall market growth. On the other hand, it indicated that it was considering the introduction of a licensing requirement for all hire-purchase companies and the expansion of the controls. The imposition of restrictions on their competitors was instantly taken up by the finance houses, which offered their full assistance in lobbying the Treasury to take action in the suggested direction. By this point, there was little talk of the Bank's fundamental objective of strengthening the system of credit controls while protecting the best interests of the finance houses. Instead, the proposals were supported by prudential arguments relating to the protection of depositors.99

In March 1956, the Bank submitted a draft bill for the regulation of deposit-taking. The proposed two-tier system was very similar to that finally adopted by the Banking Act 1979. The acceptance of deposits would be subject to licensing requirements, and licensed persons would be under an obligation to submit statistical returns and to observe specific standards of capital adequacy and liquidity. However, certain categories of deposit-takers (presumably, the established banks and finance houses) would be exempted from the statutory requirements. It is interesting to note that (unlike under the 1979 arrangements) the regulatory responsibility would belong to the Board of Trade, not to the Bank - although it can be assumed that the latter's advise would be sought as a matter of practice.100

99 At an early point in the discussion, the Chairman of a leading finance house, United Dominion Trust, wrote to the Bank to express his worries concerning advertisements for deposits by small firms. In his view, even powerful institutions such as his own would be jeopardised if any of the small deposit-takers were to fail. Accordingly, he advocated action, possibly in the form of a prohibition on deposit-seeking by companies capitalised at less than "several millions". The Bank responded by assuring him that "this is a matter which is much in our minds". Later on, when the Bank embarked in an effort to convince the Treasury of the desirability of regulation, a club of large retailers and finance houses, the Hire-Purchase Trade Association, assisted it in lobbying the Treasury, employing arguments similar to those of United Dominion Trust. Ibid., pp.762-763.

100 The draft was the work of the then Deputy Chief Cashier, J.Q. Hollom, who by the time of the 1979 enactment had risen to the position of Deputy Governor. Thus, the original conception of
The plan was referred to an interdepartmental committee of the Board of Trade, the Treasury, the Scottish Office and the Bank. However, the committee's work was hindered by uncertainty as to the aims and focus of the proposed legislation. It was not clear whether the bill should be defined as involving the regulation of hire-purchase business or the acceptance of deposits. To a certain extent, this reflected a disagreement over the ultimate objectives of the scheme. While the Bank was mainly interested in reinforcing the system of credit controls, the Board of Trade insisted that the only purpose of the legislation should be the protection of depositors and refused to support provisions that could be used for credit-control purposes, such as variable liquidity ratios. The Board of Trade won the initial argument, but was immediately faced with serious drafting problems: any comprehensive definition of "deposit-taking" would be unduly over-inclusive. Finally, an unsatisfactory halfway solution was reached: the committee made recommendations for a bill whose purpose would be the protection of depositors but which would apply only to hire-purchase companies.

The measure was included in the Queen's Speech for the opening of the 1956-57 Parliamentary Session, but was never enacted. Indeed, the sponsoring coalition was falling apart. The finance houses, which supported strongly the introduction of entry controls, objected to the proposal for a statutory liquidity ratio. Instead, they proposed the granting of wide discretionary powers to a special registrar of finance houses. This, however, seemed politically unacceptable to the Bank and the Board of Trade. Moreover, new drafting difficulties arose, as the Treasury and the Bank attempted to reintroduce elements of credit control, while the Attorney-General was unhappy with the imprecision of the draft provisions. Interdepartmental infighting finally led the Cabinet to drop the bill from its legislative agenda in March 1957.

A subsequent effort by the Bank to reintroduce the bill as a measure for the protection of depositors that would not be confined to finance companies, failed to attract the government's interest. By that time, the incentives for regulation had become less acute, because the credit squeeze was coming to an end, while it was envisaged that the affiliation of clearing banks and finance houses would be allowed in the future - something that would put small hire-purchase companies, which had flourished exactly because of the discriminatory financing constrains on their big competitors, under strong competitive pressure. The Bank made a final attempt to

101 Apparently, this was not considered to be a significant problem in 1979 or 1987. On the current statutory definitions, see infra, ch.2, section 1(b)-(c).
103 Ibid., pp.768-769.
organise a self-regulatory club, based on the earlier proposals of the finance houses in support of a widely discretionary supervisory system. However, now that regulation did not appear to offer any particular competitive advantage, its erstwhile proponents showed little interest, despite their past claims regarding the threat of market instability.\textsuperscript{104}

Although the legislative effort eventually stumbled on the ambiguity of its objectives and the divergent views of its sponsors, this episode is significant, because it illustrates on a small scale certain forces that shaped the evolution of the regulatory system in the longer run. First, although the legislation was introduced purportedly for the purpose of depositor protection, the real demand for regulation derived, at least in part, from the F.H.A., a club of powerful intermediaries who had a strong interest in restricting entry in their market, since this would protect them from outside competition. Second, the monetary authorities had a clear intention to use the prospective regulatory powers in the service of their own set of priorities (which was determined by the needs of macroeconomic policy), taxing away part of the value of the license by imposing credit controls on the regulatees. Third, the need for new regulation was created in the first place by the asymmetrical effect of existing regulatory arrangements: outside competitors flourished precisely because the existing credit controls placed disproportionate burdens on the finance houses.

2. The rise of statutory prudential regulation

At the dawn of the 1970s, the system of credit controls had caused already significant distortions in the structure of the British banking industry, without ensuring an appreciable longer-term improvement in the economy. As the leakages from disintermediation continued to increase, the monetary authorities realised that the credit controls had outlived their technical effectiveness. This added the element of urgency to their search for new and more neutral instruments of economic policy. On the other hand, the banking system was still perceived to be safe and stable and little interest was shown for the elaboration of a banking policy specifically directed to prudential aims.

\textit{(a) The secondary banking crisis.} At long last, an overhaul of the increasingly distortive monetary-control instruments of the 1960s was undertaken by the Heath government. The new policy, which was aimed at "combining an effective measure of control over credit conditions with greater scope for competition and innovation",

\textsuperscript{104} \textit{Ibid.}, pp.775-776.
was announced in the policy paper "Competition and Credit Control" ("C.C.C."), and implemented from 16 September 1971. At the same time, the clearing banks renounced their interest-rate cartel arrangements.

C.C.C. replaced the old ratios and the anti-competitive credit ceilings, which applied to individual banking institutions and large finance houses, with a uniform reserve-asset ratio, set close to the average banking practice of recent years, i.e. at 12.5% of a bank's "eligible liabilities" - an aggregate including current and deposit sterling deposits, excluding those of an original maturity of over two years, certificates of deposit and interbank deposits on a net basis. Reserve assets would include balances at the Bank of England, Treasury and local-authority bills, gilts of less than one year to maturity, secured money at call placed with the discount market and, up to 2% of eligible liabilities, commercial bills eligible for rediscount. The ratio would be calculated by reference to sterling deposits. Finance houses without a banking recognition but having eligible liabilities of more than £5 million, were required to observe a ratio of 10%. The reserve-asset ratio would provide a firm base for the control of the total eligible liabilities of the banking sector and the broader money supply. The authorities would be able to apply pressure on the supply of reserve assets through open-market operations or through calls for the making of Special Deposits with the Bank of England, which would not count as reserve assets. The intention was that the authorities would rely on a flexible and aggressive use of the Bank Rate (which the following year was replaced by the Minimum Lending Rate as the benchmark for interest rates) for the purpose of affecting the structure of interest rates. However, qualitative guidance for the direction of bank credit would continue to be used.

For all the hopes generated by C.C.C., during the following two years there was rapid increase in the supply of money. The authorities' failure to control the situation was only to a limited extent a result of technical defects in the design of the new

---

105 "Competition and credit control" (1971) 11 B.E.Q.B. 189. The paper was originally issued as a consultative document on 14 May 1971. Its implementation was announced in "Reserve ratios and Special Deposits" (Sep. 1971), supplement to 11 B.E.Q.B. See also "Competition and credit control: extract from a lecture by the Chief Cashier of the Bank of England" (1971) 11 B.E.Q.B. 477. For a detailed technical description and assessment of the C.C.C. and subsequent developments regarding monetary control during the 1970s, see K.K.F. Zawadzki, Competition and Credit Control (1981).

106 "Reserve ratios: further definitions" (1971) 11 B.E.Q.B. 482. Additionally, the clearing banks were to hold 1.5% of their eligible liabilities in the form of non-interest bearing balances with the Bank.

107 See "Key issues in monetary and credit policy" (1971) 11 B.E.Q.B. 195.

108 "Bank lending" (1972) 12 B.E.Q.B. 327.
ratio, especially the difficulties involved in restraining the supply of reserve assets, which included certain classes of private-sector liabilities as well as Treasury bills, which were the residual source of finance for the government. Deliberate policy choices were a more significant factor. At the outset of C.C.C., the banking sector had been consciously left with spare lending capacity. This was part of the government's broader economic strategy to boost economy activity in a "dash for growth". The strategy also involved changes in the tax system and the running of a large deficit. As the ensuing monetary expansion unfolded, the authorities were initially unable to interpret the data or understand what exactly was taking place. When the need for restrictive measures was recognised in summer 1972, the authorities were reluctant to induce sufficiently sharp increases in interest rates. Non-monetary factors were implicated in the timidity of the response, such as a fear, typical of the prevailing policy culture of practical Keynesianism, that a rise in rates would increase industrial production costs with negative effects on inflation or the political need to keep mortgage rates as low as possible. Instead, the authorities preferred to rely on a restrictive, statute-backed incomes and prices policy without, however, abandoning their growth strategy.\footnote{See Reid, \textit{op.cit.}, n.47, ch.6; M. Moran, \textit{The Politics of Banking: The Strange Case of Competition and Credit Control} (2nd ed., 1986), pp.58-70.}

A concerted effort to contain the monetary expansion was made only in late 1973.\footnote{See "Credit notice" (1973) \textit{13 B.E.Q.B.} 445.} Even then, in order to mitigate a major rise in interest rates that would be otherwise necessary, the authorities chose to reintroduce direct controls, including in particular the so-called "corset". This scheme worked by requiring each banking institution to place with the Bank non-interest-bearing supplementary special deposits, if its interest-bearing eligible liabilities grew above a specified rate. The penalty deposits had to be made on a scale rising progressively with the excess over the allowable rate of growth, making further expansion increasingly unprofitable.\footnote{"Credit control: a supplementary scheme" (1974) \textit{14 B.E.Q.B.} 37. The scheme was introduced on 17 Dec. 1973. On the same day, hire-purchase controls, which had been suspended in 1971, were reintroduced; "Credit control: consumer credit" (1974) \textit{14 B.E.Q.B.} 40.} Only interest-bearing liabilities were covered, because their volume depends in part on the interest rates offered by banks. This was supposed to be less distortionary than an outright credit ceiling or the general imposition of maximum interest rates. However, by operating at the level of the individual institution, the corset was a serious retreat from the competition-oriented policy of C.C.C., since the prescribed growth paths tended to preserve each institution's existing market share. Even though it was successful in arresting the growth of bank liabilities, particularly of wholesale deposits, the corset caused substantial distortions and encouraged
disintermediation, by redirecting funds to uncontrolled, parallel markets.\textsuperscript{112} The scheme was finally terminated in June 1980.\textsuperscript{113}

There is little doubt that, during the two years of the boom, many banks made seriously flawed lending decisions. But their strategies must be seen in the context of the official policies and the common misapprehension of the monetary conditions. One of the aims of C.C.C. was to remove the constraints which inhibited the growth of primary banks, in the expectation that before long the secondary banking sector would disappear under the competitive pressure. Indeed, at about this time the clearing banks, which had traditionally confined their lending to short-term commitments, usually on self-liquidating assets, began to extend medium-term finance for industrial investment. On the other hand, the mainstream banks had little experience of providing financing for property developments, which had been discouraged, first by the credit controls of the 1960s and again by the qualitative guidance which the Bank issued starting in August 1972.\textsuperscript{114} In contrast, many fringe institutions were heavily involved in extending finance to property companies, especially in connection to commercial-building developments, at a time when property prices were rising fast. These institutions had little difficulty in obtaining indirectly financing from the primary sector in the wholesale markets, where they were accepted as equals. Their limited recognition as "banks" under Section 123 of the Companies Act 1967 and their various degrees of sponsorship by primary banks contributed to their credibility, while the concentrated nature of their investments had not as yet raised concerns.

The fringe institutions and the primary banks which provided their ultimate source of funds were certainly guilty of ignoring the signs of concentrated and excessive exposure to commercial property. On the other hand, the conditions for overinvestment had been created by shifts in governmental policy, as the rapid expansion of property developments was suddenly encouraged, after a long period of disincentives, through a combination of tax incentives (with interest payments being offsettable against tax), a relaxation of planning procedures and the creation of expectations that a régime of cheap money would be maintained.\textsuperscript{115} The resultant collapse in property prices was also precipitated by the actions of the authorities and other adverse developments, for which the financial sector was not responsible. Late in 1972, a freeze on commercial rents was imposed as part of the government's


\textsuperscript{113} "Credit control notice" (1980) 20 B.E.Q.B. 153.

\textsuperscript{114} "Bank lending", loc.cit., n.108.

\textsuperscript{115} See Reid, op.cit., n.47, pp.59-65.
incomes and prices policy. The following January, the government made clear that the availability of building land would increase while the rent freeze remained in place.\textsuperscript{116} By November 1973, the Minimum Lending Rate had reached the critical level of 13\%, while special deposits were increased from 2\% to 6\%. These developments took place in the midst of a sharp deterioration in the general economic situation, marked by strikes and the introduction of a three-day working week in response to the international oil crisis. The growing apprehension of the financial markets was expressed in the form of credit rationing, shorter terms and wider margins in the interbank market for wholesale deposits. The final blow was dealt on 17 December, with the simultaneous presentation by the government of its proposals for a new Development Land Tax on commercial property in its restrictive Mini Budget and introduction of the corset. A banking crisis broke two days later, as a number of fringe banks were unable to replenish their resources.\textsuperscript{117}

Concerned that the drain of wholesale deposits made imminent the failure of these institutions, the Bank decided to intervene. The explanation provided by the Bank for its intervention was that the failure of the fringe banks was likely to lead to a rapidly escalating confidence crisis. More precisely, despite the fact that the clearing banks were secure from domestic runs, they had considerable exposure in the international markets and a loss of external confidence could put them under pressure. Accordingly,

"the Bank felt it essential to meet their responsibility for fully-recognised banks by mounting a rescue operation for the benefit of the depositors of a group of institutions which were not fully-recognised banks, but whose otherwise inevitable collapse would have threatened the well-being of some recognised banks."\textsuperscript{118}

In this effort, the Bank enlisted the support of the clearing banks. After certain \textit{ad hoc} arrangements, the chairmen of the Big Four clearing banks met with the Governor of the Bank on 21 December 1973 and agreed to the launching of a "Lifeboat" for the institutions under pressure. For this purpose, a Control Committee of the Bank and the clearers was established to arrange the recycling of lost wholesale deposits back to these institutions, which should be undertaken by that clearing bank which was most closely connected with each of them. The clearing banks accepted to participate in the Lifeboat on the mistaken assumption that the institutions that would receive support were facing a liquidity crisis, due to a temporary loss of public confidence, but were fundamentally solvent and potentially


\textsuperscript{117} See Reid, \textit{op.cit.}, n.47, ch.6.

viable. Even so, there were certain tensions, with some members of the senior management of the clearing banks expressing reservations about this course of action. To avoid more persistent objections, the Bank undertook to underwrite the provision of finance, accepting 10% of the risk on the amounts outstanding.

Despite the optimistic predictions that confidence would be restored soon, over the next months it became apparent that the crisis was one of solvency. At the same time, the number of institutions turning to the Lifeboat for support continued to increase. Among them were several large finance houses, including the United Dominions Trust, the country's largest. As a result, the Lifeboat grew to massive proportions. By August 1974, total commitments had approached £1,200 million, or approximately 40% of the estimated aggregate capital and reserves of all clearing banks, threatening confidence in them - precisely what the Lifeboat was supposedly intended to prevent. Predictably, the tensions between the Bank and the clearers, who were anxious to put a limit on their exposure, resurfaced. National Westminster was even forced to deny publicly rumours that it was in trouble, while the other participants refused to extend any more funds. As a result, the Bank assumed all further risk. The maximum overall exposure reached £1,285.4 million in March 1975, before starting to recede, although in late 1975, and again in May 1976, the Bank became involved in additional support operations outside the Lifeboat. In the course of the whole exercise, many institutions changed ownership, while others went in liquidation, so that, by 1980, few of the 25 institutions which received support from the Control Committee remained independent.

Although the costs of the rescue strategy cannot be estimated with any accuracy, it is clear that it involved much larger risks than originally envisaged. Nonetheless, the Bank's conclusion was that its decisions were justified and that any losses incurred were far less than what would have been the case otherwise.

"The lifeboat and subsequent support operations were undertaken in the compelling interests of maintaining confidence, domestic and international, in the banking system. In this they were wholly successful."

119 In this connection, the Bank was criticised for assisting Slater Walker Ltd., an institution which had known spectacular growth during the boom, but had then fallen into insolvency. The Bank's support to Slater Walker was thought to validate the sort of questionable business strategy that had led to the crisis, creating considerable moral hazard. See S. Fay, Portrait of an Old Lady: Turmoil at the Bank of England (1987), pp.61-62.

120 On the launching and operation of the Lifeboat, see ibid.; Reid, op.cit., n.47, pt.I; Moran, The Politics of Banking..., op.cit., n.109, pp.97-106. The Bank participated in the rescues without ministerial interference, on the ground that it was committing its own resources.

121 According to Reid, op.cit., n.47, pp.190-192, total support extended to property and financial companies both under the Lifeboat arrangements and independently of them may have reached £3 billion. The clearers made provisions against their Lifeboat operations probably in excess of £50 million, while the Bank set aside about £100 million for possible loss to itself from all the rescues.

(b) Regulatory overhaul and the enactment of the Banking Act 1979. The Bank's conduct before and during the secondary banking crisis could be criticised on a number of grounds. It had failed to arrest the rapid monetary expansion or to deflate the property bubble at an early stage, while the eventual collapse of the market had apparently taken it by surprise. There was also a failure in the quality of its monitoring. The Bank had always encouraged financial institutions to keep its Discount Office informed of all significant developments, but in this case it had been unable to interpret correctly the warning signals or to take any action before it was forced to do so by the events. When it actually intervened, it inadvertently misled the clearing banks, causing them to provide huge amounts of resources to essentially insolvent institutions.

Nonetheless, far from accepting that the debacle raised questions about its performance as a monetary and banking authority, the Bank chose almost immediately to interpret the crisis as a result of insufficient regulatory control, maintaining that the main policy lesson was that "self-regulation can be put to too great a test if competition from the less-regulated and less-disciplined is too easily permitted", and exploited the opportunity to press for the expansion of its regulatory arrangements beyond their previous frontier and the tightening of the legal use of banking names and descriptions. This was despite the fact that some of the failed institutions had higher-level banking recognitions, bringing them clearly within its area of responsibility. In contrast, there was scant recognition on the part of the authorities of the role of monetary and economic policy in exacerbating the banking problems.

During 1974, the Bank took a number of steps in the direction of strengthening its supervisory role. A Banking and Money Market Supervision Section, with more staff and greater senior management involvement, was established to take over the responsibility for market supervision from the small Discount Office. At the same time, the Bank extended its supervisory arrangements to about eighty deposit-taking institutions outside the circle of recognised ("statistical") banks, in particular finance houses and small Section 123 banks. All institutions within the supervisory net, with the exception of the clearing banks which received special supervisory treatment on grounds of their very large size and institutional uniqueness, were asked to submit periodically, beyond the usual statistical and credit-control-related returns, new returns for prudential purposes only. The analysis of these returns would form the basis for regular prudential discussions between the Bank and the senior

\footnote{123 See Moran, *The Politics of Banking...*, op.cit., n.109, pp.92-96.}

\footnote{124 "Speeches by the Governor of the Bank of England" (1974) 14 *B.E.Q.B.* 53, p.54.}
management of the reporting institutions, which would form the central element of
the new supervisory process. At the end of the year, the Bank distributed a letter
drawing the attention of banking institutions to factors that should be included in
their internal control systems regarding foreign-exchange-related activities. This was
apparently the first time that the Bank explicitly intervened in a matter concerning
the internal arrangements of other institutions.

The following year, the Bank issued a paper containing the conclusions of a
Working Party that it had established jointly with the clearing banks for the purpose
of reviewing the accepted standards of capital and liquidity adequacy that should be
observed by banking institutions. That paper set out in embryonic form the basic
framework of the present regulatory system. It placed the primary emphasis on
capital adequacy and introduced two ratios for monitoring purposes, the "free-
resources" and the "risk-asset" ratio, but refrained from prescribing mandatory
balance-sheet ratios, on the ground that such ratios would be inflexible and unable to
address the special circumstances of different institutions or groups of institutions.
However, it was accepted that broad standards could develop as yardsticks for
different groups of institutions sharing common business characteristics.

The imposition by the Bank of comprehensive prudential and reporting
requirements marked a major departure from past practice. Being unable to point
to a formal justification for its new, self-granted powers, the Bank was anxious to
conceal how radical was the change. Instead, it emphasised the general acceptance
of its de facto authority in the City and the continuity of its regulatory arrangements.
In a much-quoted statement, G. Blunden, the director in charge of banking
supervision, singled out four essential characteristics of the Bank's regulatory
approach, which was said to be: (a) flexible, without rigid patterns; (b) personal,
with each institution being judged according to its individual situation; (c)
progressive, with institutions rising step-by-step through a status ladder; and (d)
participative, with the opinions of each institution's peer-group taken into
consideration. On this view, although the changing face of banking had necessitated
a review and intensification of the Bank's methods for providing support and
supervising a broadening range of banking institutions, the basic approach, which
had been established by a long process of evolution, remained always constant.

126 See "Banks under supervision" (1975) 125 The Banker 1149, p.1150.
128 See supra, section 1(b).
129 G. Blunden, "The supervision of the U.K. banking system" (1975) 15 B.E.Q.B. 188.
The expansion of the regulatory net took place on a voluntary basis. Historically, the Bank had extended its authority only in exchange for special privileges for the institutions within its sphere of influence. This time, however, its supervision was accepted by the new regulatees as a means of restoring confidence, even though no corresponding benefits were conferred upon them. Nonetheless, it was doubtful whether these institutions would continue to co-operate once the crisis had receded. Even worse, there was a gradual loosening in the Bank's grip over the primary banking sector, as a result of the latter's increasing diversity and internationalisation and the Bank's reduced ability to confer selective benefits, following the adoption of more neutral policy instruments. These factors created the need for formal recognition of the Bank's role by means of special legislation.

In particular, the interests of the Bank converged with those of the primary banking industry in favour of entry controls in banking. The introduction of licensing requirements would expand and legitimise the Bank's regulatory power. At the same time, it would erect a barrier to entry, preventing opportunistic competition at the industry's fringe and reducing the contestability of banking markets, to the benefit of established institutions.

The U.K.'s entry in the E.E.C. in 1973 created an additional pressure for statutory regulation, because it necessitated the country's participation in the harmonisation of banking law. Almost immediately, the U.K. took a strong lead in the development of European banking policy, probably equalled only by Germany. Through their lobbying efforts, British bankers were instrumental in thwarting the Commission's original proposals for a comprehensive European regulatory framework, whose consequences could be detrimental for London's status as an international financial centre, which was based primarily on a permissive regulatory environment. Later, they played a key role in shaping the First Banking Directive of 1977 and most subsequent measures. Nonetheless, it was evident from the first moment that some change in the direction of greater formalisation would be unavoidable.

---

130 See ibid.; "Supervision and central banking" (1987) 27 B.E.Q.B. 380, p.381; Moran, The Politics of Banking..., op.cit., n.109, pp.114-118. In the words of A.C. Page and R.B. Ferguson, Investor Protection (1992), p.81, for non-statutory regulation "[t]o be an effective substitute for legal coercion, the benefits offered, or the denial of which is threatened, must be exclusive; i.e. they must be unobtainable in any other way. Moreover, they must exceed the costs entailed by submission, otherwise firms may simply decline to submit; and the benefits must continue to exceed the costs, otherwise firms may simply defect."


Finally, statutory regulation appeared to offer a means of deflecting political criticisms of the Bank and the City, which had intensified as a result of the crisis. The hostility to the City was compounded by demands for the nationalisation of the main financial institutions, which had gained ground within the Labour party, partly as a reaction to the perceived irresponsibility of the banking sector during the boom and partly for the purpose of channelling the funds available to the financial system to industrial investment. These demands found clear expression in a policy document issued in 1976 by the National Executive Committee of the Labour Party, which called for the nationalisation of the four major clearing banks and seven leading insurance companies. Although the Wilson government rejected publicly the nationalisation plans, even some Cabinet ministers, such as the Secretary of State for Energy, Tony Benn, were more equivocal. To suspend further discussion of the matter, the Prime Minister launched a broad inquiry into the role and functioning of financial institutions and the proposals for regulatory changes, including the possible extension of the public sector. When the work of the committee of the inquiry eventually began in 1977, Wilson, having retired from the premiership in the meantime, became himself its chairman. The committee's report was not published until after the Conservatives' return to power under Margaret Thatcher. It contained a precise description of the current state of the financial sector and was accompanied with substantial minutes of evidence, but made only marginal recommendations for reforms.

Wilson's diversionary tactics gave the time to the banking industry, under the coordination of the Bank, to present a strong advocacy of its role and to revive the British Bankers Association ("B.B.A.") as a lobbying organisation. Part of the effort consisted in refuting the arguments for nationalisation by showing that the industrial decline of the nation was attributable to poor productivity and macroeconomic

---

134 See Middlemas, op.cit., n.6, Vol.3, pp.64-68.
135 See the debate on nationalisation in the House of Commons, H.C. (5th Series) Vol. 911, col. 1453.
137 Regarding prudential regulation, the report noted the growing tendency to impose entry controls and the increased use of balance-sheet ratios as a method for judging the standing of financial institutions. Pointing to the fact that substantial reliance on non-statutory regulation is practical only in limited circumstances, it emphasised the important implications for regulation of the increasing complexity and internationalisation of the financial sector. Significantly, it rejected the arguments that statutory regulation cannot achieve flexibility, cheapness and adaptability and that it necessarily encourages greater attention to the letter than to the spirit of the regulatory arrangements. The report refrained from making any significant proposals for a regulatory overhaul. It simply proposed the creation of a body with strategic responsibilities, that would keep the regulation of all parts of the financial system under continuous review. Ibid., ch.21.
imbalances, rather than lack of investment by the financial sector. The banks had considerable success in turning the debate in their favour. Furthermore, the proceedings before the Wilson Committee gave them the opportunity to air their own grievances, to criticise the departures from the spirit of C.C.C., in particular the imposition of the corset and the continuing practice of selective controls on lending, and to demand the elimination of fiscal advantages for building societies and life-assurance companies and the uniform application of monetary controls to all financial institutions without exception. At the same time, however, it was common ground between the authorities and the banking industry that the enactment of a limited statutory regulatory framework was needed as a means of showing that the outside criticisms were not simply ignored.

From the government's standpoint, the legislation had to be directed at the protection of depositors as consumers of banking services. During these years, the trend of consumerism was gaining strength. In the financial area, the Consumer Credit Act was enacted in 1974, for the purpose of protecting the personal recipients of credit, while in 1976 the prohibition on restrictive trade practices was extended to financial services. Making the interests of depositors the focus of the banking bill would be consistent with the prevailing climate of opinion and would ensure the required political support for its enactment, particularly since by the mid-1970s the habit of holding bank accounts had spread to most walks of life.

The government, which relied on the Bank's help in order to stabilise the turbulent economic situation and avoid the collapse of sterling, was willing to leave at its hands the responsibility for regulation, even though different views on this matter were expressed even among the Bank's own ranks. On the other hand, the government was adamant that the primary banking sector should be formally included in the ambit of the bill and that a deposit-guarantee scheme should be introduced for all banking institutions. The latter proposal was energetically opposed by the major banks, on the ground that it would impose an obligation on sound banks to underwrite the activities of their less sound competitors.

---


139 Committee of London Clearing Bankers, ibid.


For the Bank, the main problem was how to obtain a statutory mandate that would enhance its regulatory powers, while maintaining essentially intact its discretion and autonomy and its co-operative and informal relationship with the major financial institutions.\footnote{See "Speeches by the Governor of the Bank of England" (1975) 15 B.E.Q.B. 365.} Its active involvement in the drafting of the legislation gave it the opportunity to resist demands for precise and transparent forms of supervision as excessively legalistic, costly and inefficient. This was consistent with the interests of the primary banking sector, which wanted the subjection of the fringe to tight regulatory controls, but was totally opposed to the politicisation of banking affairs and outside interference with the City.

The synthesis of the concerns of the government, the Bank and the City - or, rather, its leading institutions - was expressed in the White Paper of August 1976, which set out the fundamental parameters of the future statutory system.\footnote{White Paper "The Licensing and Supervision of Deposit-Taking Institutions" (Cmnd. 6584, Aug. 1976).} The White Paper announced the introduction of a licensing system for deposit-taking institutions, under which the latter would be required to comply with certain prudential criteria. The system would be operated by the Bank in a flexible manner, since this could ensure more willing acceptance and effective support than would formal statutory rules. The ladder of recognitions, whose complicated structure made it non-transparent to depositors, would be replaced by a two-tier division of deposit-takers, between "recognised banks" and other licensed deposit-takers.\footnote{To assuage the fears of the secondary sector, whose membership included certain significant institutions, such as the larger finance houses, the Bank insisted that the two-tier distinction was based on function, rather than status, and that it was not intended as a great divide. See "Speeches by the Governor of the Bank of England" (1980) 20 B.E.Q.B. 203, pp.206-207.}

Although the primary banking sector would not be exempted from the licensing requirements, it was expected that most of its members would qualify for full recognition as banks. Since the use of banking names and descriptions would be confined to recognised banks only, this would be a significant advantage. Finally, as no supervisory system could exclude entirely the possibility of bank failures, a mandatory deposit protection fund, to which each deposit-taking institution would contribute in proportion to the size of its deposit base, would be instituted to provide an additional safeguard to the public against the loss of deposits.

A bill incorporating the White Paper's proposals was brought before Parliament early in 1979, with bipartisan support. The fault lines in the legislative process were determined, not by political or ideological differences, but by the struggle between different groups of financial institutions for comparative advantages. While almost everybody, including the B.B.A., the Committee of London Clearing Bankers and the Finance House Association, accepted the fundamental principles of the new
licensing system, there were profound disagreements in connection to the other aspects of the bill. The parliamentary discussions provided a rare opportunity to the secondary institutions, whose contribution to the drafting of the bill had been limited, to influence the final shape of the regulatory scheme, obtaining with the help of their representatives in the House of Commons a lowering of the minimum contribution to the Deposit Protection Fund and the extension of the permissible use of banking descriptions (but not of banking names) to all licensed institutions. Generally, however, the debates were dominated by the attempts of the major banks' lobby to extract as many additional concessions as possible. In particular, a cap on the absolute size of initial contributions to the Fund was included for the exclusive benefit of the Big Four clearing banks, which would be otherwise liable for considerably higher amounts, due to the enormous size of their deposit base. In the House of Lords, the banking lobby and the opposition ensured the removal of a provision for the making of additional calls for contributions beyond the statutory limit of 0.6% of each institution's deposit base by means of secondary legislation, as well as the exception of the overdrafts of recognised banks from the requirement on lenders, under the Consumer Credit Act 1974, to state the exact rate of interest payable by their borrowers. The government extended this exception, which involved significant administrative economies, to the second-tier licensed institutions. The reason for the considerable effectiveness of the banking lobby in securing these changes was that, by this point, the collapse of the Labour government was imminent and the amendments had to be accepted in a last-ditch effort to place the bill in the statute-book before the calling of the general election.

(c) The separation of banking regulation and macroeconomic policy.

Probably the most significant development affecting banking regulation in recent decades has been its gradual separation from macroeconomic policy and its exclusive reorientation on issues of prudential concern, especially after the adoption of the Banking Act 1979. The breaking of the nexus was the result of a long process of incubation, characterised by the ascendancy of monetary thinking and greater reliance on competitive markets.

Although the movement in this direction had started as early as the late 1960s, its progress during the next decade was checked by discontinuities and reversals. Initially, the search for an overhaul of the instruments of macroeconomic policy was triggered, as has been discussed above, by the persistent aggravation of the nation's

146 Ibid., cols.1083-1091.
147 Ibid., cols.1736-1741.
148 See, e.g., Collins, op.cit., n.5, p.488.
economic problems and the increasing dissatisfaction with the distortions caused by direct credit controls. At the same time, the control of monetary growth was gradually emerging as a central policy objective. The market-oriented experiment of C.C.C. was the first direct application of the new thinking, but, before long, there was a retreat from its spirit, in favour of a return to the familiar strategies of prices and incomes policies and demand management through fiscal measures and direct controls over the volume and direction of liquidity.

During the course of the 1970s, however, the prolonged economic instability, particularly the combination of unprecedented levels of inflation with stagnation, had confirmed the need for a "change of paradigm" in economic strategy, involving an abandonment, not merely of the instruments, but even of the fundamental aims of the post-War policy consensus.

The defining insight of the new orthodoxy was that there can be no real trade-off between the toleration of the inflationary tendencies, which were inherent in the attempts to reheat the economy in repeated "dashes for growth", on the one hand, and higher output and employment, on the other. The monetarists had established that the growth generated by inflated nominal demand is illusory: if in the short term a change in the rate of money growth could trigger a change in the same direction in output, a sustained change in the supply of money is bound to be met by a corresponding, corrective movement in the nominal level of prices. In the long run, output depends on the economic fundamentals, not on money illusions. At the same time, the inflationary process has deleterious effects on real economic behaviour. By distorting the information conveyed by price signals, and thus affecting relative prices in the short run, it can lead to serious misallocation of investment resources. Inflation is also an endemic phenomenon. It creates self-fulfilling

---

149 See supra, section 1(c)-(d).

150 Following the devaluation of sterling in 1967, the International Monetary Fund imposed on the British government an obligation to restrict monetary growth (measured in terms of a broad credit aggregate), as a condition for the provision of borrowing facilities. This signalled the return to prominence of monetary considerations, after a long period in which the authorities were primarily interested in regulating the availability and direction of credit to private capital-users ("liquidity management"). The shift was in tune with the increased intellectual respectability achieved internationally in the late 1960s by money-growth-directed policy prescriptions, as a result of support received from statistical evidence. See M. Friedman, *The Counter-Revolution in Monetary Theory* (1970); and "Reflections on the conduct of monetary policy" (1978) 18 B.E.Q.B. 31, pp.31-32. After the collapse of the Bretton Woods arrangements and the removal of the fixed exchange rate as the main constraint of monetary policy, the control of the money supply became the primary intermediate policy objective. See "British economic policy over the last decade" (1983) 23 B.E.Q.B. 194, pp.197-198.


152 Hayek, *ibid.*, p.46, observes that, by insisting on the long-term irrelevance of movements in the nominal price level for the real economy, "mechanical monetarism" missed an important point: "[I]t pays attention only to the effect of changes in the quantity of money on the general price level and not to the effects on the structure of relative prices. In consequence, it tends to
expectations of more inflation in the future, which trigger pre-emptive responses on
the part of private economic agents. This path gradually generates an accelerating
spiral of distortions and rigidities in economic behaviour, especially with regard to
the expected level of wages, which undermines future employment prospects. In
short, inflation is conducive to economic instability and financial fragility. Only the
stabilisation of the economy can provide a basis for sustainable growth and
employment.

In terms of practical policy decisions, the turning point was the sterling crisis of
1976, which led to an application to the International Monetary Fund for a loan. The
crisis precipitated the endorsement by the Labour Chancellor of the Exchequer,
Dennis Healey, acting in accordance to the strong advice of the Bank of England, of
a policy of "practical monetarism". Following the conclusion of the loan, the
government placed unprecedented emphasis on the restriction of both P.S.B.R. and
the domestic credit expansion, setting firm targets for the growth of money supply
(expressed in terms of growth of the £M3 aggregate), which signalled a decisive
break with the past and added credibility and resilience to its anti-inflationary policy.

The break with the past was entrenched with the accession to power of Margaret
Thatcher's Conservative government in 1979. From that point, the fight against
inflation became, and remains still, the highest priority of public policy - at least as a
professed ideal, because in practice it was not always pursued with the same degree
of conviction. Monetary policy reverted to its traditional role of stabilising the
economy by ensuring sound money. Under the Medium Term Financial Strategy,
which was announced in 1980, targets for the rate of growth of money aggregates
(particularly £M3, and later M3 and M0) continued to serve as the intermediate
policy objectives. Now, however, the emphasis on these targets was even stronger
than before, with the government announcing targets for several years ahead, so as
to emphasise the permanence and consistency of the commitment to defeating
inflation.

A temporary relaxation of monetary policy in 1984-85, in an attempt to keep
interest rates (including the politically significant mortgage rates) low, led to intense
pressure on sterling and a renewed inflationary spiral. As the credibility of the
M.T.F.S. was waning, the 1985 Budget placed increased emphasis on the exchange
rate as an indicator. The reliance on external constraints intensified in the following
years. In 1987-88, the then Chancellor of the Exchequer, Nigel Lawson, pursued
vigorously a policy of "shadowing the Deutschmark", paying less attention to the
disregard what seems to me the most harmful effects of inflation, the misdirection of resources it
causes and the unemployment which ultimately results from it."

153 On monetary policy and operations in the early 1980s, see P. Temperton, A Guide to U.K.
Monetary Policy (1986).
internal monetary conditions. By the end of this experiment, inflation had reached new heights. Later, from sterling's entry in the Exchange Rate Mechanism on 5 October 1990 to its turbulent exit as a result of the currency crisis of September 1992, the maintenance of the parity provided the fixed point, around which domestic financial policies were conducted. Following these diversions from a strict counter-inflationary policy, from 1992 onwards the authorities have set a specific target of between 1 and 4 percent for retail-price inflation, with the aim of bringing inflation in the lower half of the band before the next general election.

The abandonment of attempts to use the financial system as a means of fine-tuning and micromanaging the economy in favour of a policy directed at ensuring a stable monetary environment had major implications for the type of policy instruments employed by the authorities and the structure of monetary operations. The main instruments of the previous period were irrelevant for the new policy objectives and incompatible with the government's free-market philosophy. Their dismantling and replacement with market-oriented arrangements was pursued with urgency. An important side-effect of this transition was that regulatory controls were not any more necessary for the achievement of the goals of economic policy, nor directly influenced by them. This made possible the emancipation of regulatory policy from the Bank's monetary concerns and its exclusive concentration on prudential issues. Conversely, the new régime set strict limits on the Bank's ability to influence bank behaviour by offering or withholding privileged treatment in relation to the operation of selective controls. This increased considerably the significance of the formal powers which were entrusted to the Bank with the enactment of the Banking Act 1979.

One of the very first actions of the Thatcher government was to abolish all exchange controls, the dismantling of which was completed by 23 October 1979. This development had very important implications for the regulatory functions of the Bank of England, which under the Exchange Control Act 1947 had the discretion to block the transfer of any substantial sum abroad. The loss of this power eliminated the Bank's control over the activities of "authorised banks", but also much of its leverage elsewhere in the City, especially in the area of commodity trading, where the threat of use of its exchange-control powers guaranteed its residual control over organisations such as the London Metal Exchange.\textsuperscript{155}

\textsuperscript{154} This policy had been adopted by the Chancellor alone, without reference to the Prime Minister or the Cabinet; M. Thatcher, \textit{The Downing Street Years} (1993), pp.699-705.

\textsuperscript{155} See Fay, \textit{op.cit.}, n.119, pp.105-106.
During the next two years, a comprehensive discussion was conducted on the technical aspects of alternative systems of monetary control. In March 1980, the Bank and the Treasury set out their main conclusions on the changes that would be necessary for the reform of the existing arrangements. After extensive consultations and the clarification of certain aspects of the proposals, the new arrangements came into effect on 20 August 1981. Their main effect was to abolish the central fulcrum of the C.C.C. system, the reserve-asset ratio, and to scrap the corset. Although the Bank retained the option of making calls for special deposits as a reserve policy instrument, this has never happened in practice. Furthermore, the Bank ceased to announce the Minimum Lending Rate, thus strengthening the influence of market factors in the determination of the structure of short-term interest rates.

Under the new system, the authorities continue to target the desired level and structure of short-term rates, which they seek to keep within an undisclosed band. This is achieved by means of the Bank's open-market operations - primarily through transactions in bills with the discount houses, otherwise through discount-window lending. In connection with the Bank's operations in bills, the acceptance houses no longer enjoy an exclusive privilege regarding the eligibility of acceptances for rediscount with the Bank; the acceptances of all institutions (including overseas banks) with a substantial and broadly-based acceptance business in the U.K. are now eligible for rediscount, provided that they can command the lowest discount rates in the market. The Bank's ability to conduct policy in this manner, without a reserve ratio, is facilitated by the convention requiring clearing banks to inform it on a daily basis of their target clearing balances. The use of administered discount rates is envisaged in exceptional circumstances. Thus, the Bank has resorted to announced rates for one day in January 1985, and again during the sterling crisis of September 1992.

In order to ensure a steady source of financing for the Bank of England, the new arrangements included an obligation on all institutions with an average volume of eligible liabilities (calculated net of interbank deposits) of £10 million or more to lodge non-interest-bearing deposits with the Bank. A cash-ratio requirement of 0.5%

---


160 For a description of the Bank's day-to-day monetary operations, see "The role of the Bank of England in the money market" (1982) 22 B.E.Q.B. 86.
was applied for this purpose, replacing a 1.5% cash-ratio that was up to that time observed by the clearing banks only.\textsuperscript{161} This ratio is equivalent to a tax on the banking industry and is not used for monetary-control purposes.

With the introduction of these arrangements and the subsequent completion of the dismantling of direct controls with the abolition of hire-purchase terms controls in July 1982, the Bank's ability to exercise effective pressure on individual banking institutions by relying on its role as a monetary authority has been reduced, although it has not been eliminated. To the extent that this is possible under the new circumstances, the Bank continues to employ its power of persuasion in support of its non-prudential policies. In its frequent discussions with financial institutions, particularly the committees of London and Scottish clearing banks, it puts forward its views relating to its exchange-rate and interest-rate policies, the priorities that should be observed in terms of lending to the various sectors of the economy and the desirability of assistance to ailing companies.\textsuperscript{162} Nonetheless, its moral suasion has lost the bite that it used to have in the 1960s, at the heyday of selective credit controls and discretionary recognitions.

\textit{(d) The regulatory system after 1979.} In the first years of operation of the Banking Act 1979, the Bank concentrated its efforts on the refinement of the supervisory framework regarding the financial soundness of the regulated institutions. Following an overhaul of the internal supervisory arrangements of the Bank, with the creation in March 1980 of an enlarged Banking Supervision Division as the successor of the Banking and Money Market Supervision Section, a series of consultative papers were issued for the purpose of advising the banking community of the developing supervisory policies of the Bank and soliciting comment. The papers were followed by final policy notices on capital adequacy, foreign currency exposures and liquidity, so that the basic financial-monitoring framework was complete by July 1982.\textsuperscript{163}

During these years, the main prudential concerns arose from the activities of international banks. In particular, the collapse of Banco Ambrosiano in 1982 alerted the banking authorities of the industrialised nations to gaps left between their

\textsuperscript{161} From October 1986 onwards, the cash-ratio deposits have been gradually reduced to a current level of 0.35% of a bank's deposit base; "Cash ratio deposits" (1986) 26 \textit{B.E.Q.B.} 346; Bank of England, "Report and Accounts for the Year Ended 28 February 1994" (12 May 1994), pp.9-10.

\textsuperscript{162} Clearing banks and discount houses are still quick to respond to the Governor's "raised eyebrows" for reasons of reputation, although sometimes they may privately express their reservations to the Bank at the highest level; observation of P. Hatton, an official of the Bank, during an interview conducted in the Banking Supervision Division on 5 Oct. 1990.

supervisory nets, which allowed some international banking groups to escape effective supervision altogether, while during the following two years the Third World debt crisis raised a major threat to the stability of the global financial system. These events precipitated an intensification of the process of international regulatory co-operation and convergence of prudential standards, which will be discussed in the following section.

In contrast, domestically the statutory regulatory framework appeared to work well. This perception was dispelled abruptly in late 1984, as a result of the failure of Johnson Matthey Bankers ("J.M.B."), a recognised bank and a member of the "gold ring" (i.e. one of the handful of market-makers in gold bullion). The failure was caused by accumulated losses on concentrated lending exposures to a small number of clients, of which the Bank had been kept ignorant. Indeed, there had been significant delays in the making of prudential returns by the institution, but the Bank had failed to investigate the matter, relying instead on the institution's reputation as a primary bank.164 In an ill-advised move, the Bank decided to rescue J.M.B. by taking it over. The institution was assumed for a token single pound, while its parent company honoured its moral responsibility by contributing to the Bank £50 million. The assumption was backed by guarantees of £150 million against J.M.B.'s liabilities, of which only half were given by the Bank. The London clearing banks, the thirteen accepting houses and the other four members of the gold market were called to provide the rest, without getting anything in return.165

In justification of its actions, the Bank argued that, although the liquidation of J.M.B. was unlikely to cause a system-wide crisis, it could have a series of negative effects: there could be contagion of the other four members of the gold ring; the fragility of financial markets could increase; it was even possible that foreign governments and central banks, some of which had substantial deposits of gold with J.M.B., could suffer losses, with serious repercussions for the standing of British banks generally.166 These arguments failed to gain broad acceptance; the participating institutions, in particular, were very annoyed by the manner in which they were forced to shoulder the cost of the rescue, despite the lack of a probable

165 In fact, under the Bank's original proposals, the banks were asked to put £90 million of a £100 million indemnity package, without even being given the right to charge potential payments against tax. However, the clearers forced the Bank to increase its own exposure and to secure a permission by the Inland Revenue regarding the tax treatment of indemnity payments. On the negotiation of the rescue package, see Ollard and Routledge, ibid., p.56.
systemic threat. Soon the matter was brought to the political arena, apparently as a result of the disclosure of information about the Bank's handling of the affair by two of the unwilling rescuers, an accepting house and a member of the gold ring, to David Owen, the leader of the Social Democratic Party. Owen and other opposition politicians had some success in publicising the issue, but the pressure on the Bank was not sufficient to compel it to give full account for its actions, as its critics in the banking sector fought shy of voicing their objections in public. Nonetheless, as a whole the affair inflicted unprecedented damage to the reputation of the Bank, exposing its supervisory practices as naive and complacent and injuring its relations with the major British banks. Even worse, by misleadingly maintaining that no public funds had been used for the rescue, the Bank managed to cause personal embarrassment to the Chancellor of the Exchequer, Nigel Lawson, who, unaware of the true facts, repeated the false claim in the House of Commons.

With its status at its lowest ebb ever, the Bank moved with remarkable dexterity to regain the lost ground and even to exploit the perceptions of crisis for the purpose of expanding its regulatory turf, placing the blame for its inability to detect in time the irregularities in J.M.B. to gaps in its statutory mandate. Significantly, the Chancellor was persuaded to appoint the Bank's own Governor, Robin Leigh-Pemberton, as chairman of an investigation into the causes and lessons of the affair.

The report of the Leigh-Pemberton Committee, while defending the flexible and co-operative system of U.K. banking supervision, noted that this could not rely entirely on the responsiveness of regulatees, so that stronger reserve powers should be given to the Bank. The report recognised that the more relaxed supervisory treatment of recognised banks as compared to licensed deposit-takers could not be justified, and in J.M.B.'s case had even been a factor that delayed supervisory awareness of the problems. At any rate, discrimination had failed to yield the expected benefits:

"More generally, the two-tier system has not fully achieved its objective of signalling some differentiation between the institutions in the two tiers and

---


168 In fact, Owen was reported to complain that the City privately said one thing, and publicly something different. Ollard and Routledge, loc.cit., n.164, p.53.

169 Speaking of J.M.B., the Bank's Governor, Robin Leigh-Pemberton, boasted that, "[d]espite the substantial resources involved, this whole operation was thus undertaken with no expenditure of public funds beyond the pound coin handed over as consideration in the early hours of that Monday morning."; "Domestic financial markets: progress and problems" (1984) 24 B.E.Q.B. 472, p.473.

170 See infra, ch.6, text and nn.72-79.

has led to confusion in the public mind on the way in which the related
criteria of function and status are applied. There is also no clear division in
the use of banking names and descriptions between the institutions in the two
tiers.”

Moreover, the administration of the two-tier system involved particular
difficulties. For these reasons, the report called for its abolition. It also identified
weaknesses in the supervision of large exposures and of the adequacy of control
systems and recommended the introduction of statutory arrangements for the
exchange of information between auditors and regulators.

The recommendations of the report were accepted by the government in a White
Paper which appeared in December 1985. Traces of the Treasury's distrust of the
Bank could still be felt in the White Paper, whose one major additional proposal
concerned the introduction of a new Board of Banking Supervision "to assist the
Governor in the performance of his banking supervisory duties." The Board
would include independent members, drawn from the banking community, with
advisory functions; in case of disagreement with the ex officio members, i.e. the
Governor, Deputy Governor and head of banking supervision of the Bank, the
independent members should inform the Chancellor in writing. This was supposed to
place the Bank under increased accountability. Generally, however, under the
proposals the Bank's position would be reinforced with new formal powers; this was
ironic, since it was the Bank's own failure to carry out properly its existing
responsibilities that had opened the way to this expansion of its powers. Improvements in the organisation of the Banking Supervision Division and an
increase in its staffing were also arranged.

Even though the substance of the authorisation requirements of the Banking Act
1979 was not affected by the proposed reforms, the government chose to introduce
an entirely new bill, because that Act's structure was so closely related to the two-
tier system that its amendment would be particularly cumbersome. The main
innovations of the Banking Bill were: (a) the establishment of the Board of Banking
Supervision; (b) the abolition of the two-tier system; (c) the more detailed
description of the authorisation criteria; (d) the grant to the Bank of a new power of

173 "Banking Supervision" (Cmdn. 9695, Dec. 1985). The only significant departure from the
Committee's proposals concerned the maintenance of a vestige of the two-tier system in the form
of a restriction in the use of banking names by small institutions; paras.7.16-7.19.
174 *Ibid.*, para.5.5.
175 The White Paper, *Ibid.*, paras.5.3-5.4, revealed that the government had considered the
establishment of a separate supervisory organisation, leaving to the Bank only its functions as
central bank, but the idea was rejected, because it would entail loss of continuity and
administrative upheaval.
176 See the remarks of the then Economic Secretary to the Treasury, Ian Stewart, H.C. (6th Series)
objection to take-overs and changes in the control of authorised institutions; (e) the introduction of new appeal procedures against decisions of the Bank involving the refusal, revocation or restriction of authorisation or the raising of objections to the controllers, directors or managers of authorised institutions; (f) the imposition of new reporting requirements for large exposures; (g) the strengthening of the Bank’s powers to require information and to commence investigations into the affairs of authorised institutions; (h) the release of bank auditors from their duty of confidentiality to their client institutions, to the extent necessary for facilitating the communication to the Bank of information of regulatory relevance; (i) the criminalisation of the provision of misleading information to the Bank; and (j) the replacement of the provisions on the regulation of banking names and descriptions.

The bill had the support of the banking lobby, which made no attempt to salvage the two-tier structure as a whole, since this had proved to be of limited value to the primary institutions, but merely sought to assure the retention a restriction over the use of banking names by smaller institutions, thus preserving the partial survival of that structure’s main real benefit. The only reservations of the banking lobby concerned the "rigid" provisions for the reporting of large exposures, while the objections to the Deposit Protection Fund were reiterated.

The bill was enacted by Parliament as the Banking Act 1987 with minor alterations, including an increase in the level of protection provided by the Deposit Protection Fund, the introduction of a power of objection to changes in the control of authorised institutions on grounds of reciprocity and a relative strengthening of the role of independent members in the Board of Banking Supervision. The specific operations of the Bank of England under the Banking Act 1987 are discussed in detail in Chapters 2 and 3.

The main trends in banking regulation since 1987 are defined by the international convergence on common minimum standards of capital adequacy and the increasing "Europeanisation" of regulatory policy, about which more will be said in the following section. The purely domestic changes in the regulatory structure have been few and relatively modest.

Nonetheless, a very significant, but not widely appreciated, step in the direction of greater safety of the banking system as a whole has been taken independently of the statutory framework, with the assumption by the Bank of a leading role in the

---

178 Ibid., pp.3 and 33.
179 On this matter, the B.B.A. noted: "What has never been satisfactorily explained is why the cost should fall predominantly on the major banks. Banks which are sound and seen to be sound derive no benefit from the scheme; for them it is just a tax."; Ibid., p.44.
overhaul of the City's settlement systems. The risk implications of the huge, and continuously growing, volume of financial transactions settled through the interbank payment system should not be underestimated. Participating banks may have little control over their counterparties or the pattern of payment traffic. This creates a danger that the failure of a single bank will contaminate a number of the other members of the system. For the minimisation of the risk, the conversion of the U.K.'s main large-value payment system, C.H.A.P.S., from an end-of-day net settlement system into a real-time gross settlement system was agreed between its fourteen members and the Bank. The conversion was gradual, taking overall six years from its initial conception to its planned completion by the end of 1995 and passing from the tidying-up of existing arrangements, with the definition of intraday exposures as the bilateral, rather than the multilateral, net amount, to the introduction of limits on bilateral exposures, which since December 1992 have been brought under the full control of the bank bearing the risk, and from there to the imposition of net sender limits or system-wide caps on indebtedness in March 1993. The final phase involves the transition to real-time gross settlement, with all payment messages being routed through the Bank for immediate settlement. For the prevention of undue delays, the system will be backed by fully collateralised intraday credit lines offered by the Bank to the participating institutions. The new arrangements increase significantly the cost of using the system, but put the risk under control.

In terms of public perceptions, the single most important event of the last few years has been the failure of Bank of Credit and Commerce International S.A. ("B.C.C.I."), an institution incorporated in Luxembourg but based in London and having an extensive network of international operations. By the time of its closure, on 5 July 1991, B.C.C.I. had accumulated a deficit of many billion pounds, as a result of frauds of unprecedented scale by the institution's senior management. The criminal aspects of the affair would be sufficient to attract the interest of public opinion, even if the supervision of B.C.C.I. had been impeccable. In reality, it was evident from the beginning that the Bank's handling of the institution had been at least complacent. As one commentator observed at the time,

"it seems that nearly everybody who dealt with B.C.C.I., small depositors apart, had concerns about it. B.C.C.I. has been the object of concern amongst central banks internationally for several years".

---


The fact that thousands of depositors had lost money as a result of the failure only made matters worse. With political criticisms mounting against the Bank, an inquiry into the affair was launched under Lord Justice Bingham.

The bulk of the Bingham Report, which was published on 22 October 1992, was devoted to a detailed account of the B.C.C.I. story, which, in spite of Lord Bingham's careful efforts to avoid censuring the Bank on the basis of hindsight, made clear that from the day of the institution's formation in 1977 until almost the end its supervision had been deficient.

The Bank had authorised B.C.C.I. as a licensed deposit-taker under the 1979 Act, even though it did not know or understand the shareholding structure of the institution's group, and thus could not form a view on whether its controllers were fit and proper persons. Moreover, the Bank had not tried to prevent B.C.C.I. from using a banking name, even though it was aware that, as a U.K.-based second-tier institution, the institution was not entitled to do so. During the following years, the Bank had remained inactive in the face of the institution's negative market reputation, breaches of statutory provisions and an evident inability of Luxembourg to exercise effective supervision. The revocation of B.C.C.I.'s license was considered in 1986, but not pursued, because there seemed to be no imminent threat to the interests of depositors and no clear ground for revocation, but also because shutting down the institution's forty-five U.K. branches could cause substantial political and diplomatic friction.

When the Luxembourg authorities, acknowledging the ineffectiveness of their supervision, proposed the local incorporation of the institution's U.K. operations, the Bank, anxious to avoid becoming the group's lead regulator, refused. Accordingly, a "college of supervisors" was created as an ad hoc solution to the unique problems created by B.C.C.I.'s multinational presence. Although serious allegations of wrongdoing continued to come to the Bank's attention, no investigations were

---

184 The conclusion that the Bank's supervision had been wholly inadequate and had even obstructed the efforts of the regulators of other nations, was expressed in particularly strong terms in a parallel report on B.C.C.I. prepared by the U.S. Senators John Kerry and Hank Brown, "The B.C.C.I. Affair: A Report to the Senate Committee on Foreign Relations", 102nd Congress, 2nd Session (30 Sep. 1992, 2 Vols.), especially pp.18-20, 420-423, 426-427, 456-466.
185 Bingham Report, loc.cit., n.183, paras.2.28, 2.30.
186 Ibid., para.2.33
187 Ibid., paras.2.37-2.42. By the mid-1980s, one internal strand of opinion, possibly influenced by the J.M.B. debacle, resisted the assumption of a closer supervisory role, fearing that involvement with new and risky assignments could expose the Bank to renewed criticisms; paras.2.51, 2.55.
188 Ibid., para.2.62. In Bingham's opinion, the Bank's response was not adequate; para.2.64.
189 Ibid., paras.2.81-2.84.
conducted, and in one case the informant was even redirected to the police! Following the conviction of certain officers of the institution in the U.S. for money-laundering, an internal review of its authorisation was finally launched, but was soon abandoned on the ground that the evidence was insufficient.

The final phase of the affair commenced with the preparation in April 1990 by B.C.C.I.'s auditors, Price Waterhouse, of a devastating financial report, which alerted the supervisors to the seriousness of the institution's difficulties without, however, awakening them to the fact that these difficulties were the result of wrongdoing. This was in part the fault of Price Waterhouse, who on numerous occasions had failed to convey to the Bank fully and clearly their knowledge about the situation. From October 1990 onwards, the college of supervisors pursued actively B.C.C.I.'s restructuring through changes in the institution's ownership, financing and management. At the same time, however, the U.S. authorities, convinced that the institution was fraudulent, were putting pressure on the Bank to take action. Eventually, the Bank commissioned a report into B.C.C.I.'s running from Price Waterhouse, without expecting the uncovering of widespread fraud and misconduct. In fact, the revelations in the report were so damaging that the Bank found itself obliged to intervene without any delay.

Although Lord Justice Bingham did not find fault in the decision to close B.C.C.I. after receiving the report, he did criticise the Bank for its past inaction, its failure to investigate allegations of misconduct, its weak internal communications and failure to pass critical information to the Board of Banking Supervision and its preoccupation with the institution's financial restructuring and insufficient consideration of the possibility of formal remedial action, which would be justified under the circumstances. Overall, in his opinion, the B.C.C.I. affair was idiosyncratic and could not justify a general regulatory intensification, but a number of minor corrections to the system were necessary to ensure the concentration of supervisory attention on suspect banks.

The recommendations in the report included: the strengthening of communication systems within the Bank, to ensure that all critical information

---

190 Ibid., paras.2.94-2.98, 2.120.
191 Ibid., paras.2.157-2.162. Bingham noted that the Bank had received "erroneous" internal legal advise and that, more generally, "it has considerably exaggerated the conditions to be met before it can act": a fear of appeal "loomed much larger than it should in the Bank's mind". In addition, the Banking Supervision Division was sympathetic to B.C.C.I. and relied almost exclusively on its account of the U.S. incident.
192 Ibid., paras.2.186-2.484.
193 Ibid., paras.3.1-3.3. In response to the Bank's request for amendments to the Banking Act for the purpose of broadening its powers, Bingham noted that, while such amendments could help to make the law more explicit, there was no need for substantial change, because the Act already included implicitly the requested powers; paras.3.13-3.18.
reaches its senior officials, and the closer involvement of the Board of Banking Supervision in the supervisory process\(^{3.6,3.11}\); an increase in the Bank's responsiveness to allegations of wrongdoing and the more active investigation of suspect banks, through the establishment of a Special Investigation Unit with special expertise in detecting fraud and malpractice\(^{3.9-3.10}\); the strengthening of the Banking Supervision Division's legal unit\(^{3.12}\); the imposition on bank auditors of a statutory duty to report to the Bank all information that they know or should reasonably expect to be relevant to the exercise of its supervisory responsibilities under the Banking Act\(^{3.43-3.45}\); and the undertaking of an effort for the improvement of flows of information between the various domestic and foreign authorities having responsibility for the regulation of banks and the enforcement of criminal laws.\(^{3.31-3.38}\) All these recommendations were immediately endorsed by the Bank and the government.\(^{3.39-3.45}\)

Although its performance continued to be the subject of strong cross-party criticisms, the Bank defended vigorously its broader supervisory strategy, including its policy of favouring restructuring over immediate closure of problem banks, and confined its response to the implementation of the proposed changes.\(^{200}\) There was no personal allocation of responsibilities for the fiasco within the Bank. The government's tolerance was crucial in this regard. In Parliament, the Treasury ministers acknowledged that there had been certain deficiencies in B.C.C.I.'s supervision, but refused to call for the resignation of the Governor of the Bank or to blame the Bank for negligence and rejected proposals for the creation of a separate supervisory agency and the confinement of the Bank to its central-banking functions only, on the ground that this would involve "upheaval and loss of continuity", while the Bank's expertise and authority is already established; at the same time, they refused to provide compensation to depositors over and above the amounts payable by the Deposit Protection Fund since this could exacerbate moral hazard, emphasising that depositor self-reliance is always necessary and that bank authorisation must not be confused with a public guarantee.\(^{201}\)

\(^{194}\) Ibid., paras.3.6, 3.11.
\(^{195}\) Ibid., paras.3.9-3.10
\(^{196}\) Ibid., para.3.12.
\(^{197}\) Ibid., paras.3.43-3.45.
\(^{198}\) Ibid., paras.3.31-3.38.
With the implementation of the Bingham recommendations, the regulatory framework reached in most essential respects its present form. Since 1991, there have been no banking failures or other adversities of a magnitude that could trigger drastic changes in the system. In particular, the recent failure of Barings p.l.c. on 24-26 February 1995, as a result of huge losses on unauthorised derivatives trading in a Singapore subsidiary, did not have significant regulatory repercussions, possibly because the critical events took place outside the U.K., while the failed institution's assumption by a Dutch bank, Internationale Nederlanded Groep N.V., a week later prevented the loss of depositor money.

An investigation by the Board of Banking Supervision into the circumstances of the failure identified a single individual, Nicholas Leeson, as the primary responsible for the unauthorised trading, but also pointed to the total failure of the management of Barings to implement effective controls and to appreciate the significance of numerous warning signals.202 A parallel investigation conducted in Singapore by company inspectors appointed by the Minister of Finance drew a more sinister picture regarding the responsibility of Barings' London management, concluding that certain key individuals in the group's management were either actively trying to cover up the irregularities or were grossly negligent, or wilfully blind and reckless to the truth.203

With regard to the Bank of England's supervisory role in Barings, the independent members of the Board of Banking Supervision identified certain shortcomings, especially in terms of a lack of understanding of the non-banking risks undertaken at group level, including in particular risks arising from derivatives trading, of lax enforcement of the rules on large exposures and of the supervision of the group on a consolidated basis.204 Nonetheless, they did not propose the making of amendments to the Banking Act.205

The criticisms of the Bank in the Board's report have been taken up by the Treasury and Civil Service Committee, which has made its displeasure with the Bank's conduct of prudential supervision abundantly clear. In a report on the regulation of financial services in the U.K., the Committee states the following:

"We are dismayed that the Governor can on the one hand claim that London is the best regulated and supervised market in the world and on the other have to concede that his supervisory staff actually have little real

205 Ibid., para.14.61.
understanding what its charges are up to. The Bank has acknowledged that it must learn more about the securities business yet there are no details of how the Bank will acquire or develop this expertise.\textsuperscript{206}

The Committee has also proposed a review of "the continued appropriateness of the Bank of England as the prudential supervisory and regulator of the banking industry."\textsuperscript{207} This call is echoed by the Labour party, which is examining whether supervision should be transferred to a separate Banking Commission under a future government.\textsuperscript{208} Such a move, however, would not necessarily be welcome by the banking industry, which has already made clear, through the British Bankers' Association, that in its view there is no need for a new supervisory body.\textsuperscript{209} Nor does it seem to be any broader interest in a drastic overhaul of the regulatory system. As things currently stand, there would not seem to be a prospect of imminent removal of the Bank's regulatory responsibilities.

The overall analysis of the evolution of domestic banking policy reveals a pattern in the growth of prudential regulation. The most important regulatory overhauls occurred in response to major incidents of financial failure, namely the secondary banking crisis, the J.M.B. affair and, to a lesser extent, the B.C.C.I. affair. Each of these incidents attracted public attention and, regardless of its fundamental causes, was perceived to be symptomatic of a "crisis" in the regulatory system.

In each case the Bank shared some part of the blame, because of its inability to ensure a stable monetary environment, in the first occasion, or of its mediocre performance in the exercise of its supervisory responsibilities, in the other two. Paradoxically, after the initial spate of criticisms, in every case the Bank managed to regain control of the developments, which it used to expand or reinforce its legal mandate. This was achieved through its close involvement in the governmental policy-making process, from which its critics were largely excluded. The exercise involved a subtle shift of emphasis from the obscure failures in the Bank's internal operations to the supposed inadequacies of the legal framework, even though in all three cases the Bank possessed already the necessary powers which could have permitted it to prevent the damaging events.

Legal reforms have distinct political advantages, because they provide immediate reassurance to the public that the lessons of a crisis have been learned and something has been done to prevent relapses and, at the same time, achieve the expansion of

\textsuperscript{207} Ibid., para.109.
\textsuperscript{208} See the comments of A. Darling M.P., the Opposition Spokesman on City and Financial Services, "The regulatory structure of the City" (1995) 10 J.I.B.L. 419.
the regulatory turf. Whether the additional regulatory costs or the less tangible
distortions in the operation of the markets are justifiable as ensuring an appreciable
decrease of risk, is a different question. In fact, in terms of actual risk-reduction, the
regulatory innovations could even be largely superficial without affecting the policy
choice. An observation of D.W. Cox goes to the heart of the matter:

"It is always the customers that end up paying the cost of increased
regulation, even when they receive no benefit for it. When they call for
increased regulation and security, the cost of this decision is rarely brought
home to them. It is doubtful that they recognise the true extent of the
additionally liability that they, the customers, are incurring."210

Moreover, even if the expansion of the regulatory net could ensure the total
prevention of bank failures, the result might not be desirable, since some degree of
bank failures, frauds and depositor losses is necessary for preserving market
discipline through the minimisation of moral hazards and for maintaining a tolerable
balance between regulatory costs and benefits.

In any event, as a result of developments described above, for the last twenty
years regulation has been the Bank's indisputable growth sector, contributing to a
very considerable expansion of its formal legal powers and gaining an important role
in its workload. Thus, by February 1995, the Bank's statutory jurisdiction
encompassed 525 institutions (the so-called "authorised population"), including 379
institutions authorised in the U.K. under the Banking Act 1987 and 146 institutions
from other Member States of the E.E.A., operating in the U.K. on the basis of their
home-State authorisation.211 The increased significance of regulatory affairs is also
reflected in the numbers of persons employed in supervisory functions, which rose
from the twelve employees of the pre-1973 Discount Office to a budgeted staff of
334 for the year ending February 1996, including 200 managers, analysts and
assistants employed in banking supervision and 42 in surveillance of overseas
banking markets, who are supported by 92 secretarial and information-and-records
support staff.212

A pervasive internal reorganisation of the Bank, which was implemented in July
1994, confirmed the new reality. The purpose of the reorganisation was to achieve
an organisational structure that would match with greater accuracy the Bank's main
policy functions, since the old internal divisions were the result of historical accident
and did not reflect the Bank's present priorities.213 The new structure groups
together in two "wings" those working on each of the Bank's core functions; the
Monetary Stability wing covers the traditional monetary functions of a central bank,

212 Ibid., p.39.
from economic analysis through to the dealing desks and their back-offices, while
the Financial Stability wing focuses primarily on the recently developed regulatory
functions. It encompasses regulatory policy-making, day-to-day supervision and
surveillance, and also the Bank's broader work on "financial infrastructure",
including matters such as finance for industry, financial markets and institutions or
settlement systems, with the aim of promoting efficiency and competitiveness the
financial industry. Within the Financial Stability wing, banking supervision, which
was until now conducted in the Banking Supervision Division, has been aligned with
surveillance of developments in overseas economies and banking markets, with the
purpose of identifying risks to financial stability arising in foreign countries to which
U.K. institutions have significant exposures or whose banks have a presence in the
U.K. This task was previously undertaken by the Bank's International Division,
which disappeared as a result of the reorganisation. The new Supervision and
Surveillance area is subdivided in five divisions, two dealing with the supervision of
U.K. institutions (Major U.K. Banks Division and Medium and Smaller U.K. Banks
and Enforcement Division), two with the supervision of foreign institutions and
international surveillance (Industrial World and Developing World Divisions), and
one with regulatory policy (Banking Supervisory Policy Division).

Overall, having defined openly regulation as one of the two pillars of its
institutional identity, the Bank is likely to press ahead with a consistently
interventionist agenda. Thus, the regulatory bureaucratisation of financial risk-taking
can be expected to continue unabated in the foreseeable future.

3. The international and European regulatory convergence processes

The development of domestic regulatory policy over the last two decades has
been directly and intimately linked to sustained moves at the multilateral level
towards the creation of a consistent international framework of banking regulation
and supervision, reflecting the increasing preoccupation of banking regulators across
the world with the prudential aspects of international banking operations.

The origins of the international regulatory convergence process can be traced
back to a series of banking scandals and crises, which erupted in the major
industrialised nations in the mid-1970s (namely, the failures of Bankhaus I.D.
Herstatt in West Germany and of Franklin National Bank in the U.S., as well as the

---


secondary banking crisis in the U.K.) and again in the early 1980s (with the collapse of Banco Ambrosiano in Italy, the international Third-World debt crisis, and the failure of Continental Illinois in the U.S.). The banking failures proved in many cases to have significant cross-border dimensions, reflecting the dramatic explosion of international banking activities in recent decades.

Since the early 1960s, fundamental changes in the structure of the banking industry have taken place as a result of the dramatic expansion of international banking operations. The trend commenced as a response to the increased demand of banks' multinational corporate clients for cross-border financial services and to the very significant growth of trade flows, but regulatory considerations played also a part. In particular, the desire of U.S. banks to avoid their country's restrictive monetary regulations was a significant factor in the emergence of euro-currency markets. As has been indicated earlier, this was the source of very significant benefits for London, ensuring the entrenchment of its position as one of the major banking centres of the world.

The internationalisation of banking operations has been made feasible by the new communication technologies, whose effect was to gradually remove the constraint of geographical distance, which impeded market integration in the past. Politically, internationalisation has benefited from the increasingly liberal attitudes of many governments with regard to international trade in services, the opening up of domestic markets and the abandonment of discriminatory measures against foreign firms. The trend of liberalisation has been formalised and deepened in multilateral fora, in particular the E.C. and the O.E.C.D. and, more recently, the 8th (Uruguay) Round of multilateral trade negotiations under the G.A.T.T., which covered trade in services, including financial services, leading to the adoption of the General Agreement on Trade in Services ("G.A.T.S.") on 15 December 1993.

For the banking industry, internationalisation has been the source of new profit opportunities, but also of strong competitive pressures and increased risks. Internationalisation has proved to be a self-reinforcing process, since, in the face of growing foreign competition, most large banks have found it necessary to expand their international presence in order to increase, or simply to protect, their market share. Nonetheless, it has not always been easy for them to manage the attending

---

217 See supra, section 1(d).
218 See Pecchioli, op.cit., n.216, pp.74-77; and Bröker, op.cit., n.216, chs.3-4.
risks. The intense competition for market share, in combination with the initially limited understanding of the new environment, has resulted in many cases, at least in the short term, in overtrading and excessively low pricing, which did not reflect the actual risks taken by banks. The difficulties have been exacerbated by the widespread macroeconomic disruptions of the 1970s and much of the 1980s. At the same time, the wholesale and predominantly interbank nature of the booming international markets has resulted in a sharp increase in bank interdependence. This has been a potentially serious source of contagion risk, insofar as the costs from the failure of one institution are borne by its counterparties in the interbank market and the payment and settlement systems.

The increase in banks' risk-taking as a result of international operations presents national banking authorities with a policy dilemma. Given that every significant banking jurisdiction has an interest in protecting and promoting the national banking industry's international competitiveness, it would be undesirable for the authorities of any such jurisdiction to impose unilaterally countervailing regulatory restrictions on their domestic banks, because this would increase their costs of doing business and, if the restrictions were more burdensome than those applicable to their foreign competitors, undermine their ability to compete globally. On the other hand, a failure of the authorities to contain risk-taking by banks would lead unavoidably to an explosion in the costs of keeping in place the prevailing regimes of implicit and/or explicit public safety-nets for the banking industry, as the authorities would be forced to bail out a growing number of insolvent banks.\(^\text{220}\)

In this climate, international regulatory convergence appears probably as the best means of tackling the problem of increased bank risk-taking without dissipating the benefits from banking operations abroad. A multilateral approach to the definition of prudential standards could ensure some sort of competitive "level playing field" for international banks, while permitting national authorities to keep the costs from the public safety-nets under control.

(a) The work of the Basle Committee. The first concrete evidence of the growing risks from international banking operations was provided in 1974, when two significant institutions, the German Bankhaus I.D. Herstatt and the American Franklin National Bank, failed after suffering very heavy losses through unhedged

\(^{220}\) The implications of risk-taking by banks for the public safety-nets deter the national regulatory authorities from pursuing a simple policy of "competition in laxity". "In the longer run, there are some forces that will help keep capital ratios across countries from getting too far out of line. Low capital requirements that allow institutions to grow faster and take on more risk in their loan portfolios than their international competitors ultimately become a source of concern to their countries' governments", D.B. Crane and S.L. Hayes, "The evolution of international banking competition and its implications for regulation" (1983) 14 J.B.R. 39, p.51.
foreign-exchange trading. Central-bank intervention was necessary in order to prevent the contamination of numerous other banks which had not received payment for currency that they had forwarded to the failed institutions immediately prior to their closure. These failures, which illustrated the vulnerability of internationally active banks to uncompleted interbank currency transactions, raised unprecedented concerns with the prudential aspects of international banking operations amongst banking regulators and triggered a process of convergence of the supervisory standards of different countries.

In response to the Bankhaus I.D. Herstatt failure, the governors of the central banks of the Group of Ten ("G-10") countries and Switzerland formed at the end of 1974 an ad hoc committee, the Committee on Banking Regulations and Supervisory Practices. The initiative for the Committee's formation apparently belonged to the Bank of England. The Committee, which became better known as the "Basle Committee" from its permanent meeting place at the Bank for International Settlements in Basle, Switzerland, met for the first time in February 1975. Meetings have taken place regularly (about three to four times a year) ever since.

The purpose of the Basle Committee is to provide a forum for the study of the international aspects of prudential regulation and the discussion of policy issues between the participating national authorities, leading gradually to the elaboration of common principles concerning the strengthening of banking supervision and the harmonisation of prudential standards.

The Committee operates on a totally informal basis. It does not have legal existence as an international institution, does not function on the basis of a formal mandate and does not follow specific procedures or bylaws. Convergence on particular policies is reached through discussion and gradual achievement of mutual understanding, and is based strictly on the principle of consensus. Policies are set out in papers notable for their not strictly technical and relatively flexible language, which eschews the exact style and precise definitions of legal documentation. As the institutions represented in the Committee lack the legal power to conclude binding

221 See Press Communiqué of the Governors of the central banks of the G-10 countries, 12 Feb. 1975, released by the B.I.S. The Committee, whose full name has since been changed to the Basle Committee on Banking Supervision, is made up of representatives of the central banks and banking supervisory authorities of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. For an introduction to the Committee's work, see A. Comford, *The Role of the Basle Committee on Banking Supervision in the Regulation of International Banking* (Sep. 1993).

222 See Revell, *op.cit.*, n.50, p.51. The Bank of England's representatives held the chairmanship of the Committee during its early years.

treaties on behalf of their countries or to legislate domestically, Committee policy pronouncements are presented merely as "reports", "consultative documents", "statements", "guidelines" or "recommendations" and are not purported to have any specific legal effect. In 1984, Peter Cooke, the chairman of the Basle Committee at the time, described its status and role in the following words:

"The Committee does not undertake a formal supernational supervisory role; its conclusions do not have, and were never intended to have, legal force. Rather it formulates and recommends broad supervisory principles and guidelines of best practices in the hope and expectation that individual authorities will take steps to implement them through detailed arrangements - statutory or otherwise - which are best suited to their own national systems."224

The Committee's policy papers are not signed by its members and do not include express references to its composition, other than in a footnote explaining in general terms that the Committee "consists of senior representatives of bank supervisory authorities and central banks" from the twelve participating countries, without however naming its members or the institutions that they represent. In fact, until the early 1980s the Committee's operations were covered by almost total secrecy and its papers were not even publicly available. Since then, however, there has been a marked shift towards openness. The Committee's discussion and final papers are now circulated widely and comments by the banking industry are invited. Moreover, since 1982 the Committee has produced on a regular basis (annual until 1986 and biennial thereafter) a series of "Reports on International Developments in Banking Supervision", whose purpose is to keep bank supervisors and other interested parties around the world informed about the Committee's recent work.225

Largely due to the prestige and institutional power of its membership, the regulatory standards that emanate under the Committee's auspices enjoy a far wider legitimacy than would be justified by their doubtful legal status. Through their de facto implementation by the represented institutions within the limits of their discretionary powers, but also through their formal adoption by national legislators, Committee pronouncements, despite their lack of formal force, exert in practice a very powerful influence in the generation of national and regional legal rules and formal institutional structures.226 The process could be described as the inculcation of formal legal systems by central bankers' "club" law.

224 "Basle Supervisors' Committee" (Committee document for external distribution) (21 June 1984).
226 See the observations of Peter Cooke, a former head of the Bank's banking supervision and chairman of the Basle Committee, "The Basle 'Concordat' on the supervision of banks' foreign establishments" (1984) 39 Aussenwirtschaft 151. See also J.J. Norton, "The work of the Basle Supervisors Committee on bank capital adequacy and the July 1988 report on International
Although its principles are directed primarily to the participating countries, the Basle Committee makes every effort to ensure their world-wide acceptance. For this purpose, it has encouraged the setting up of several regional groups of banking supervisors, with which it co-operates closely. In addition, the Basle Committee is the organiser, in co-operation with the authorities of the host country, of the biennial International Conferences of Banking Supervisors ("I.C.B.S."), which have been held regularly since 1979. The conferences provide a forum for the discussion of supervisory issues and the promotion of co-operation between regulators, permitting the dissemination of the Committee's policy thinking to regulators from every corner of the world. The number of participants in the conferences has increased over the years; currently around 110 countries attend the I.C.B.S.

The Committee has had considerable success in its efforts to export its standards, even though in numerous jurisdictions their effective implementation is resisted in practice or is impeded by the limited resources of the local regulatory authorities. The Committee maintains particularly strong links with the banking fora of the E.C., primarily because the membership of the G-10 and the E.C. is

227 At the Committee's instigation, an Offshore Group of Banking Supervisors was set up in October 1980. See "Report on International Developments in Banking Supervision, 1981", loc.cit., n.223, p.18. Subsequently, the Committee has assisted or encouraged other regional groups of regulators who have established permanent contacts in the following fora: in 1981, the Commission of Latin American and Caribbean Banking Supervisory and Inspection Organisations (now renamed the Association of Banking Supervisory Authorities of Latin America and the Caribbean); in 1983, the Caribbean Banking Supervisors' Group and the G.C.C. (Gulf Co-operation Council) Committee of Banking Supervisors; in 1984, the S.E.A.N.Z.A. (South East Asia, New Zealand and Australia) Forum of Banking Supervisors; in 1990, the Group of Banking Supervisors from Central and Eastern European Countries; in 1991, the Group of Banking Supervision Officials in Arab Countries; in 1993, the East and Southern Africa Banking Supervisors' Group; and in 1994, the West and Central Africa Group of Bank Supervisors.


230 I.e. the informal Contact Group of Supervisory Authorities, the Banking Advisory Committee, which was formed in accordance with Article 11 of First Council Directive 77/780/EEC of 12.12.77 on the co-ordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions (the "First Banking Directive"), and the Banking Supervisory Sub-Committee of the European Monetary Institute, which was originally constituted as a sub-committee of the Committee of Governors of the Community's central banks under Article 3(1) of Council Decision 64/300/EEC of 08.05.64 on co-operation between the central banks of the Member States of the E.E.C., as amended by Council Decision
characterised by substantial overlap. In many cases, work has been conducted in parallel, although in certain matters the E.C., motivated by the need to complete the internal market, has achieved harmonisation in areas where the Basle Committee has not for the time being made concrete progress.231

The Committee's first task following its formation in 1975 was to reach an understanding regarding the division of responsibilities for the supervision of the foreign establishments (i.e., subsidiaries, branches and joint ventures) of banks operating in more than one jurisdiction between the authorities of the home and the host country. In September 1975, guidelines to this effect were set out in a report prepared for internal distribution.232 The report, which became known as the "Concordat", allocated responsibilities for the supervision of the liquidity, solvency and foreign-exchange operations and positions of foreign establishments and encouraged close co-operation and mutual exchange of information between the various national supervisors. The Concordat was followed three years later by a paper recommending that the supervision of solvency should be conducted by the authorities of a bank's home country on the basis of the consolidated balance sheets of the bank's world-wide operations.233

Nonetheless, it soon became evident that there was significant divergence in the manner in which different countries applied the Concordat in practice. The concerns increased with the collapse of Banco Ambrosiano in summer 1982. In that case, the Italian authorities provided protection to the bank's domestic depositors, but disclaimed responsibility for its subsidiary in Luxembourg; the Luxembourg banking authorities, on their turn, rejected any responsibility for the subsidiary, on the ground that it was licensed as a holding company, not as a bank, and was, accordingly, outside their jurisdiction. To prevent the reoccurrence of similar situations, a revised Concordat was issued in 1983.234 The paper refined the 1975 allocation of responsibilities and introduced two basic principles: first, that no foreign banking establishment should escape supervision; and second, that this supervision should be

---

231 See infra, section 3(b).

232 Basle Committee, "Report to the Governors on the Supervision of Banks' Foreign Establishments" (the "Concordat") (Sep. 1975).


234 Basle Committee, "Principles for the Supervision of Banks' Foreign Establishments" (the "revised Concordat") (May 1983). The revised Concordat was released to the public in June 1983, putting an end to the Committee's initial practice of keeping its papers secret.
adequate. The paper emphasised that the responsibilities of the authorities in the home and the host country are complementary and overlapping: if the former are not satisfied with the quality of supervision of a bank's foreign establishment in the host country, they should extend their own supervision to cover that establishment, or even dissuade the bank from operating in the host country; conversely, if the authorities in the host country have reasons to doubt the adequacy of supervision by a bank's home regulators, they should discourage or forbid the continuation of the bank's local establishment or impose appropriate conditions. The revised Concordat incorporated the principle of consolidated supervision of solvency, noting however that this should not supersede the separate supervision of a bank's component entities by the authorities in the host countries ("solo supervision").

In 1990, the revised Concordat was supplemented by a paper concerning the exchange of supervisory information. This paper encourages co-operation between supervisors on a best-effort basis, particularly in matters relating to the detection of crime and fraud and the enforcement of banking laws, and urges the amendment of regulatory confidentiality laws insofar as these impede such cooperation, subject to strict safeguards that the information disclosed should be used only for prudential purposes. It also recommends the establishment of lines of communication between supervisors and the auditors of banking institutions, expressing a preference for the appointment as auditors of internationally qualified firms with experience in bank auditing.

Despite all these efforts of the Basle Committee to co-ordinate the work of the various national authorities, differences in the quality of the various national authorities' supervisory performance have not disappeared. The B.C.C.I. affair provided clear illustration of the inability of supervisory authorities in countries such as Luxembourg to exercise effective supervision. It also showed that the adoption by an internationally active banking group of a sufficiently convoluted corporate structure could create serious confusion regarding the lines of supervisory responsibility for its activities. In the wake of the affair, the Basle Committee sought to address these problems by issuing in summer 1992 a further supplement to the revised Concordat. This paper sets out minimum standards for supervisors, which qualify the Committee's stated preference for consolidated supervision by emphasising the need for the host country to ensure that the authorities in the home country are capable of exercising effective supervision. Specifically, the minimum standards require that:

---

1. All international banking groups and international banks should be supervised by a home-country authority that capably performs consolidated supervision. [...] 

2. The creation of a cross-border banking establishment should receive the prior consent of both the host-country supervisory authority and the bank's and, if different, banking group's home-country supervisory authority. [...] 

3. Supervisory authorities should possess the right to gather information from the cross-border banking establishments of the banks or banking groups for which they are the home-country supervisor. [...] 

4. If a host-country authority determines that any one of the foregoing minimum standards is not met to its satisfaction, that authority could impose restrictive measures necessary to satisfy its prudential concerns consistent with these minimum standards, including the prohibition of the creation of banking establishments. [...]"237

The Committee allows for flexibility in the implementation of these principles, and provides that groups of countries may reach negotiated agreements for the convergence and mutual recognition of their regulatory rules. This has already happened within the E.C., where the harmonisation of banking law has made considerable progress in recent years.238 Evidently, the operation at Community level of the principle of mutual recognition of the regulatory standards of the Member States precludes the application of the second and fourth Basle principles between them.

While initially the work of the Basle Committee was focused primarily on the delineation of supervisory responsibilities and the achievement of co-ordination between home- and host-country authorities (an effort that was met with limited practical success), later its attention turned to the substance of prudential regulatory norms.239 The result was the publication of a series of recommendations on matters such as the assessment and control of country exposures,240 the expansion of

---

237 Ibid.


239 Writing in 1984, Peter Cooke, then chairman of the Basle Committee, noted that "[t]he process of international supervisory co-operation during the last decade has passed through several phases. The first consisted of simple steps to establish the practice of supervisory co-operation and some basic agreement on its essential framework and principles. The second has seen the spread of supervisory co-operation, its practice and its principles around the world, beyond the areas where it first developed. This is now well under way but much remains to be done. The third phase, which has scarcely built up momentum yet, is directed toward a closer convergence of supervisory standards and techniques in different countries reflecting that single international marketplace in which major banks in so many countries are now operating extensively."; loc.cit., n.226, pp.155-156.

supervision to the off-balance-sheet activities of banks, the imposition of limits on large credit exposures, and even the promulgation of principles for the prevention of money laundering.

The Committee's most important initiative to-date, however, involved the elaboration of common minimum standards of capital adequacy for international banks. A historical agreement on this matter, the so-called "Basle Accord", was reached in July 1988. The Basle Accord was the outcome of several years' work. Its significance consists in the achievement of multilateral agreement on a consistent definition of the elements of bank capital, on a framework for assessing the adequacy of a bank's capital base as a function of the credit risk of its assets (i.e., of the risk that its assets will become non-performing as a result of its counterparties' default on their obligations) and on the imposition on all internationally active banks of a common minimum standard of 8% of capital to risk-weighted assets, which should be applied on a consolidated basis.

The issue of bank capital was brought to the forefront of the Basle Committee's concerns at the beginning of the 1980s. Responding to the worries of the Governors of the central banks of the G-10 countries relating to a world-wide trend of erosion of capital-to-asset ratios at a time of very aggressive expansion of banks' international lending, in 1981 the Committee began to monitor systematically the capital ratios of leading banks with a view to preparing a report to the Governors.

On the basis of its fact-finding work, the Committee was able to confirm that further deterioration of capital ratios should be resolutely resisted by banking regulators on prudential grounds and that, at the very least, the major banks should be forced to maintain their capital positions at the levels prevailing at the time, whatever those levels happened to be. These conclusions were strongly endorsed by the G-10 central bank Governors, to whom the Committee's report was presented in June 1982. Conscious of the need for greater homogeneity in the levels of capital maintained by major international banks, but recognising that the widely divergent national definitions of bank capital for supervisory purposes impeded the

244 Basle Committee, "International Convergence of Capital Measurement and Capital Standards" (the "Basle Accord") (Jul. 1988). See also the Committee's "Proposals for the Inclusion of General Provisions / General Loan-Loss Reserves in Capital" (Feb. 1991), which were followed by an "Amendment to the Basle Accord" (Nov. 1991).
245 Ibid., Part I.
246 Ibid., Part II.
247 Ibid., Part III.
achievement of convergence in this area, the Committee also stressed in its report the desirability of further work aimed at narrowing the differences between member countries regarding the main constituent elements of capital, in particular insofar as the treatment of subordinated loan stocks and the status of hidden reserves were concerned, and at testing different ratios which relate balance-sheet items to capital (e.g., risk-asset ratios, gearing ratios, large loan exposure ratios).249

The grave threat to the international banking system from the Third-World debt crisis, which was met only through the co-ordinated rescheduling organised by the central banks of the major creditor countries, exposed the total inadequacy of bank capital in comparison to the gigantic volume of international lending and gave new momentum to the search for a solution.

A connected issue, that also attracted the interest of the Basle Committee, concerned the explosion of off-balance-sheet credit exposures, frequently in the form of innovative, securitised instruments. As the various national regulatory authorities relied for the supervision of capital adequacy on gearing ratios, which simply related capital to the total volume of assets on a bank's balance sheet, the rearrangement of their activities by moving assets off-balance-sheet provided banks with an opportunity of avoiding supervisory pressures for the strengthening of capital positions. However, the new instruments were particularly complex and posed previously unknown risks, which the bankers might perhaps underestimate.250

Competitive considerations precluded a unilateral solution to the problem of bank capital adequacy. The imposition of capital requirements constrains the ability of banks to expand and increases their costs of doing business. Capital is not only a scarce, but also an expensive, resource. For a bank it is much cheaper to raise other bank liabilities, especially deposits, when these are effectively protected by explicit or implicit public safety-nets, because capital instruments carry considerable residual risk for the investors. For this reason, the unilateral imposition of more onerous capital rules on the banks of one country only would jeopardise their competitiveness in the international markets and could also have perverse prudential effects, by encouraging a more risky strategy in an attempt to counteract the impact of the regulator-induced cost disadvantage on their profitability.

As early as 1980, the Bank of England had taken measures to improve the capital adequacy of U.K. banks by putting in place an informal risk-related

framework of capital adequacy standards. A year later, the U.S. Federal Reserve Board and the Office of the Comptroller of the Currency issued a joint policy statement, imposing for the first time federal minimum gearing ratios (at a level of 5% of "primary capital" to total assets for regional banks and 6% for community institutions). Nonetheless, an indirect effect of these efforts was to provide a very significant cost advantage to Japanese banks, which were able to operate safely on much lower capital levels (gearing ratios of 2 to 3%), because the Japanese government was standing firmly behind them and had never allowed a significant bank to fail in the post-War era. With the help of this advantage, the share of international banking business of Japanese banks rose from 17% in 1983 to 38% in 1988, while during the same period the share of U.S. banks fell from over 26% to under 15%. Anglo-American domestic markets were also threatened by the expansion of Japanese banks. While in the mid-1980s there was no Japanese presence in domestic U.S. banking markets, by the end of the decade one-eighth of all bank assets were controlled by Japanese banks. In comparison, U.S. banks were barely present in Japan's protected, and very profitable, domestic markets.

In the wake of the Third-World debt crisis, the U.S. Congress gave statutory legitimacy to the promulgation of federal standards of capital adequacy by enacting the International Lending Supervision Act of 1983 ("I.L.S.A."). The enactment of I.L.S.A. also provided the Federal Reserve Board and the U.S. Treasury with a mandate to pursue the international convergence of capital standards and the achievement of a competitive "level playing field" through consultations with bank regulators from other nations. In March 1984, Paul Volcker, then Chairman of the Federal Reserve Board, armed with the recent mandate, raised with the other G-10

253 It should be noted, however, that higher leverage was not the only source of cost advantages for Japanese banks, which also benefited from the anti-competitive elements in Japanese patterns of market entry, deposit-rate regulation, etc. The introduction of uniform international minimum capital standards cannot provide a remedy for such more opaque forms of competitive inequality; see E.J. Kane, "Incentive conflict in the international risk-based capital agreement" (May-June 1990) 14:3 Fed.Res.B. Chicago Ec.Persp. 33. Thus, even after the adoption of the Basle Accord, Japanese banks continued to enjoy a competitive advantage, due to their ability to raise capital at significantly lower cost than their U.S., U.K. and Canadian competitors, who face particularly high costs, with German and Swiss banks standing somewhere in the middle; see S.A. Zimmer and R.N. McCauley, "Bank cost of capital and international competition" (Winter 1991) 15:3-4 Fed.Res.B. New York Quarterly Rev. 33. The phenomenon of unequal cost of capital is intimately linked to fundamental differences in shareholders' valuations of bank earnings in the equity markets of each country.
central bank Governors the issue of an international framework for the measurement of capital adequacy that could ensure the "functional equivalence" of the disparate national regulatory regimes. At the conclusion of the Governors' meeting, the chairman of the Basle Committee, Peter Cooke, was charged with the task of reporting within the year on how comparability of the different measures of capital adequacy could be achieved.\textsuperscript{257}

Of the three elements on which convergence depended, \textit{i.e.}, a common definition of capital, a common framework for measuring capital adequacy and a common minimum standard, the Basle Committee was able to make progress only on the second. Under the influence of the seven participating countries which were also Member States of the E.C., where a common framework risk-based measurement of capital was used for observation purposes since the late 1970s, by February 1986 the Basle Committee had reached agreement that a risk-weighted approach should be preferred over a gearing measure.\textsuperscript{258} The collapse of Continental Illinois in May 1984, despite its relatively high gearing ratio of 5.8\%, helped to convince the Americans of the merit of the risk-weighted approach, by showing that straight gearing ratios could be seriously misleading and even perverse, since they could induce banks to take on riskier business as a means of restoring their profitability. On the other hand, fundamental disagreements continued to divide the countries on the issue of the constituent elements of capital. The only commonly acceptable items were shareholders equity and retained earnings. Regarding the admission of "impure" forms of capital, however, there were insurmountable difficulties: Germany wanted their total exclusion, the U.S. pressed for the inclusion of loan loss provisions, while Japan alone insisted on the admission of unrealised capital gains on a bank's equity portfolio as capital. None of the authorities represented in the Committee was ready to accept a radical departure from its own national approach.\textsuperscript{259}

Faced with this impasse, in a meeting on 2 September 1986 the Chairman of the Federal Reserve Board, Paul Volcker, and the Governor of the Bank of England, Robin Leigh-Pemberton, decided that, as there was little chance of a multilateral breakthrough, action should be undertaken on a bilateral basis by the two leading financial jurisdictions.\textsuperscript{260} By adopting simultaneously a common set of risk-based

\textsuperscript{258} See Basle Committee, "Report on International Developments in Banking Supervision: Report No.5" (Sep. 1986), pp.16-19.
\textsuperscript{259} See Solomon, \textit{op.cit.}, n.254, pp.420-421.
capital standards, the authorities in the U.S. and the U.K. could probably convince their national banking industries to abandon their implacable opposition, for well-founded reasons of competitiveness, to their attempts to strengthen bank capital requirements.261

By the end of the year, the technical experts of the two central banks, working outside the Basle framework, had managed to generate a fully articulated risk-based capital adequacy measure for the two countries. This was incorporated in an informal "Agreed Proposal of the United States Federal Banking Supervisory Authorities and the Bank of England on Primary Capital and Capital Adequacy Assessment" (the "U.S./U.K. Accord"), released on 8 January 1987.262 Although agreement had not been achieved on the common minimum standard, the common understanding was that this should be higher than U.S.'s existing 6%.

Crucially, one of the express aims of the U.S./U.K. Accord was "to promote the convergence of supervisory policy and capital adequacy assessments among countries with major banking centres". This implied that it was not necessarily the intention of the Anglo-American regulators to implement its provision as such, but to exert pressure on their counterparties from the other G-10 countries, and in particular Japan, to reach multilateral agreement at Basle. In other words, the U.S./U.K. Accord was intended to provide the "intervening catalyst" in the Basle process.263 The implicit threat was that, if this process did not bear fruit, other countries would be left with the choice either to comply with the Anglo-American standards or to face exclusion of their banks from New York and London.

Despite some initial negative reactions from the European Commission and elsewhere to such an "ultimatum", the G-10 central bank Governors were generally understanding.264 It was agreed that the Basle Committee should explore the feasibility of a multilateral alternative, otherwise the bilateral Accord would be implemented by the end of 1987. Capital definitions continued to be the biggest stumbling block. Both Germany and Japan resisted the idea of international convergence on the basis of the bilateral agreement, but for opposite reasons,
leaving the initiative with the Anglo-American axis. With the possibility of a financial trade war looming larger by the day, a compromise was finally achieved with the Japanese. By September 1987, the Basle Committee had concluded its draft report. Three months later, the G-10 central bank Governors finalised the emerging agreement and circulated it for comment in the form of a consultative paper. The final agreement was eventually endorsed by the Governors in July 1988. From this point, its implementation was left to the national supervisors represented in the Basle Committee.

The Basle Accord bases its definition of capital on a distinction between "Tier 1" or core capital (comprising equity, disclosed retained earnings and certain types of perpetual preferred stock) and "Tier 2" or supplementary capital (including a number of other sources of more or less permanent bank funding, such as undisclosed reserves, revaluation reserves, general loan loss reserves, certain hybrid instruments combining equity and debt characteristics and subordinated term debt with a minimum maturity of five years). At least half of a bank's minimum capital requirement should be met out of Tier 1 items. Moreover, for the measurement of a bank's capital adequacy, its goodwill, its investments in unconsolidated subsidiaries engaged in banking and financial activities, and its holdings of capital instruments issued by other banks or deposit-taking institutions should be deducted from its capital base.

Under the Basle Accord, a bank's capital base should be related to its risk-weighted assets, i.e., the sum of the value of its assets as adjusted to reflect their different credit risk. Assets should be allocated to five risk-weighting categories (0%, 10%, 20%, 50%, 100%), depending on the nature of the relevant counterparty. A 0% weight was assigned to cash, claims on (or guaranteed by) central governments and central banks of the O.E.C.D. countries, claims collateralised by cash or O.E.C.D. central-government securities, and claims on (or guaranteed by) other central governments and central banks insofar as they are denominated in the national currency and funded in that currency - in other words, these assets were totally excluded from the calculation of the bank's credit exposure. A weight of between 0% and 50%, at the discretion of the national authorities, should be applied to claims on entities of the domestic public sector and local government. A 20% weight was assigned to claims on multilateral lending institutions and regional development banks, claims on other banks incorporated in the O.E.C.D. countries,

---

265 Germany pleaded for a formal framework based on a very narrow definition, while Japan pressed for maximum informality and the inclusion in a bank's capital base of so suspect an item as unrealised capital gains from shareholdings - a form of capital that could be dissipated quickly in the event of a sharp decline in equity markets. See ibid., p.426.

266 Basle Accord, loc.cit., n.244, Part I.
claims on banks incorporated outside the O.E.C.D. countries with a remaining maturity of less than one year, and claims on non-domestic entities of the public sector of the O.E.C.D. countries. Loans secured by mortgages on residential property attracted a 50% weight. Finally, a 100% weight was stipulated for almost all commercial and consumer loans or other exposures to the private sector, claims on, or guaranteed by, non-O.E.C.D. central governments and central banks which are not denominated and funded in the local currency, or longer-term claims on banks incorporated outside the O.E.C.D. - that is, these assets are taken into account at their full nominal value for the calculation of the bank's capital adequacy. Off-balance-sheet exposures should be converted into estimated equivalent on-balance-sheet exposures to the same counterparties according to specified procedures and then included in the calculation.267

The Basle Accord set the minimum ratio of total capital to risk-weighted assets at 8% on a consolidated basis, although the national supervisors were left free to impose higher requirements. The Accord required that all internationally active banks comply with the minimum ratio by the end of 1992, at the latest.268

The Basle Accord was expressly adopted as a means for attaining a high degree of consistency in bank capital standards, with the purpose of diminishing an existing source of competitive inequality.269 Nonetheless, it has by no means achieved real uniformity. The Basle Committee itself accepted in the introduction to the Accord that differences in the fiscal treatment and accounting presentation of various items for tax purposes could distort the measurement of the capital positions of international banks, but noted that there was little that it could do in this connection.270 Moreover, to ensure widespread acceptance, the Basle Accord has given national authorities a substantial degree of discretion in the interpretation and implementation of its requirements. This has increased the number of countries willing to adhere to the spirit of the agreement, but only at the cost of minimising the Accord's benefits in terms of ensuring competitive equality.271

267 Ibid., Part II.
268 Ibid., Part III. Insofar as the deadline for compliance with the 8% minimum standard was concerned, the UK had pressed for a short transition period, because all its banks were already operating on high capital levels. However, the other countries insisted on a longer transitional period, and the final date for compliance was set at the end of 1992.
269 Ibid., para.3.
270 Ibid., para.9
271 M.J.B. Hall, Banking Regulation and Supervision: A Comparative Study of the U.K., U.S.A. and Japan (1993), ch.8, identifies examples of resulting discrepancies in the acceptance of Tier 2 capital items, e.g., in the deductions from the capital base and in the assignment of particular risk weights to bank assets, which can have a significant impact on the marginal pricing of banking services. The specification of different capital adequacy requirements for individual banks by their national regulators, subject to the agreed minimum ratio, is also an important source of inequalities.
Insufficient uniformity, however, may not be the most significant defect of the Accord. Numerous other fundamental problems have been identified. The division of assets in risk categories, driven by political considerations, is a mechanical accounting exercise with bears little relationship to the assets' actual credit risk, while the relationship of the risk weights between one another is unrealistic. The measurement ensures very favourable regulatory treatment for the sovereign debt of the O.E.C.D. countries (and of other countries, provided that the relevant claims are denominated and funded in the domestic currency) and for interbank claims on banks incorporated in the O.E.C.D. countries, but makes no effort to differentiate between various claims on the private sector, which attract a blanket 100% risk-weight. The correlation of risks within a bank's asset portfolio, or the effects of specialisation on its ability to monitor and manage particular categories of risk, are not taken into account and there is no provision for non-credit risks. Moreover, the capital standards apply only to banks, distorting the competition between banks and non-bank financial intermediaries such as securities firms, and creating incentives for the avoidance, or at least minimisation, of regulatory burdens through market adaptation. The Accord also fails to deal directly with the competitive implications of government support in the form of safety-net policies which protect banks and their depositors in many countries.

Nevertheless, for all its technical crudeness, the Basle Accord has probably been beneficial as a multilateral response to the problem of falling capital standards. It has impeded an escalation of the subsidisation of banks' risk-taking though unilateral competition in laxity by national banking authorities and set a basis for co-ordinated regulatory responses for the purpose of moving the costs from the globalisation of banking activities back to the private sector.

---


273 H.S. Scott and S. Inwahara, In Search of a Level Playing Field: The Implementation of the Basle Capital Accord in Japan and the United States (1994), p.69, summarise the situation with regards to competitive advantages as follows: first, factors for which the Basle process cannot provide a remedy, like public subsidies, have a heavy impact on competition; second, the effect of the Basle Accord is highly influenced by national accounting rules and other balance-sheet regulations - for example, loan loss reserve policies; third, cross-national differences in legal regimes and capital markets can provide significant advantages in utilising various capital instruments and in holding assets of different risk-weights; fourth, differences in the public enforcement of capital requirements have not been remedied by the Basle Accord.

With the Accord finally in place, the interest of the Basle Committee has turned in recent years to its refinement, but, more importantly, to its expansion to cover non-credit risks undertaken by banks, in particular risks arising in the context of banks' securities business. The significance of securities activities relative to banks' traditional lending business increases steadily from year to year. At the same time, the progressive integration of banking and securities markets is reflected in the growing presence of financial conglomerates, combining in the same group banks and securities firms.

The involvement of banks in the securities markets, whether directly or through affiliated firms, has momentous regulatory implications, forcing banking supervisors to develop prudential mechanisms for the control of the additional risks incurred by the banks in this manner. In its turn, the introduction of prudential controls creates the need for banking supervisors to establish contacts with the regulators of securities firms, because without co-ordination of the regulatory responses banks may find themselves at a competitive disadvantage against their non-bank competitors in the securities markets. The approaches of different jurisdictions towards the monitoring and control of risks from securities business is also necessary to ensure a "level playing field" internationally.

Nonetheless, regulatory convergence in this area meets tremendous practical difficulties, due in part to technical difficulties relating to the measurement of risk exposure, but primarily to the fact that the commitment of the regulators of non-bank securities firms to the project of harmonisation is rather limited. The internationalisation of securities markets is a recent phenomenon, and pressures for equal regulatory treatment for all participants are not yet particularly strong. At the same time, regulatory responsibilities for securities markets at the national level are often fragmented, while international co-ordination between them is still in its

275 Over the years, the Committee has made a number of amendments to the Accord, for the following purposes: to refine the definition of capital through a differentiation between different categories of provisions, which may or may not be counted in a bank's capital base; to change the definition of O.E.C.D. countries for the purpose of calculating capital requirements for exposures to foreign governments, by refusing the lowest risk-weights to countries which have rescheduled their external sovereign debt within the previous five years; to reduce a bank's capital requirements insofar as valid bilateral netting arrangements between that bank and its counterparties are in place, since such arrangements effectively reduce credit risk; and to modify capital requirements in the direction of capturing more accurately the potential future credit exposure associated with off-balance-sheet items. See, respectively, "Amendment to the Basle Accord" (Nov. 1991); "Amendment to the Capital Accord of July 1988" (July 1994); "The Capital Adequacy Treatment of the Credit Risk Associated with Certain Off-Balance-Sheet Items" (July 1994); and "Basle Capital Accord: Treatment of Potential Exposure for Off-Balance-Sheet Items" (Apr. 1995).

infancy. Moreover, securities regulators have fewer incentives than their banking colleagues to converge on uniform standards: securities activities are organised in discrete national markets and are subject to conduct-of-business constraints, thus facilitating control; there are valid reasons for employing different methods of regulation for different activities or markets; finally, securities regulators do not provide safety-nets to their regulatees and, accordingly, do not have an immediate budgetary reason to curtail their risk-taking. In contrast, the value of the public safety-nets for banking institutions increases in pace with their expansion to securities activities, putting pressure on banking regulators to control risk-taking, without however undermining the ability of their regulatees to compete internationally or domestically with non-banks.

The Basle Committee has undertaken a great deal of work in co-operation with the Technical Committee of the International Organisation of Securities Commissions ("I.O.S.CO.") for the purpose of devising common capital standards for financial intermediaries' market risk, i.e. the risk of losses on open positions in securities, derivative instruments and foreign exchange in an institution's trading portfolio as a result of adverse movements in market prices, including interest rates, exchange rates and equity values. However, the discussions between the two groups broke down in late 1992, because of the inability of I.O.S.CO.'s members to reach agreement amongst themselves. Following this, the Basle Committee decided to proceed on its own. Taking account of the banking industry's responses to its original proposals, in April 1995 the Committee issued a set of revised consultative proposals, aiming to issue a definitive Supplement to the Accord by around the end of 1995, which the member countries should implement by the end of 1997. The proposals include a modified definition of capital and a framework for the calculation of explicit capital charges for market risks. Where a bank uses sophisticated in-house models for measuring and managing its market risk, these

---

281 "Proposal to Issue a Supplement to the Basle Capital Accord to Cover Market Risks", ibid., para.25.
282 "Planned Supplement to the Capital Accord to Incorporate Market Risks", loc.cit., n.280. In addition to market risks from the trading of debt and equity securities, derivatives and foreign exchange, the framework also covers risks arising in connection to commodities trading.
may be employed, instead of the Committee's standardised methodology, for the calculation of the capital requirements, subject to a number of carefully defined criteria\textsuperscript{283}; in this case, however, the bank will be required to hold capital amounting to a multiple (at least three times) of its measured overall market risk exposure ("total value-at-risk").\textsuperscript{284} In a Press Communiqué issued on 12 December 1995, the Basle Committee disclosed that at their meeting in Basle the previous day the Governors of the G-10 central banks had endorsed its proposal to supplement the Accord to take account of market risks and announced that a full package of papers for this purpose would be issued in January 1996. The papers would reflect the proposals of April 1995, subject to certain amendments. It is still early to say whether the new arrangements will be successfully implemented and, if so, how they will affect competition between banks and non-bank financial firms, which may not be subject to similar requirements.

For the time being, however, comprehensive harmonisation in this area has been achieved only by the E.C., where the application of common capital requirements for the trading activities of all financial intermediaries, regardless of whether they are organised as credit institutions or investment firms, was necessary as a prerequisite for the integration of the internal market in financial services and the mutual recognition of national regulatory standards for investment firms.\textsuperscript{285}

\textit{(b) Harmonisation of banking regulation in the E.C.} Within the E.C., the aims of market integration and Community-wide provision of services by their suppliers under conditions of competitive equality have been enshrined in the Treaty of Rome.\textsuperscript{286} In the area of financial services, the necessities of integration have provided a strong impetus towards comparable regulatory standards. Accordingly, harmonisation at the Community level has been more comprehensive than anything achieved by the Basle Committee and has taken binding legal form. The U.K. and

\begin{itemize}
\item \textsuperscript{283} "An Internal Model-Based Approach to Market Risk Capital Requirements", \textit{loc.cit.}, n.280.
\item \textsuperscript{284} \textit{Ibid.}, paras.IV.19-20. "The multiplication factor will be set by individual supervisors on the basis of their assessment of the quality of the bank's risk management system, subject to an absolute minimum of 3 (although this minimum number may be reviewed in light of additional experience). The Committee has agreed that banks should be required to add to this factor a "plus" directly related to the ex-post performance of the model, thereby introducing a built-in positive incentive to keep high the predictive quality of the model (e.g. it could be derived from the outcome of so-called "back-testing" and be zero when such results are satisfactory); para.IV.20 (emphasis in the original). See also Patricia Jackson, \textit{"Risk measurement and capital requirements for banks"} (1995) 35 \textit{B.E.Q.B.} 177.
\item \textsuperscript{285} Council Directive 93/6/EEC of 15.3.93 on the capital adequacy of investment firms and credit institutions (the "Capital Adequacy Directive"). The Capital Adequacy Directive's scope is wider than the Basle Committee's proposals, but the methodology and much of the detail is similar.
\item \textsuperscript{286} Arts.52-58 on the right of establishment and arts.59-66 on the freedom to provide services.
\end{itemize}
Germany, being the Member States with the most significant banking industries, have played probably the leading role in the elaboration of common rules.

The initial Community strategy for financial integration was predicated on the need to introduce a compulsory common legislative framework for all European banks. However, the attempts undertaken in this direction in the early 1970s failed, as the Member States were unable to reach agreement on the appropriate legislation. As a result, a new approach was adopted which, without abandoning the aim of substantial uniformity, would attempt to implement it gradually. The legal form of directives, instead of regulations, was chosen for this purpose, since directives require implementation by the Member States and, accordingly, preserve a semblance of national discretion, at least in the details. For some time, however, even this approach had only modest results.

In 1977, the First Banking Directive concentrated on the co-ordination of the conditions for the pursuit of banking activities, in the expectation that eventually banks with their head office in a Member State wishing to establish themselves in another Member State through a branch would be exempt from the latter's regulatory requirements. In this manner, home-country control was recognised in principle as an objective of Community banking law. As a first step of harmonisation, the First Banking Directive introduced a requirement of prior authorisation for the operation of "credit institutions", i.e. undertakings whose business is to receive deposits or other repayable funds from the public and to grant credits for their own account. The Directive set out as minimum requirements for an institution's authorisation its adequate and separate capitalisation, the effective direction of its business by at least two persons of good repute and appropriate

---

287 The one concrete step towards market integration in this period was Council Directive 73/183/EEC of 28.6.73 on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of self-employed activities of banks and other financial institutions, which abolished discriminatory national restrictions on the taking-up of banking activities by banks originating in another Member State. However, a series of decisions of the E.C.J., establishing the direct effect of art.52 (on the freedom of establishment) and art.59 (on the freedom to provide services) of the Treaty of Rome, made the Directive redundant almost immediately; Case 2/74, Jean Reyners v. Belgium [1974] E.C.R. 631; and Case 33/74, Van Binsbergen v. Bestuur van de Bedrijfsvereniging voor de Metaalnijverheid [1974] E.C.R. 1299, respectively. On the other hand, Van Binsberger established that the application of specific national restrictions to the cross-border provision of services was compatible with the Treaty, if these were objectively justified by the general interest and non-discriminatory; see also Joined cases 110 and 111/78, Ministère Public v. Willy van Wesemael [1979] E.C.R. 35; Case 115/78, J. Knoores v. Secretary of State for Economic Affairs [1979] E.C.R. 399.


289 Ibid., preamble, 10th recital.

290 Art.3(1). The concept of "credit institution" is defined in art.1.
experience and the submission to the authorities of a program of operations. The Directive precluded Member States from applying the economic needs of the market as a criterion of authorisation. For the prevention of abuses of the authorisation process, Member States were required to provide reasons for their decisions by means of which authorisation is refused or withdrawn and to give to the institution concerned a right of appeal to the courts. As this limited harmonisation was not sufficient for carrying out the principle of home-country control, the authorisation and regulation of local branches remained at the hands of the host Member State, pending further co-ordination.

Although the First Banking Directive was envisaged as only a first step towards the full harmonisation of banking regulation, for a number of years little additional progress was made. In response to the failure of Banco Ambrosiano, the principle of consolidated supervision, which had been developed by the Basle Committee, was adopted by the Community. Furthermore, the requirements concerning the annual and consolidated accounts of credit institutions were harmonised, as part of the more general harmonisation of company accounts. Finally, the Commission issued non-binding recommendations on the control of large exposures and the introduction of deposit-guarantee schemes by the Member States. None of these, however, had

291 Art.3(2) and (4).
292 Art.3(3).
293 Art.3(6), 8(5) and 13.
294 Art.4(1). Nonetheless, the Directive required close collaboration between the competent national authorities regarding the supervision of institutions operating in more than one Member State and the exchange of all information likely to facilitate the monitoring of their liquidity and solvency; art.7(1). It also forbade the application by Member States of more favourable treatment to the branches of third-country institutions than to those of institutions having their head office within the Community; art.9(1).
296 Council Directive 86/635/EEC of 8.12.86 on the annual accounts and consolidated accounts of banks and other financial institutions. The Directive applied to financial institutions the principles of the Fourth Council Directive 78/660/EEC of 25.7.78 on the annual accounts of certain types of companies and the Seventh Council Directive 83/349/EEC of 13.6.83 on consolidated accounts, but provided for certain exceptions in the format of the accounts to reflect the specific characteristics of these institutions. Council Directive 89/117/EEC of 13.2.89 on the obligations of branches established in a Member State by credit and financial institutions having their head offices outside that Member State regarding the publication of annual accounting documents exempts the branches of banks whose accounts conform to the standards of Directive 86/635/EEC from the obligation to publish further accounts relating to their own activities, although it allows the host Member State to require the publication by branches of additional information on certain specified matters.
297 Commission Recommendation 87/62/EEC of 22.12.86 on monitoring and controlling large exposures of credit institutions; and Commission Recommendation 87/63/EEC of 22.12.86 concerning the introduction of deposit-guarantee schemes in the Community. The adoption of binding directives on these matters made both of these recommendations redundant. These Recommendations have now been replaced by binding directives; see infra, nn.314 and 318.
any appreciable impact in terms of market integration. The requirement of host-
country authorisation and control continued to separate the national banking
markets of the Member States, especially as harmonisation had not been achieved
with regard to basic prudential standards, including the financial requirements for
banks. The host Member State, especially if it had a strong domestic banking industry,
could always artificially inflate or manipulate its regulatory demands in order to deny
access to foreign banks.

A number of factors impeded further convergence: the Member States continued
to exercise close control on banking for purposes of monetary and general economic
policy; their conceptions of appropriate regulation diverged; as the freedom of
movement of capital had not yet been implemented, the policy autonomy of the
Member States on regulatory matters was not constrained by the threat of
disintermediation and flight of capital abroad; and the requirement of unanimity for
the adoption of directives made decision-making particularly cumbersome.

The breakthrough in this connection was the decision for the completion of the
internal market by the end of 1992. The new emphasis on market integration and
the amendment of the Treaty of Rome, which made possible the adoption of banking
directives by qualified majority voting, rather than unanimity, in the Council,
created the conditions for further harmonisation. Furthermore, the full liberalisation
of capital movements, in pursuance of Article 57 of the Treaty of Rome, which was
accomplished on 1 July 1990, made the opening up of banking markets
unavoidable. This necessitated regulatory approximation as a means of ensuring
that banks of different national origin would compete on equal terms in the single
market and that these terms would not be dictated by the most liberal national
régime, but would reflect the concerns of the major Member States. In the
meantime, its close involvement in the convergence work of the Basle Committee, in
which seven of the twelve Member States were represented, and in particular the

298 See European Commission, White Paper, "Completing the Internal Market", COM (85) 310;
and the amendments to the Treaty of Rome made by the Single European Act. On the
Commission's policy for the accomplishment of a single banking market, see G.S. Zavvos,
"Towards a European Banking Act" (1988) 25 CMLR 263; idem, "The integration of banking
markets in the EEC: the Second Banking Coordination Directive" (1988) 3 JIBL 53; idem,
463.

299 New art.100A, inserted by the Single European Act.
Rome.
301 The close link between the liberalisation of capital movements and banking services was
recognised by the Treaty of Rome, art.61(2).
302 Following the accession of Sweden to the European Union, currently the Community is
represented in the Basle Committee by eight Member States.
promulgation of the Accord in 1988, had provided the Community with commonly accepted understandings and a framework of regulatory standards on which to build.

Even so, comprehensive harmonisation appeared still to be politically unattainable. A solution to this problem emerged when the objective of full harmonisation was abandoned in favour of the mutual recognition of the regulatory standards of the Member States, subject to the harmonisation of only those elements of regulation, as to which convergence was accepted to be essential. The idea of mutual recognition was adapted from the case-law of the European Court of Justice on the free movement of goods.  

The new strategy permitted the adoption of the Second Banking Directive in December 1989, which established firmly the shift from host-country control of branches to the mutual recognition of national licenses, opening the way to Community-wide provision of banking services, whether cross-border or by establishment of branches, on the basis of a credit institution's home authorisation, with prudential supervision also being reserved, subject to limited exceptions (relating to the supervision of liquidity and of market risks from securities trading, which were made a joint responsibility of the home and host authorities, and the preservation of the host Member State's right to ensure compliance with its monetary policy), for the home authorities ("single banking license"). An indirect effect of the single banking license, by means of which most of the functions of a "universal bank", combining traditional lending finance with securities activities, can now be carried out by a credit institution in any host Member State, was that it fostered product deregulation and the Community-wide prevalence of universal banking.

The minimum harmonisation that was a prerequisite of the mutual recognition of national regulatory standards was achieved in part by certain provisions in the Second Banking Directive, which set an absolute minimum capital requirement of ECU 5 million for credit institutions, required the vetting of their owners and imposed limits on their participations in non-financial undertakings. The more significant element of harmonisation, however, consisted in the formal adoption, by

---

305 Title V (arts.18-21).
means of the Own Funds Directive\textsuperscript{309} and the Solvency Ratio Directive,\textsuperscript{310} of the Basle Accord's risk-related capital requirements, including the minimum ratio of 8\% of acceptable capital items ("own funds") to risk-weighted assets, for all credit institutions within the Community.

The harmonisation of a limited number of minimum rules only has been criticised by some commentators, on the ground that it does not lead to a really unified market.\textsuperscript{311} On this view, if there is to be a truly European market, regulation should be conducted at the E.C. level. Instead, the approach adopted by the Community did not remove the incentives of national authorities to compete for attracting financial activity.

Against this argument (and apart from any argument of subsidiarity or objection to the centralist idea of Europe as a super-state in waiting), the political impossibility of wholesale agreement in uniform standards, that would oblige the Member States to give up immediately all control over an industry serving frequently as a vehicle for the implementation of national economic policy, and the need to achieve agreement in steps must be kept always in mind. Despite these constraints, the single license made redundant the anti-competitive effects of the higher regulatory standards of certain Member States, as incoming banks can now secure access to their markets simply by conforming to their home-State rules.

Conversely, it is doubtful whether the Member States can engage unilaterally in competitive relaxation of their regulatory standards, as implied by the criticisms. By insisting on uniform minimum capital standards, the Community has preempted this development to a considerable extent. These, far from encouraging "competition in laxity", could be interpreted as introducing an effective constraint on the growth of banks originating in the weaker Member States, as these may find it difficult to meet the uniform solvency levels due to low profitability and their limited ability to raise new capital. In addition, the credible implicit safety-nets provided by the authorities of the stronger Member States discourages the drift of banking business to jurisdictions with low supervisory standards. However, even on the assumption that the national authorities can relax unilaterally their regulatory standards in a manner designed to provide a competitive advantage to their banking industries, the host

\textsuperscript{309} Council Directive 89/299/EEC of 17.4.89 on the own funds of credit institutions (the "Own Funds Directive"). This technical directive determined the items which may be included in the calculation of a bank's capital ("own funds").

\textsuperscript{310} Council Directive 89/647/EEC of 18.12.89 on a solvency ratio for credit institutions (the "Solvency Ratio Directive"). This establishes common rules for the risk-weighting of assets and off-balance sheet items and set the minimum ratio of 8\%.

authorities could respond by imposing higher liquidity requirements on the suspect banks.312

In any event, the fundamental success of the Community's policy is displayed by the fact that the mutual recognition of regulatory standards, instead of entrenching national differences, has actually accelerated the trend of convergence, gradually levelling the remaining differences. In 1992, directives introducing a revised framework for consolidated supervision313 and setting limits on large exposures314 were adopted. The following year, in conjunction with the application of the single-license approach to the securities industry,315 uniform capital requirements for both investment firms and credit institutions were promulgated in the Capital Adequacy Directive,316 with the aim of covering risks arising from the securities and foreign-exchange trading activities of these institutions. In combination with the Own Funds and Solvency Ratio Directives, the Capital Adequacy Directive completes the risk-related framework of capital adequacy for banks.317 In May 1994, the Deposit-Guarantee Directive was adopted, requiring the introduction by the Member States of deposit-guarantee schemes ensuring a degree of protection for all depositors of credit institutions.318 As a minimum, the national schemes must guarantee the repayment of at least the first ECU 20,000 of a depositor's aggregate deposits with the participating banks' branches in any Member State (although a lower optional minimum of ECU 15,000 may be applied provisionally); national schemes may limit the guarantee to a specified percentage of aggregate deposits, but this percentage must be at least 90% of aggregate deposits until the amount that the depositor is entitled to recover reaches ECU 20,000. The Directive is based on the home-country principle. As a result, the costs of bank failure are shifted, at least insofar as formal deposit insurance is concerned, to the national authorities who are responsible for exercising supervisory control. This is an important disincentive to competition in laxity, because it dissuades Member States which act as centres for international

312 For a game-theoretical analysis of the effects of the mutual-recognition approach, see P. van Cayseele and D. Heremans, "Legal principles of financial market integration in 1992: an economic analysis" (1991) 11 Int.Rev.L.&Econ. 83.
317 For a discussion of these Directives' requirements and U.K. implementations, see infra, ch.3, section 2.
financial operations, such as Luxembourg, from tolerating the operation of weak banks from their jurisdiction or exercising inadequate prudential supervision, in the expectation that the costs of failure will be shouldered by other countries.

With the adoption of these measures, and in particular of the common capital rules for the securities activities of banks, the Community has achieved substantial convergence in matters as to which the Basle Committee has been unable to make concrete progress. The pace of harmonisation indicates, not simply a strong commitment to the objective of a single banking market, but also the high degree of integration which has already been achieved and which necessitates an active search for competitive-neutral regulatory solutions by the Member States.

The residual discrepancies in national regulatory régimes seem to reflect, not as much conscious competitive strategies aimed at attracting banking business by manipulating the prudential standards, as more mundane differences in the quality of supervisory performance, which can be explained by the limited manpower, sophistication or resources of the national authorities of the smaller Member States. By requiring them to supervise groups headed by credit institutions authorised by them on a consolidated basis, the current allocation of regulatory responsibilities increases unduly the regulatory burden on these authorities.319

The significance of these developments for the internal development of banking regulation in the U.K. cannot be underestimated. It is true that, for the most part, the regulatory solutions endorsed by either the Basle Committee or the E.C. bear a close resemblance to policies developed somewhat earlier by the Bank of England. This is a result of the predominant position of London as a financial centre and of the leading role taken by the Bank in the convergence process. In the context of the Basle Committee, the proactive, and even hegemonic, approach of the Bank culminated, as has been already explained, in the bilateral U.S./U.K. Accord of 1987, which acted as a catalyst for the acceptance of the Accord by the other members of the Committee, not least Japan. Within the E.C., the U.K. and Germany, the two most significant financial jurisdictions, have had a greater input in the policy-making process than any other Member State. In this sense, the influence of the Bank's internal policy-making on multilateral convergence has been stronger than any influence exercised in the opposite direction. Nonetheless, even leaving aside particular rules which do not reflect U.K. thinking, the adoption of a growing number of regulatory rules at Community level is particularly significant in terms of the legal formalisation of regulatory policy. It also imposes strong constraints on the Bank's future policy autonomy.

Chapter 2

Authorisation and Supervision of Deposit-Taking Institutions under the Banking Act 1987

The Banking Act 1987 provides the statutory basis for the administration by the Bank of England of prudential regulatory controls, applicable to all undertakings that accept deposits within the jurisdiction. The Act, which replaced the original Banking Act of 1979, is described in its long title as "[a]n Act to make new provision for regulating the acceptance of deposits in the course of a business, for protecting depositors and for regulating the use of banking names and descriptions".

The Act pursues its protective purposes mainly by establishing a licensing system for deposit-taking institutions, restricting the use of banking names and descriptions and setting up a deposit-guarantee scheme for the partial compensation of the depositors of insolvent authorised institutions.

The specific intention of the Act's licensing requirements is to limit participation in the deposit-taking industry only to those institutions which appear to satisfy appropriate criteria of safety and soundness that indicate that their conduct is unlikely to jeopardise the interests of their depositors. The functions relating to the licensing of deposit-takers are delegated to the Bank of England, which is given the power to grant, restrict or withdraw authorisation on a largely discretionary basis. The Bank can rely on this power to regulate authorised institutions on an on-going basis.

The Act's provisions on authorisation constitute for the Bank the primary jurisdictional basis for its regulatory activities. An understanding of their operation is necessary for the legal evaluation of its role as banking regulator. In essence,

1 Pt.I (ss.3-49). Generally on licensing as a regulatory instrument, see G. Williams, "Control by licensing" (1967) 20 C.L.P. 81; H. Street, Justice in the Welfare State (2nd ed., 1975), ch.4; S. Breyer, Regulation and its Reform (1982), chs.4-5 and 7.
2 Pt.III (ss.67-73).
3 Pt.II (ss.50-66). See infra, ch.5, section 5.
4 However, the Bank also exercises regulatory functions in areas which are outside the Banking Act; see infra, ch.4.
although the provisions impose certain constraints on the Bank, their overall effect is to give to the latter a large degree of discretion, subject to limited external controls.

The boundaries of the statutory scheme of banking regulation are set by the prohibition on unauthorised deposit-taking, which provides the cornerstone for the delegation to the Bank of regulatory responsibility in this area. In an effort to prevent the phenomenon of regulatory avoidance, the scope of the prohibition is not confined to the business of "banking" as traditionally understood and defined in common law, but extends to a much broader range of activities which fall within the intentionally over-inclusive statutory definition of "deposit-taking" business (section 1).

The authorisation of deposit-taking institutions depends on the fulfilment by the deposit-taking institution of a number of "minimum" statutory criteria, which must be met not only at the time of the initial application for authorisation, but at all times following authorisation. Otherwise, the Bank's powers of intervention, in the form of withdrawal or restriction of authorisation, become exercisable. The statutory criteria, however, are not sufficiently precise or their meaning sufficiently entrenched to be self-implementing. Accordingly, a judgement on whether individual institutions satisfy the conditions for authorisation does not involve merely questions of fact but also discretionary choices regarding the individuation and operationalisation of the statutory criteria. As the authority responsible for their interpretation and elaboration, the Bank retains wide discretion of an essentially policy-making nature. In addition, even after the Bank has come to the conclusion that the low statutory threshold for its formal intervention has been passed with regard to a particular institution, it remains free to decide whether to take remedial action and of what form. As will be explained in the following chapter, the Bank's discretion is especially wide in connection to some issues of strategic importance, including the specification of financial prudential requirements for individual institutions, the vetting of their individual controllers, directors and managers and, last but not least, their termination.

In cases where the Bank refuses an application for authorisation, restricts or withdraws an existing authorisation or objects to an individual controller, director or manager of a deposit-taking institution, the Act provides rights of appeal to those affected by the relevant decisions. The operation of the appeal mechanism imposes certain constraints on the Bank. However, in view of the low threshold at which the Bank's powers become exercisable and the likelihood that its "expert" regulatory judgements will be treated on appeal with a measure of deference, it is unlikely to lead to systematic outside interventions that could have a considerable impact upon the direction of its regulatory approach and its ability to enforce its views (section 2).
The Bank's capability to individuate its prudential requirements by taking into consideration the distinctive situation of each particular institution, to police effectively the continuing observance of these requirements and to exercise its powers of intervention whenever appropriate, depends on the effective monitoring and supervision of authorised institutions on an on-going basis. The Act provides the necessary legal powers for this purpose. The supervision of authorised institutions is based to a considerable extent on financial returns provided by the institutions themselves and on the Bank's direct contacts with their managers. To ensure the quality of information received in this manner, emphasis is placed on the active involvement of bank auditors in the regulatory process and the opening of channels of communication between them and the Bank (section 3).

1. The authorisation requirement

The statutory prohibition on unauthorised deposit-taking provides the cornerstone of the Bank's regulatory powers. Although the term "banking" appears in the short titles of both the 1979 and 1987 Banking Acts, the statutory regulatory scheme has focused exclusively on a particular characteristic of banks, the engagement in deposit-taking activities, without attempting to provide a statutory definition of the banking firm as a complex institutional form or relying on the common-law definition of banking.\(^5\)

\(^5\) The acceptance of deposits is an essential aspect of banking. Nonetheless, other elements are also necessary before a business can be meaningfully called a bank. A more difficult question is whether these elements are stable enough to generate a legal definition of banking. The sense of the word "bank" depends to a considerable degree on the specific context. For instance, the term can be used for the description of specialist financial intermediaries, such as "investment" or "merchant" banks, which may not present all the characteristics associated with a typical commercial bank. Even with regard to the latter, however, it is questionable whether there is something constant and unique about the bundle of functions performed by them or whether their different functions should instead be disentangled and examined separately. See P.R. Schweitzer, "The definition of banking markets" (1973) 90 Banking L.J. 745, p.747. The historical persistence and geographical spread of banks as a distinctive and successful kind of financial institution, combining within a single business organisation at least three distinctive services, i.e. the acceptance of deposits, the extension of credit on the organisation's own account and the operation of payments, suggests that there are important economies of scope in the production of these services. If this is correct, it could be sensible to use the term "banks" to describe financial institutions involved in the joint production of these services; see P.R. Schweitzer, "Banks and banking - a review of a definition" (1977) 94 Banking L.J. 6. However, a more focused notion of banking could still be warranted for specific purposes. For instance, discussions concerning the possibility of contagious runs are mainly concerned only with a specific aspect of the banking firm, i.e. the production of withdrawable deposits or of a combination of deposits and loans. Contextual and purposive considerations can, thus, be particularly significant for the demarcation of the business of banking for legal purposes.
(a) Meaning of "banking" in common law. The legal definition of "banking" is a matter of considerable significance. The common law recognises the operation of special implicit terms in the contractual relationship of banker and customer. Furthermore, statutory provisions confer in certain cases particular duties or privileges on bankers only. Prior to the enactment of the Banking Act 1979, various enactments referred to "bankers", the "business of banking", etc., either leaving these words undefined or defining them merely in a partial or circular manner. Since 1979 most of these provisions have been brought in line with the Banking Acts, and their scope is now defined by reference to authorised deposit-takers. There are currently only two significant exceptions, where statutory provisions continue to refer directly to bankers, as distinct from authorised deposit-takers. One of them, in the Bills of Exchange Act 1882, is of great importance for the law of negotiable instruments. Although the common-law concept of banking is not necessarily relevant or binding for purposes of statutory interpretation, most references to "bankers" or the "business of banking" in older enactments seemed in practice to rely on these words' usual legal usage.

In their attempt to determine what is a bank, the courts have focused on two main questions: whether, in view of the commercial significance of cheques as a means of payments and the importance of the defences under the Bills of Exchange Act 1882, the collection and payment of cheques is an indispensable element of banking; and whether a firm's reputation as being a "bank" is sufficient to establish banking capacity in circumstances where the essential substantive traits of a banking business are missing.

By providing that only bills drawn on bankers can be cheques, the Bills of Exchange Act 1882 makes the definition of the latter to depend upon that of bankers, and not the other way round. In practice, however, the prevalence of cheques has been accompanied by an implicit assumption that they constitute a
central part of ordinary banking practice. In conjunction with the belief that the nature of the business of banking can change with time and place, this has gradually elevated the operation of chequing accounts into a necessary ingredient of banking, over and above the acceptance of deposits.

At the dawn of this century, the matter came for consideration in an Irish case, Re Shields' Estate. The case concerned a firm which was in the business of lending out money received on deposit against promissory notes and deposit receipts. The firm kept rudimentary books and did not issue cheque-books nor pass-books. Nonetheless, it called itself a "banking" firm and had been so called by the officials of the Bank of Ireland, who were the petitioners in the judicial dispute. Despite an allegation that the firm was not a bank because it did not pay out money on cheques, the court held that for the purposes of the Irish statute in question it would be regarded as one. The opinions, nonetheless, revealed a divergence in the judges' approach. Lord Ashbourne C., noting that the meaning of the word "bank" depended on the facts of each case, admitted that the petitioners' allegation might be plausible in the light of contemporary commercial practice, but should nonetheless fail because the payment of cheques could not have been an essential element of banking at the time when the statute in question was first enacted. In their concurring judgements, Fitz Gibbon L.J. and Holmes L.J. disputed the relevance of cheque business in more general terms. The words of Fitz Gibbon L.J. are worthy of quotation, as they stress precisely those aspects of banking that provide the focal point of the recent Banking Acts:

"What is the essence of banking? The business of banking, from the banker's point of view, is to traffic with the money of others, for the purpose of making profit. But from the customer's point of view, he is a banker ab initio from the moment of receiving the money into his bank; and, in my opinion, the essence of the trade, business, or calling of a banker, is not primarily or essentially to be found in the mode in which he disposes of the money which is deposited with him, but in the mode in which he receives the money of

---

12 Ex p. Coe; Re The District Savings Bank (Limited) (1862) 5 L.T.Rep.(N.S.) 566 (Chan.), is early testimony to the importance attached to the payment of cheques, although it is not clear whether this was the decisive factor in that case. On the other hand, Re The Bottomgate Industrial Co-operative Society (1892) 65 L.T.Rep.(N.S.) 712 (Q.B.D.), p.714, suggested that the operation of deposit accounts repayable on demand would be sufficient to make one a banker, although a fully-fledged banking business could involve additional functions. By the early 1960s, however, the editor of the influential Paget's Law of Banking (6th ed., by M. Megrah, 1961), p.8, could write that, "[i]n view of the provisions of the Bills of Exchange Act, and the later affirmation of cheque business as the leading feature of a bank, the scale would appear to have turned", elevating cheque collection and payments to constituent aspects of banking.
13 [1901] 1 Ir.R. 173 (C.A., Ir.).
14 Ibid., pp.195, 197.
others. If he keeps open shop for the receipt of money from all who choose
to deposit it with him; if his business is to trade for profit in money deposited
with him for that purpose, he answers the description of a 'Banker' ...
[T]hose who take money 'on deposit account' are just as much bankers as
those who hold it 'on current account'."^{15}

On his part, Holmes L.J. placed equal emphasis on a second element, that of lending:
although the occupation of banker had adapted to the changing circumstances, its
true character remained the obtaining of deposits of money for "profit by lending it
out again".^{16}

A number of later foreign decisions support the view that the operation of
chequing accounts is not a necessary part of the business of banking.^{17} Most of them
follow Holmes L.J. in considering that the essence of banking consists in the
financing of a lending business by means of deposit liabilities.^{18} Nonetheless, modern
English law seems to require some measure of cheque business before a firm can be
considered as a bank. Thus, the Privy Council, considering the definition in section
330 of the Ceylon Companies Ordinance, No.51 of 1938, of a banking company as
one "which carries on as its principal business the accepting of money on current
account or otherwise, subject to withdrawal by cheque, draft or order", found that it
"in no way conflicted with the meaning attached to the word in England in 1932".^{19}

In the landmark United Dominions Trust Ltd. v. Kirkwood case,^{20} the Court of
Appeal was faced with a critical dilemma, relating to the exemption from the
provisions for the registration of moneylenders then in force of "any person bona
fide carrying on the business of banking".^{21} Having endorsed five dishonoured bills
of exchange given to a major finance house as security for loans made to the drawee
company, the defendant alleged that the plaintiffs could not recover because they
were unregistered moneylenders. The plaintiffs relied on the banking exemption. A
finding for the defendant would have had devastating repercussions for the whole
finance-house industry.

^{15} Ibid., p.198.
^{16} Ibid., pp.206-207.
^{17} See Commercial Banking Co. Ltd. v. Hartigan (1952) 86 I.L.R. 109 (Cir.Ct., Ir.).
^{18} See in particular Commissioners of the State Savings Bank of Victoria v. Permewan, Wright &
Co.Ltd. (1914) 19 C.L.R. 457 (H.C. of A.); and Australian Independent Distributors Ltd. v.
Winter (1964) 112 C.L.R. 443 (H.C. of A.).
(P.C.), p.383.
^{21} Under the Money-lenders Acts 1900-1927 loans made by unregistered money-lenders were
unenforceable, but bankers were excluded from the definition of "money-lender"; Money-lenders
Act 1900, s.6(d). See supra, ch.1, section 1.
The judge of first instance, Mocatta J., had accepted the view of the editor of the most recent edition of *Paget's Law of Banking* that to carry on the business of banking at that date a person should at least accept deposits on current account, pay cheques drawn on him and collect cheques for customers. In his opinion, the plaintiffs were bankers, because their business included these duties. The Court of Appeal, however, was reluctant to treat the evidence as establishing that the plaintiffs' business presented the usual characteristics of banking. Lord Denning M.R., agreeing with Mocatta J. and *Paget's*, gave the following definition of banking:

"There are [...] two characteristics usually found in banks today: (i) They accept money from, and collect cheques for, their customers and place them to their credit; (ii) They honour cheques or orders drawn on them by their customers when presented for payment and debit their customers accordingly. These two characteristics carry with them also a third, namely: (iii) They keep current accounts, or something of that nature, in their books in which the credits and debits are entered."

Although the plaintiffs did not come within his definition, the Master of the Rolls found a way out by holding that "the usual characteristics are not the sole characteristics". There were "other characteristics which go to make a banker". In particular, reputation as being a banker would suffice to turn the scale. Accordingly, in his opinion, the plaintiffs succeeded only because of their reputation. In a dissenting judgement, Harman L.J. emphasised that the requirement of "*bona fide*" banking business meant that a real banking business had to be shown to exist. Reputation alone was not enough when the essential characteristics of banking, regarding which he shared Lord Denning's views, were missing. On this basis of legal principle and despite being aware of the dire practical implications of his judgement, Harman L.J. found for the defendant. The third judge, Diplock L.J., declared himself inclined to agree with Lord Denning's definition of banking, although he refrained from actually endorsing it. Like Harman J., he found that the "*bona fide*" requirement meant that banking transactions should not be negligible in comparison with the rest of a firm's business and should be "genuinely of this legal nature". Nonetheless, he gave judgement for the plaintiffs on the rather artificial ground that it could be reasonably assumed that their reputation as being bankers, to

---

22 See *supra*, n.12.
25 Ibid., p.447.
26 Ibid., pp.453-456. See also *Stafford v. Henry* (1850) 12 Ir.Eq.R. 400 (Eq.Exch., Ir.).
28 Ibid., pp.465-466.
29 Ibid., pp.466-467.
which several witnesses' had testified, was not based on mistaken belief.\textsuperscript{30} All the speeches in the Court of Appeal indicated that for the purpose of establishing banking identity it was immaterial whether the money accepted on deposit was on "current account", \textit{i.e.} withdrawable on demand, or on "deposit account", \textit{i.e.} withdrawable only on notice. However, term borrowing could not be regarded as deposit-taking.\textsuperscript{31}

The special circumstances of the case can explain the divergence in the judicial opinions. The actual result appears to be one of expediency,\textsuperscript{32} to the extent allowing the defendant to succeed would be tantamount to declaring "a debtors' amnesty",\textsuperscript{33} with disastrous effects for many reputable finance houses. Nonetheless, although its immediate concern was confined to the interpretation of a particular statute, the case has a wider significance because it establishes that deposit-taking together with the collection and payment of cheques are essential elements of banking in modern English law. In addition, Lord Diplock's view that, for a \textit{bona fide} banking business to exist, the banking activities must form a significant part of overall business and must not be a cloak for activities of different legal description, is now generally accepted.\textsuperscript{34} This would appear to exclude mere reputation as a source of banking status, leaving the presence of the objective characteristics as the only correct test of being a bank.\textsuperscript{35}

From the standpoint of private law, the composite definition of banking that emerges from \textit{United Dominions Trust Ltd. v. Kirkwood} seems preferable to a test turning exclusively on the acceptance of deposits, which would go far beyond the common usage of the word "bank". Remarkably, however, the extension of loans out of the money received on deposit was not mentioned as an essential characteristic of banking in the decision. A plausible explanation is that the plaintiffs were evidently satisfying this potential requirement. Nevertheless, the effect of this omission is that lending may not be regarded at present as an indispensable aspect of

\begin{footnotesize}
\textsuperscript{30} Ibid., pp.473-475.
\textsuperscript{31} Ibid., pp.447, 458, 465.
\textsuperscript{32} See M. Megrah, "Banks and moneylenders" (1967) 30 M.L.R. 86.
\textsuperscript{33} In the formulation of Ryder, \textit{op.cit.}, n.6, p.20.
\textsuperscript{34} \textit{Re Roe's Legal Charge} [1982] 2 Lloyd's Rep. 370 (C.A.). The relevant activities must constitute an integral part of a normal course of commercial business. See \textit{Lowe v. Shields} [1902] 1 Ir.R. 320 (C.A., Ir.), holding that assets placed by the executor of a will with another person in his capacity as the will's co-executor were not lodged with a banker, despite the fact that that person was otherwise a banker. It is also well established that activities merely incidental to another business are not enough to make the person carrying them on a banker; \textit{Stafford v. Henry} (1850) 12 Ir.Eq.R. 400; see also \textit{Ex p. Coe; Re The District Savings Bank (Limited)} (1862) 5 L.T.Rep.(N.S.) 566.
\end{footnotesize}
banking. A better definition, which would be of potential use for both private-law and regulatory purposes, would recognise explicitly that, consistently with older and foreign judicial opinion but also with Community law, the combination within the banking firm of deposit-taking and lending services is necessary.

The common-law definition of banking has not been immediately modified by the operation since 1979 of the statutory scheme of banking regulation. The Banking Act stipulates expressly that it does not affect the question whether a person is a banker for purposes external to the particular statutory scheme. However, the prohibition on the unauthorised acceptance of deposits has the necessary effect that the common-law banks must now also be authorised deposit-takers. As a result of this overlap, in combination with the relative decline of cheque payments and ascendance of electronic fund transfers, the terms "bank" and "banker", whose meaning in common law can shift over time, could eventually lose their conceptual independence and be submerged to the concept of "lawful deposit-taker".

(b) The prohibition on unauthorised deposit-taking. The pivotal section 3(1) of Banking Act 1987 prohibits unauthorised deposit-taking in the following terms:

"Subject to [the exemption of a number of persons and transactions], no person shall in the United Kingdom accept a deposit in the course of carrying on (whether there or elsewhere) a business which for the purposes of this Act is a deposit-taking business unless that person is an institution for the time being authorised by the Bank under the [...] provisions [...] of this Act."

The infringement of the prohibition is a serious criminal offence. The words "deposit" and "deposit-taking business", on which the true scope of the restriction hinges, are defined in the following sections in considerable detail.

The meaning of "deposit" in the Banking Act is much wider than in United Dominions Trust Ltd. v. Kirkwood, where the word covered only withdrawable

---

36 In Hafton Properties Ltd. v. McHugh (Inspector of Taxes) [1987] S.T.C. 16 (Ch.D.), the engagement in lending activities, in circumstances where no deposit-taking was taking place within the jurisdiction, was considered insufficient to locate the carrying-on of a banking business in the United Kingdom.

37 See infra, text and nn.84-85.

38 Banking Act 1979, s.36(2); Banking Act 1987, s.69(4).


40 S.3(2). See also s.96.

41 Ss.5 and 6, respectively. See also G. Penn, Banking Supervision: Regulation of the U.K. Banking Sector under the Banking Act 1987 (1989), pp.27-39. The prohibition on unauthorised deposit-taking was drawn in very similar terms in the Banking Act 1979, ss.1-2. A number of minor changes introduced in 1987 aimed mainly at the clarification of the statutory definitions. In contrast with its 1979 predecessor, however, in s.3(1) the Banking Act 1987 provides an explicit determination of the prohibition's territorial ambit; and in s.7 it gives to the Treasury the power to amend by delegated legislation the definitions of "deposit" and "deposit-taking business".

110
money obligations, that is, debts repayable on the creditor's demand or notice. In contrast, the statutory test covers all types of money debts, including term loans and debt securities, regardless of the terms or currency of repayment,^43 provided that the underlying transactions are purely financial and "not referable to the provision of property or services or the giving of security". Nonetheless, certain debts are expressly excluded from the definition despite the fact that they are clearly intended to finance the debtor's business activities. In particular, loans made by authorised deposit-takers and other lawful financial institutions to their clients, as well as financial support provided by companies to other members of their own group or by natural persons to close relatives and their companies, are outside the statutory definition of deposits.  

"Deposit-taking business" is defined in an equally peculiar and wide way. Generally, almost any occupation or duty which requires attention and which is not merely for pleasure, can be a business. A predominant profit-making motive is not a necessary element but, generally, spare-time activities which do not entail a commercial involvement or which are intended solely for social enjoyment will be excluded. The persons carrying on a business will be those managing or conducting it as their own, as distinct from those assisting with, or being employed by, the business of another person. In principle, the carrying on of a business presupposes an engagement of some permanence and not simply the participation in an isolated transaction.  

---

43 Any sum repayable "with or without interest or a premium", either on demand or "at a time or in circumstances agreed", is included; s.5(1)(a). S.5(1) has been amended and a new s.5(1A) inserted by the Credit Institutions (Protection of Depositors) Regulations 1995, S.I. 1995/1442, reg.45, for the purpose of making clear that the definition of deposits includes bank liabilities denominated in private ECU. Certain unintended situations may fall within the net of the statutory definition. For instance, in Chow Yoong Hong v. Choong Fah Rubber Manufactory [1962] A.C. 209 (P.C.), a transaction involving the discounting by the one party of the other party's post-dated cheques or unmatured securities was held not to be a loan (unless it was used as a cloak). Now, however, similar transactions could conceivably constitute "deposits" for the purposes of the Banking Act. 

Any business receiving funds by way of deposits, as defined in the Act, is a deposit-taking business if it either on-lends these funds or employs them to finance "wholly or to any material extent" any other type of activity. The latter alternative means that even businesses which do not engage in financial intermediation can be deposit-taking businesses. A broad range of ordinary commercial activities could fall within this extremely broad definition simply by virtue of being financed with borrowed funds which are not raised through a bank or a related person. Since the extension of the statutory prohibition to most such activities would be clearly undesirable, it becomes necessary to moderate the effect of the statutory definition by excluding from its ambit the most evidently inappropriate cases. Thus, it is provided that a business is not a deposit-taking business if both (a) "the person carrying it on does not hold himself out as accepting deposits on a day to day basis" and (b) deposits are accepted "only on particular occasions".

For an infringement of the prohibition, it is not necessary that the business falling within the statutory description is carried on as a whole or to any substantial extent in the U.K. The acceptance of an isolated deposit within the jurisdiction by a foreign firm, e.g. through a local agent, will suffice.

The Bank has consistently insisted on a very restrictive interpretation of the statutory prohibition on unauthorised deposit-taking. In particular, the Bank has expressed its opinion that advances or sums paid by way of security are excluded from the definition of deposit only if they refer to specific property or services, so that, for instance, balances in a "budget account" operated by a retailer or money placed with an investment manager for investment at his discretion would be within the definition.

Considering the judicial interpretation of the almost identical provisions of the 1979 Act, it is surprising that the Bank can endorse such a view. In S.C.F. Finance Co. Ltd. v. Masri (No. 2), the plaintiffs, who were licensed futures dealers, tried to

---

50 S.6(1).
51 S.6(2); see also s.6(4).
52 The situation was different under the 1979 Act. Since the territorial ambit of the prohibition in that Act was not specified in express terms, its implicit restriction to the U.K. was thought to apply to all the relevant circumstances, so that the deposit-taking business itself should be carried on within the jurisdiction. Cf. Income and Corporations Taxes Act 1988, s.353; and Hafton Properties Ltd. v. McHugh (Inspector of Taxes) [1987] S.T.C. 16.
54 Ibid., p.1/1.
recover loss suffered by them as a result of dealing on the defendant's behalf. The
defendant had placed with them margins to cover their risk of loss, but when his
account was eventually liquidated these proved to be insufficient. The defendant
counterclaimed, arguing that any payments that he had made to the plaintiffs
constituted deposits with an unauthorised deposit-taking business and that, as a
result of the illegality tainting their transactions, the plaintiffs were not entitled to
recovery while he was entitled to restitution of the amounts paid to them. Affirming
the decision of the lower court, the Court of Appeals held that the so-called
"deposits", although not referable to specific services or property, had nonetheless
been paid by way of security for the provision of property (in the unlikely event that
the future contracts would have resulted in actual delivery of commodities) or of
services (the credit and management services in relation to the futures contracts) and
were, accordingly, excluded from the definition.\(^5\)

As an alternative ground for its decision, the Court of Appeal held that, even if
the relevant payments were deposits, the plaintiffs would still not be deposit-takers,
because they did not "hold themselves out to accept deposits on a day to day basis".
The fact that they were making requests for specific payments from their clients
whenever they thought it appropriate, could not be interpreted to suggest that they
were so holding themselves out. In any event, despite their large number, these
requests should be regarded as made "on particular occasions", which again would
exclude the plaintiffs from the definition of deposit-taker.\(^5\) This ground of the
decision has been rightly criticised as resting on a number of artificial distinctions.\(^5\)
In any event, its current relevance is doubtful, following the explicatory addition in
the 1987 Act that "particular occasions" denote infrequent and dissimilar occasions only.\(^6\)

The question has been raised again in different circumstances in Bank of
England v. Mortimer,\(^6\) a case concerning an application by the Bank for a summary
judgement for the repayment of deposits against the directors of what was said to be
an unauthorised deposit-taking company.\(^5\) As a means of overcoming its financial
difficulties, the defendants' company had received money on loan from a relatively
small number (nine or ten) of its existing clients against "deposit-receipts"
evidencing the borrowings and specifying its maturity and interest rate. It was
common ground that the borrowings were within the definition of deposit and that

\(^{57}\) [1987] 2 W.L.R. 58, pp.72-75.
\(^{58}\) Ibid., pp.75-76.
\(^{59}\) Penn, Shea and Arora, op.cit., n.55, p.11-12.
\(^{60}\) S.6(4).
\(^{62}\) The application was made under s.48(1) of the 1987 Act. See infra, section 3(d).
the company's activities were financed to a material extent by them. As the Bank appeared to accept that the company did not "hold itself out as accepting deposits on a day to day basis", the question turned on the interpretation of "particular occasions" in the 1987 Act. The Bank contended that, in view of their frequency and lack of distinguishing characteristics, the deposits were not accepted only on particular occasions. The defendants, however, submitted that their company was excluded from the definition of a deposit-taking business because the deposits, which involved only a limited number of their customers and were confined to what amounted to only two separate periods during its seventeen-month life, were accepted only as and when the company was in difficulty. The case was inconclusive, because Millett J. refused to grant an order on a summary basis as requested by the Bank, for the reason that he was unable to decide the issue on the limited evidence before him and without a full trial. Nonetheless, it provides an example of the uncertainty and possible overreach of the statutory definitions and of the Bank's occasionally overzealous approach regarding the interpretation and enforcement of the prohibition in situations where there is little threat to the interests of the wider public.

Returning to Masri, a final point raised before the Court of Appeal concerned the effects of illegality for the deposit transactions involved. Despite an express statutory provision that the contravention of the restriction on the acceptance of deposits shall not affect civil liability, the defendant contented that only the liability of the deposit-taker with regard to the deposited funds was thus preserved, while the counterclaims of the deposit-taker against his depositors would be tainted by the illegality. This argument was rejected, but the door was left open for a different result in situations where one or both of the parties entering into a transaction in contravention of the statutory prohibition are aware of the illegality involved.

63 S.6(2) and (4).
64 In addition, s.48(1)(a) provides that an order for the repayment of deposits can only be made against an unauthorised deposit-taker and "any other person who appears to the court to have been knowingly concerned in the contravention" of the prohibition on unauthorised deposit-taking in s.3. In the latter situation, according to Millett J., the requisite knowledge includes, not only that an unauthorised taking of deposits has taken place, but also that the deposits have been accepted in the course of a deposit-taking business. However, it was not clear on the evidence that at least one of the defendants had such knowledge.
65 Banking Act 1979, s.1(6); Banking Act 1987, s.3(3).
66 [1987] 2 W.L.R. 58, pp.78-80. On the civil effects of illegality, see also Bedford Insurance Co. Ltd. v. Instituto de Resseguros do Brasil [1985] Q.B. 966 (Q.B.D.); and Phoenix General Insurance Co. of Greece v. Administratia Asigurarilor de Stat [1987] 2 All E.R. 152 (C.A.). In the latter case, a distinction was drawn between the general prohibition of certain classes of business, which is directed to all parties, and a unilateral prohibition obliging only one of the potential parties to the transaction to abstain from the contract. However, even in the latter case, the contract may not be voidable at the instance of the innocent party. Thus, in Hughes v. Asset Managers p.l.c. [1995] 3 All E.R. 669 (C.A.), the prohibition on the carrying on of securities
The complexity and overreach of the basic statutory definitions has resulted in the need for further clarification and containment. For this purpose, the Act exempts from the prohibition a range of listed persons. These include domestic public-sector institutions, inter-governmental financial bodies and the central banks of E.C. Member States. In addition, certain classes of financial institutions regulated under other statutory schemes are exempted to avoid regulatory overlap. Of particular interest in this connection is the exemption of building societies, whose traditional subjection to an independent system of regulation creates a significant regulatory asymmetry. Like banking firms, building societies are credit institutions for the purposes of Community law and form part of an increasingly integrated monetary industry. To the extent that the legal framework for societies entails more pronounced restrictions regarding the management of their portfolios than is the case for banks, their continuing survival could be threatened in the new competitive environment which gradually erodes their traditionally protected market niches. In the long term, regulatory arbitrage could lead the societies to seek incorporation as limited companies and regulation by the Bank. Thus, the feasibility of mutuality as a form of organisation for credit institutions could hinge on the scrapping of regulatory discrepancies and the adoption of a common prudential régime for banks and societies alike.

---

67 S.4(1)-(3) and Sch.2. The Treasury has the power to amend the list of exempted persons of Sch.2 after consultation with the Bank. In exercise of this power, alterations have been made to the list by means of the Banking Act 1987 (Exempt Persons) Orders 1989-1993, S.I. 1989/125, S.I. 1991/66, S.I. 1991/2734 and S.I. 1993/953, and by the Insurance Companies (Third Insurance Directives) Regulations, S.I. 1994/1696, reg.68(1) and Sch.8, pt.I, para.14(2).

68 Sch.2, para.5.

69 The societies are regulated under the Building Societies Act 1986. The goals of the traditional legal framework for societies are ones of social policy, i.e. to guarantee to home buyers a steady source of mortgage finance and to unsophisticated small savers a totally safe investment opportunity.

70 See infra, text and nn.84-85.

71 See D.T. Llewellyn, "Regulation of building societies: the need for overhaul" (1990) 5 B.J.I.B.&F.L. 391. In a report published on 21 Dec. 1994, the Treasury and Civil Service Committee formally endorsed the view that building societies should be subjected to supervision...
The Act also makes provision for the exemption, by means of regulations made by the Treasury, of certain classes of transactions, defined by reference to any of their characteristics, including the identity of the parties involved. The exemptions currently in force include the acceptance of particular types of deposits by charities, the Church of England, industrial and provident societies, agricultural, forestry and fisheries associations, retail and co-operative societies, solicitors, estate agents, certain public undertakings and certain other persons. Significantly, the exemptions also include the acceptance of deposits by persons authorised or exempted under the Financial Services Act 1986 relating to activities covered by their authorisation or exemption as well as the issuance of large-denomination debt securities by listed companies and foreign governmental bodies. Overall, the exemptions cover transactions that do not raise concerns relating to investor protection, either because alternative regulatory arrangements are in place or, in certain cases, because they involve sophisticated wholesale investors and are subject to appropriate disclosure safeguards.

In addition to the power to amend the exemptions discussed above, the Act delegates to the Treasury a more fundamental legislative power to amend after consultation with the Bank the statutory definitions of deposit and deposit-taking business. Ostensibly, this power is given to ensure that the definitions are kept in line with market developments and shall not be circumvented. However, the legislative subjection of the definitions to continuing review can be interpreted, not merely as an indication of pragmatism, but as testimony to the rigidity and artificiality of the concepts used as the cornerstones of the regulatory system.

(c) The statutory definitions: rationale and shortcomings. To a certain extent, the exclusive legislative emphasis on deposit-taking, in isolation from the other fundamental banking functions, may be explained as a result of the ambiguity of the

---

by the Bank on the same basis as commercial banks; Treasury and Civil Service Committee, Second Report, "Financial Services Regulation: The Building Societies", H.C. (1994-95) 26. The publication of the Committee's report coincided with, and was aimed at influencing, the Treasury's conduct of its own review of the regulatory arrangements for building societies. See also Treasury and Civil Service Committee, Sixth Report: "The Regulation of Financial Services in the U.K.", H.C. (1994-95) 332-1, para.110, where the establishment of a "free-standing prudential supervisor of banks and building societies - answerable to and appointed by the Treasury - is put forward as a credible way for achieving the amalgamation of the Building Societies Commission with the supervisory divisions of the Bank of England.

72 S.4(4)-(6).


74 S.7.
term "banking" in English law, which created the need for a new, transparent statutory formula for the determination of the scope of banking regulation. In this connection, the "consumerist" justification of the regulatory scheme made a functional definition centring on deposit-taking more appropriate than an institutional definition of banking. However, the legislative choice may have been influenced by two additional objectives.

The first relates to the attempt of the drafters of the Banking Act 1979 to protect, as far as this was possible under the circumstances, the privileged position of the primary banking sector. For this purpose, it was necessary to avoid defining the regulated business in terms that could provide support to the secondary institutions' claims of banking status. Accordingly, the 1979 Act's "two-tier" approach took the form of a legal distinction between mere deposit-takers and banks proper, which should be able to satisfy additional statutory criteria. Although the distinction was abandoned for most purposes following the enactment of the Banking Act 1987, its historical significance for the formative stages of statutory banking regulation should not be underestimated.

The second hidden objective could well have been to preempt disintermediation as a result of the emergence of a direct-user market for wholesale deposits that would bypass the banking system altogether. Although most discussions of the origins of the Banking Act 1979 overlook this possibility, the evidence, although limited, is persuasive. During the parliamentary discussions of the 1979 bill, the question was asked, whether the proposed definition of deposit would inhibit direct inter-company lending. In a written reply, the government suggested that, although the definition would cover repayable funds taken by one company from another, this would not by itself make the borrowing company subject to the prohibition.

"It would, however, discourage the development of a market in which some participants borrowed from others on a significant and systematic basis. This is desirable on prudential grounds since it is difficult for ordinary trading companies to reach a proper appreciation of the risks involved in lending...

---

75 It is doubtful whether the absence of a satisfactory legal definition of banking was one of the factors which prevented the timely detection of the lacunae in the pre-1973 regulatory system, as it is sometimes suggested; see Penn, Banking Supervision..., op. cit., n.41, p.4. Instead, the then prevailing perception that banking is in most respects a business like any other, which does not require special treatment, made the question of definition less pressing; see E.P.M. Gardener, "Supervision in the U.K.", in E.P.M. Gardener (ed.), U.K. Banking Supervision: Evolution, Practice and Issues (1986), p.71. When the decision to subject banks to comprehensive regulation was eventually taken in the late 1970s, the issue was bypassed with little difficulty by means of the statutory concentration on deposit-taking only.

76 Banking Act 1979, s.3 and Sch.2. See supra, ch.1, section 2(a).

77 The one exception concerns the use of banking names, which is precluded by virtue of s.67 for those institutions whose size satisfies the minimum requirement for authorisation but not the higher minimum for the use of banking names; see infra, subsection (d).

through this market to companies with which they have no business relationship; and in some circumstances it may also make monetary policy more effective and remove a grievance not unreasonably expressed from time to time by the banking system."\(^7\)

While the government's professed paternalistic aim of preventing large companies from undertaking risks for which they were ill-equipped cannot be taken easily at face value, the latter part of this response suggests that the elimination of disintermediation was indeed a conscious legislative objective.

For a number of years, the statutory restriction on unauthorised deposit-taking, in combination with the need of getting timing consent from the Bank as a condition for issuing most types of debt securities denominated in sterling,\(^8\) impeded the development of a disintermediated market in large-denomination debt securities. Because of the standard practice of paying for new securities through an account in the principal financial centre of the currency of denomination, however, the issuance of non-sterling securities in the London market was not prevented. From 1986 onwards, a gradual softening of the law made possible, under certain conditions, the issuance of large-denomination securities, first in the form of sterling commercial paper and later of medium-term notes - even though at about the same time the prospectus requirements of the Financial Services Act 1986 came into effect, creating new hurdles with regard to the direct issuance of debentures to non-financial entities.\(^9\) Currently, the conditions for the lawful issuance of commercial paper or medium-term notes by unauthorised persons include the following: (a) that the issuer or guarantor of the securities is a company whose shares or securities have been admitted in the Stock Exchange and whose net assets exceed £25 million or an equivalent non-sterling amount, or that the issuer is a foreign government or public authority whose debt is traded in an exchange, or that the guarantor of the securities is an authorised deposit-taking institution; (b) that the redemption value of each security is over £100,000 or an equivalent non-sterling amount; (c) that certain statements are included in the securities; and (d) that the issuer or guarantor has

\(^7\) Ibid., col.W30.
\(^8\) Control of Borrowing Order 1958, as amended, issued under the Borrowing (Control and Guarantees) Act 1946 (repealed by the Government Trading Act 1990, s.4 and Sch.2, pt.1). Consent for issues of short-term securities on a regular basis and at short notice was not feasible under the Order's procedures. Issues of sterling commercial paper, however, were excepted from the requirement.
complied with appropriate listing requirements or requirements to make notifications to the Stock Exchange and the Bank.\(^2\)

Whatever the value of the historical explanations offered above regarding the legislative selection of deposit-taking as the cornerstone of the Bank's regulatory jurisdiction, the formulation of the statutory definitions can be criticised on a number of grounds.

The very wide prima facie test for deposit-taking business in the Banking Act makes necessary a complicated system of exemptions, which cannot nevertheless totally eliminate uncertainty or regulatory overinclusiveness. Although this may have been in part the implicit cost of a conscious legislative attempt to preclude regulatory avoidance, from a legal point of view the complexity and residual ambiguity of the statutory provisions is clearly undesirable.

Curiously, wholesale banking has been left outside the scope of the otherwise overinclusive definitions. As it would be unreasonable to characterise as deposit-taking the borrowing of funds from the banking system by its end-users, the definition of deposits excludes all bankers' lending, including all wholesale lending. This, however, means that the potential emergence of a class of wholesale financial intermediaries, relying exclusively on funds borrowed in the interbank market, is left unchecked.\(^3\) This is ironic, inasmuch as the ascendance of the secondary banks which eventually caused the 1973 crisis - that "nightmare" experience which supposedly proved the need for a statutory scheme of banking regulation - was made possible precisely through the exploitation of opportunities offered in this market.

Finally, it is notable that the statutory concept of a deposit-taking business is broader than that of "credit institution" in Community law. A credit institution is defined for the latter's purposes as "an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account".\(^4\) This definition derives its components from both the asset and liabilities sides of a bank's activities and is more consistent with the usual systemic

---


\(^3\) It is true that, as a matter of fact, the institutions which are exclusively active in the wholesale markets, i.e. the discount houses, have received authorisation under the Banking Act and are regulated by the Bank. This, however, seems to be the result more of practical necessities than of the authorisation requirement of s.3 of the Act; see infra, ch.4, section 2.

justifications for regulation. Member States are under an obligation to require
credit institutions to obtain authorisation before going into business. Originally,
those deposit-taking institutions that did not fall within the definition of a credit
institution, because they did not engage in lending, remained unregulated at the E.C.
level. Following the adoption of the Second Banking Directive, however, non-credit
institutions have been prohibited from carrying on a deposit-taking business unless
their activities are subject to regulatory controls aiming at the protection of
depositors and investors. In this manner, Community law has been brought
effectively in line with the U.K. position.

Nonetheless, the definitional discrepancy has remained a source of technical
difficulties regarding the U.K. implementation of the Community measures, by
means of which a common regulatory framework is created only for credit
institutions but which leave the regulation of other deposit-takers to the discretion of
national authorities. In particular, the implementation of the Second Banking
Directive has necessitated extensive and important amendments to the Banking Act
1987 (concerning the minimum criteria for authorisation, the supervision of
authorised institutions, including their supervision on a consolidated basis, and the
disclosure of regulatory information), which were made in the form of regulations in
pursuance of the European Community Act 1972. The consequence of this type
of implementation, however, has been that the amendments may only apply to
institutions which are covered by the Directive. This excludes deposit-taking
institutions which do not satisfy the description of a credit institution or which are
the branches (as distinct from U.K.-incorporated subsidiaries) of third-country
banks. The original provisions of the Act remain in force insofar as such institutions
are concerned, since any amendment with regard to them would require new

---

85 Evidently, a composite definition of this type generates more opportunities than a
unidimensional one for potential regulatory avoidance, or even inadvertent underinclusion,
especially if its elements are narrowly defined. See, e.g., on the American phenomenon of "non-
bank banks", P.D. Schellie and B.L. Climo, "Nonbank banks: current status and opportunities"
(1985) 102 Banking L.J. 4. Nonetheless, this danger must be weighed against the costs involved
in a simple but indiscriminate definition, with can result in considerable regulatory overkill.
86 First Banking Directive, art.3(1).
87 Second Council Directive 89/646/EEC of 15.12.89 on the coordination of laws, regulations and
administrative provisions relating to the taking up and pursuit of the business of credit
institutions and amending Directive 77/780/EEC (the "Second Banking Directive"), art.3.
(reg.25-47).
89 S.2(2).
90 See Second Banking Directive, art.2 and preamble, 19th recital.
91 S.I. 1992/3218, reg.46.
primary legislation. This has brought about an anomalous situation, as different versions of the Act operate simultaneously for different classes of institutions.

(d) European credit institutions. Banking institutions accepting deposits in the U.K. are subject to the statutory requirement for authorisation irrespective of their place of incorporation or principal place of business. This does not apply, however, to credit institutions formed in the other Member States of the E.C., or the non-E.C. countries of the European Economic Area, and authorised to carry on banking activities by their national authorities. By virtue of the Second Banking Directive, which is the main measure of Community law giving effect to the European Commission's designs for the completion of a single market in the field of banking by 1 January 1993, credit institutions authorised in a Member State are now free or establish branches (but not foreign subsidiaries) or to provide cross-border banking services anywhere within the E.E.A. on the basis of their home authorisation ("single banking license"). The single license is based on the model of the "universal bank". Accordingly, credit institutions can carry on throughout the Community a broad range of banking activities, which are enumerated in the Annex to the Directive, provided that these are covered by their home authorisation. Nonetheless, the exercise of this freedom is subject to notification requirements, which are intended to ensure that the authorities in the home and the host Member States are aware of the situation and able to exercise their respective responsibilities. Insofar as the responsibility for the prudential control and supervision of the credit institutions is concerned, the Directive allocates it to the home regulatory authorities, with only limited exceptions. Under strict conditions, certain fully-owned domestic financial subsidiaries of credit institutions are also allowed to rely on their parents' license in

94 See European Commission, White Paper "Completing the Internal Market", COM (85) 310, paras.100-107; and the additions to the Treaty of Rome made by the Single European Act, in particular arts.7A, 100A and 100B. See also supra, ch.1, section 3(b).
95 Second Banking Directive, arts.6(1) and 18(1). The aim of a single license had been set out in the First Banking Directive, preamble, 10th recital.
96 The activities listed in the Annex include: deposit-taking; lending; leasing; money-transmission and payment services; guarantees and commitments; securities, foreign exchange and derivatives trading for one account or for the account of customers; services with relation to the issuing of securities; merchant-banking activities; money-broking; portfolio management and advice; safekeeping and custodial services; and the provision of credit references.
97 Arts.19 and 20.
98 Ibid., art.13.
order to carry on Annex activities by providing services or establishing branches in other Member States. The Community-wide operation of credit institutions on this basis has been made possible through the harmonisation, by means of provisions in the Second Banking Directive and other directives, of prudential requirements, but only to the extent that this appeared both necessary and sufficient for achieving the mutual recognition of the authorisation procedures and regulatory standards of the Member States. The main limitation of the single license is that it does not extend to the establishment of subsidiaries in host Member States. This is significant, because banks wishing to provide services in another state have traditionally expanded through the use of subsidiaries. As subsidiaries remain subject to host-State authorisation and continue to incur the costs of separate capitalisation, this

---

99 The subsidiaries of a credit institution which are "financial institutions" as defined in art.1(6) (i.e. undertakings whose principal activity is to acquire holdings or to carry on any activity listed in the Annex other than deposit-taking) are permitted to provide services throughout the Community on the basis of their parent's license, provided: that the parent holds directly 90% or more of the voting rights in these subsidiaries; that the subsidiaries are governed by the law of the Member State in which the parent is incorporated and authorised; that the subsidiaries carry on within that Member State's territory those of the activities listed in the Annex which they intend to carry in another Member State on the basis of their parent's license; that the parent's home supervisor is satisfied that the subsidiaries are prudently managed; that the subsidiaries' commitments are fully guaranteed by the parent; and that the subsidiaries are effectively included in the parent's consolidated supervision; ibid., art.18(2). The provision also applies to subsidiaries which are jointly owned by two or more credit institutions. Many of the subsidiaries of art.18(2) also fall within the definition of "investment firm" in art.1(2) of the Council Directive 93/22/EEC of 10.5.93 on investment services in the securities field (the "Investment Services Directive"); accordingly, after that Directive's entry into force on 1 Jan. 1996, they will require separate authorisation and will only be entitled to a single license under its provisions.

100 See ibid., preamble, 4th and 5th recitals. The mutual recognition of regulatory standards in matters of lesser importance or of a contentious nature was a key component of the Commission's strategy for the construction of a single market in financial services. Despite the introduction of qualified-majority voting by the Single European Act of 1985, which inserted the new art.l00A in the Treaty of Rome, the traditional approach of comprehensive harmonisation had very few prospects of producing results, especially within the tight time-limits imposed by the 31 Dec. 1992 deadline. To solve this problem, the Commission abandoned the idea of uniformity in favour of the mutual recognition of national standards in non-essential matters. The concept of mutual recognition was originally developed in the E.C.J.'s jurisprudence on the free movement of goods, most notably in Case 120/78, Rewe-Zentral A.G. v. Bundesmonopolverwaltung für Branntwein ("Cassis de Dijon") [1979] E.C.R. 649. The adaptation of the concept to the context of services provided the solution, because it simplified dramatically the negotiations and made politically feasible the harmonisation of those minimum standards, without which most Member States, fearful of the competitive advantages that would accrue to the least regulated banks in a single market but unwilling to undertake drastic deregulation of their domestic banking systems, would resist the liberalisation of banking services and the opening up of the national banking markets to direct and unrestricted competition. See the remarks of the then Economic Secretary to the Treasury, P. Lilley, in the course of the Parliamentary debate of 9 Feb. 1989 on the proposed banking directives, H.C. (6th Ser.) Vol.146, cols.1229-1230. See also U.H. Schneider, "The harmonization of E.C. banking laws: the Euro-passport to profitability and international competitiveness of financial institutions" (1991) 22 Law & Pol'y Int'l Bus. 261, pp.267-276.
pattern is now reversed, in favour of branching and the cross-border provision of services.\textsuperscript{101}

Under the Second Banking Directive, the host authorities retain, pending further harmonisation, joint competence with the home authorities regarding the supervision of the liquidity of branches established within their territory as well as the control of trading risks assumed by incoming institutions as a consequence of transactions carried out on the financial markets of the host Member State.\textsuperscript{102} Furthermore, the host authorities are enabled to conduct on-the-spot investigations and to request regulatory and statistical information from the branches of credit institutions from other Member States.\textsuperscript{103} In the event of violation of rules adopted in exercise of their reserved powers under the Directive by an institution having a branch or providing cross-border services within their territory, the host authorities can take appropriate remedial action against the institution, but only as a last resort. Accordingly, it is necessary for the host authorities first to require the institution to remedy the irregularity and, failing that, to inform the home authorities of the situation. Only if the response of the home authorities proves inadequate, can the host authorities take appropriate measures, which may include criminal penalties and even, insofar as this is necessary, a prohibition on the institution from making further transactions within their territory.\textsuperscript{104} Finally, in the event that the authorisation of an institution is withdrawn, the home authorities must inform the host authorities, and the latter must ensure that the institution will be prevented from carrying on further business within their jurisdiction and must take the measures necessary for the protection of depositors.\textsuperscript{105}

The competence of the host Member State to take all measures necessary for the implementation of its monetary policy remains intact, provided that such measures do not involve discriminatory or restrictive treatment of the credit institutions of the other Member States.\textsuperscript{106} In addition, the host Member State's right to enforce the legal rules that it has adopted in "the interest of the general good" against incoming

\textsuperscript{102} Art.14(2) and (3), respectively. With regard to market risks, see now the Council Directive 93/6/EEC of 15.3.93 on the capital adequacy of investment firms and credit institutions (the "Capital Adequacy Directive"), whose measures of national implementation must come into effect by 1 Jan. 1996 at the latest.
\textsuperscript{103} Arts.15(3) and 21(1), respectively.
\textsuperscript{104} Art.21(2)-(4). Proper reasons must be given for the measures taken against an institution under this procedure, which must also be subject to a right of appeal; art.21(6). In emergencies, the host authorities may take measures for the protection of the consumers of banking services before following this procedure, but in this case the Commission and the authorities of the other Member States concerned must be notified promptly and the Commission can decide that these measures must be amended or abolished; art.21(7).
\textsuperscript{105} Art.21(9).
\textsuperscript{106} Art.14(2).
institutions is not affected.\textsuperscript{107} However, the jurisprudence of the European Court of Justice has established that the restriction of the freedom to provide services by national rules for reasons of general good will only be accepted under strict conditions.\textsuperscript{108} In particular, the national rules must be justified on one of the grounds of general interest listed in Article 36 of the Treaty of Rome (public security, protection of public health, protection of industrial and commercial property) or otherwise recognised as legitimate in the Court's case-law (consumer protection, improvement of working conditions, fair trading, effectiveness of fiscal policies, protection of the environment); they must not lead to overt or disguised discrimination on grounds of nationality; they must not duplicate comparable regulatory requirements imposed by the home Member States\textsuperscript{109}; they must be objectively justified, \textit{i.e.} they must be necessary for the achievement of their aims, in the sense that a less restrictive alternative is not available, and proportional to both their aims and actual results; and they must only apply to matters which have not yet been harmonised.\textsuperscript{110} In the formulation used by the Court in \textit{Säger v. Dennemeyer \& Co. Ltd.},

"the freedom to provide services may be limited only by rules which are justified by imperative reasons relating to the public interest and which apply to all persons or undertakings pursuing an activity in the State of destination, in so far as that interest is not protected by the rules to which the person providing the services is subject in the Member State in which he is established. In particular, those requirements must be objectively necessary in order to ensure compliance with professional rules and to guarantee the protection of the recipient of services and they must not exceed what is necessary to attain those objectives."\textsuperscript{111}

Evidently, host-State measures of a prudential nature cannot be justified on this ground, because the Directive's provisions determines the remaining competencies of the host Member State in this area. On the other hand, the permitted measures could include a variety of conduct-of-business rules designed to protect the investing public or the borrowers of credit institutions, as well as rules of market organisation, relating, \textit{e.g.}, to uniform instruments or the conditions of participation in clearing houses, provided that substantially equivalent home-State rules are not in force.\textsuperscript{112}

\textsuperscript{107} Preamble, 15th and 16th recitals, and art.21(5). See also art.21(8).
\textsuperscript{112} The power of the host Member State to enforce rules governing the form and content of advertisements of banking services is specifically recognised by art.21(11). On the other hand, the outright prohibition of advertisements for particular services, on the basis that thereby
The Banking Coordination (Second Council Directive) Regulations 1992,\(^{113}\) by means of which the Second Banking Directive was implemented in the U.K.,\(^{114}\) regulates the recognition in the U.K. of credit institutions originating in other Member States and of those subsidiaries which are eligible to rely upon their parent credit institution's home license.\(^{115}\) To make possible the operation of these institutions in the U.K. in accordance with the principle of the single license, the regulations disapply the national statutory restrictions on the unauthorised carrying-on of a deposit-taking, investment, consumer-credit or insurance business,\(^{116}\) insofar as these could prevent such institutions from carrying on within the jurisdiction any Annex activities which they are authorised or permitted to carry on in their home Member State.\(^{117}\) However, the exemption applies only to those eligible institutions as to which certain initial notification requirements have been satisfied ("European institutions").\(^{118}\) When there is a failure to comply with the appropriate notification requirements, the carrying-on of any home-regulated Annex activity (i.e. an activity in relation to which a home-State authority has regulatory functions, whether this is subject to regulatory controls in the U.K. or not) by an incoming institution constitutes a criminal offence.\(^{119}\) To safeguard the allocation of regulatory responsibilities between home and host authorities, the U.K. regulatory authorities are prohibited from granting authorisations or licenses permitting the undertaking of

consumer confusion will be avoided, is unlikely to be accepted by the European Court of Justice, in whose decisions the close affinity between the provision of information and the protection of consumers is recognised; Case C-362/88, GB-INNO-BM v. Confédération du Commerce Luxembourgeois [1990] E.C.R 1-667 (E.C.J.). Insofar as the advertising/marketing technique of cold-calling is concerned, the existence of a cooling-off period, within which the consumer can cancel contracts entered into as a consequence of cold-calling by the supplier of the service in question, will normally provide sufficient protection. However, cold-calling may be prohibited if the potential consumers belong to a category of people who are susceptible to manipulation; see Case 382/87, Buet v. Ministère Public [1989] E.C.R. 1235 (E.C.J.).

\(^{113}\) S.I. 1992/3218.

\(^{114}\) The adoption of primary legislation (Criminal Justice Act 1993, s.70) was necessary for the creation under the Regulations of regulatory offences punishable in the same way as the equivalent offences of the Banking Act, because the penalties involved go beyond those which can be imposed by regulations made in pursuance the European Communities Act 1972.

\(^{115}\) Pt.II (regs.3-19).

\(^{116}\) Respectively, Banking Act 1987, s.3; Financial Services Act 1986, ss.3 and 4; Consumer Credit Act 1974, ss.21, 39(1) and 147(1); and Insurance Companies Act, s.2.

\(^{117}\) S.I. 1992/3218, reg.5(1). The lack of precision in the description of the relevant activities in the Annex necessitates a potentially controversial judgement as to whether particular investment activities, which would otherwise require authorisation under the Financial Services Act, are covered by the single license or not.

\(^{118}\) The definition of "European institution" is set out in reg.3 and the notification requirements in Sch.2.

\(^{119}\) Regs.6-7, in conjunction with reg.3(7).
home-regulated Annex activities in the U.K. by incoming institutions, which are in this manner obliged to use the single-license route.\textsuperscript{120}

The Regulations establish the Bank as the main host regulatory authority for all incoming institutions and in respect of all their Annex activities,\textsuperscript{121} although other financial regulators (namely, the Securities and Investments Board and the Director-General of Fair Trading) retain certain host-authority powers within their area of responsibility.\textsuperscript{122} After receiving from the relevant home authority notification of the pending establishment of a branch, the Bank must, within a period of two months, prepare for the supervision of that branch and draw to the attention of the institution concerned those regulatory provisions of domestic law, adopted in the interest of the general good, with which the branch will be expected to comply.\textsuperscript{123}

Under certain circumstances, the Bank has remedial powers to prohibit, or impose conditions on, the acceptance of deposits by European institutions or to restrict their other home-regulated Annex activities.\textsuperscript{124} In particular, these powers become exercisable: if the Bank has concerns about the liquidity of an institution's branch; if it is informed by the home authorities of their concerns about the market risks assumed by an institution in the U.K.; if it appears to it that an institution has breached any applicable U.K. regulatory provisions; if it is informed by the home authorities that an institution has contravened home-State provisions relating to the implementation of the Second Banking Directive or the Deposit-Guarantee Directive; or if it has been provided with false or misleading information by, or on

\textsuperscript{120} Regs.25, 48(1), 49, 50(1), 52(1), 57(1), 58(1)(a). If, however, no formal supervisory regime is in place in the home Member State for certain Annex activities, an institution is free to conduct these activities in the U.K., provided that it complies with the relevant domestic rules and that its home supervisor does not object.

\textsuperscript{121} Regs.8-13.

\textsuperscript{122} Regs.14-17 and Sch.4 set out the functions and remedial powers of the Board with regard to an incoming institution's investment business; and reg.18-19 and Sch.5 set out those of the Director-General with regard to consumer-credit business (including activities relating to mortgage credit, financial leasing and the administration of credit cards).

\textsuperscript{123} Reg.8(1)-(2), (4)-(5), implementing art.19(4) of the Second Banking Directive. See also reg.14(1), by virtue of which the Securities and Investments Board must also draw, within the same period, the attention of the institution to provisions falling within its limited sphere of competence.

\textsuperscript{124} Regs.9-10. The Securities and Investments Board and the Director-General of Fair Trading have a parallel power to prohibit or restrict the carrying-on of business by European institutions where these have either breached conduct-of-business rules relating to home-regulated investment business or engaged in deceitful, oppressive or otherwise unfair practices or specific offences in the area of consumer credit, respectively; reg.15-16 and Sch.4 and reg.18-19 and Sch.5. "The bulk of the general good rules which will apply to incoming institutions in the United Kingdom consist of conduct of business rules under the Financial Services Act and Consumer Credit Act, rules on advertisements, and the requirement that institutions in the United Kingdom be covered by investor compensation or deposit protection arrangements"; statement to Parliament of the then Economic Secretary to the Treasury, A. Nelson, H.C. (6th Series) Vol. 215, col.1055.
behalf of, an institution.\textsuperscript{125} Once its powers become exercisable on any of these grounds, the Bank has a wide discretion, whether to take formal action or to seek an improvement in the situation by means of informal persuasion. However, the Bank will be generally reluctant to take formal action as long as the institution concerned is likely to take adequate and speedy steps to solve the problem.\textsuperscript{126}

Before taking action against an institution on the ground that it has failed to maintain sufficient liquidity or to comply with a requirement relating to the provision of statistical information, the Bank must follow an elaborate procedure of co-operation with the home authorities, as provided for in the Second Banking Directive and described above.\textsuperscript{127} In practice, even where its powers become exercisable on some other ground, the Bank will normally act in consultation with the home authorities.\textsuperscript{128} To facilitate co-operation in this direction, the Bank has signed memoranda of understanding with the authorities of the other Member States.\textsuperscript{129}

More controversially, the Bank is empowered to take action where an institution's situation is such that, if the institution were an authorised deposit-taker under the Banking Act, the revocation of its authorisation would be justified, but in this case the Bank can act only if, following its request to the institution's home authorities to take adequate measures for remedying the situation, these authorities have failed or refused to do so.\textsuperscript{130} This provision appears to be incompatible with the allocation of responsibilities in the Second Banking Directive. The matters that would justify the revocation of an authorisation relate clearly, as will be shown in the next section, to the prudential supervision of the relevant institution, which is the exclusive responsibility of the home authorities, subject only to the exceptions specifically provided for in the Directive. Accordingly, the host authorities cannot take remedial action in this area, even as a last resort, since this would amount to second-guessing and overriding the home authorities in an area reserved for them.

In all cases where the Bank takes action against a European institution, the latter has the same rights of appeal that would be available to an institution authorised

\textsuperscript{125} Reg.9(2)(a)-(e), as amended by S.I. 1995/1442, reg.50. On the Deposit-Guarantee Directive and its implementation, see infra, ch.5, section 5. Procedural requirements for taking action are set out in Sch.3, paras.2-3. Sch.3, para.5, requires the Bank to publish a statement of the principles in accordance with which it intends to exercise its powers. This was done a few months after the Regulations came into force, with the statement being incorporated in the Bank's "Statements of Principles: Banking Act 1987; The Banking Coordination (Second Council Directive) Regulations 1992" (May 1993).
\textsuperscript{127} Reg.11. See supra, text and n.104.
\textsuperscript{128} Statement of principles made under the Regulations, loc.cit., n.126, para.2.3.
\textsuperscript{129} Ibid., para.2.4.
\textsuperscript{130} Reg.9(2)(f), (3).
under the Banking Act which becomes the target of the Bank's powers of revocation or restriction of authorisation.\textsuperscript{131}

In order to ensure that the deposit-taking authorisation granted by the Bank constitutes an effective outward "passport", which makes possible for U.K.-incorporated institutions to engage in the territory of other Member States, without need for further authorisation, in any of the activities mentioned in the Directive's Annex (including those which are regulated by other authorities or are not subject to authorisation) which they can lawfully carry on in the U.K., the Regulations establish formal links between the authorisations which banks may obtain from the various U.K. financial regulators and expand the Bank's supervision to any Annex activities which do not require specific authorisation under U.K. law.\textsuperscript{132} By virtue of the Regulations, a U.K.-incorporated institution's deposit-taking authorisation is deemed to cover all activities mentioned in the Directive's Annex.\textsuperscript{133} The Bank, which is the authority responsible for matters concerning the recognition in other Member States of U.K.-incorporated institutions,\textsuperscript{134} is given an effective veto over the performance of such activities, and its power to revoke authorisation if there are irregularities in connection with them is made explicit, although the responsibility of other

\textsuperscript{131} Sch.3, para.4. On the appeal mechanism under the Banking Act, see infra, section 2(d).

\textsuperscript{132} Regarding this aspect of the Directive's national implementation, see the statement to Parliament of A. Nelson, then Economic Secretary to the Treasury, H.C. (6th Series) Vol. 215, col.1055. In the view of T. Shea, it is not self-evident that giving a power on the Bank to prevent authorised institutions from engaging in non-deposit-taking activities was necessary for the correct implementation of the Directive: arguably, "it would have been sufficient to specify that a U.K. credit institution is authorised to carry on in the United Kingdom any listed activity which it is lawful for it to carry on"; "Implementation in the United Kingdom of the Second Banking Directive" (1992) 7 J.I.B.L. 506, p.510.

\textsuperscript{133} S.I. 1992/3218, reg.21.

\textsuperscript{134} The procedural requirements which must be satisfied before a U.K.-incorporated institution can carry on listed activities in another Member State are set out in reg.22 and Sch.6. Sch.6, para.4, specifies that, where a U.K.-incorporated institution has notified the Bank of its intention to provide services in another Member State through the establishment of a branch or the cross-border provision of services, the Bank is required to give notice to the authorities of that Member State of the institution's authorised status. The Bank can only refuse to notify the host authorities if the institution intends to establish a branch and, having regard to the home-regulated activities that the institution proposes to carry on, the Bank doubts the adequacy of its administrative structure or financial situation. Before determining whether to give or refuse to give notice, the Bank must seek and take into account the views of all other U.K. regulators having responsibility for any of the home-regulated activities proposed to be carried on by the institution, and can defer to the opinions of such regulators. In situations where the Bank refuses to give the relevant notice to the host authorities, a right of appeal is given to the institution; Sch.6, para.8. See also regs.23-24 and Sch.7, regarding supervisory powers conferred on the Bank in relation to those subsidiaries of U.K.-incorporated institutions which can provide services across the Community on the basis of their parent institution's license, in pursuance to art.18(2) of the Second Banking Directive (see supra, n.99).

\textsuperscript{135} Regs.28(1), 48(2), 50(2), 58(2).
financial regulators in relation to the authorisation and supervision of particular activities within their supervisory competence remains unaffected.

(e) Banking names and descriptions. The Banking Act prohibits, on threat of criminal sanctions, the use by persons who are not authorised deposit-takers of business names and descriptions indicating that the business in question is a bank.\(^{136}\)

According to a widely accepted view, such is the psychological significance of the word "bank", that potential investors could be seriously misled if the use of banking names and descriptions by institutions of lesser standing were allowed. For this reason, long before the enactment of the first Banking Act in 1979 the use of terms such as "bank" or "banker" as part of company names and of banking descriptions in deposit advertisements had been confined to fully recognised banks only.\(^{137}\) However, the proliferation of minor banking recognitions, by virtue of which institutions enjoying only a limited banking status were able to represent themselves as banks, undermined the effectiveness of the older restrictions.\(^{138}\) This necessitated the overhaul of the relevant statutory provisions.

The matter was originally addressed in the 1979 Act. The prohibitions on the use of banking names and descriptions by non-banks in that statute can be seen as a development of the pre-existing regulations. However, they also reflected the new regulatory régime's discriminatory "two-tier" approach, which favoured larger, well-established banks, the "recognised banks", over their less important competitors, the "licensed deposit-takers". While the use of banking descriptions was open to both types of institutions, banking names were confined to the primary sector of recognised banks only. In the more open and competitive environment of the late 1970s, the imposition of this additional restriction on the use of banking names had important competitive ramifications. For this reason, it was resisted by the smaller domestic institutions, but without success.\(^{139}\)

Although the 1987 Act eliminated the distinction between recognised banks and licensed deposit-takers, one vestige of the "two-tier" approach was preserved in the statutory treatment of banking names. Thus, U.K.-incorporated authorised

\(^{136}\) Pt.III (ss.67-73). Nonetheless, any person may describe himself as a "bank" or "banker" for the specific purpose of asserting the application in his case of any legal provisions or commercial usage conferring advantages to persons characterised as banks or bankers; s.69(4).

\(^{137}\) Companies Act 1948, s.17, and Protection of Depositors Act 1963.

\(^{138}\) See supra, ch.1, section 1.

\(^{139}\) Particularly annoying for such institutions was the fact that the prohibition on the use of banking names did not apply to foreign banks, however small. Their concerns were voiced during the legislative process by a few M.P.s. In the words of Peter Tapsell M.P., the relevant part of the Act was "a charter for the existing banking establishment, which is why the clearing banks acquiesce to it and direct their fire only at [the Deposit Protection Scheme]"; H.C. (5th Ser.) Vol.958, col.1520.
institutions are permitted to use banking names only if they have paid-up capital and undistributable reserves amounting to at least £5 million (or a non-sterling amount of equivalent value). European institutions and authorised institutions incorporated in third countries, however, can use their original business name regardless of their size. It must be noted that the discriminatory effect of the £5 million threshold has lost much of its importance following the implementation of the Second Banking Directive, which increased the absolute minimum capital requirement for authorised institutions from £1 million to ECU 5 million, thus narrowing considerably the range of institutions which may fall below the threshold. In any event, even those authorised institutions which are not permitted to adopt banking names are entitled to describe themselves as being banking institutions, although banking descriptions should not be used for this purpose in such immediate conjunction with the institutions' business name as to appear to be part of it.

Insofar as non-authorised persons are concerned, the restrictions on the use of banking names and descriptions are subject to certain exemptions. In particular, the parent companies of authorised institutions can incorporate in their own business names the banking names of their subsidiaries for the purpose of indicating the group connection, while the representative offices of third-country banks which are not authorised to accept deposits in the U.K. are entitled to use their original business names in immediate conjunction with their description as such representative offices. Savings banks, municipal banks or school banks can use names and descriptions which indicate that they are such entities. Finally, the central banks of the Member States and certain inter-governmental development banks are not precluded from using their official names and banking descriptions.

After consultation with the Bank, the Treasury may amend by order the range of institutions which are permitted to use banking names and descriptions and may substitute another sum for the £5 million minimum-capital requirement for the use of banking names by domestic authorised institutions.

Characteristically, the statutory provisions are not confined to imposing restrictions of general application on the use of banking names. They also delegate

140 S.67(1)-(2) and s.73.
141 S.68(3). Under the First Banking Directive, art.5, European institutions are entitled to use their home banking names throughout the Community.
142 Sch.3, para.6, as replaced by S.I. 1992/3218, reg.27(4). See infra, ch.3, section 2(a).
143 S.69(1)-(2). Building societies enjoy the same right; s.69(3).
144 S.68(4)-(5).
145 Ss.68(1)-(2) and 69(5).
146 Ss.68(6) and 69(6).
147 Ss.68(7)-(8) and 69(7)-(8).
148 S.67(6).
to the Bank the discretionary power to object to the names of authorised institutions on the ground that they are "misleading to the public or otherwise undesirable". The regulated institutions are required to notify the Bank of the name they propose to use in their deposit-taking capacity when they apply for authorisation and prior to any subsequent change of their name, at which point the Bank's power of objection becomes exercisable. The Bank can also object to a name which is already in use, if this is appropriate as a result of a "material change in circumstances" or in the light of new information. An institution which receives a notice of objection is entitled to apply to the High Court to set it aside, and the application to the court involves a hearing on the merits of the Bank's decision.

The Act does not impose on the Bank any particular procedural requirements with regard to the making of objections. However, the general principles of administrative law probably impose on the Bank a duty to exercise its power fairly. This duty is not negatived by the existence of the statutory right of appeal. This could mean that the Bank, before reaching a decision to object, should give an opportunity to the institution concerned to make representations. In the case of an objection to a pre-existing name, in particular, the duty to act fairly, afford a prior hearing and give reasons for the objection may be owed by the Bank by virtue of the institution's legitimate expectation to continue using its previously approved name.

(f) Representative offices. Foreign banks which do not accept deposits in the U.K. ("overseas institutions") are not precluded from establishing a representative office within the jurisdiction for the purpose of promoting in any way their financial or banking activities, including the acceptance of deposits abroad, provided that they give prior notice to the Bank. The notice must specify the business name that the overseas institution proposes to use for its activities in the U.K. Subsequent changes of the institution's business name also require prior notification. The Bank has the power to object to names which appear to it misleading to the public or undesirable, either at the time of notification or following a material change in

---

149 However, the Bank cannot object to the use of the terms "bank" or "banker" *per se* if an institution has the statutory right to use a banking name. S.70(3).
150 S.70(1)-(2).
151 S.70(4).
152 S.71(3), (5).
153 Pt.IV (ss.74-81) of the Act regulates the establishment of representative offices by overseas institutions. The definitions of "overseas institution" and "representative office" can be found in s.74. Remarkably, the definition of an overseas institution includes institutions possessing, or claiming to possess, a foreign banking authorisation or using banking names or describing themselves as bankers, whether or not they are actually accepting deposits; s.74(2).
154 S.75.
155 S.76(1).

131
circumstances or the collection of new information,\textsuperscript{156} in which case the institution concerned has the right to apply to the High Court to set aside the objection.\textsuperscript{157} The Bank may require any institution having or proposing to establish a representative office to provide it with information or documents relating to its company affairs.\textsuperscript{158} Otherwise, the establishment of representative offices by foreign banks is not currently subject to restrictions or regulation. However, the Treasury has the power to impose, after consultation with the Bank, regulatory requirements, including a requirement for the authorisation of representative offices, by means of secondary legislation.\textsuperscript{159}

That overseas institutions are permitted to promote and assist through representative offices their banking business - including the making of arrangements for the acceptance of deposits abroad - practically unregulated, is remarkable, especially in view of the fact that the acceptance of deposits within the jurisdiction by the same institutions is strictly prohibited, even if it takes place only on isolated occasions and not through a permanent establishment. Since the territorial location of deposit-taking depends on the locus of the account into which a depositor's funds are placed, it would appear that a representative office can be used with little difficulty as a vehicle for the systematic circumvention of the prohibition on unauthorised deposit-taking by making all the preparatory arrangements for the remittance of deposit funds by U.K. residents to an account kept by the overseas institution abroad. This, however, is inconsistent with the Act's apparent protective purpose.

2. The authorisation process

The Banking Act 1987 contains detailed provisions, setting out the procedural and substantive conditions for the exercise by the Bank of its powers to grant, revoke or restrict authorisation and establishing a special appeal mechanism for the benefit of deposit-taking institutions or their directors, controllers or managers who are negatively affected by the Bank's decisions in this context.

\textsuperscript{156} S.76(2), (4).
\textsuperscript{157} S.77(3), (5)-(6). The arrangements with regard to objections to the names of overseas institutions is strictly analogous to those concerning objections to the names of authorised institutions; see supra, subsection (c).
\textsuperscript{158} S.79(1)-(6). The provisions of ss.39-40 on the collection of regulatory information, which currently apply only to authorised institutions, can be applied by order of the Treasury, after consultation with the Bank, to representative offices; s.79(7).
\textsuperscript{159} S.80.
(a) Grant of authorisation: application and criteria. Sections 8 to 10 of the Banking Act set out the procedural and substantive rules which govern the grant or refusal of authorisation to applicant institutions. An application under these provisions can be made only by bodies corporate or by partnerships or other unincorporated associations of two or more individuals. Individual entrepreneurs are excluded, as are partnerships and unincorporated entities whose assets are fully owned by a single person. As a result of the affirmation of the principle of home-State control in the Second Banking Directive, credit institutions incorporated in another Member State may no longer apply to the Bank for authorisation and can only carry on banking activities in the U.K. under the single-license procedure, while the authorisation of U.K.-incorporated credit institutions is precluded if their principal place of business is outside the jurisdiction.

The application must be made to the Bank in the manner determined by it and must be accompanied by a statement specifying the nature and scale of the institution's intended banking activities, the plans for their future development and the arrangements for their management. In addition, the Bank is empowered to require the production by the institution or by any person who is, or is intended to become, a director, controller or manager of the institution of any other information or documents that could assist it in the assessment of the application. As a means of verifying the information received from the applicant institution, the Bank may demand the production of a report on particular aspects of that information by an accountant or other qualified person of its approval.

The required disclosures vary from case to case. As a matter of practice, however, the initial application of each institution takes the form of a standard questionnaire, requesting the institution to provide details regarding the following matters: its name, legal form and country and date of incorporation; the address of

---

160 S.106(1), definition of the term "institution", and s.9(5)-(6).
161 See supra, section 1(d).
163 The current definitions of the terms "director", "controller" and "manager" are set out in s.105, as amended by the Banking Coordination (Second Council Directive) Regulations 1992, S.I. 1992/3218, reg.43.
164 S.8(1)-(5).
165 S.8(4).
its head office and of its principal place of business in the U.K.; any foreign banking authorisations already received by it; its bankers in the U.K. and its auditors; the names of all its directors, managers, controllers and significant shareholders and of the persons effectively directing the institution; any existing authorisations to conduct a regulated business in the U.K. and any applications for such authorisations which have been refused; the other companies in the same group; any adverse legal events that raise doubts about the institution's financial standing, such as a failure to satisfy a judgement debt under a court order, the making of an arrangement with creditors, a failure of the institution to satisfy its creditors in full, an order or petition for its administration, a resolution for its voluntary liquidation, a compulsory liquidation, the appointment of investigators under regulatory statutes or the making of an order against the institution for the production of books; any regulatory action taken against the institution or refusal of an application to join a professional body or trading association in the field of banking and finance; any problems with the tax authorities; any litigation that could put in jeopardy its resources; its business relationships with connected persons; and its aims and program for a minimum of three years, including a sensitivity analysis of its business plan. The submission of audited accounts for the last three years and the disclosure of any other information that could assist the Bank in determining its application are also required. Similar questionnaires, requesting details of their business affairs and specific role in the institution, must be answered separately by its directors, controllers and managers.167

Normally, before the formal submission of an application, the Bank engages in informal preliminary consultations with the prospective applicant institution's management, after being introduced to them by established bankers or professional advisers.168 This practice provides an opportunity for the early elimination of unsuitable candidates for authorisation. As an application can be withdrawn by written notice at any time before its final determination,169 an institution can also be informally persuaded to withdraw its application at a later stage, if the Bank is inclined to reject it.

166 Application Form 1, "Banking Act 1987: Application for Authority to Accept Deposits in the Course of Carrying On a Deposit-Taking Business".
167 Application Form 2, "Banking Act 1987: Questionnaire for Institutional Controllers"; and Application Form 3, "Banking Act 1987: Personal questionnaire for individuals who are, or are proposing to become, directors, controllers or managers". The forms were included in the Bank's "Banking Act 1987: Banking Supervision Guide" (Sep. 1987).
168 See Penn, Banking Supervision..., op.cit., n.41, p.53.
169 S.8(6).
The Bank can only reach a favourable decision on an application for authorisation if it is satisfied, on the basis of the applicants' disclosures or any relevant additional information collected by it in other ways, that the institution satisfies the minimum criteria for authorisation, which are set out in Schedule 3 of the Banking Act.\textsuperscript{170}

In summary, the criteria of Schedule 3 require:

1. that the institution's directors, controllers and managers are fit and proper persons to hold their particular positions\textsuperscript{171};
2. that the effective direction of the institution's business is at the hands of at least two individuals\textsuperscript{172};
3. if the institution is incorporated in the U.K., that it has such number of non-executive directors as appears appropriate in view of its special circumstances and the nature and scale of its operations\textsuperscript{173};
4. that the institution's business is conducted, or will be conducted, in a prudent manner,\textsuperscript{174} especially through the maintenance of adequate capital, liquidity and reserves relative to the nature and scale of its operations and the risks undertaken by it,\textsuperscript{175} as well as of accounting and other records and control systems able to ensure its effective internal management and compliance with the institution's regulatory obligations under the Banking Act\textsuperscript{176};
5. that the institution's business is carried on, or will be carried on, with integrity and the requisite professional skill\textsuperscript{177}; and
6. that the institution has at the time of authorisation initial capital of ECU 5 million or more.\textsuperscript{178}

All the criteria must be satisfied for an institution to be authorised. However, in cases of applications for authorisation by third-country institutions who intend to establish branches in the U.K., the Bank, instead of forming its own judgement that

\textsuperscript{170} S.9(1)-(2). In determining the issue, the Bank may take into account matters relating to any person currently or prospectively employed by, or associated with, the applicant institution in connection to its deposit-taking business and, if the institution is an incorporated entity, to any other entities within its group or to the directors or controllers of such entities; s.9(4). If the applicant institution is the U.K. subsidiary of, or is under common ownership with, a European credit institution, before granting authorisation the Bank must consult the supervisory authorities of the home Member State of that institution; s.9(7), inserted by S.I. 1992/3218, reg.26, in implementation of the Second Banking Directive, art.7.

\textsuperscript{171} Sch.3, para.1. On the fitness requirement, see infra, ch.4, section 3(a).

\textsuperscript{172} Sch.3, para.2.

\textsuperscript{173} Sch.3, para.3.

\textsuperscript{174} Sch.3, para.4, as amended by S.I. 1992/3218, reg.27(1)-(3).

\textsuperscript{175} Sch.3, para.4(2)-(6). On the financial standards that must be observed by authorised institutions, see infra, ch.4, section 2.

\textsuperscript{176} Sch.3, para.4(7)-(8).

\textsuperscript{177} Sch.3, para.5.

\textsuperscript{178} Sch.3, para.6, as replaced by S.I. 1992/3218, reg.27(4).
the first, fourth and fifth of these criteria are fulfilled, may rely upon assurances received by those institutions' home regulatory authorities as to their "prudent management and overall financial soundness", provided that it is satisfied as to the nature and scope of the supervision exercised by these authorities.\textsuperscript{179}

The need for continuing fulfilment of the authorisation requirements explains why many of them become fully operative only after authorisation has been granted and the institution has started to accept deposits. In particular, the requirements relating to the "prudent manner" and "integrity and skill" of the institution's business belong in this category, since their fulfilment will primarily depend on the institution's conduct subsequent to its actual engagement in deposit-taking business.

From a substantive point of view, the second, the third and, in part, the fourth of the criteria of Schedule 3 are intended to ensure that the institution has in place appropriate internal controls, so that misconduct can be avoided or, at least, detected at an early stage, before putting at risk the institution or its clients.

As interpreted by the Bank, the requirement that an institution's business is directed by at least two individuals (the so-called "four-eyes" criterion) will not be satisfied unless at least two persons share executive power with regard to all significant decisions involving the formulation and implementation of the institution's business strategy. Although these persons need not be immediately involved in the day-to-day implementation of the institution's policies, they must have knowledge of the manner in which the institution's longer-term strategy is pursued in practice and a real ability to influence its policies. If an institution is directed by more than two executives, these may divide between them the relevant responsibilities, but responsibility for each area of decision-making must be shared by at least two of them.\textsuperscript{180}

In the case of U.K.-incorporated institutions, an additional level of internal checks and balances is ensured by the presence of non-executive directors, who can offer independent strategic advice and, as members of audit committees, keep a watchful eye against misbehaviour or malpractice. The Bank is strongly in favour of the formation within every British bank of an audit committee, although it recognises that the appointment for this purpose of a sufficient number of suitable non-executive directors can be particularly burdensome for small institutions. With few exceptions, however, all U.K.-incorporated institutions are required to appoint at least one non-executive director to undertake surveillance functions.\textsuperscript{181}

\textsuperscript{179} S.9(3).
\textsuperscript{181} \textit{Ibid.}, paras.2.34-2.36.
The Bank places particular emphasis on the maintenance by each deposit-taking institution of adequate records and internal control systems, which must allow the institution's management to exercise effective control over its activities, to identify potential risks to the institution and its depositors and to ensure compliance with the regulatory requirements and the provision of accurate and reliable supervisory information to the Bank. The adequacy of the records and systems will depend on the size, business characteristics and management structure of the institution and the nature, volume and complexity of its transactions. The complexity of the institution's branch structure will be a major consideration in this context. Since the existence of foreign operations can complicate considerably the task of control, the Bank requires to be notified before the establishment of such operations and will object to them if it is not satisfied that the institution's systems ensure their prudent management. Although the requirement of adequate records and control systems does not apply to other members of a deposit-taking institution's group, the Bank requires the maintenance of the control mechanisms necessary for the production of reliable data and information for the supervision of the group's financial situation on a consolidated basis.\textsuperscript{182}

The sufficiency of an institution's records and control systems must be judged by reference to the institution's ability, not only to conduct its business without putting at risk the interests of its depositors, but also to comply fully with any regulatory duties imposed on it under the Banking Act, including the generation of timely and accurate supervisory information.\textsuperscript{183} An institution's failure to ensure that its systems guarantee adequate compliance with the Bank's reporting requirements - not to mention a failure to co-operate honestly and openly with the supervisors - may be taken of itself as a serious breach of the authorisation criteria, even if the institution displays full competence and honesty in its conduct towards its depositors and other clients. In particular, the arrangement of an institution's business with a view to minimising compliance costs will not be accepted as legitimate. Even an intention to comply with the supervisory requirements will not be good enough, if the capacity to comply is objectively lacking.\textsuperscript{184}

\textsuperscript{182} Ibid., paras 2.26-2.30.

\textsuperscript{183} Sch.3, para.4(8).

In a notice addressed to the institutions authorised by it, the Bank specifies the scope and nature of the information that must be reflected in an institution's records, the types of information that must be available to the management and the objectives and standards that must be met by the internal control systems. However, the Bank refrains from prescribing detailed rules regarding the precise content and structure of records and control systems, and has even retracted the checklists of specific records and control requirements and monitoring procedures, whose maintenance used to be required as standard practice in the past. Generally, an institution's records should capture and record timely and orderly every transaction or commitment entered into by the institution; provide details of each transaction and each credit assessment made by the institution; enable the prompt extraction of such information as might be necessary to the management in order to monitor the institution's assets, to identify, quantify and control the various risks undertaken by the institution, to determine the state of all aspects of its business on an up-to-date basis and to make timely and informed decisions; and contain details of the exposure limits authorised by the management. Its controls should be able to ensure that the business is planned and conducted in an orderly, prudent and cost-effective manner; that all transactions are entered into with management's authority; that the management is able to safeguard the institution's assets, control its liabilities, monitor its capital adequacy, liquidity and profitability and identify and quantify any risk; that the institution's records provide complete, accurate and timely information; and that the management is able to provide to the Bank complete and accurate supervisory returns. The institution must have in place a transparent organisational structure and clear lines of responsibility, sufficient monitoring procedures, mechanisms for the segregation of duties, so that transactions cannot be completed on its behalf by a single individual acting alone, procedures for the authorisation of transactions, controls for ensuring that all transactions are authorised and properly recorded, appropriate systems for the safeguarding of assets and information, and procedures for ensuring the competence of its personnel. In addition, where the operating environment is based on the electronic processing of information, special attention must be paid to the maintenance of such controls as may be necessary for the

186 See the "Guidance Note on Accounting and Other Records and Internal Control Systems and Reporting Accountants' Reports Thereon" (BSD/1987/2, Sep. 1987), which was replaced by BSD/1994/2. This is probably the only example where the regulatory requirements have become less, rather than more, detailed with the passage of time.
187 BSD/1994/2, loc.cit., n.185, para.10.
188 Ibid., para.15.
189 Ibid., paras.18-26.
prevention of theft and fraud, system errors, interruptions and failures or the production of misleading information by poorly specified programs.\(^{190}\) It is the responsibility of management to review, monitor and test the internal controls on a regular basis.\(^{191}\)

The criteria for authorisation do not currently include a formal requirement that, where a credit institution is part of a group structure, that structure must be sufficiently transparent to allow effective supervision, although in practice authorisation will be refused if an applicant institution's group structure appears likely to deny supervisors a clear view.\(^{192}\) A statutory duty to refuse authorisation if an institution's close links with other natural or legal persons prevent effective supervision, either due to their inherent structure or to the fact that any of these persons is subject to legal or administrative requirements of a third country whose effect is to impede supervision or is inadequately supervised in a third country, must be introduced in the near future, in pursuance to the recent Directive on the Reinforcement of Prudential Supervision.\(^{193}\)

Other criteria of Schedule 3, which will be discussed in greater detail in the relevant sections of the following chapter, focus on the suitability of those persons who play leading roles in the conduct of the institution's business and the quality of the manner in which this business is conducted, including in particular its financial soundness.

The Banking Act states that the Bank "may" grant or refuse an application for authorisation, but "shall not grant an application unless satisfied that the criteria specified in Schedule 3 [...] are fulfilled with respect to the applicant."\(^{194}\) This wording suggests that, while the fulfilment of the specified criteria is indispensable, it does not guarantee of itself the grant of authorisation. The Bank emphasises its right to refuse authorisation even where it is satisfied that an institution fulfils the minimum criteria of Schedule 3. This will be, in particular, possible if the Bank considers for any reason that, despite the fulfilment of the criteria, there are significant threats to the interests of the depositors and potential depositors of the institution.\(^{195}\) Thus, its overall assessment will depend on the viability of an institution and the potential threats to its depositors.

\(^{190}\) Ibid., paras.27-29.

\(^{191}\) Ibid., paras.16-17.


\(^{193}\) Directive on the Reinforcement of Prudential Supervision (the Post-B.C.C.I. Directive), art.2(2). The European duty must be implemented by the Member States by 18 July 1996; art.6.

\(^{194}\) S.9(1)-(2).

However, an important characteristic of the minimum criteria taken together is their propensity to cover almost all potentially relevant aspects of the business of banking and all management decisions which may influence the levels of risk undertaken by an institution. Thus, an institution which is found to satisfy the minimum criteria will be generally unlikely to be refused authorisation on the ground that it endangers the interests of depositors is some other way.

The Bank enjoys, indeed, wide discretion in granting or refusing authorisation. In practice, however, this discretion relates more to its ability to interpret authoritatively the minimum criteria of Schedule 3 and to determine whether these are satisfied by particular institutions, than to its power to look beyond these criteria. Only in a few cases, as with the "four-eyes" criterion or the absolute minimum capital requirement of ECU 5 million, can the fulfilment of the statutory criteria be determined in a fairly straightforward manner, without reference to more specific standards. In contrast, the most important criteria, e.g. those requiring the "fitness" of an institution's directors, controllers and managers or the conduct of its business in a "prudent manner", are too broad and imprecise to provide direct and effective guidance for the determination of individual cases. In essence, despite the attempted elaboration of the minimum criteria in the more detailed provisions of Schedule 3, the Banking Act does not set out strict and unambiguous standards of banking performance which can be applied unambiguously to the factual circumstances of particular institutions, but simply indicates the type of considerations which the Bank is required to take into account in reaching its decisions. This means that the Bank enjoys considerable flexibility regarding the interpretation of the statutory requirements, their elaboration through secondary standard-setting in its regulatory pronouncements and their concrete application to the situation of particular institutions.

The Act itself confirms this view, by imposing on the Bank a duty to make public a statement of the principles in accordance with which it is acting, or proposing to act, in interpreting the criteria of Schedule 3 and in exercising its powers to grant authorisation. It is made in this manner explicit that the Bank's role is not limited to the quasi-judicial function of applying directly the statutory criteria to particular factual circumstances, but entails significant aspects of discretionary policy-making.

On the other hand, the statutory provisions establish boundaries to the legitimate exercise of the Bank's regulatory functions. The Bank's powers in relation to the grant, revocation or restriction of authorisation may be defined in subjective terms in the statute, but this does not mean that it can be exercised arbitrarily, unreasonably or oppressively. Any decision that can be shown to be unfair or discriminatory will

196 S.16(1).
be *ultra vires* the Bank. The same applies to any decision that cannot be rationally related to, or is inconsistent with, the policy of the Banking Act.\(^{197}\) Although the Act does not define explicitly the ultimate aims of the Bank's regulatory functions,\(^{198}\) the provisions setting out the substantive criteria for authorisation leave no doubt that the purposes of the authorisation régime are specifically prudential and that the Bank's overriding concern in exercising its statutory powers must be to protect the depositing public by ensuring that only safe and sound institutions are allowed to accept deposits. More specifically, there is a clear emphasis on microprudential considerations, focusing on the safety of each individual institution, rather than on macroprudential questions of systemic risk. The delegation of the function of authorisation to the Bank may be construed broadly, to cover all regulatory functions which are incidental or consequential to its prudential aims.

However, the Bank cannot legitimately use its statutory powers to achieve other objectives. For example, the Bank should not refuse authorisation for the purpose of preserving the existing structure of the banking industry or preventing foreign entry in the domestic banking markets, if this is unnecessary for the prevention of unsound banking and the eventual protection of depositors.\(^{199}\) It should not seek the indirect enforcement through its powers of authorisation of conduct-of-business rules in relation to particular classes of transaction or of policies aimed at ensuring greater efficiency in the provision of particular banking services or at promoting objectives of a social nature. And it should not employ these powers in the service of macroeconomic objectives.\(^{200}\)

(b) **Revocation and restriction of authorisation.** The termination of a deposit-taking institution's authorised status can occur either through the institution's own decision to surrender its authorisation\(^{201}\) or as a result of the Bank's exercise of its power under Section 11 of the Banking Act to revoke it.

An authorisation may be revoked for any of the grounds listed in the provision. In particular, the power of revocation is exercisable "if it appears to the Bank that:


\[^{198}\text{The reference to the protection of depositors in the Act's long title appears to relate primarily to the Deposit Protection Scheme, not to the regulation of deposit-taking activities.}\]

\[^{199}\text{Cf. A. Au, "The new Banking Ordinance in Hong Kong: legal boundary of administrative power" (1987) 2 J.I.B.L. 170, pp.174-175.}\]

\[^{200}\text{Cf. Bank of England Act 1946, s.4; see supra, ch.2, section 1.}\]

\[^{201}\text{Banking Act 1987, s.15, as amended by S.I. 1992/3218, reg.30(2). The institution may surrender its authorisation by giving written notice to the Bank to this effect. The notice may specify the date when the surrender will take effect.}\]
(a) any of the criteria specified in Schedule 3 to [the Banking Act] is not or has not been fulfilled, or may not be or may not have been fulfilled, in respect of the institution;
(b) the institution has failed to comply with any obligation imposed on it by or under [the Banking Act];
(c) a person has become a controller of the institution in contravention of section 21 [of the Banking Act, i.e. without giving notice to the Bank,] or has become or remains a controller after being given a notice of objection under section 22, 23 or 24 [...];
(d) the Bank has been provided with false, misleading or inaccurate information has been provided to the Bank by or on behalf of the institution or, in connection with an application for authorisation, by or on behalf of a person who is or is to be a director, controller or manager of the institution; or
(e) the interests of depositors or potential depositors of the institution are in any other way threatened, whether by the manner in which the institution is conducting or proposes to conduct its affairs or for any other reason.202

The Bank may also revoke authorisation if it appears to it that the institution has not accepted any deposits within the first twelve months from the day of its authorisation or, after accepting deposits within this period, has subsequently failed to do so for any period of more than six months203; or that the institution's authorisation under the Financial Services Act 1986, or its consumer credit license under the Consumer Credit Act 1974, has been withdrawn by the competent regulators.204 Moreover, in the case of an institution whose principal place of business is in a third country, the Bank may revoke authorisation if it appears to it that the supervisory authorities of that country have withdrawn from the institution its banking authorisation.205

In the case of a U.K.-incorporated institution, the Bank is required to revoke authorisation if it appears to it that a winding-up order has been made against the institution or a resolution for its voluntary winding up has been passed in the U.K.206; and it may revoke authorisation if it appears to it that a composition or arrangement with creditors has been made in respect to the institution, that a receiver or manager has been appointed, that the institution's secured creditors have taken possession of any property subject to a charge, or that an administration order has been made under section 8 of the Insolvency Act 1986 in relation to the

202 s.11(1).
203 s.11(2).
204 s.11(4). The Treasury has a rule-making power to make, after consultation with the Bank, the withdrawal of any other authorisation or licence granted under other enactments a ground for revocation; s.11(5).
205 s.11(3).
206 s.11(6).
institution. In the case of an institution incorporated in another jurisdiction, the Bank may revoke authorisation if any event equivalent to the above has occurred outside the U.K.

Additional grounds of revocation are provided in connection to U.K.-incorporated institutions, in order to achieve the effective operation of the principle of the single banking license under the Second Banking Directive in relation to such institutions. Thus, the Bank may revoke the authorisation of a U.K.-incorporated institution: if it appears to it that the institution's principal place of business is not located in the U.K.; if it appears to it that the institution has failed to comply with obligations imposed on it by the regulations implementing the Second Banking Directive or the Deposit-Guarantee Directive; or if it is informed by the supervisory authorities of another Member State where the institution is active that the institution has failed to comply with obligations imposed in that State in connection with the implementation of the Second Banking Directive or the Deposit-Guarantee Directive. As the authority responsible with matters concerning the recognition in other Member States of U.K.-incorporated institutions with regard to all activities covered by the Annex to the Second Banking Directive, the Bank may revoke the authorisation of a U.K.-incorporated institution: if it appears to it that the institution has carried on in the U.K. or elsewhere a listed activity other than deposit-taking without having given prior notice to the Bank; if it is informed by the Securities and Investments Board, or one of the self-regulating organisations exercising regulatory functions in the field of investment services of which the institution is a member, that the institution has failed to comply with any provision of the Financial Services Act 1986, or any rule, regulation or statement of principles made under that enactment, has furnished the Board or the self-regulating organisation with false, misleading or inaccurate information, or has contravened any regulatory requirement imposed by them upon it; or if it is informed by the Director General of Fair Trading of the institution's misconduct in connection to certain provisions of the Consumer Credit Act 1974.

The existence of any of the grounds mentioned above entitles the Bank to take action against the institution concerned by revoking its authorisation, but does not

---

207 S.11(7)-(8), as amended by the Insolvency (Northern Ireland) Order 1989, S.I. 1989/2405 (N.I. 19), art.381(2) and Sch.9, Pt.II, para.49. The revocation of the authorisation of an unincorporated deposit-taking institution will be warranted in equivalent circumstances; see s.9(9).
208 S.11(6)-(7).
209 S.11(1A) and (10), inserted by S.I. 1992/3218, reg.28(1) and (3), respectively.
210 S.11(1A)(a) and (e)-(f), as amended by S.I. 1995/1442, reg.49(1). On the Deposit-Guarantee Directive and its implementation, see infras, ch.5, section 5.
211 Banking Act 1987, s.11(1A)(b)-(d).
oblige it to do so ("the Bank may revoke the authorisation" (emphasis added)). Only in two occasions the statutory grounds for revocation are mandatory, imposing on the Bank a duty to act ("the Bank shall revoke the authorisation" (emphasis added)), namely: (a) the winding up of the authorised institution\(^\text{212}\); and (b) the withdrawal of a banking authorisation by the supervisory authorities of another Member State, in circumstances where an authorised institution which is incorporated in a third country has its principal place of business in that Member State.\(^\text{213}\)

If the power of revocation is exercisable for any of the other grounds, but in the Bank’s judgement the circumstances do not justify the revocation of the institution’s authorisation, the Bank may instead restrict the authorisation, by imposing a time limit on its duration and/or any conditions which the Bank considers appropriate for the protection of the institution’s depositors or potential depositors.\(^\text{214}\)

A time-limited authorisation will be appropriate especially in cases where an immediate withdrawal of authorisation would prevent the orderly repayment of the institution’s existing deposits. The limit on the authorisation’s duration must be such as not to allow the authorisation to continue in force for more than three years.\(^\text{215}\) However, an institution whose authorisation is restricted in this manner, may apply for a new authorisation.\(^\text{216}\)

The conditions imposed on an institution’s authorisation may, in particular, require the institution to take (or refrain from taking) a particular course of action, impose limitations on the acceptance of deposits, the expansion of credit or the making of investments, prohibit the solicitation of new deposits or the entering into particular transactions, or require the removal of any director, controller or manager of the institution.\(^\text{217}\) Any condition imposed on the authorisation may be subsequently varied or withdrawn by the Bank.\(^\text{218}\) An institution which fails to comply which the requirements of the conditions on its authorisation is guilty of a criminal offence.\(^\text{219}\) Moreover, breach of the conditions is of itself a ground for the outright revocation of the institution’s authorisation.\(^\text{220}\)

Where the Bank has given to an institution notice of its intention to revoke its authorisation or has actually revoked that authorisation, or an institution has given notice surrendering its authorisation, or a restricted authorisation has expired, the

\(^{212}\) s.11(6) and (9).
\(^{213}\) s.11(3) and (3A), inserted by S.I. 1992/3218, reg.28(2).
\(^{214}\) s.12(1)-(2).
\(^{215}\) s.12(3).
\(^{216}\) s.12(8).
\(^{217}\) s.12(4).
\(^{218}\) s.12(5).
\(^{219}\) s.12(6).
\(^{220}\) s.12(7).
Bank has a similar power to give to the institution such directions as appear to it to be desirable in the interests of its depositors under the circumstances. The directions may impose the same requirements that a condition might impose in connection to a restricted authorisation, and may also be varied by a further direction or revoked by the Bank. The directions may remain in force only as long as the institution has not repaid in full its deposit liabilities; after their repayment, they automatically cease to have effect. An institution which fails to comply with the Bank's directions is guilty of a criminal offence.

With the exception of the precisely defined mandatory grounds for revocation, the Bank retains considerable discretion in respect to whether and how to intervene when its powers become exercisable. It is for the Bank to choose between a revocation or a restriction of authorisation. Probably more important, however, is the fact that the threshold for the exercise of its powers is particularly low. The most significant grounds of revocation are not objectively verifiable, but depend on the Bank's own evaluation of an institution's situation.

In particular, the Bank does not need conclusive evidence that the criteria of Schedule 3 have actually been breached before taking action against an institution on this ground: it is sufficient that it appears to it that the criteria "may not be or may not have been fulfilled". The reason is that in many cases the Bank may have well-founded concerns about an institution, but may be unable to establish beyond doubt, on the basis of hard evidence, that the institution does not fulfil the criteria. It is not even necessary that the non-fulfilment of the criteria appears to continue to the present day. Even if it can be demonstrated that the irregularity has ceased and appropriate reforms implemented, a ground for revocation continues to exist in principle.

On the other hand, there must exist adequate prudential reasons which make the revocation or restriction of authorisation a reasonable response in the circumstances. This, however, will be the case only if the institution's situation presents some threat, however remote, to the interests of depositors or potential depositors. In this sense, as a ground for revocation, the non-fulfilment of the minimum criteria appears to be

---

221 S.19.
222 S.19(2).
223 S.20(1).
224 S.19(5).
225 S.19(6).
226 See the relevant remarks of Lord Beaverbrook, who introduced the Banking Bill in the House of Lords, H.L. (5th Series), Vol. 485, col.1297.
intimately linked with the residual ground of Section 11(e), *i.e.* that there are circumstances which, in the Bank's view, could pose a potential threat to the interests of depositors. In a commentary on the Banking Act, the British Bankers' Association observed that

"the fact that grounds exist for applying the sanctions does not of course mean that the Bank will automatically apply them. It can act only if the circumstances are such that it is reasonable to do so. In other words, the grounds are just the starting point: the Bank must also have reasons. Seen in this light, some of the detailed grounds seem strange. For example, it is surely inconceivable that the fact that a person has become a controller without first notifying the Bank could itself be a sufficient reason for revocation; revocation would only be reasonable if the identity of the controller was such that his presence posed a threat to depositors, in which case the catch-all ground would apply." 228

Nonetheless, to justify intervention, the threat to the depositors need not be imminent. 229 The Bank is not required to wait until the situation of an institution is critical and its eventual failure to meet its obligations, virtually certain. It is sufficient that it has a reasonable belief that there is a potential risk of loss to the depositors. 230 Moreover, it is not necessary that the perceived risk is attributable to the conduct of the institution itself. The Bank may act even if the threat arises from an external factor, over which the institution has no control and for which it is not responsible. The Bank itself mentions the examples of "a natural catastrophe or the imposition by a government of a debt moratorium." 231 In this manner, however, the range of situations that could justify the Bank's intervention becomes very wide.

In practice, the Bank follows a pragmatic approach to the question of remedial action. As its former Governor, Robin Leigh-Pemberton, has said, "if we were to respond by closing down all the banks whose accounts caused us serious concern, I think we would probably be taking far too unrealistic a view of the depositors' interest." 232

Generally, the Bank will not act against an institution unless there are serious and immediate causes for concern. Even then, it may refrain from taking formal action, if adequate and speedy corrective steps are likely to be taken by the authorised institution, although in this case it will also take into consideration the risks to which the institution's depositors may be exposed during any period of recovery or reconstruction. If, however, the institution's financial position is weak or is


deteriorating rapidly, the Bank will tend to take decisive action. In cases where formal action seems appropriate, the Bank may decide to restrict the institution's authorisation rather than revoke it, if it considers that the imposition of conditions is necessary to underpin the institution's reform program and that there are reasonable prospects that all the criteria for authorisation will be met again within a reasonable period.

Despite this pragmatic approach and the Bank's high standards of supervisory conduct, its wide discretion with regard to the taking of remedial action entails the danger that different institutions may not be treated equally. In some cases the Bank may take harsh action, while in others it may be particularly lenient and slow in its actions. B.C.C.I. is an example of the second approach.

(c) Procedural protections. The question of procedural protections is relevant, not only to the exercise of the Bank's powers under the Banking Act, but to all regulatory arrangements of the financial sector. It was raised with particular force in connection to the enactment of the Insurance Companies Amendment Act 1973, when the government of the day withdrew proposals for the imposition on the Secretary of State for Trade of an obligation to give particulars and receive representations before exercising his power of intervention with regard to insurance companies. As enacted, the statute provided a modicum of protection to directors, insofar as their alleged unfitness was the ground of an intended regulatory intervention against their company, by requiring their prior notification and giving them a right to be heard. On the other hand, despite strong parliamentary pressure, especially in the House of Lords, the government was adamant in its refusal to require prior notification before a company's original application for authorisation could be rejected or to introduce a statutory appeal mechanism.

Rejecting the need of procedural protections for new applicants, the government maintained that the requirements of fairness, which depend on the balance between the regulatory system's primary aim, i.e. the protection of the public, on the one hand, and the interests of the service provider, on the other, are different when somebody is merely prevented from entering a new business than when he is deprived of an existing livelihood. A new entrant should be given an opportunity to establish to the authorities' satisfaction that he meets the requirements for authorisation. In this context, the authorities should give to the applicant sufficient indication of the substance of any concerns that they may have regarding his fitness,

234 Ibid., para.6.5.
235 Insurance Companies Amendment Act 1973, s.23.
so as to allow him to respond to them.\textsuperscript{237} On the other hand, the authorities should be under no duty to reveal the source or the details of their information, since this could involve the disclosure of information provided to them confidentially, which could discourage potential informants. Nor should they be required to give full reasons if they remained unconvinced: as long as the refusal of the application was not for an arbitrary or capricious reason, the authority had no duty to grant authorisation, while the public interest required that, in case any doubt, the scale should tilt against the applicant.\textsuperscript{238} In the words of the Lord Chancellor:

"It is not here a case of being innocent unless and until you are proved guilty; it is a case of positively establishing your reliability and suitability, owing to the inherent nature of the insurance business".\textsuperscript{239}

In contrast, an existing business should not be put in danger without being given an opportunity to answer specific charges.

Insofar as the alleged need for an appeal procedure was concerned, the government maintained that the matter was not justiciable: it was "a subjective judgement made by an instructed person upon a question of experience",\textsuperscript{240} often with the benefit of confidential information. In short, "the trouble is that if you once impose upon a public authority the obligation to state grounds for a subjective judgment you have in fact undermined their ability to withhold authorisation where grounds are either vague or based upon a confidential source which they dare not compromise."\textsuperscript{241}

Those opposing the government's positions, on the other hand, insisted that specific reasons ought to be given in all cases, even those concerning new applicants. As Lord Stow Hill observed, the situation was not comparable to professional entry examinations, which are taken at a young age.

"When you are considering the controller, director or manager of an insurance company, or the prospective controller, director or manager, you are considering somebody who is probably in the full flight of his career, who has probably had years in the field of commercial and industrial undertakings before he ever reaches the situation in which he might be considered for such a position. You are saying with regard to a man of that sort, 'Stop! You are so undesirable that your presence is not to be tolerated'.\textsuperscript{242}

Furthermore, the implications of an adverse regulatory decision were so serious that a right of appeal would appear necessary, even if the onus should be on the appellant to establish that the decision of the authorities was wrong.

\textsuperscript{239} H.L. (5th Series) Vol.340, col.874.
\textsuperscript{240} Ibid., col.904.
\textsuperscript{241} Ibid., col.918.
\textsuperscript{242} Ibid., col.879.
The arguments outlined above on whether the same or lower levels of protection should be afforded new entrants as compared to existing institutions or whether a right of appeal against adverse decisions should be provided to regulatees, are equally relevant in the present context. However, the approach adopted in the Banking Act is different, to the extent that comparable procedural protections apply to all the decisions of the Bank, which are also subject to a right of appeal. From a substantive point of view, the Banking Act places on an institution applying for authorisation the burden of convincing the Bank that it satisfies each and every one of the minimum criteria for authorisation. In contrast, when the Bank takes action against an already authorised institution, it is required to show that it has reasonable grounds for such action, even though the burden on the Bank will be light, because the threshold for action is very low.

In all cases involving an adverse formal decision, however, the Bank must satisfy certain procedural requirements. On an application for authorisation, if the Bank proposes to refuse the application, it must give the applicant institution written notice of its intention to do so, stating the grounds and informing it of its right to make written representations within a specified period, which may not be less than 28 days. The applicant institution's representations must be taken into account by the Bank before it reaches its final decision on the application. If the ground for the proposed refusal is that any of the directors, controllers or managers of the institution is not fit and proper to hold his position, this person must also be served with a copy of the notice of intention and will be entitled to submit to the Bank written representations of his own. The Bank must always give notice to the applicant institution of its final determination; if this is negative, the notice must state the reasons for the refusal of the authorisation and give particulars of the relevant rights of appeal.

Similarly, in cases where the Bank proposes to revoke or restrict an institution's authorisation or to vary an existing restriction without the consent of the institution, the Bank must give to the institution notice of its intention to do so, stating the grounds. The institution has a right to make written representation within fourteen days from receiving notice of the Bank's intention, and the Bank must take these representations into account before reaching a final decision to proceed with its intention, take no further action, restrict authorisation rather than revoke it, or

---

244 S.10(2) and (4).
245 S.10(3)-(4).
247 S.13(1)-(3).
impose a different restriction than that originally proposed. Where a ground for 
the proposed revocation or restriction is that any director, controller or manager is 
not a fit and proper person, or where the effect of a proposed restriction is to 
remove any person from his position as director, controller or manager, that person 
must also be notified and given an opportunity to make written representations.

Only in occasions where the revocation of an institution's authorisation is 
mandatory, or where a restriction on an institution's authorisation is imposed or 
varied by the Bank as a matter of urgency, the prior notification of the institution is 
not required.250 Even then, however, the Bank needs to give notice of its decision, 
providing reasons.251 Moreover, where a restriction is imposed without prior 
notification in cases of urgency, the institution, or any person whose removal is 
required by the restriction, has a right to make written representations within a 
period of fourteen days from the day of receiving notice of the restriction, and the 
Bank must take into account their representations before deciding whether to 
confirm or rescind its original decision or whether to impose a different 
restriction.252

Finally, certain procedural protections also apply where the Bank gives a 
direction in connection to the revocation or surrender of an institution's 
authorisation.253

The reasons that the Bank is required to give for its decision must not only be 
intelligible, but must also deal with all the substantial points which the Bank 
addressed.254 It must be apparent from what is stated, either expressly or 
inferentially, what were the issues with which the Bank was concerned and what was 
the evidential basis upon which it reached its conclusions on those issues.255

It might be argued that, in cases where the Bank proposes to refuse, or finally 
refuses, an application for authorisation, a statement on the part of the Bank that it 
has not been satisfied that the applicant institution satisfies the minimum 
requirements should be sufficient, since at this point the burden is on the applicant to 
satisfy the Bank that authorisation should be granted.256 If this is accepted, unless

248 S.13(5)-(7).
249 S.13(4)-(5) and (7).
250 S.14(1).
251 S.14(2)-(3).
252 S.14(4)-(6).
253 S.20.
795.
(C.A.).
there is evidence to suggest that its refusal is irrational or flawed, there will probably be no grounds for challenging the Bank.

In fact, the reasons given by the Bank for its decisions are very detailed, even in connection to non-appealable decisions. They include a detailed description of the institution's history and references to the evidence collected by the Bank and the reports of reporting accountants, investigators, etc.\textsuperscript{257}

In \textit{R. v. Bank of England, ex p. Mellstrom},\textsuperscript{258} the Bank had served to a small deposit-taking institution, National Guardian Mortgage Corporation Ltd., notice of its intention to revoke its authorisation, citing among other grounds that the institution's ultimate beneficial owner and controller, G.F.C. Mellstrom, was not a fit and proper person to hold the position of an executive controller and principal shareholder. Soon afterwards, an administration order was made in respect of the institution and Mellstrom resigned from his directorship. Following representations by the institution's administrator, the Bank ultimately decided merely to restrict, rather than revoke, its authorisation. On the other hand, the Bank, rejecting personal representations by Mellstrom, stood by its finding of unfitness, maintaining its position in relation to each of eight matters of concern listed in its original notice.

Mellstrom sought to challenge the Bank's finding of unfitness, on the ground that he was treated unfairly. In effect, his claim was that the Bank, in reaching its conclusions, had relied on detrimental material in its files which had not been disclosed in its notice or the accompanying documents, thus depriving him of his opportunity to comment on this material, as required under the Act; or, alternatively, that, even if the Bank had not in fact taken this material into account, it should nevertheless have disclosed it to him, in order to offer him an opportunity to comment and prevent the taking into account of uncontradicted undisclosed material.

Initially, Mellstrom appealed to the Banking Appeal Tribunal, but when the Tribunal refused him leave to adduce evidence to the effect that the detrimental material in the Bank's files contained errors of fact, he abandoned his appeal, bringing instead an application for judicial review. Responding to his application, the Bank insisted that it had done all that it was required to do under the Banking Act and that the court should be slow to impose upon it procedural requirements over and above the statutory ones.

\textsuperscript{257} Interview with officials of the Banking Supervision Division (A. Boxall and P. Hatton), 5 Oct. 1990. The Bank's reasons for its decision to restrict the authorisation of Mount Banking are set out in detailed in \textit{Mount Banking Corporation Ltd. (in administration) v. The Governor and Company of the Bank of England, 13 Oct. 1993, Banking Appeal Tribunal, unreported.}

\textsuperscript{258} 19 Jan. 1995, Q.B.D., reported in LEXIS.
In the High Court, Schiemman J. rejected Mellstrom's arguments that the decision was based on undisclosed material. It was common ground that the Bank's files contained detrimental material suggesting the occurrence of numerous irregularities, which reflected negatively on the applicant's fitness, including his probity. This material had been available to the review committee of the Bank's Banking Supervision Division prior to the making of its decision to serve the notice. However, Schiemman J. was satisfied that it has not been consciously relied upon by the committee: if certain members had consciously given importance to it, and certainly if they had persuaded a majority of the committee to do the same, this would have been reflected in the committee's minutes and the affidavit; nor was the view of the committee one which could not rationally be reached on the basis of the matters actually disclosed in the notice. It was not for the court to say whether the committee's view was right or wrong. This matter should have been pursued by Mellstrom before the Banking Appeal Tribunal; there, the Bank would not have been able to rely on the detrimental material, which it had not disclosed upon being required by order of the Tribunal's chairman to disclose all documents on which it intended to defend its decision.

The alternative submission that, since the Bank was in possession of significant, credible and relevant detrimental material upon which the person concerned had been given no opportunity to comment, its decision was in breach of natural justice and should be set aside, whether or not those matters were actually taken into account, was also rejected by Schiemman J. The applicant had been treated fairly, for the following reasons: (a) provided that the detrimental material had not been taken consciously into account, the Bank had followed the statutory notification requirements; (b) the notification to the applicant of all detrimental material in the Bank's files would be burdensome and distracting for him (since he would be tempted to respond, within the very short time available for representations against the Bank's decisions regarding authorisation, to inferences which the Bank did not perceive as determinative), burdensome for the Bank and would lead to delay; and (c) the statutory appeal procedure provided an opportunity for the merits of the Bank's decision in such circumstances to be examined by an expert tribunal.

The decision establishes that it is sufficient for the Bank to disclose in its notices the grounds which actually form the basis of its decision, and does not need to reveal all potentially damaging information in its possession or provide to its regulatees an opportunity to rebut such information. On the other hand, it would be inappropriate for the Bank to rely on grounds of which it has failed to give advance notice.
(d) **The appeal mechanism.** The Banking Act 1987 gives a right of appeal to any institution aggrieved by a decision of the Bank to refuse its application for authorisation, to revoke or restrict its existing authorisation or to give it a binding direction in connection with the revocation or restriction of its authorisation.\(^{259}\)

Where the ground for the refusal, withdrawal or restriction of authorisation relates to the unfitness of a particular controller, director or manager of the institution, the person concerned has a limited right of appeal against the Bank's finding of unfitness. Similarly, where a restriction of authorisation or direction given to an institution requires the removal of a controller, director or manager of that institution from his position, the latter is entitled to appeal against the decision requiring his removal.\(^{260}\)

Finally, a prospective or existing controller of an authorised institution on whom the Bank has served directly a notice of objection can appeal against the objection. However, a controller who has acquired new or increased control of an authorised institution without notifying the Bank or despite an objection by the Bank, loses his right of appeal.\(^{261}\)

Appeals under these provisions are heard by a specially constituted tribunal, the Banking Appeal Tribunal. The Tribunal consists of three members. The chairman must be a lawyer (solicitor, barrister or Scottish advocate) of at least seven years' standing and is appointed by the Lord Chancellor; the other members, one experienced in accountancy and the other in banking, are appointed by the Chancellor of the Exchequer.\(^{262}\)

Where an institution brings an appeal against the revocation of its authorisation, the operation of the revocation is suspended automatically pending the appeal's determination. In comparison, where the appeal is directed against a restriction of authorisation or direction, the provision of interim relief, through the suspension of the operation of the relevant decision, is left to the Tribunal's discretion.\(^{263}\)

On appeals by institutions or by controllers on whom the Bank has served notice of objection the question for the Tribunal is "whether, for the reasons adduced by the appellant, the decision was unlawful or not justified by the evidence on which it

\(^{259}\) S.27(1).

\(^{260}\) S.27(2).

\(^{261}\) S.27(3). On the power of the Bank to object to the controllers of authorised institutions, see infra, ch.4, text and nn.216-223.

\(^{262}\) S.28, as amended by the Courts and Legal Services Act 1990, s.71(2) and Sch.10, para.69, and the Judicial Pensions and Retirement Act 1993, s.26(10) and Sch.6, para.65. The Banking Appeal Tribunal has been placed under the general supervision of the Council on Tribunals; Tribunals and Inquiries Act 1992, s.1(1)(a) and Sch.1, Pt.1; see also Council on Tribunals, "The Annual Report for 1987-88", H.C. (1988-89) 102, p.33. Generally on the Council, see Special Report by the Council on Tribunals, "The Functions of the Council on Tribunals" (Cmdn. 7805, Jan. 1980); and M. Sayers, "The Council on Tribunals" (1986) 20 Social Policy and Admin. 39.

\(^{263}\) S.27(4)-(5).
was based". On such appeals, the Tribunal may confirm or reverse the Bank's decision. Where an institution's appeal is against the revocation of its authorisation, the Tribunal can also direct the Bank to replace the revocation with a restriction on the authorisation; where the appeal is against the imposition of restrictions or the giving of directions, it can direct the Bank to impose different restrictions or give different directions. In these cases, the decision regarding the content of the new restrictions or directions belongs to the Bank, but the institution may bring another appeal to the Tribunal if it does not accept it; then, the Tribunal may confirm the Bank's decision or direct it again to replace the restrictions or directions with different ones.

The ambit of the Tribunal's jurisdiction is narrower in the case of appeals by directors, controllers or managers against the Bank's finding that they are unfit to hold their position. In this case, the Tribunal is not concerned with the lawfulness of the Bank's decision, but considers only "whether, for the reasons adduced by the appellant, the finding of the Bank was not justified by the evidence on which it was based"; and, unless the institution concerned brings itself a parallel appeal against the Bank's formal decision to refuse, revoke or restrict authorisation, even if the Tribunal's conclusion is that there was no justification for the particular finding of unfitness, the validity of that decision is not affected, despite being based in whole or in part on the erroneous finding. In comparison, when an appeal by a director, controller or manager is directed against a restriction of authorisation or direction given to his institution whose effect is to require his removal, the Tribunal's jurisdiction is not so restricted: the Tribunal is entitled to examine the lawfulness as well as the justification of that decision and can confirm or reverse it.

The procedural rules governing the conduct of appeals and the collection of evidence are set out in regulations made by the Treasury. Under the regulations, an appeal can be brought by sending a notice to the secretary of the Tribunal within a short time limit from the date on which the Bank gave to the appellant notice in writing of the decision against which the appeal is directed (10 or 28 days, depending on the type of the decision). As soon as an appeal is lodged, the secretary must request the Lord Chancellor and the Chancellor of the Exchequer to

---

264 S.29(1).
265 S.29(2)-(4).
266 S.29(5)-(6).

267 Banking Appeal Tribunal Regulations 1987, S.I. 1987/1299, as amended by S.I. 1993/982. The power of the Treasury to make regulations governing the Tribunal's procedure is granted by s.30(3) of the Banking Act 1987, as amended by the Tribunals and Inquiries Act 1992, s.18(2) and Sch.4, Pt.I. The power is now exercisable only after consultation with the Council on Tribunals; Tribunals and Inquiries Act 1992, s.8(2)(b).

268 S.I. 1987/1299, reg.4, as substituted by S.I. 1993/982, reg.2(b).
appoint, in accordance to the statutory provision, the members of the Tribunal who will hear the appeal. The appellant can withdraw the appeal at any time before or during its hearing by the Tribunal. The Bank can also withdraw at any time its opposition to the appeal.

A notice of appeal must be supplemented within a short period (in the case of appeals against the revocation of an institution's authorisation or against findings of unfitness contained in a revocation, within 28 days from the date on which the Bank served notice of its decision; otherwise, within 14 days from the date of servicing of the notice of appeal) by a notice setting out the grounds of the appeal, which must contain sufficient particulars to show why the Bank's decision was unlawful or not justified by the evidence on which it was based, or why the finding of unfitness was not justified by the evidence. On its part, within 14 days of receiving notification of the appeal, the Bank must send to the secretary of the Tribunal copies of the documents relating to the appeal (applications for authorisation, documents and information submitted by the institution on the Bank's request, notices served by the Bank, written representations, etc.).

In situations where a decision of the Bank against an authorised institution is taken on the ground that a director, controller or manager of that institution is not fit to hold his position, or where the decision requires the removal of a director, controller or manager from his position, and both the institution and the person concerned bring parallel appeals against the decision, the chairman of the Tribunal may make a direction for the consolidation of the appeals.

With the exception of appeals by controllers of authorised institutions on whom the Bank has served notice of objection, the procedure before the Tribunal commences with a preliminary hearing, which is heard in private by the chairman alone. At this stage the chairman may give any directions that he considers necessary or desirable for the conduct of the appeal and fixes the date of the main hearing.

By direction given at the preliminary hearing or by notice in writing, the chairman may also require the appellant, the Bank or any other person to attend and give evidence or produce documents under his custody or control. However, third parties cannot be compelled to give evidence or produce documents unless they are compensated for their expenses. Moreover, before demanding the giving of evidence

---

274 S.I. 1987/1299, reg.10, as amended by S.I. 1993/982, reg.2(e). In addition to the parties and their representatives, the other members of the Tribunal and any member of the Council on Tribunals can attend the preliminary hearing.
or production of documents, the chairman must take into account need to protect commercially sensitive or confidential information relating to third parties, while he cannot force the disclosure of evidence which the person concerned could not be compelled to supply if the proceedings were taking place in a court of law. The Banking Act imposes criminal sanctions on any person who, in contravention of a requirement made in accordance of the regulations and without reasonable excuse, fails to attend and give evidence or alters, suppresses, conceals, destroys or refuses to produce documents which he has been required to produce.

Like the preliminary hearing, the main hearing of appeals by the Tribunal is in private, unless the chairman directs that it shall be in public, in whole or in part. Both the appellant and the Bank may be appear at the hearing, where they can be represented by counsel, solicitor or any other person, and are entitled to make an opening statement, call witnesses, cross-examine the witnesses of the other party and make a final statement. On a personal appeal by the director, manager or controller against a finding of unfitness in a decision affecting the authorisation of his institution or giving a direction to the latter, the Banking Act provides that the institution has a right to be heard by the Tribunal.

The Tribunal may arrange for the publication of its final decision after hearing representations by the parties, but for this purpose it must take into consideration "the desirability of safeguarding commercially sensitive information or information given to the appellant or the Bank in confidence and the interests of depositors and potential depositors"; to protect these interests, it is entitled to make appropriate amendments to the published text of the decision, so as to conceal the identity of the appellant or the source of sensitive information.

It is specifically stipulated that procedural irregularities which arise as a result of a failure to comply with the regulations do not of themselves render the proceedings void. If at any time before the making of its final decision such an irregularity comes

---

276 S.30(5)-(6).
277 S.I. 1987/1299, reg.13(5). However, members of the Council on Tribunals can always attend the hearing. Cf. R. v. Chief Registrar of Friendly Societies, ex p. New Cross Building Society [1984] 1 Q.B. 227 (C.A.), where a building society appealed against the Chief Registrar's decision to revoke its designation under s.1(1) of the House Purchase and Housing Act 1959, so that it ceased to be an acceptable depository for most trust funds, and to apply s.48(2) of the Building Societies Act 1962, thereby in effect preventing it from accepting investments or deposits from the public. The case was heard wholly in camera: due to the building society's vulnerability to the risk of abnormal levels of deposit withdrawal if there were a loss of confidence on the part of its customers, a public hearing would effectively deprive the society of any relief to which it might be entitled.
279 S.30(2); and S.I. 1987/1299, reg.13(8).
to its attention, the Tribunal can cure them by taking such corrective steps as it
thinks fit. Finally, the Tribunal has a statutory discretion to order the payment of
costs and expenses by any party to the appeal.

As a safeguard that the appeal system will not result in legally erroneous
decision, the Banking Act gives to the appellant or the Bank a right to bring a
further appeal to the High Court on a point of law if they are not satisfied with the
decision of the Banking Appeal Tribunal. If on such a further appeal the court
reaches the conclusion that the Tribunal's decision was indeed erroneous in point of
law, it must overturn it and remit the matter to the Tribunal for rehearing.

In practice, many of the institutions whose authorisation is revoked or restricted
make no attempt to refer the matter to the Banking Appeal Tribunal. Even those
institutions which do commence appeal proceedings, however, tend to withdraw
their appeals at a preliminary stage, before the actual hearing of their case.

The Bank's preferred explanation for this phenomenon is that, almost invariably,
the appeals are lodged for purely tactical reasons: the appellants can see that the
Bank's decision concerning them is fair and reasonable; nonetheless, as a long time
may pass between the launching of an appeal and its eventual hearing, they file
appeals which they do not intend to actually contest, with the intention of delaying
the decision's actual effect and thus gaining time for the orderly winding down of
their operations.

Conceivably, however, in certain cases appeals may not be contested in spite of
the appellants' genuine grievances, because the inherent characteristics of the appeal
mechanism set practical limitations to the reviewability of the Bank's decisions and
diminish the appellants' prospects of success. In particular, the scope of the appeal
procedure is restricted, precluding the full rehearing of the relevant cases. The

282 Banking Act 1987, s.30(1); see also S.I. 1987/1299, reg.17.
283 S.31.
284 According to information released by the Lord Chancellor's office and reported in the press, in
the eighteen months prior to the hearing by the Banking Appeal Tribunal of the Mount Banking
appeals (see infra, text and nn.288-301), seven or eight attempts had been made by other banks
to appeal against decisions of the Bank. All stumbled at the preliminary hearings held by
Jonathan Mance, Q.C., the Tribunal's appointed chairman, and were withdrawn; A. Jack, "Bank
challenged over regulatory powers", Financial Times, 9 Sep. 1993, 8.
285 Interview with officials of the Banking Supervision Division (A. Boxall and P. Hatton), 5 Oct.
1990.
286 In comparison, final decisions were reached in three different occasions on appeals brought
under s.11 of the Banking Act 1979, which provided for the full reconsideration of the Bank's
decisions following an appeal to the Chancellor of the Exchequer. In one of these occasions, an
appeal against the revocation of a deposit-taking license was upheld with the Bank's agreement,
on the ground that the shortcomings cited by the Bank had been met subsequently by satisfactory
remedies; see Bank of England, "Report and Accounts for the Year 1986-87", p.57. In the case of
appellants may also reasonably assume that the Banking Appeal Tribunal and, in the
case of further appeals, the High Court would be reluctant to oppose the Bank's
substantive judgements, deferring instead to its presumed regulatory expertise.
Indeed, a high degree of appellate and judicial deference to the Bank's regulatory
judgements would not be surprising, since the courts have consistently displayed
similar attitudes of deference to the decisions of other City regulators in the context
of judicial review proceedings relating to company and commercial matters.\textsuperscript{287}

The exact nature and scope of the appellate jurisdiction was a primary issue in
the only case until now where appeals to the Banking Appeal Tribunal have been
actually contested to the end, leading to a full hearing of the matter.\textsuperscript{288} The case
arose from the imposition of a short time restriction on the authorisation of a small
institution in administration, Mount Banking Corporation Ltd. The administrators
brought an appeal in the institution's name seeking to reverse the restriction,\textsuperscript{289} while
its two owners/directors challenged separately the Bank's findings of unfitness
against them.

The parties in \textit{Mount Banking} expressed conflicting opinions as to the role of the
Banking Appeal Tribunal on a number of issues. A first disputed point in this
connection was whether evidence that had not been actually considered by the Bank
in the course of reaching its decision should be taken into account for the purposes
of the appeals. This point was resolved at the instance of the parties by the chairman
of the Tribunal, Jonathan Mance, Q.C., at an interlocutory stage.\textsuperscript{290} Mr. Mance drew
a distinction between two types of potentially relevant evidence. Thus, fresh
evidence which had not been before the Bank at the time of its decision could not be
adduced in an appeal; however, the Bank's failure to investigate matters on which
evidence would have been readily available could open its decision to attack on the
ground that it was not based on sufficient evidence. On the other hand, evidentiary
material that had been in the Bank's possession but had been disregarded in the

\textsuperscript{287} See infra, text and nn.328-334.
\textsuperscript{288} \textit{Mount Banking Corporation Ltd. (in administration) v. The Governor and Company of the
Bank of England}, 13 Oct. 1993, Banking Appeal Tribunal, unreported; and, on a further appeal
to the High Court by one of the appellants, \textit{Navinchandra Bhagwanji Shah v. The Governor and
\textsuperscript{289} In pursuance of the Order of Direction made on 29 April by the Banking Appeal Tribunal's
chairman, Jonathan Mance Q.C., Mount Banking's authorisation was extended pending the
determination of the appeals.
\textsuperscript{290} Ruling on Preliminary Issue, 24 June 1993.
decision-making process should be evaluated. Moreover, Mr. Mance expressed a view, that it would be irrelevant whether or not the material had actually reached the Banking Supervision Division's review committee, or such other body or person that had taken the critical decision as a matter of fact, because the Banking Act delegated regulatory responsibilities to the Bank as a whole and not to its internal divisions. Although the Bank did not accept the correctness of this view, it did not pursue further the matter in this case.

Other jurisdictional questions were contested before the Tribunal during the full hearing of the appeals. On the basis of esoteric textual arguments, the Bank contended that, where the ground for a revocation or restriction of an institution's authorisation is that the Bank is not satisfied that the institution's controllers, directors or managers are fit and proper persons, the finding that the Tribunal is called upon to assess on an appeal is not that the existing evidence justifies objectively the conclusion that the persons in question are not, have not been, may not be, or may not have been, fit and proper, but a distinct finding concerning the Bank's subjective state of mind, i.e. that it does indeed appear to the Bank that the requirement of fitness is not or may not be satisfied. As should be expected, the Tribunal dismissed without difficulty this "stilted" contention and endorsed, instead, the more natural objective test.\(^{291}\)

The real difficulty with regard to the appellate jurisdiction concerned the meaning of the phrase "not justified by the evidence on which it was based". The Bank submitted that this phrase imported the \textit{Wednesbury} test of unreasonableness,\(^{292}\) so that its decisions should be repudiated only if they could be shown to be based on irrelevant considerations or to be so unreasonable that no reasonable authority would reach the same result on the evidence before the Bank.\(^{293}\) If this view were accepted, the Tribunal's function would be very similar to that of the High Court on an application for judicial review.

After careful consideration, the Tribunal concluded that its jurisdiction was not so confined. In its opinion, by subjecting the Bank's decisions regarding authorisation and its findings of unfitness to a special appeal procedure, the Banking Act imposed on the Tribunal a responsibility to form its own view on whether these decisions and findings were justified objectively by the evidence on which they were

\(^{291}\) Transcript of the Tribunal's decision, pp.9-10.


\(^{293}\) As has been rightly observed by Sir William Wade, despite the fact that, "taken by itself, the standard of unreasonableness is nominally pitched very high [...] there are abundant instances of legally unreasonable decisions and actions at all levels. This is not because public authorities take leave of their senses, but because the courts in deciding cases tend to lower the threshold of unreasonableness to fit their more exacting ideas of administrative good behaviour"; \textit{Administrative Law} (6th ed., 1988), pp.408-409.
based. A number of factors could support this conclusion. Firstly, an appeal of the type suggested by the Bank would be exceptionally inefficacious. Secondly, in cases of Wednesbury unreasonableness, judicial review would provide a remedy even if the statutory mechanism of appeal did not exist. On the Bank’s interpretation, this mechanism was simply intended to formalise the procedure for bringing a challenge and to direct the matter to a more specialised forum. However, the availability under the Banking Act of a further appeal to the High Court on a point of law, which could include allegations of unreasonableness, does not support this view. Thirdly, there are important differences in the formulation of the two rights of appeal, which suggest that their scope is not the same. In particular, while following a successful further appeal to the High Court on a point of law the matter is remitted to the Tribunal for reconsideration, as would happen in a case of judicial review, there is no analogous provision for remitting a case to the Bank when the Tribunal comes to the conclusion that the Bank’s conclusions are unreasonable. Fourthly, the limited power of the Tribunal to direct the Bank to vary its decision by imposing a restriction instead of a revocation or to substitute a different restriction or direction for that originally imposed is *sui generis* and does not fit into the mould of Wednesbury review. All these factors led the Tribunal to endorse the wider interpretation, which would require it to reconsider the evidence with a view to forming an opinion on the merits of the Bank’s decision to rely on the grounds mentioned in its formal notices.

Significantly, however, the Tribunal qualified its conclusion by stressing “that it is both entitled and likely to give the policies and approach of the Bank of England as the statutory regulator with unrivalled experience in the field very considerable weight”. Moreover, the Tribunal drew a distinction between the Bank’s preliminary finding of fact that the very low threshold empowering it to act has been crossed (i.e. that there are sufficient grounds for suggesting that one or more of the minimum criteria for authorisation has not or may have not been fulfilled) and its discretionary decision to take formal action in the light of such findings. In its immediate context, the distinction served as the premise for refuting the Bank’s argument that its broad discretion sets limits to the Tribunal’s jurisdiction to consider whether the factual threshold for remedial regulatory action had been crossed. Nonetheless, a necessary corollary of the distinction is that, once the legal challenge moves from the finding of fact regarding the breach of the minimum criteria of authorisation to the way in which the Bank has exercised its discretion, the Tribunal

294 Transcript of the Tribunal’s decision, pp.10-15.
should adopt a more circumspect attitude, deferring to the Bank's judgement concerning the form and intensity of intervention.

The text of the statute requires the Tribunal, on an appeal by an institution, to address the question, whether "the decision was [...] not justified by the evidence". The wording of this provision strongly suggests that the decision under attack should be addressed as a single act of the Bank, which encompasses both a factual finding that the statutory criteria for authorisation are not, or may not be, satisfied and the response to this finding. It might appear that the same standard of justification should apply to all aspects of the Bank's decision. Nonetheless, this was not the Tribunal's view. In its opinion, admittedly

"an issue regarding the exercise of the Bank's discretion in relation to a decision probably raises a question whether the Bank's decision was 'not justified by the evidence on which it was based' (rather than a question whether it was 'unlawful' (cf. section 29(1) and (5)). But, by whatever route, the exercise of discretion is commonly only reconsidered on appeal on a circumscribed basis. It does not follow that such an approach is also required in respect of the statutory threshold for the exercise of discretion." Under this analysis, the appropriate approach to matters of discretion would be "similar to that which a court would adopt on an appeal from a first instance judge". Accordingly, a different standard would be appropriate in relation to the appeals brought by Mount Banking's two owners/directors, which were directed against the Bank's findings of unfitness, than to the institution's appeal, which was simply against the Bank's imposition of a three-month limit on its authorisation.

The Tribunal's analysis disentangles the factual from the discretionary elements of the decision-making process and evaluates them separately, using two different tests. This might have a negative influence on potential appellants' prospects of success, especially since it precludes a consideration of the proportionality or suitability of the Bank's response to identified irregularities. Conversely, appellants' prospects could be more promising if the Tribunal were prepared to form its own independent view on the substantive appropriateness of the Bank's remedial action as a structured whole.

Even under a unified test, however, appellants would still face the burden of overcoming attitudes of judicial deference to the Bank's regulatory responsibility and expertise. This has been made clear in the judgement of Vinelott J. on a further appeal to the High Court by one of the owners/directors of Mount Banking, N.

296 S.29(1).
298 Ibid., p.16.
299 Ibid., pp.15-16 and 46.
Shah, following the dismissal of the original appeals by the Tribunal. On the jurisdictional issue, Vinelott J. affirmed that the scope of an appeal to the Banking Appeal Tribunal is not coextensive with the High Court's power of review on *Wednesbury* principles. Nonetheless, he rejected the appellant's submission that the Tribunal was required to reach its own, independent view on whether the Bank's decision on the merits was the correct one. Something less was required by the Tribunal, namely, to determine

"whether on a review of all the evidence in the possession of the Bank, it can be said that the Bank's decision went beyond the range of what could be said to have been justified by the evidence." In essence, this formulation gives explicit and direct recognition to the Bank's overall margin of appreciation, without reference to the Tribunal's elaborate distinction between threshold factual findings and discretionary remedial decisions.

The conclusion that can be drawn from the above is that the Tribunal's function is to evaluate the evidence with a view to determining whether the Bank's decision is acceptable, in the sense that it is supported by adequate grounds, regardless of whether it appears to the Tribunal to be absolutely correct. This conclusion is also consistent with the remarks of Lord Justice Bingham in his report on the B.C.C.I. affair, where he castigated the Bank for its unreasonable fear of finding itself overruled on an appeal, which "loomed much larger than it should in the Bank's mind". In the relevant passage, which was quoted approvingly by Vinelott J. in his judgement on N. Shah's further appeal, Lord Bingham observes that the Banking Act gives the Bank a very wide margin of appreciation.

"It does not have to be satisfied that a criterion has not been fulfilled. It is enough that it (genuinely and not irrationally) appears to the Bank that a criterion may have been fulfilled. The clear intention of the legislature was, in my opinion, to provide a very low threshold before the Bank's powers to revoke (and restrict) become exercisable. On the question whether the threshold condition is met, as on the question whether the power to revoke or restrict (if exercisable) should be exercised, paramount weight is given to the Bank's experience and informed judgment. [...] Parliament intended the Bank to back its professional judgment. Provided it does so objectively, fairly, rationally and, preferably, with the benefit of sound legal advice, it need have little to fear."^

---

301 Ibid., pp.25-26.
303 Ibid. Sensitive to the tension between this passage and its own contention that the scope of an appeal was not limited to questions of *Wednesbury* unreasonableness, in its decision on the *Mount Banking* case the Banking Appeal Tribunal commented that the observations of Lord Bingham concerned the low threshold of the regulatory jurisdiction but could not provide guidance regarding the nature of the appeal procedure; transcript of the Tribunal's decision, p.13,
In short, given the strong insistence on the need for deference to the Bank's judgements, it is questionable whether the appeal mechanism can be of significant practical assistance to regulatees with substantive grievances, unless they can show that the Bank's decisions affecting them were contaminated by bad faith or oppressive.

The burden on the appellant will be equally onerous in the event of a further appeal to the High Court on a point of law. On an appeal of this type the appellant will be called, in principle, to show that the decision of the Banking Appeal Tribunal was based on an erroneous interpretation of the law or that it was unreasonable, because it was unsupported by evidence or because the only reasonable conclusion that the Tribunal could have reached on the basis of the available evidence was that the Bank's decision in relation to the appellant was illegal or unjustified. This may be possible only in exceptional cases.

(e) A residual role for judicial review? The special appeal procedure of the Banking Act does not preclude ipso facto the possibility of judicial review, which could still have a significant role to play in the context of banking regulation. Nonetheless, where an aggrieved person has not pursued and exhausted his statutory rights of appeal, the courts may not allow him to proceed by way of an application for review. This is a consequence of the courts' broader policy of providing only in exceptional circumstances judicial review where an effective and convenient alternative statutory remedy is available to the applicant.

n.3. This interpretation is not particularly convincing. The context of his remarks makes clear that the fear that Lord Bingham intended to dispel with his remarks was that of potential appellate intervention. Moreover, the passage reveals Lord Bingham's belief that the same test of justification should apply to the Bank's threshold findings of fact as to the subsequent exercise of its regulatory discretion.


305 See Penn, Banking Supervision..., op.cit., n.41, pp.143-144. A similar view has been expressed in the context of investment services regulation under the Financial Services Act 1986 by Sir Harry Woolf, "Judicial review in the commercial arena" (1987) 8 Co.Law. 167, p.169.

306 See R. v. Inland Revenue Commissioners, ex p. Preston [1985] A.C. 835 (H.L.), p. 852 per Lord Scarman and p.862 per Lord Templeman; R. v. Chief Constable of Merseyside Police, ex p. Calvey [1986] 1 All.E.R. 257 (C.A.); R. v. Secretary of State for the Home Department, ex p. Swati [1986] 1 All.E.R. 717 (C.A.). The existence of an alternative remedy may be "a factor, and a very weighty factor, in the assessment of whether the discretion which the court undoubtedly has to grant or refuse judicial review should be exercised", even though it does not oust the High Court's jurisdiction to review the case; Leech v. Governor of Parkhurst Prison [1988] 2 W.L.R. 290 (H.L.), p.323 per Lord Oliver. Recourse to judicial review may be prevented if the statute that the applicant seeks to enforce provides a specific remedy which performs an equivalent function; Barraclough v. Brown [1897] A.C. 615 (H.L.). For this to
Where an institution is aggrieved by the Bank's formal decision to refuse, revoke or restrict its authorisation, or to give it a direction pursuant to the revocation, surrender or expiry of its authorisation, the statutory appeals provide an appropriate channel for the hearing of its grievance, permitting the raising of all the issues that could be raised in review proceedings. For this reason, an application for the judicial review of the offending decision will probably not be allowed in such a case. Similar considerations apply in situations where a director, controller or manager of an authorised institution is aggrieved by a restriction of his institution's authorisation or by a direction given to that institution by the Bank whose effect is to remove him from his position; or where a shareholder controller of an authorised institution is aggrieved by a decision of the Bank to serve directly on him notice of its objection to his control.

In <cite>R v. Bank of England, ex p. Mellstrom</cite>, the owner of a small deposit-taking institution sought to challenge by way of judicial review the Bank's finding that he was not a fit and proper person to hold his position as controller, on the basis of which his institution's authorisation had been restricted. The applicant maintained that the Bank had acted unfairly, because it had failed to disclose in its notices detrimental material in its files concerning him personally. An appeal by the applicant before the Banking Appeal Tribunal had been abandoned after the Tribunal refused him leave to adduce evidence to the effect that the relevant material contained errors of fact.

Responding to the application, the Bank accepted that its regulatory activities are in principle amenable to judicial review and that in the instant case the applicant had sufficient interest to start proceedings, but submitted that the existence of an alternative statutory remedy of appeal should lead the court to refuse to grant judicial review.

Happen, however, the remedy must be capable, not merely of resolving the grievance, but of providing an equivalent measure of protection. On this basis, if a comprehensive appeal structure is available to the applicant, the courts may refuse his application for judicial review. In principle, the ultimate criterion is the effectiveness and convenience of the alternative remedy; <cite>R v. Hillingdon L.B.C., ex p. Royco Homes Ltd. [1974] 2 All E.R. 643 (Q.B.D.), p.648 per Widgey, C.J.</cite> Nonetheless, the specific policy context may be the crucial factor in practice. In the words of N. Collar, "Judicial review and alternative remedies - an analysis of recent English decisions" (1991) 10 Civ.J.Q. 138, p.150, "[t]he alternative remedies rule can be seen as a device which allows the judges to support the strong arguments favouring use of statutory remedies on the one hand, whilst on the other retaining their supervisory jurisdiction over suitable cases irrespective of the presence of an alternative remedy. It is an inherently discretionary device and its use is influenced by policy issues, such as the need to avoid the conflict with Parliament caused by supplanting statutory remedies with judicial review and to ration the number of cases using judicial review procedure in order to preserve its expeditious nature."

307 See Banking Act 1987, s.27(1).
308 See s.27(2)(b) and (3).
309 19 Jan. 1995, Q.B.D., reported in LEXIS. See supra, text and n.258.
Observing that, as the Bank had not sought to rely on the detrimental material before the Tribunal, the applicant would have been able to obtain by the Tribunal a decision on the merits of his case which would be unaffected by that material, Schiemman J. came to the conclusion that there was no justification for interference by the court in the expert appellate process established by Parliament and so it would be wrong to grant judicial review. Although he went on to refuse relief on substantive grounds, he did so only on pragmatic grounds, because the whole of the substantive arguments on each side had already been put before the court. Nonetheless, he was careful to note that his decision should not be taken to suggest that "in other circumstances, in particular in cases where the Bank does intend to rely on appeal on matters of which it had failed to give advance notice, judicial review would [...] necessarily be inappropriate."

A compelling reason for allowing judicial review in cases of the type alluded to by Schiemman J. is that they raise questions concerning the lawfulness and procedural propriety of the Bank's actions, while on a statutory appeal by an allegedly "unfit" director, controller or manager the only question for the Tribunal is whether the Bank's finding of unfitness was justified by the evidence.

An apparently similar argument could be made in favour of allowing review proceedings in cases where, following a decision by the Bank to refuse, revoke or restrict an institution's authorisation on the ground that a particular director, controller or manager is not a fit and proper person to hold his position in the institution, the person concerned seeks to challenge that decision per se, rather than the specific finding of unfitness. In such cases, the ability to proceed by way of judicial review would have significant advantages in terms of effectiveness, because on a personal appeal the Banking Appeal Tribunal may only declare that the finding of unfitness was unjustifiable, and a separate appeal by the institution will be necessary for the reversal of the Bank's decision regarding authorisation. It is questionable, however, whether in this situation an allegedly "unfit" manager or director would have sufficient standing to challenge the Bank's decision by way of review, because his interest in the Bank's decision insofar as this affects his institution's authorisation is no greater than that of any other employee of that institution. As for his clear and direct interest in the protection of his reputation, this could be effectively pursued by means of an appeal. Different considerations could be relevant, however, where the application is brought by an institution's owners, especially if that institution is in administration or provisional liquidation, in

---

310 Cf. Banking Act, s.27(2)(a).
311 See s.29(5)-(6).
312 On the question of standing, see infra, text and nn.321-327.
which case the administrators may be unwilling to bring an appeal in the institution's name against the Bank's decision.\textsuperscript{313}

Judicial review will be the primary way of challenging regulatory decisions of the Bank which do not pertain immediately or formally to the authorisation of individual institutions. For instance, formal directions given to authorised institutions regarding their deposit advertisements\textsuperscript{314} are not amenable to appeal and could only be challenged by way of an application for review. Probably the most important category of individual decisions open to review are those relating to the gathering of supervisory information on a non-voluntary basis, especially through specific requests for the provision of information or production of documents, searches of the premises of deposit-taking institutions and formal investigations of their affairs\textsuperscript{315}.

Regulatory measures of general applicability may also be amenable to judicial review.\textsuperscript{316} The exercise by the Treasury of its powers to issue delegated legislation under certain provisions of the Banking Act is a case in point.\textsuperscript{317} Guidance notices setting out the Bank's regulatory policies on matters concerning authorisation could also challenged in this manner, provided at least that they determine the matters to which they are directed with a sufficient degree of conclusiveness to qualify as reviewable "decisions".\textsuperscript{318}

Finally, judicial review may be available in appropriate cases against informal regulatory actions. "Moral suasion" has always been the Bank's favoured way of doing things. There are several ways in which the Bank can apply pressure upon an authorised institution without exercising formally its legal powers. In certain cases, informal directions may be given unilaterally under the implicit or explicit threat of revocation or restriction of the institution's authorisation in the event of non-compliance. More commonly, the discussions between the Bank's supervisors and the institution's senior management culminate in the formulation of specific regulatory requirements, including precise financial ratios; these are formally presented in the notes of the discussions as mutually "agreed" steps that should be

\textsuperscript{313} See \textit{infra}, ch.4, section 5(b), \textit{in fine}.
\textsuperscript{314} Under s.33 of the Banking Act 1987; see \textit{infra}, ch.4, section 4(c).
\textsuperscript{315} See \textit{infra}, section 3(a).
\textsuperscript{316} Subordinated rules can be invalid because they are inconsistent with the statutory provisions, or because they are unreasonable, in the sense of being discriminatory in their operation, being manifestly unjust, disclosing bad faith, or "involving such oppressive or gratuitous interference with the rights of those subject to them as could find no justification in the minds of reasonable men"; \textit{Kruze v. Johnson} [1898] 2 Q.B. 91, p.99 per Lord Russel C.J.
\textsuperscript{317} See ss.4(3)-(4), 7, 11(5), 30(3)-(7), 32, 34, 38(11), 47(5)-(6), 54, 58(7), 60(5), 64(1)-(2), 67(6), 68(7)-(8), 69(7)-(8), 79(7), 80, 84(2)-(3), 102 and 110(2), and Sch.1, para.3.
\textsuperscript{318} On the legal status and reviewability of the Bank's policy pronouncements, see \textit{infra}, ch.4, section 1.
implemented by the institution. Even though in such cases the Bank does not formally profess to determine unilaterally the rights or duties of its regulatees, its actions may still be reviewable. Much could depend on the factual circumstances, but if the Bank sought to impose its will by making the institution's continuing authorisation effectively contingent upon the observance of requirements to which the management objects, or if it offered to the institution the option of surrendering its authorisation or having it formally withdrawn, the institution would probably be allowed to challenge the Bank's "decision" on the usual grounds of illegality, irrationality or breach of natural justice.

In certain cases, third parties may be negatively affected by a particular regulatory decision (or omission) of the Bank which is not immediately directed to them (e.g. in their capacity as shareholders, competitors, depositors, employees, etc. of an institution whose authorised status is affected by the decision). Such third parties, or "strangers", are totally excluded from the statutory appeal mechanism and may only seek to challenge the Bank's decisions in the courts. However, their lack of standing, or of "a sufficient interest in the matter to which the application arises", can be an insurmountable barrier to a challenge brought by way of review.

The question of what is a "sufficient interest" is a mixed question of fact and law, which depends on the specific context of each case and cannot be considered in the abstract. Generally, however, the courts are very reluctant to allow applications by one person against administrative decisions affecting the tax, company or commercial affairs of another. Exceptionally, certain applicants have been allowed to seek judicial review of decisions favouring their direct competitors in very concentrated markets or their rivals in contested take-over bids. On the other

---

321 "This term could refer either to a person who has no grievance, or to a person who has a grievance but was not a party to the challenged proceedings nor the person at whose instigation or in respect of whom the challenged decision was made."; P. Cane, "The function of standing rules in administrative law" [1980] P.L. 303, p.316.
322 Supreme Court Act 1981, s.31(3); Rules of the Supreme Court, Order 53, r.3(7). See also R. v. Inland Revenue Commissioners, ex p. National Federation of Self-Employed and Small Businesses Ltd. [1982] A.C. 617 (H.L.).
323 For example, as a rule, a taxpayer does not have a sufficient interest to bring review proceedings for the purpose of challenging acts or omissions of the Inland Revenue which relate to another taxpayer's affairs; an application of this type may only be allowed if an exceptionally grave or widespread illegality has taken place, or if the decision is vitiated by some grossly improper pressure or motive; R. v. Inland Revenue Commissioners, ex p. National Federation of Self-Employed and Small Businesses Ltd. [1982] A.C. 617 (H.L.). Cf. R. v. Her Majesty's Treasury, ex p. Smedley [1985] Q.B. 657 (C.A.), where a "single public-spirited taxpayer" succeeded in challenging a statutory instrument.
324 In R. v. Attorney-General, ex p. Imperial Chemical Industries plc. [1986] B.T.C. 8,015 (C.A.), an industrial company succeeded in its attempt to overturn certain tax-assessment policies which
hand, in ordinary cases it is unlikely that the creditors, shareholders or employees of commercial enterprises, including deposit-taking institutions, will have sufficient standing to challenge in the courts regulatory and other administrative decisions concerning these enterprises.

Regardless of the question of standing, however, the outcome of an application for judicial review against a decision of the Bank may ultimately depend on the degree of judicial deference to the decisions of City regulators. Legislative and judicial attitudes seem to converge in recognising a high level of autonomy to the expert regulatory authorities of the financial field. Courts are generally respectful of the wide discretion afforded by Parliament to regulators in this area and unwilling to interfere with their determinations, which often involve complicated questions regarding the balancing of conflicting interests and public policies. They are influenced by the practices of the regulators and the acceptance that these enjoy the City and will defer in most cases to the regulators' expert judgement in matters concerning the promulgation of regulatory standards and their interpretation and

afforded too lenient treatment to its competitors. Although the company would have been unable to launch its challenge simply by virtue of being a taxpayer, it had applied for judicial review in its capacity as a direct competitor of the benefiting companies, whose competitive position was inevitably affected by the misapplication of the relevant statutory requirements. It was the discriminatory element of the illegality that had given standing to the company, and the extremely limited number of competing firms in the particular market was clearly a decisive factor.

325 The minority shareholders and aspirant sole owners of a company have a clear interest in the outcome of a rival take-over bid, which allows them to challenge a decision of the Monopolies and Mergers Commission permitting that bid to proceed; R. v. Monopolies and Mergers Commission, ex p. Argyll Group plc. [1986] 2 All E.R. 257 (C.A.). See also R. v. Secretary of State for Trade and Industry, ex p. Lonrho plc. [1989] 2 All E.R. 609 (H.L.), where the applicant company sought judicial review of the Secretary of State's decision to defer publication of a company inspectors' report into the acquisition of the House of Fraser by its rival bidders, the Fayed brothers, and of his refusal to refer their bid to the Monopolies and Mergers Commission; and R. v. Secretary of State for Trade and Industry, ex p. Lonrho plc. [(No.2)] [1992] B.C.C. 325 (D.C.), where the same company, following the eventual publication of the inspectors' report, which included damaging revelations regarding the conduct the Fayed brothers, challenged the Secretary of State's decision not to apply for their disqualification as company directors.

326 E.g., as long as a company remained a going concern, an unsecured creditor would not have standing to challenge the Registrar's decision in respect to a defective registration of a charge under s.95(1) of the Companies Act 1948, since his interest on the matter would only become operative after some occasion of insolvency or winding-up; R. v. Registrar of Companies, ex p. Central Bank of India [1986] 1 All E.R. 105 (C.A.).

327 Since a company is a legal entity separate and distinct from its shareholders, even these are not entitled to be notified of, and given the opportunity to make representations about, an impending decision concerning the cancellation of the company's listing and are unlikely to have a sufficient interest to mount a retrospective challenge to that decision; R. v. International Stock Exchange of the United Kingdom and the Republic of Ireland, ex p. Else [1982] Ltd. [1993] 1 All E.R. 420 (C.A.).

application in individual cases. In particular, they will be rarely ready to hold that the rules promulgated by a financial regulator are unreasonable in the sense of being without proper justification,\(^{329}\) or that the existing evidence cannot rationally justify a specific regulatory determination. On the other hand, they may be more willing to intervene in procedural matters, especially where there is a credible allegation of bad faith or breach of the rules of natural justice, since they feel that such matters are within their own special competence.

The discretionary element of judicial review must also be emphasised in this context. On statutory appeals to the Banking Appeal Tribunal and the High Court the appellant has a right to a decision in his favour if the illegality or non-justifiability of the Bank's decision has been established. In contrast, on applications for judicial review the granting of a remedy is always discretionary.\(^{330}\) A number of cases establishes the reluctance of the judiciary to grant relief against the decisions of financial regulators. The courts are careful to safeguard the speed, decisiveness and finality of these decisions and tend to emphasise the need for effective protection of the public over the protection of the individual interests of the members of the regulated industry. Moreover, the courts are anxious to prevent the use of litigation by regulatees as a delaying tactical tool.\(^{331}\) Even where an applicant's complaint has been established, the courts may refuse, in the interest of good administration, to provide retrospective relief, if this will disrupt ex post facto commercial relationships created in reliance of the flawed decision and involving third parties which are not represented in the proceedings.\(^{332}\) Nonetheless, the provision of declaratory relief only may not be sufficient for protecting the interests of the successful applicant. As Lord Oliver observed in one case,

"it must be wrong in principle, when a litigant has succeeded in making good his case and has done nothing to disentitle himself to relief, to deny him any remedy, unless, at any rate, there are extremely strong reasons in public policy for doing so."\(^{333}\)

Where such reasons are not in operation, e.g. because the matter involves action which does not affect immediately the wider investing public, but only the legitimate


\(^{330}\) On the discretionary nature of judicial review, see Sir Thomas Bingham, "Should public law remedies be discretionary?" [1991] P.L. 64.


\(^{332}\) See Datafin, ibid.

\(^{333}\) R. v. Attorney-General, ex p. Imperial Chemical Industries plc. [1986] B.T.C. 8,015, p.8,047; see also p.8,057 per Lloyd L.J.
individual interests of the applicant, there would be no reason for the courts to refuse full retrospective relief, involving the overturning of the offending decision.\(^{334}\)

Overall, however, the prevailing attitudes of strong judicial deference to the judgements of expert regulators in a financial context sets strict limits to the practical effectiveness of judicial review as a potential remedy against regulatory decisions of the Bank.

\(f\) The Bank's internal decision-making process and the Board of Banking Supervision. The protection of the interests of deposit-taking institutions and their officers and controllers against arbitrary or biased regulatory decisions is not confined to the statutory procedural protections, but extends to the practical organisational arrangements which are in place within the Bank. The Bank's decision-making in this area is supported by a comprehensive supervisory record, which includes the financial returns of the authorised institutions and all reporting accountants' reports on their affairs,\(^{335}\) as well as extensive documentation of the various contacts and communications between these institutions and the supervisors of the Supervision and Surveillance area of the Bank's Financial Stability wing.

The decision-making process within the Bank is hierarchical. The junior supervisors who are entrusted with the day-to-day monitoring of authorised institutions are not authorised to take corrective action where this appears to them appropriate. Instead, the critical decision is taken, after full consideration of the circumstances of the case, at a higher level by a review committee of senior regulators and is subject to the Governor's approval.\(^{336}\) In \textit{ex p. Mellstrom},\(^{337}\) the internal procedure of the Bank's supervisory divisions was described as follows:

\(\ldots\)


\(^{335}\) See \textit{infra}, section 3(c).

\(^{336}\) See Treasury and Civil Service Committee, Fourth Report: "Banking Supervision and B.C.C.I.: International and National Regulation", H.C. (1991-92) 177, Minutes of Evidence, 23 July 1991, p.112, q.57; and \textit{Mount Banking Corporation Ltd. (in administration) v. The Governor and Company of the Bank of England,} 13th October 1993, Banking Appeal Tribunal (unreported), transcript of the decision, p.11. On the other hand, the Court of Directors (whose membership includes twelve outside members, representing the industry, the City and the organised labour, in addition to the Bank's Governor, Deputy Governor and four executive directors) is excluded from regulatory matters, ultimate responsibility for which rests in the hands of the Governor and a few other executive officers; see Trade and Industry Committee, "Company Investigations: House of Fraser. Minutes of Evidence, Tuesday 19 February 1991", H.C. (1990-91) 239-i, qq.1078, 1089. In contrast, the Court may be exceptionally involved in decisions relating to the rescue of ailing banking institutions. Thus, in the Johnson Matthey affair, the decision to provide support was approved by the full Court of Directors, although the inside members, all of which were present, dominated the meeting; W. Ollard and N. Routledge, "How the Bank of England failed the J.M.B. test" [Feb. 1985] \textit{Euromoney} 49, p.56.

\(^{337}\) 19 Jan. 1995, Q.B.D., reported in LEXIS.
"The Bank's procedure was for a lot of material to be looked through by its officers, for much of this to be put before the Assessment Committee for a preliminary view and for that preliminary view to be put, alongside the material upon which it was based, before the Review Committee which was the actual decision making body."

These arrangements indicate a conscious effort to guarantee a high degree of internal scrutiny in the regulatory deliberations and to ensure that the regulatory decision-making is conducted by persons which are not involved in the day-to-day handling of individual institutions.

At the same time, a formal framework for independent scrutiny of the Bank's regulatory work is provided by the Board of Banking Supervision. The Board was established on an informal basis in May 1986, in response to the relative loss of confidence in the Bank's performance following the Johnson Matthey affair. Its position was formalised the following year, with the enactment of the Banking Act 1987.338 The Board is a forum where the Bank can receive expert, practitioner-based advice on matters relating to its regulatory responsibilities under the Banking Act.339 At the same time, it provides a mechanism for keeping the Treasury informed of controversial regulatory activities and for increasing the responsiveness of the regulatory process to the opinions of the commercial banking community. It consists of three ex officio members, i.e. the Governor, the Deputy Governor and the executive director responsible for banking supervision of the Bank, and six independent members having no executive responsibility in the Bank and being appointed jointly by the Chancellor and the Governor.340

It is the duty of the independent members to advise the ex officio members on the exercise of regulatory functions by the Bank, in relation either to general supervisory policy or to individual action. To enable them to perform this duty, the Bank must keep them informed on regulatory developments.341 If their advise is not followed by the Bank, the independent members are entitled to explain their position

338 S.2 and Sch.1.
340 S.2(2).
341 S.2(3)-(4). It is conceivable in principle that the advice offered could be considered as an independent administrative decision amenable to judicial review; see R. v. Agricultural Dwelling-House Advisory Committee for Bedfordshire, Cambridgeshire and Northamptonshire, ex p. Brough (1987) 19 H.L.R. 367 (Q.B.D.), p.374, where two requirements are set for reviewability, namely that the ultimate deciding authority "is required by statute to take full account" of the advice and that there is "evidence that in practice the advice is - to put it no higher - highly likely to be followed". It is questionable whether the second requirement is satisfied in the case of the Board. In practice, however, since the independent member's advise is given in secret and forms an integral part of the internal workings of the Bank's regulatory operations, it is very unlikely that it will ever be challenged separately from the final regulatory decision of the Bank.
to the Chancellor.342 As the minutes of the Board's meetings are kept secret, its
precise manner of operation and its true input in the Bank's decision-making cannot
be ascertain easily. The annual reports of the Board, which must be incorporated in
the Bank's annual report on its regulatory operations,343 duly report the number of
its meetings and note that the Board kept under review the Bank's supervisory
responsibilities, the independent members offering advice both on matters of policy
and on the conduct of individual cases. No information is supplied on the actual
discussions relating to particular regulatory issues and the substantive opinions
expressed by the members. The Board has reported on one occasion only that advise
given by the independent members was not followed by the Bank. No clarification,
however, was provided other than that the advise concerned the application of the
confidentiality requirements of the Banking Act.344

The Board receives reports on the work of the Bank's Supervision and
Surveillance area on a monthly basis. All cases where the taking of formal action is
under consideration, but also cases of institutions about which the Bank's officials
have less immediate concerns, are reported to the Board. The Bingham Report
noted that in the B.C.C.I. case the Board lacked important information which it
needed to fulfil its role.345 This raises doubt as to the effectiveness of the Board as
an internal control mechanism. Following the B.C.C.I. debacle, however, the level
and detail of information received by the Board has been extended. The Board now
meets more frequently and is more actively involved in every aspect of the Bank's
regulatory work.346 Nonetheless, the fact that the Board relies entirely upon
information provided by the supervisors, sets important limits in the capacity of the
Board's independent members to scrutinise regulatory performance. In addition,
even though the Board is intended to bring the voice of the practitioners into the
formal policy-making process, the partial control exercised by the Bank over the
appointment of the independent members, raises questions about their actual
independence and reduces the Board's credibility.

342 S.2(5).
343 S.2(6).
344 "Report by the Board of Banking Supervision", Annex to "Banking Act 1987: Annual Report
345 Bingham Report, loc.cit., n.302, paras.2.259-2.260, 2.479-2.480. Nonetheless, on certain
occasions in the course of the B.C.C.I. saga, the Board seemed to adopt a more rigorous stance
than the Bank's Banking Supervision Division, which was immediately responsible for the
supervision of that institution; paras.2.86-2.92. This demonstrates that, if provided with the
appropriate information, the Board can have a beneficial impact in fighting administrative
complacency and the fear of assuming responsibilities.
H.C. (1993-94) 98, para.89; and "Report by the Board of Banking Supervision", Annex to the
3. Continuous supervision and enforcement

The continuous supervision of the institutions authorised by it is the Bank's explicit statutory responsibility. To facilitate its effective performance, the Banking Act vests in the Bank wide powers relating to the collection of information and the on-going monitoring of authorised institutions.

Close and detailed banking supervision is a relatively recent phenomenon. Until the early 1970s, the Bank's information-gathering activities were confined to the collection of monetary statistics and the informal monitoring of banking institutions as an incidental part of its Discount Office's money-market operations. The intensity of monitoring depended on the type of relationship that each institution maintained with the Bank; closest attention was paid to discount houses and accepting houses.

A first attempt to streamline the collection of information and to reorient it to primarily prudential purposes was made in the aftermath of the secondary banking crisis of 1973-74. Under non-statutory arrangements which came into effect in 1974, all banks and large finance houses were asked to submit to the newly-formed Banking and Money Market Supervision Section (the predecessor of the Banking Supervision Division, which has now become the Supervision and Surveillance area of the Bank's Financial Stability wing) quarterly statistical returns for both monetary and supervisory purposes. An institution's returns reflected its balance sheet structure, maturity profile, large loans, provisions and profitability. The analysis of this quantitative information was intended to provide the Bank with a preliminary understanding of the institution's business, preparing the ground for regular interviews with its senior management. The latter would be the "cornerstone" of supervision, aiming "to build up within the Bank an intimate picture of the institution" which would permit a "qualitative" assessment of its true condition.

---

347 The word "duty" is used in the Banking Act 1987 in connection with the Bank's responsibility to supervise the authorised institutions and to keep under review the operation of the Act and developments in the field of banking which appear to be relevant to the exercise of its powers and duties; s.1(1)-(2). In this context, the word does not signify an obligation which is strictly enforceable in law, but is used in a wider sense as synonymous to "functions"; cf. Attorney-General v. Cooper [1974] 2 N.Z.L.R. 713 (C.A., N.Z.), p.720; Canadian Pacific Tobacco Co. Ltd. v. Stapleton (1952) 86 C.L.R. 1 (H.C. of A.).
348 See supra, ch.1, section 1(b).
349 "Supervision of banks and other deposit-taking institutions" (1978) 18 B.E.Q.B. 383, p.384; see also "The capital and liquidity adequacy of banks" (1975) 15 B.E.Q.B. 240, p.243. Clearing banks were to be supervised less frequently (on an annual basis), but more thoroughly (through more detailed returns and several issue-specific interviews), particularly with regard to the...
Purportedly, this would make possible the early identification of problem banks. On this basis, *ad hoc* regulatory interventions could be attempted in appropriate cases, without need for prescriptive prudential requirements.\(^{350}\)

Compliance with the reporting requirements was originally voluntary. Even after the introduction of licensing requirements for deposit-taking institutions under the Banking Act 1979, there was no concerted attempt to depart from established cooperative supervisory practices.\(^{351}\) The survival of the Bank's "flexible, personal, progressive [i.e. tiered], and participative" supervisory style\(^{352}\) was thought to be possible within the context of the new statutory régime, despite the fact that under the new licensing requirements large numbers of previously unregulated institutions were brought for the first time under the Bank's responsibility.

The Banking Act 1979 did not make special provision for the periodic submission of supervisory returns, since it was taken for granted that authorised institutions would comply willingly with the Bank's policies. However, the Bank was given a reserve power to compel "licensed deposit-takers" (the lower tier of institutions authorised under that statute) to disclose any information that might be specifically requested from them or to produce reports on such information by an accountant approved by the Bank.\(^{353}\) In view of a long tradition of co-operative relationships between the Bank and the primary banking sector, it was not deemed necessary to extend the same power over institutions enjoying full authorisation as "recognised banks". The Bank was also given the power to appoint investigators for the purpose of examining the affairs of an authorised institution.\(^{354}\) Due to fears that confidence in the institution could be undermined if the appointment of investigators became known to the market, use of this power was envisaged only in exceptional situations, where the institution's financial or organisational viability was already in doubt.\(^{355}\)

The failure of Johnson Matthey Bankers in 1984, as a result of bad loans whose existence had not been reported to the Bank until it was too late, proved conclusively that the timely detection of irregularities was not possible on the basis of warning signs provided voluntarily by the "delinquent" institutions themselves. This was recognised by the Leigh-Pemberton Committee, which was set up to

---

\(^{350}\) Although it was accepted that with time numerical standards concerning capital and liquidity requirements could be developed for different groups of banks; "The capital and liquidity adequacy of banks" (1975) *B.E.Q.B.* 240.


\(^{353}\) Banking Act 1979, s.16.

\(^{354}\) Banking Act 1979, s.17.

\(^{355}\) Morison, Tillett and Welch, *op.cit.*, n.351, p.58.
review banking supervisory arrangements in the light of the Johnson Matthey affair: "The system cannot [...] rely totally on [regulatee] responsiveness in all circumstances: the supervisors must have adequate powers to deal with cases where this co-operation is not forthcoming.\textsuperscript{356} As a partial solution, it was decided that the "tiered" approach to supervision should be abandoned and the Bank's power to request information extended to cover all banks. Moreover, increased emphasis was placed on the maintenance by authorised institutions of sufficient internal control systems and the establishment of audit committees consisting of non-executive directors. The Bank also sought to intensify and improve the quality of its monitoring practices. Although the shift to a more proactive approach was not carried to the point of initiating a policy of regular full-scale bank examinations,\textsuperscript{357} a system of occasional on-site examinations was introduced, whereby small review teams of supervisors, together with accountants or bankers on temporary secondment from their firms to the Bank, visit, usually for a period of a few days, the premises of authorised institutions for the purpose of assessing the quality of their lending and control systems or examining particular areas of concern.\textsuperscript{358}

The new approach was reflected in the provisions of the new Banking Act of 1987. Without going so far as to mark a complete break with the earlier cooperative supervisory approach, the Act strengthened considerably the Bank's powers to collect information unilaterally and introduced several related innovations, especially with regard to the involvement of bank auditors in the supervisory process.\textsuperscript{359}

\textsuperscript{356} "Report of the Committee set up to Consider the System of Banking Supervision" (Cmd. 9550, Jun. 1985), para. 2.3.

\textsuperscript{357} P.M. Horvitz, "A reconsideration of the role of bank examination" (1980) 12 J.M.C.B. 654, defines bank examination as "an on-site evaluation of the assets, liabilities, and procedures of a bank conducted by government employees who arrive unannounced and have virtually unlimited access to the records of the institution". Horvitz thinks that "[t]he appropriate purpose of bank examination [...] is the detection of insolvency, so that the bank can be closed before its losses exceed the amount of its capital"; p.656. This raises difficult questions relating to the precise definition of the circumstances that should lead to the preventive closing down of banking institutions. In principle, however, a highly efficient system of bank examinations that could achieve the resolution of ailing institutions just before they become economically insolvent would render redundant regulatory measures aiming to contain risk-taking by banks. Accordingly, Horvitz maintains that "it is not appropriate for the supervisory agencies to seek to lower bank risk. If bank failure is not traumatic to the economy or to the community, if depositors are protected by insurance, and if promptly recognized bank failure does not impose great costs on the insurance system, it follows that bankers should be allowed to take whatever risk they deem appropriate. [...] Thus the true role of bank examination is the prompt detection of insolvency, not its prevention."; p.658.

\textsuperscript{358} See, e.g., "Banking Act 1987: Annual Report under the Banking Act for 1994-95", pp.35-36. On-the-spot visits also take place to the head offices of foreign institutions with branches or subsidiaries in the U.K.

\textsuperscript{359} Ss.36-47.
Moreover, the 1987 Act made explicit the responsibility of the Bank of England to supervise on a continuous basis the deposit-taking institutions authorised by it.\(^{360}\)

More recently, a reappraisal of the Bank's supervisory style took place following the B.C.C.I. debacle. In his report on the affair, Lord Justice Bingham declined to recommend the wholesale intensification of supervision or the adoption of a policy of routine bank inspections and expressed his support for the Bank's traditional co-operative techniques; at the same time, however, he emphasised the need for increased vigilance, alertness to the possibility of fraud and a readiness to investigate the affairs of suspect banks.\(^{361}\)

While defending its general supervisory approach and rejecting its critics' calls for the adoption of a policy of full-scale bank examinations, the Bank was ready to concede that a less trusting supervisory style and more aggressive enforcement approach would be in order in cases of perceived fraud or malpractice. Accordingly, a Special Investigation Unit, consisting of experts recruited from the law and accountancy professions, was formed within the Bank with the specific task of pursuing any indication of fraud or other criminal activity affecting the financial sector and ensuring that other authorities are involved as appropriate. In addition, a new Legal Unit was set up for the purpose of ensuring that the Bank takes full account of the supervisory powers available to it under the Banking Act; the training of supervisors was redirected at enhancing their alertness to indications of fraud and malpractice; and the chains of communication of supervisory information, both within the Bank and between the Bank and the Treasury and other authorities, were reinforced.\(^{362}\)

At a practical level, the B.C.C.I. affair led to the adoption of a more intrusive supervisory attitude. The number of on-site bank examinations increased, running currently at some 120 to 130 visits per year. Nonetheless, supervision remains largely dependent on information received from the authorised institutions themselves, and the introduction of bank examinations on a quasi-permanent basis, in the manner of the U.S. supervisory system, is still strongly resisted.\(^{363}\) In the

\(^{360}\) S.1(1).

\(^{361}\) Bingham Report, loc.cit., n.302, paras.3.3 and 3.7-3.10.


Bank's opinion, the on-site work of its review teams should concentrate on matters of their specialised knowledge, while the routine examination of the accuracy of authorised institutions' prudential returns and the quality of their internal controls and systems - a type of work similar to the ordinary audit tasks - should generally be left to their auditors, who are already familiar with their business.\textsuperscript{364}

\textit{(a) Collection of supervisory information and powers of investigation.} Under the Banking Act 1987, authorised institutions are specifically required to keep the Bank informed of the identity of their controllers and senior management,\textsuperscript{365} as well as to report their large risk exposures.\textsuperscript{366} In addition, if they know, or have

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{365} The definitions of the terms "director", "controller" and "manager" are given in s.105, as amended by the Banking Coordination (Second Council Directive) Regulations 1992, S.I. 1992/3218, reg.43. Authorised institutions are required to notify the Bank of any change in the persons of their directors, controllers or managers when they become aware of the relevant facts, but the Bank may exempt foreign institutions from this obligation; s.36. Authorised institutions are also required to give annual notification of the identity of all their shareholder controllers, together with details of their percentage of shareholding or voting rights; s.36A, inserted by S.I. 1992/3218, reg.33. Shareholder controllers and indirect controllers are also personally liable to give to the Bank prior notification of their intention to acquire for the first time a controlling interest in an authorised institution or to increase their controlling interest above certain thresholds, at which point the Bank has the power to object to the new or increased control; s.21, as amended by S.I. 1992/3218, reg.31(1). In addition, shareholder controllers of U.K.-incorporated institutions cannot divest their shareholdings so that they cease to be shareholder controllers of the particular description without giving prior notification to the Bank; s.37A, inserted by S.I. 1992/3218, reg.35. Finally, persons acquiring shareholdings of between 5% and 10% of a U.K.-incorporated institution or its parent company are also personally required to notify the Bank, but this obligation arises only after the acquisition; s.37, as amended by S.I. 1992/3218, reg.34. On the Bank's power to object to an institution's directors, controllers and managers, see infra, ch.3, section 3.
\item \textsuperscript{366} S.38. Since 1 Jan. 1994, the reporting of large exposures is also required under Community law; Large Exposures Directive, art.3. Under s.38, it is the statutory duty of U.K.-based institutions to report all transactions as a result of which their total risk exposure to one person or group of persons connected in such a way that their financial soundness is subject to the same factors, so that they represent a single banking risk, exceeds 10% of capital resources. Prior notification is required for transactions which, in conjunction with any previous transactions, would bring their exposure to one person or group of connected persons to more than 25% of capital. Relevant transactions are those that involve direct credit risk, \textit{i.e.} that arise from lending to another party or from a commitment to provide credit to that party, as well as any contingent liabilities of the institution whose payment depends on that party's default or holdings of assets whose value depends on that party's financial position (\textit{e.g.} underwriting exposures or equity warrants in his shares). Although the duty of reporting large exposures is enforceable by criminal sanctions, its exact scope is not clearly defined in the Act itself. Instead, the Bank is given rule-making powers to determine the principles for the calculation of large exposures and to regulate the reporting method, and can exclude from consideration particular types of risks. The Treasury, after consultation with the Bank, may amend by way of secondary legislation the threshold
\end{itemize}
\end{footnotesize}
reasonable cause to believe, that any other information in their possession is relevant to the exercise of the Bank's supervisory functions in relation to them and that withholding it is likely to result in the Bank being misled to a material degree in this connection, they are obliged to disclose this information on their own initiative.\textsuperscript{367} These disclosures are a matter of statutory duty, contravention of which is a criminal offence. However, the Banking Act also confers on the Bank broad general powers to require other information of supervisory interest and to initiate investigations into the affairs of deposit-taking institutions.

Where this is "reasonably required" to assist it in performing its statutory functions, the Bank may demand by written notice the provision of information by an authorised institution, or the production of specific documents or documents of a particular description by an institution or any other person who appears to be in possession of them; and it may authorise an officer or agent to require the immediate provision of information or production of documents.\textsuperscript{368} The Bank can exercise these powers in relation not only to the authorised institution itself, but also to all other undertakings belonging to the same group or owned by the institution's shareholder controllers.\textsuperscript{369} A power to obtain information and documents from actual or prospective directors, controllers and managers of authorised institutions when this is reasonably required for determining whether these are fit to hold their particular position, is also available.\textsuperscript{370} These information-gathering powers of the Bank are supported by powers of entry and search, but the Bank can only authorise

\textsuperscript{367} S.94(3). "Former authorised institutions", \textit{i.e.} institutions which have lost or surrendered their authorisation but continue to have a liability in respect of deposits that they accepted while they were authorised (s.106(1)), are under the same obligation.

\textsuperscript{368} S.39(1)-(4). The power of the Bank to require the production of documents includes a power to require current and former directors, controllers, managers and employees of the institution to explain the content of the documents in question or, if these are not produced to the Bank, to require the person who has failed to produce them to state to the best of his knowledge their whereabouts; s.39(5). The same information-gathering powers apply to former authorised institutions; s.39(8). A requirement to produce documents which is not precise enough in its terms may be held invalid for reasons of unreasonable and excessiveness; see \textit{R. v. Secretary of State for Trade, ex p. Perestrello [1981] 1 Q.B. 19 (Q.B.D.).}

\textsuperscript{369} S.39(6)-(7), as replaced by S.I. 1992/3218, reg.36.

\textsuperscript{370} S.39(9).
a search without prior notice if it has reasonable cause to believe that, if notice were served, the recipient would fail to comply or that relevant documents would be removed, tampered with or destroyed.\textsuperscript{371}

Although the Bank must have reasonable grounds for believing that any information that it requires under these powers will assist it in performing its supervisory functions under the Act, it is probably entitled to refuse to give reasons for its decision to ask particular questions or seize particular documents, and it is for the person resisting a request for information to show that the Bank is acting unreasonably or in bad faith.\textsuperscript{372} When the production of documents is required by a third party,\textsuperscript{373} e.g. an authorised institution's accountants, the fact that a duty of confidentiality is owed by that third party to the institution concerned does not entitle the latter to object to the disclosure, because this would have a stultifying effect on the collection of supervisory information in the public interest.\textsuperscript{374}

In addition to requiring information, the Bank has the power to appoint investigators to investigate and report on an institution's nature and state of business or ownership structure. The power is exercisable "[i]f it appears to the Bank desirable to do so in the interests of depositors".\textsuperscript{375} If they consider it necessary, the investigators may extend an investigation to the affairs of other companies belonging to the same group by giving them written notice.\textsuperscript{376} A broad range of persons currently or formerly related with an institution or connected company under investigation, including its directors, controllers, managers, employees, and professional advisors, must produce to the investigators all relevant documents that are in their custody or power, attend interviews before the investigators and provide all reasonable assistance in connection to the investigation.\textsuperscript{377} The investigators also have powers of entry into the premises of the institution and its connected companies covered by the investigation.\textsuperscript{378}

The Bank is given more specific inquisitorial powers in relation to the investigation of infringements of the prohibitions on unauthorised deposit-taking and

\footnotesize{\textsuperscript{371} S.40.  
\textsuperscript{372} See \textit{R. v. Inland Revenue Commissioners, ex p. Rossminter Ltd.} \textit{[1979]} 3 All E.R. 385 (C.A.); \textit{[1980]} 1 All E.R. 80 (H.L.).  
\textsuperscript{373} S.39(4).  
\textsuperscript{375} S.41(1). An investigation may also be commenced in relation to a former authorised institution; s.41(6).  
\textsuperscript{376} S.41, sub-s.(2)-(3), as replaced by S.I. 1992/3218, reg.37, and (4). The range of connected companies whose affairs can be investigated under this section is even broader than that from which the Bank may require information under s.39(6)-(7).  
\textsuperscript{377} S.41(5).  
\textsuperscript{378} S.41(7).}
on fraudulent inducements to make deposits. If it has reasonable grounds for suspecting a contravention of the relevant provisions, the Bank may require by notice the suspected offender or any other person to give information, produce documents forthwith or at a specified time and attend an interview, and there is a power of entry into premises occupied by a person on whom notice has already been served. In situations where the investigation of contraventions is obstructed by the suspected offender's refusal to comply with a notice already served on him or where there are reasonable grounds for suspecting that evidence will be removed, tampered with or destroyed if notice is given, the Bank can apply to a justice of the peace for the making of a search warrant authorising any constable, together with any other person specified therein, to enter and search the premises of the suspected offender, to take possession of documents and to require persons specifically named in the warrant to answer relevant questions.

The Bank's jurisdiction to investigate the affairs of authorised institutions and suspected contraventions of the statutory prohibitions is concurrent with that of other bodies responsible for the investigation and prosecution of suspected violations of criminal law in the commercial arena, including in particular the Serious Fraud Office. It also overlaps with the jurisdiction of the Department of Trade and Industry to conduct company investigations.

The Secretary of State for Trade can initiate company investigations by appointing inspectors in response to requests by a company itself or its members, the courts, other authorities, the public (including a company's creditors), the officers of a company in insolvency, or on his own initiative, if the circumstances suggest fraud or irregularities in the management of company affairs, or if it is necessary to investigate matters concerning a company's ownership structure. The inspectors

379 Ss.3 and 35, respectively.

381 S.43(1)-(2).
382 It is the specific function of the Serious Fraud Office to investigate suspected cases of serious or complex fraud; Criminal Justice Act 1987. The Crown Prosecution Service, which includes a special Fraud Investigation Group, and the fraud departments of local police forces can also take action for the detection and prosecution of economic crime.
383 Companies Act 1985, Pt.XIV (ss.431-453), as amended by the Companies Act 1989, Pt.III. See also Insolvency Act 1986, s.218; and Financial Services Act 1986, ss.94, 177.
384 Companies Act 1985, ss.431, 432, 442, 446. Furthermore, the Secretary of State has powers to require the production of company documents, if he thinks that there is a good reason to do so, or to authorise another competent person to demand the production of documents; ss.447-451, 451A. If they think that this is necessary, the appointed inspectors can extend their inquiries into the affairs of other companies affiliated to the one under investigation; s.433(1).
are responsible for the conduct of their investigation. All officers and agents (broadly defined) of the company under investigation are under a duty to assist them by producing all relevant documents and giving evidence.\textsuperscript{385} Obstruction of investigations is punishable as contempt of court.\textsuperscript{386} Company investigations are not an end in themselves, but only a means towards the criminal prosecution or disciplinary punishment of malefactors, the disqualification of unfit directors, the winding-up in the public interest of companies engaging in commercial malpractice, or the taking of regulatory measures.\textsuperscript{387} However, investigations are not merely an internal preparatory part of a broader supervisory process. The Secretary of State has discretion to order the publication of the reports submitted to him by company inspectors.\textsuperscript{388} As a result of publication, criticisms and adverse evidence contained in inspectors' reports can be very damaging to the reputation and commercial standing of the persons in question, and this transforms company investigations into a distinct procedure with independent corrective value.

The scope of investigations under the Companies Act 1985 is broader than that of those under the Banking Act, not only because they are not confined to banking companies, but also because of their subject-matter (which covers all types of corporate malpractice and breaches of criminal law, while the powers of the Bank to initiate an investigation are exercisable only when the interests of depositors may be at risk) and of the possibility of publication of the inspectors' report (while the results of investigations under the Banking Act are covered by the statutory duty of confidentiality of regulatory information\textsuperscript{389}).

The interests of persons subject to an investigation under either statute can be substantially prejudiced by the manner in which this is conducted. This places on investigators a duty to act fairly and reasonably. However, investigations are not

\textsuperscript{385} S.434. However, lawyers have a professional privilege to refuse disclosure of privileged communications; bankers can also claim their duty of confidentiality (except if the inspectors' requirement for the provision of information is authorised by the Secretary of State); s.452.

\textsuperscript{386} S.436.


\textsuperscript{388} S.437(3)(c). The Secretary of State may also appoint inspectors on terms that their report will not be for publication; s.432(2A). The Department's policy is to publish reports on public companies wherever possible, but publication may be deferred or altogether avoided if there is a legitimate reason; deferment will be a distinct possibility if the report's publication could prejudice potential criminal proceedings. Even in the case of confidential reports, however, the Secretary has a discretion to forward a copy to the company, any interested party, the applicants for the investigation and other authorities; Trade and Industry Committee, Memoranda Submitted by the Department of Trade and Industry, \textit{ibid.}, pp.3-4, paras.19-22; see also the Committee's recommendations in the main report, paras.86-88; and Companies Act 1985, s.437. Where matters that have come to light in the course of an investigation have already led to a criminal prosecution, the Secretary may direct the inspectors to take no further steps, in which case the investigation ends without the making of a report; s.437(1B).

\textsuperscript{389} S.82. See \textit{infra}, subsection (b).
otherwise subject to any specific procedural requirements. In particular, the commencement of an investigation by the Bank or the Secretary of State is a preliminary act, undertaken for the purposes of good administration; although suspicions may linger, the appointment of investigators does not imply in itself that a case exists against the firm under investigation, and accordingly the rules of natural justice are not at this stage applicable.390

In the course of an investigation, the requirements of fairness apply, and the investigators must not abuse their discretion by acting irrationally, for an ulterior purpose or dishonestly.391 The general nature or direction of the investigation must probably be indicated to the institution subject to it (although there is no duty to provide specific details of the concerns giving rise to the investigation, since the danger of interference with the collection of evidence must be avoided,392 but also because an element of "fishing" may be unavoidable in every investigation, as the regulators cannot be expected to know in advance what to expect at its conclusion393). However, the procedural judicialisation of investigations is resisted by the courts, and the investigators are left free to adopt a flexible approach.394

In relation to the preparation of publishable reports under the Companies Act, the inspectors' duty of fairness may entail the obligation to give any person that they intend to criticise an opportunity to correct or contradict the allegations made against him, because of the severe injury that adverse findings in their report could cause to his reputation; but it would be enough for the inspectors to disclose the substance of these allegations. The inspectors do not need to provide a draft of their

390 The decision to appoint investigators will only be invalid if it is vitiated by bad faith; Norwest Holst Ltd. v. Secretary of State for Trade [1978] Ch. 201 (C.A.). "Bad faith" should be interpreted broadly in this context, to include cases of illegality or irrationality, where the objective situation cannot reasonably support a conclusion on the part of the appointing authority that suspicious circumstances, such as would justify an investigation, exist.

391 Nonetheless, since investigations are only undertaken in situations suggesting that there is preexisting cause for concern, bias in the sense of prejudice against the persons whose affairs are subjected to scrutiny is acceptable and does not amount to unfairness; see R. v. Secretary of State for Trade, ex p. Perestrello [1981] 1 Q.B. 19 (Q.B.D.).


394 Re Pergamon Press Ltd. [1971] Ch. 388 (C.A.). Investigations under the Companies Act 1985 are not subject to the procedural requirements of the Police and Criminal Evidence Act 1984 and the codes of practice promulgated under that Act; R. v. Seelig [1991] 4 All E.R. 429 (C.A.). The same is probably the case with regard to investigations into the affairs of authorised institutions under s.41 of the Banking Act, although the position may be different with regard to investigations by the Bank of suspected contraventions of ss.3 and 35 under s.42.
proposed report and can rely on a degree of secrecy in order to protect their witnesses and evidence.  

In comparison, in an investigation under the Banking Act, the Bank's appointed investigators may not be under a legal obligation to hear any objections against prejudicial conclusions that they intend to draw in their report or negative information that they have collected. The reason is that their report is not publishable, but also that even in the case of formal remedial actions the Act gives the institutions or persons adversely affected an opportunity to answer the case against them only after the Bank has already formed an initial decision to take corrective steps.

From a jurisdictional perspective, the reviewability of investigations raises special difficulties. In the case of company investigations leading to published reports, even if unfairness is established to the satisfaction of the court, the report may not be annulled; at most, in exceptional circumstances the court can make a bare declaration that natural justice has not been observed by the inspectors in making their report. The reason is that only administrative decisions, i.e. legal decisions which are usually incorporated in a formally executed legal instrument and which produce legal consequences, are reviewable; however, a report is not a decision producing legal consequences or determining the rights of the persons criticised in it. Moreover, even if an investigation had been conducted unfairly, the authorities might be obliged to consider relevant information contained in the report. It is also unlikely that an investigation could be impugned on grounds of unfairness independently of, and prior to the making of, the investigators' report, since challenging the fairness of the investigative procedure before its conclusion could be considered premature. Obviously, these barriers to reviewability apply with even greater force to investigations under the Banking Act, since these do not result in

395 Re Pergamon Press Ltd., ibid. See also Mahon v. Air New Zealand Ltd. [1984] 1 A.C. 808 (P.C.); and Trade and Industry Committee, Memoranda Submitted by the Department of Trade and Industry, loc.cit., n.387, pp.5-6, paras.27-34.


397 Ibid., p.542. See also D. Oliver, "Void and voidable in administrative law: a problem of legal recognition" (1981) 34 C.L.P. 43, pp.54-58. In a recent unanimous decision, Fayed v. United Kingdom, The Times, 11 Oct. 1994, the European Court of Human Rights refused to accept the submission that the making and publication of a report containing damaging conclusions determined the civil right to honour and reputation of the persons concerned and that, as a result of the absence of effective access to the courts to challenge the resulting interference with that civil right, art.6(1) of the European Convention on Human Rights was violated. The Court was satisfied that the inspectors' functions were essentially investigative and that their actions had not determined the applicants' right to a good reputation. The system of investigations, including in particular the inspectors' freedom of reporting without fear, served an important public interest in the proper conduct of the affairs of public companies, and the inevitable risk of some uncompensated damage to reputation was proportionate to this legitimate purpose.
published reports but form an integral part of the supervisory mechanism and their function is to prepare the ground for the Bank’s decisions concerning authorisation or for the prosecution of breaches of the statutory prohibitions.

Regulatees are under an obligation to cooperate with the Bank’s information-gathering activities by providing the required information and refraining from impeding its investigative work. This obligation is enforceable by criminal sanctions. Any person who without reasonable excuse fails to provide the information or produce the documents required by the Bank for the supervision of authorised institutions or the investigation of suspected contraventions of the statutory prohibitions; or who, during an investigation into the affairs of an authorised institution, without reasonable excuse fails to produce documents, or to attend an interview with the investigators and to answer their questions; or who intentionally obstructs a search; or who, knowing or suspecting that an investigation may be carried out, abuses or conceals documentary evidence, or causes or permits abuse or concealment of such evidence, is guilty of an offence. A defence of "reasonable excuse" is available in this context. The defence applies, for example, in circumstances of physical inability to comply owing to illness, or to the accidental destruction of documents; otherwise, compliance is necessary, even if the disclosure of the information required by the Bank entails adverse potential legal consequences for the person obliged to provide it or for some other party. An institution cannot withhold evidence on the ground that it is self-incriminatory. Nor can an injunction restraining an authorised institution from disclosing documents relating to its clients without their consent override the institution’s obligation to produce these documents if reasonably required to do so by the Bank in the exercise of its supervisory functions.

More generally, the knowing or reckless provision to the Bank, its appointed inspectors, or other persons involved in the regulatory process, of false or misleading information in purported compliance with a statutory requirement or a specific request for information, or otherwise in the expectation that the Bank will use the information in relation to its statutory functions, is a criminal offence; the

---

398 Ss.39(11), 40(3), 41(9), 42(4), 43(5), 44. But legal professional privilege is retained with regard to privileged communications; ss.39(13), 41(11), 42(6).
400 A v. B Bank (Bank of England intervening) [1992] 1 All E.R. 778. Generally, whenever regulatory statutes create an obligation of cooperation with the investigating authorities, the defence of "reasonable excuse" is likely to be interpreted narrowly, and in balancing the various public and private interests the primary emphasis will be given to the public interest in the effectiveness of investigative activities and the detection of misfeasance; see Re an Inquiry under the Company Securities (Insider Dealing) Act 1983 [1988] 1 A.C. 660 (H.L.).
same is true of the concealment by authorised institutions of information that is likely to have a material impact on the institution's supervision.

In common law, defendants or witnesses in criminal and civil cases enjoy the privilege of not being required to disclose information of potentially self-incriminating character. In the context of the investigation of certain economic crimes, statutory law abrogates the right of silence, by compelling the disclosure of damaging information to the investigators, so as to facilitate the detection of complex wrongdoing. This is the case with regard to the investigation of theft by the police authorities and of serious and complex fraud by the Serious Fraud Office. As a concession to the traditional approach, however, any self-incriminating admissions or statements collected by these authorities are inadmissible in evidence against the person making them (except when the question concerns the validity of later inconsistent statements made by him or his prosecution for the knowing or reckless giving of false information). Nonetheless, the self-incriminating statements can be of indirect use to the investigating authorities, who can seek to prove damaging facts revealed in this manner by alternative evidentiary means.

In contrast to this compromise, by express statutory provisions any statements made in compliance with requests for information in the course of the Bank's information-gathering activities under the Banking Act or of company investigations under the Companies Act are fully admissible in evidence against the person making them. Furthermore, any doubts as to whether the privilege against self-incrimination could provide a "reasonable excuse" for non-compliance with such requests have been dispelled by the case-law, which makes clear that an obligation to respond to the supervisory authorities' enquiries exists even when the answers may be self-incriminating.

401 S.94.
402 See M. Stallworthy, "Privilege against self-incrimination in civil proceedings: how far does it go?" (1992) 7 J.I.B.L. 378. The privilege is statutorily recognised with regard to defendants in criminal cases; Criminal Evidence Act 1898, s.1. The justification of the privilege and the merits of its continuing retention have recently become the subject of passionate debate, following the announcement in Oct. 1993 of proposals by the Home Secretary, M. Howard, for the abolition of the right of silence for suspects in criminal cases.
403 Theft Act 1968, s.31(1).
404 Criminal Justice Act 1987, s.2.
405 Banking Act 1987, ss.39(12), 41(10), 42(5), 43(6); and Companies Act 1985, s.433(5); see also R. v. Harris (Richard) [1970] 3 All E.R. 746 (C.C.C.). While s.2 of the Criminal Justice Act 1987 has, as explained above, the effect of invading the right of silence of those examined by the Serious Fraud Office without nonetheless removing the immunity from use in evidence of the self-incriminating answers, the position is different under insolvency and regulatory legislation, where statements made in examination are admissible in evidence against the person making them in any proceeding, whether civil or criminal. Such statements can be communicated to the Serious Fraud Office for the purposes of a prosecution, unfettered by any restriction on their use; Re Arrows Ltd. (No. 4) [1994] 3 All E.R. 814 (H.L.). See also P. Paulden, "Corporate fraud: civil disclosures in criminal proceedings" (1994) 57 M.L.R. 280.
Thus, in *Bank of England v. Riley*,406 in the course of civil proceedings instituted by the Bank and concerning the contravention by the defendant of the statutory prohibition on unauthorised deposit-taking, the Bank obtained an order requiring the defendant to ascertain all her assets. The order was made by consent, but the defendant made clear her intention to refuse disclosure in reliance on the privilege against self-incrimination. The Court of Appeal held that a defendant to proceedings brought under the Banking Act was not entitled to rely on the privilege against self-incrimination as a reason for not answering interrogatories or disclosing documents when required to do so by the Bank. In particular, a person reasonably suspected by the Bank of contravention of the statutory prohibitions on unauthorised deposit-taking and on fraudulent inducements to make deposits was required to provide specific information and documents for the purpose of facilitating the investigation of the suspected contravention.407 It was clear by necessary implication that the defendant was not "reasonably excused" from complying simply because the result would be self-incriminatory.408

The express admissibility of confessions obtained compulsorily under the Banking Act as evidence in subsequent criminal proceedings may be in conflict with those rules of law which exclude enforced confessions with regard to offences outside the Act.409 In *Riley* there was a theoretical possibility that disclosure might lead to prosecution otherwise than under the Banking Act, as was the intention of

---


407 S.42(1).

408 The ratio of *Riley* has also been applied to company investigations under the Companies Act 1985, regarding which Parliament has decided to impose on persons possessing relevant information a duty to comply with the requirement to answer questions, despite the fact that the investigations will often be conducted in circumstances suggesting that there has been fraud in the management of the affairs of the company in question; *Re London United Investments plc.* [1992] 2 All E.R. 842 (C.A.); and *R. v. Seelig* [1991] 4 All E.R. 429 (C.A.). Similar considerations apply to examinations under the Insolvency Act 1986, ss.235-236. Persons known or suspected of holding information relevant to the investigation of the affairs of an insolvent company are not entitled to refuse to answer questions put to them by the company's office-holders during a private examination authorised by the court. The statutory provisions were enacted specifically to enable office-holders to perform their functions effectively and expeditiously by giving them greatly extended investigative powers, and imposing a duty on directors and other persons listed in s.235(3) to assist them, even though potential criminal liability for failure to keep proper accounting records might apply in practically every case of examination of a director under s.236. The object of the examination would be stultified if directors could rely upon the principle against self-incrimination, which, by necessary implication, is not available to persons examined under these sections; *Re Jeffrey S. Levitt Ltd.* [1992] 2 All E.R. 509 (Ch.D.); and *Bishopsgate Investment Management Ltd. v. Maxwell* [1992] 2 All E.R. 856 (C.A.).

409 In *Riley*, the Court of Appeal applied the decision of the House of Lords in *Commissioners of Customs and Excise v. Harz* [1967] 1 A.C. 760, where it was held that a trader was bound to provide any information required by the commissioners in the proper manner, whether or not this might tend to incriminate him; but it was thought that his answers would not be admissible in common law, since they were not free and voluntary.
the provision, or under the Theft Act 1968, in accordance to whose provisions the disclosed information would be inadmissible as evidence. The Court of Appeal thought that, in a situation of this type, the question regarding the fairness of using information thus collected or admitting it as evidence should be left to the discretion of the criminal court before which proceedings might be brought. More recently, the House of Lords has expressed a similar view in relation to disclosures by the liquidators of a company to the Serious Fraud Office of self-incriminating statements obtained under section 236 of the Insolvency Act 1986, which can also be used as evidence in criminal proceedings. In particular, it was thought that, while the Companies' Court could not properly impose restrictions on such use of the transcripts of the relevant statements, the judge at the criminal trial could exclude them, if, in the light of all the circumstances of the case before him, he came to the conclusion that their admission would be prejudicial to the trial's fairness. In principle, however, the use of the self-incriminating statements in criminal proceedings unrelated to the Banking Act does not amount to oppression and unfairness. Despite any inconsistency in the treatment of self-incriminating evidence in investigations under the Banking and Companies Acts with that in investigations by the police and the Serious Fraud Office, the differences are inherent to the respective statutory régimes and it would not be appropriate for the courts to exclude on grounds of unfairness the admission of evidence which was expressly authorised by Parliament.

Even though the Riley decision implied otherwise, more recent authority establishes that confessions obtained in pursuance of the provisions the Banking Act may be admissible even against persons charged with violations of the Theft Act, because the provision of the latter concerning the inadmissibility of self-incriminating statements made in "proceedings for the recovery or administration of any property" is limited in its application to the civil proceedings which were the subject of the scheme set out in the Insolvency Act 1986, and does not cover other proceedings.

---

410 S.31(1).
411 Re Arrows Ltd. (No.4) [1994] 3 All E.R. 814. Under the Police and Criminal Evidence Act 1984, ss.76, 78, and 82, criminal courts can refuse to allow evidence whose admission would have a corrupting adverse effect on the fairness of the proceedings, including confessions which may have been obtained by oppression.
412 Self-incriminating answers given to company inspectors are not necessarily obtained "by oppression" and are admissible in criminal proceedings, because of the significance attached to the investigation and punishment of company fraud, the limited need to protect sophisticated defendants such as company directors, who are likely to be the major witnesses in such investigations, and a clear legislative intention to that effect; overall, admitting evidence obtained under the inquisitorial process of an investigation does not render the criminal proceedings so unfair that the court should exclude it; R. v. Seelig [1991] 4 All E.R. 429. This should also apply to investigators appointed by the Bank.
e.g. bankruptcy proceedings, as to which the principle against self-incrimination has been abrogated.414

It must be noted in this connection that it is still an open question whether the use in criminal proceedings of self-incriminating evidence collected by the supervisory authorities is consistent with the European Convention on Human Rights. The issue is currently pending before the European Court of Human Rights, in relation to the case of Ernest Saunders, the former chief executive of Guinness p.l.c., who was convicted on charges of conspiracy to defraud and theft in connection with the 1986 take-over of his company. In its report on the case, which was published on 19 September 1994, the European Commission of Human Rights has concluded, by a vote of 14 to one, that

"the use at the applicant's trial of incriminating evidence obtained from him under compulsory powers [by the inspectors of the Department of Trade and Industry who conducted a company investigation into the affair] was oppressive and substantially impaired his ability to defend himself against the criminal charges facing him. He was therefore deprived of a fair hearing."415

If this opinion is accepted by the European Court, the effect of the provisions of the Banking and Companies Acts regarding the admissibility of such evidence will be drastically curtailed.

(b) Financial returns of authorised institutions, limits on the public disclosure of supervisory data and the duty of regulatory confidentiality. The Bank's statutory powers serve to underpin the collection of supervisory information on both an ad hoc and a routine basis. With regard to the latter, instead of placing its reliance on the authorised institutions' audited annual accounts, the Bank has set in place an elaborate system of more frequent and more detailed financial reporting, based on the analysis of the balance-sheet items by type and sector, to which every authorised institution must conform. Failure to submit returns in time is viewed by the Bank as a serious warning sign and can lead to reconsideration of an institution's authorisation.416 Since the collection of separate sets of overlapping data would increase unduly the costs of the reporting system for both the regulated institution and the Bank, the collection of supervisory information is for the most part

---


188
integrated with that of monetary statistics; only a limited number of additional returns are used exclusively by supervisors.417

The Bank would not dispute that "the range of statistics required from authorised institutions is wider than that necessary simply to provide a basis for the regular prudential discussions".418 However, it uses the additional returns to assist it in the operation of monetary policy, to oversee the financial system, to advise the government on financial and economic matters, to provide information to the private sector and to contribute to the nation's financial statistics.419 Recognising that the reporting system, which has been in operation since the mid-1970 subject to occasional reviews,420 is onerous, the Bank has expressed an intention of avoiding to impose reporting burdens where this is impracticable or unnecessary for the users of statistical information and of encouraging the participation of the regulated institutions in the review process.421 It must be noted that the collection of information for non-prudential, purely statistical purposes is not specifically

417 See Leigh-Pemberton Committee, loc. cit., n.356, paras.7.1-7.3. The following statistical forms are used either partially or exclusively for supervisory purposes:
Form BS: "Balance Sheet" (completed monthly; a number of small institutions file a modified quarterly version, Form QBS);
Form BSD1: "Capital Adequacy Return" (completed quarterly on an unconsolidated / solo consolidated basis, and half-yearly on a consolidated basis); in implementation of the Capital Adequacy Directive, Form BSD1 will be replaced from the beginning of 1996 by Forms RAR1: "Capital Adequacy Summary", BSD2: "Capital Adequacy Return (Banking Book)", and CAD1: "Capital Adequacy Return (Trading Book)");
Form LE: "Analysis of Large Exposures" (unless otherwise agreed with the Bank, completed quarterly on an unconsolidated basis, and half yearly on a consolidated basis, by U.K.-incorporated banks only);
Form S3: "Foreign Currency Exposure" (completed monthly);
Form Q6: "Maturity Analysis of Liabilities and Assets in Sterling" (completed quarterly; a number of small institutions file a modified quarterly version, Form QMA);
Form S5: "Maturity Analysis of Liabilities and Assets in Currencies Other Than Sterling" (completed quarterly); and
Form C1: Country exposure report of worldwide offices of U.K.-incorporated banks (completed half-yearly).
U.K. branches of foreign institutions are required to submit Form B7 on profits, exposures, etc.; and Form B1 on country exposures (both completed half-yearly). The following supervisory returns are collected from specialist money-market institutions: Form CD(DM): Discount houses' transactions in sterling CDs (completed monthly); Form MM: Bill turnover in the money market (completed monthly); Form M1: Market-makers' holdings of subordinated-loan capital issued by banks (completed quarterly). Detailed instructions for the completion of the forms are issued by the Financial Statistics Division of the Bank; see also the Banking Supervision Division papers: "Statistical Notice to Monetary Sector Institutions" (Apr. 1985); "Statistical Notice to Monetary Sector Institutions: The Measurement of Capital" (19 Jun. 1986); and "Statistical Notice to Reporting Banks: Capital Adequacy Treatment of Deferred Tax Assets" (Dec. 1990).

420 On recent efforts to improve the statistical requirements, see "Banking statistics review" (1992) 32 B.E.Q.B. 314; and "Banking statistics: recent and prospective developments" (1995) 35 B.E.Q.B. 72.
authorised under statute. Accordingly, requests by the Bank for the submission of returns which have no supervisory relevance may not be legally enforceable.

The reporting requirements of the Bank of England bring into existence a supplementary system of bank accounts, which incorporate much more comprehensive data than the ordinary financial statements of banking institutions. On the other hand, it is a fundamental characteristic of the prevailing regulatory philosophy that the information in the returns is used exclusively for supervisory purposes, and is not intended for public disclosure. This reflects an entrenched distrust of disclosure-based regulatory policies, whose aim would be to reinforce market discipline.

The mandatory public disclosure of information should not be treated as if it were a spontaneous, neutral solution to problems of market organisation. In many cases, it can have very modest effects in terms of making available to the market significant information that would otherwise be inaccessible, but may be unduly costly and burdensome; it often involves a subsidisation of particular parties, such as securities holders, who benefit from the disclosed information without paying for its production, and may even have perverse effects, if it requires the dissemination of sensitive private information to the market as a whole, including competitors.

Nonetheless, public disclosure requirements appear to be generally compatible with a market-oriented regulatory philosophy, because they tend to increase market transparency (and, at least to that extent, the efficiency of resource allocation). In addition, they have distinct advantages as a policy instrument, because they apply on a non-discretionary basis, and thus do not leave room for regulatory mistakes, inertia or arbitrariness. They also minimise the need for remedial action: the market responds directly to the information disclosed, without further regulatory involvement. In comparison, regulatory reporting requirements are of value only to the extent that the supervisors are able to assess correctly the information and act promptly upon any indication of irregularity.

Reliance on public disclosure requirements as a regulatory instrument would be consistent with the broader trends of company law, since the latter encourages the full and meaningful disclosure of the true state of corporate affairs in published...
accounts, not merely for the benefit of company shareholders, but for the promotion of the integrity of the market as a whole. Under the Companies Acts, every company is under a duty to keep accounting records, which must be such as to disclose with reasonable accuracy its financial position at any time, and to prepare annual accounts. The accounts must give "a true and fair view" of the company's financial state and comply with the statutory provisions as to their form and content. Moreover, company directors have a duty to prepare a report containing a fair review of developments during the year and their recommendations to

---


426 S.221.

427 I.e. a balance sheet as at the last day of the financial year and a profit and loss account; s.226. Parent companies must also prepare group accounts on a consolidated basis, reflecting the state of affairs of their group as a whole; s.227.

428 S.226(2); Sch.4 contains provisions as to form and content of company accounts. Accounts should conform to the Statements of Standard Accounting Practice (S.S.A.P.) that are issued by the professional accountancy bodies. These do not have the force of law, but significant departures from them must be disclosed and their material effects explained. Unjustified departures are regarded as a breach of professional duty. Compliance with the S.S.A.P. is also enforced as a disciplinary matter. See s.256; and Lloyd Cheyham & Co. Ltd. v. Littlejohn & Co. [1987] B.C.L.C. 303 (Q.B.D.), p.313. If compliance with the provisions of Sch.4 of the Companies Act is not enough to ensure that the accounts give a "true and fair view", additional information must be included in the accounts or in a note to them; in extreme cases, where this is necessary, departures can be made from the statutory provisions, but the reasons for such departures must be given in a note. The main difficulty is that there are no clear legal criteria for determining what is a "true and fair view"; see A. McGee, "The 'true and fair view' debate: a study in the legal regulation of accounting" (1991) 54 M.L.R. 874. For instance, the concept certainly does not mean that assets must be stated at their current values, and is usually applied within the framework of the "historical-cost" convention; on the other hand, it clearly excludes the creation of hidden reserves. As D. McBarnet and C. Whelan, "The elusive spirit of the law: formalism and the struggle for legal control" (1991) 54 M.L.R. 848, observe, accountants are particularly conscious of the fact that formalistic compliance to the statutory requirements can serve as a means for reducing the effectiveness and avoiding the fundamental purposes of financial reporting, e.g. through "off-balance-sheet" transactions, which hide assets or liabilities from the reader of the accounts. For this reason, in theory the antiformalist approach prevails in financial reporting and taxation, and the emphasis is placed on the substance of transactions and relationships and on the purposes and "spirit" of the relevant rules, with parallel reliance on professional standards of good practice. Nonetheless, the antiformalist approach has important practical limitations and raises objections at a number of levels, especially on grounds of its inherent antagonism to the rule of law, practicability and certainty. In statute law, the result is usually a compromise between precise formal requirements and "catch-all" substantive criteria; even so, however, at the point of their application, the "antiformalist" provisions are subject to considerable pressures for their operational formalisation, while reliance on the "substance" of transactions may itself create new rules of practice, applied in an equally formalist manner. The threat of professional liability and the need to keep the cost of accounting services under control through increased uniformity enhance the tendency towards reliance on formalist rules of practice.
shareholders as to the payment of dividends. To ensure the accuracy of the accounts, the law requires the making by the company's auditors of a report on all annual accounts, which must state whether in their opinion these have been properly drawn in accordance with all legal requirements and, especially, whether they provide a "true and fair view" of the company's state of affairs. For this purpose, the auditors must carry out the investigations necessary for enabling them to form an opinion on whether the company has kept proper records and the accounts are in agreement with these records.

Against this background, however, and in sharp contrast to prevailing attitudes in securities regulation, where the achievement of transparency in transactions and of informationally efficient markets is an important theme, in banking the current regulatory philosophy is not favourable to the public disclosure of sensitive information. Disclosure-based policies are particularly resisted on the theory that market responses to new adverse information regarding banks, rather than being calibrated, are more likely to involve abrupt credit rationing and depositor runs on the banks, which may precipitate unnecessary and uneconomical failures. The theory of potential disproportionate market reactions was used until recently to justify the continuing use of hidden reserves by banks, even though in general company law this practice had been abandoned long ago. Nonetheless, even if the

429 S.234.
430 S.235.
431 S.237.
432 In securities regulation, disclosure is also used as a sanction. See, in particular, s.60 of the Financial Services Act 1986, pursuant to which the Securities and Investments Board ("S.I.B.") may make a public statement where it appears that authorised persons have contravened certain rules of conduct or have employed a prohibited person; the person about whom a statement is made must be notified and may refer the case to the Financial Services Tribunal.
433 See Huber, loc.cit., n.423, pp.70-71.
434 Originally, all companies used to keep hidden reserves to smooth profits from year to year. The practice was discontinued under the post-war Company Acts, but exemptions were made for banks, discount houses, insurance and shipping companies. In 1962, the Jenkins Committee reaffirmed the case for hidden reserves; "Report of the Company Law Committee" (Cmd.1749, Jun. 1962), paras.398-407. In its report, the Committee maintained "that confidence in the stability of the banks is an asset of national importance as lack of confidence may induce depositors both at home and abroad to withdraw their deposits [...]; that banks are subject to very large fluctuations in the value of their investments and to periodical losses on lendings which can be out of all proportion to the profits of a single year; and that full disclosure of these fluctuations and losses in the annual accounts might well lead to loss of confidence on the part of depositors and the general public."; para.401. However, the Committee noted that there was a marked turn of public opinion against hidden reserves as a result of the operation of the general rule of full disclosure of company profits and that the practice had disadvantages in terms of reduced shareholder information and control and the concealment of weaknesses. Eventually, the shift in public opinion proved more powerful than any argument in support of the retention of hidden reserves. With the introduction of the C.C.C. in 1971, the clearing banks started to disclose their true profits and losses; but accepting houses continued to maintain hidden reserves, relying on exemptions granted by the Department of Trade and Industry under the Companies Acts. Although no new exemptions were granted after 1971, the practice survived until the late 1980s
theory is fundamentally correct, the policy implications are at best ambiguous: clearly, a thorough policy of non-disclosure would be unacceptable because it would reduce market efficiency by creating informationally defective banking markets and encouraging abuses by bank managers, who could more easily give false signals as to the true state of their institutions.435 Furthermore, there is some evidence that the impact on banks of adverse publicity may be less catastrophic than commonly assumed. One reason is that in many cases the wholesale banking markets, which are highly efficient, are able to identify and absorb the unfavourable information before its formal announcement by the institution concerned.436

In practice, despite their bias in favour of secrecy, in the longer run banking regulators appear unable or unwilling to resist the broader trends in company accounting.437 Indeed, the legal developments of the last decade mark the extension to banking undertakings of the same accounting principles that apply to all other companies.

At the European level, the Bank Accounts Directive has harmonised accounting standards for credit institutions, with a view to improving the comparability of the accounts of institutions operating across national borders and facilitating the meaningful harmonisation of supervisory standards.438 The directive does not adopt a totally new set of accounting rules for banks, because a separate accounting system would be inconsistent "with the principles underlying the coordination of

---

435 In the opinion of L. Durcan and B.K. Riordan, "Banking disclosures, financial privacy, and the public interest" (1987) 6 Ann.Rev. Banking L. 391, p.401, "[r]evelation of financial problems at particular banks will certainly cause removal of deposits and possibly even bank failures. Yet this market response may be anticipated and can serve to discipline banks. Moreover, any harm to particular banks will be more than offset by the increase in public confidence in the system as a whole."


437 A policy of public disclosure of the real financial position of banks has been followed in the U.S. for the last twenty years, in the belief that the advantages outweigh the supposed risk of undermining public confidence; R.D. Kurtz and J.F. Sinkey, "Bank disclosure policy and procedures, adverse publicity and bank deposit flows" (1973) 4 J.B.R. 177. But M.P. Malloy, "Public disclosure as a tool of Federal bank regulation" (1990) 9 Ann.Rev. Banking L. 229, pp.243-253, observes that disclosures in banking are confined to specific requirements; otherwise, there is a presumption that confidentiality is warranted. This causes a tension with U.S. securities law, which also applies to banking concerns and which is premised on the principle of full disclosure.

company law. Instead, it addresses the idiosyncratic characteristics of credit institutions that raise special accounting problems through modifications to the general accounting framework set out in the Fourth and Seventh Company Law Directives. The directive adopts the spirit of full disclosure and incorporates the "true-and-fair-view" principle; but, in a significant departure from its overall approach, it also gives to national authorities the discretion to allow the creation of hidden reserves through the undervaluation of certain assets in bank accounts.

Further, the directive makes compulsory the publication by credit institutions of annual and consolidated accounts in all Member States in which they are established.

The Bank Accounts Directive has been implemented in the U.K. by means of amendments to the Companies Act 1985. The amendments introduce special rules for the drawing of the accounts of banking companies, including the prescribed formats to be followed, the valuation rules to be applied and the disclosures to be made in the notes to the accounts. The accounting principles that must be observed in drawing the accounts are specified in the statutory provisions: the company is presumed to be carrying on business as a going concern; the accounting policies must be consistent, both within a single year's accounts and from year to year; the amounts stated for the various items must be determined on a prudent basis; only profits realised on the balance sheet can be included in the profit and loss account, while all liabilities and losses which have arisen, or are likely to arise, in

---

439 Preamble, 7th recital.
440 In particular, the directive requires contingent liabilities and commitments to be reported in a statement on the face of the balance sheet (arts.4 and 24-25); requires additional disclosures (including information on maturities of loans and advances) to be given in the notes (art.40-41); and permits Member States to continue, in their discretion, to recognise within limits (of 4% of assets) the maintenance of hidden reserves (art.37(2)).
441 Art.44(4). See also the Council Directive 89/117/EEC of 13.2.89 on the obligations of branches established in a Member State by credit institutions and financial institutions having their head offices outside that Member State regarding the publication of annual accounting documents (the "Bank Branches Directive"), which exempts branches of banks whose accounts conform to the standards of the Bank Accounts Directive from the obligation to publish separate branch accounts, although the host Member State may still require the disclosure of certain types of information regarding the branch. The Bank Branches Directive has been implemented in the U.K. in the form of the new ss.699A and 699B and Sch.21C of the Companies Act 1985, inserted by the Oversea Companies and Credit and Financial Institutions (Branch Disclosure) Regulations 1992, S.I. 1992/3179. These provisions impose disclosure requirements (the delivery of accounts in Great Britain) on branches of third-country credit institutions.
443 Bank accounts must be prepared in accordance with Sch.9, Pt.I, of the Companies Act (rather than Sch.4, which applies to ordinary companies); s.255(1). There are also provisions for the disclosure of emoluments and other benefits granted to bank directors and connected persons; s.255B and Sch.9, Pt.IV.
respect of the financial year must be taken into account; all income and charges relating to the financial year must be taken into account, without regard to the date of actual receipt or payment; finally, in determining the aggregate amount of any item, the amount of each individual asset or liability must be determined separately. 444 If there are special reasons for departures from the statutory principles, these and their effect must be explained in a note to the accounts. The new principles for the drawing of bank accounts are in all essential respects indistinguishable from those applying to other companies and individuate the "true-and-fair-view" approach. The U.K. has declined to use its national discretion under E.C. law to allow hidden reserves; instead, it has chosen to formally abandon this practice. 445 The parent company of a banking group is also required to prepare group accounts. 446 To ensure the immediate public accessibility of audited bank accounts, the Banking Act imposes on authorised institutions an obligation to make them available for inspection by any person at all their offices. 447

These developments have brought in line the accounting requirements for banks with those for other companies. On the other hand, the inherent limitations of disclosures in published accounts must be emphasised. Probably the most serious problem concerns the quality of the bank auditors' report. In theory, a bank auditor who has reservations about the truthfulness and fairness of the accounts can issue a "qualified" report or resign; in practice, he is more likely, "in the interests of the banking system", to submit an unqualified report and only then (if at all) resign, on the ground that exercising either of the other options may cause of itself the immediate collapse of the bank. There is evidence from the B.C.C.I. affair 448 that the

446 255A(1); the consolidated accounts must be prepared in accordance with Sch.9, Pt.II, which adapts the general rules on consolidated accounts of Pt.VII of the Companies Act 1985 to the special circumstances of banking groups. The consolidation of banking group accounts includes only banks and special bank-holding companies, and does not extend to non-banking parent companies, s.255A(4). Sch.9, Pt.III provides for disclosures in respect of investments in other undertakings by banking companies, the parent companies of banking groups, or other members of their group that are included in the consolidated accounts.
447 S.45.
448 B.C.C.I.'s auditors, Price Waterhouse (U.K.), have been severely criticised, in the Kerry Report and elsewhere, for their conduct in that case; see Kerry Report, "The B.C.C.I. Affair: A Report to the Senate Committee on Foreign Relations", 102nd Congress, 2nd Session (30 Sep. 1992, 2 Vols.), ch.10. The critics maintain that, even though each year from 1985 to 1990 Price Waterhouse discovered evidence of exceptionally poor practices within the institution, they continued up through 1990 to sign clean reports on the annual accounts and also failed to notify regulators of breaches of criminal law that they had identified, or to resign as auditors. It is true that their client group tried to deceive them and that its operations were divided between two different firms of auditors, so that Price Waterhouse did not have a clear picture of the whole structure. But there appear to have been numerous warning signs, which Price Waterhouse failed to bring them to light. The liquidators of B.C.C.I. have since brought actions against Price Waterhouse and the group's second auditors, Ernst & Whinney (now Ernst & Young), but
Bank does not object to this practice, and may even be ready to actively encourage it in certain circumstances, in order to gain the time necessary for finding a regulatory solution to the problems of the institution concerned.\textsuperscript{449} Giving evidence to the Treasury and Civil Service Committee of the House of Commons in connection to the B.C.C.I. debacle, the then Governor of the Bank, Robin Leigh-Pemberton, was asked whether the exercise of influence over auditors is an acceptable and normal practice for a regulator.\textsuperscript{450} In his response, the Governor set out the Bank's position in rather ambiguous terms: 

"[M]y view is that it is perfectly reasonable to say [to the auditors], 'For the purposes of the future of this bank it is desirable, if possible, to have a clean audit opinion'. But that is not going as far as to say, 'If it is not possible we still require you to produce it'."\textsuperscript{451}

However, the reluctance to qualify bank accounts is in total conflict with the core purpose of the auditing function.\textsuperscript{452} The current practice is inappropriate, because it is clearly inconsistent with the expectations and understandings of the public regarding the professional role of bank auditors. Moreover, even though the making of qualifications in auditors' reports may be fatal for the institutions immediately concerned, the long-term impact may be positive, since the termination of an institution that cannot convince its auditors of the accuracy of its accounts can

---

\textsuperscript{449} Treasury and Civil Service Committee, "Banking Supervision and B.C.C.I.: The Implications of the Bingham Report", \textit{loc.cit.}, n.323, Minutes of Evidence, qq.31-33.

\textsuperscript{450} Id., p.33.

provide a valuable degree of market discipline and increase confidence in the banking system as a whole by providing assurance that the monitoring mechanisms are operating properly.

The full implications of the prevailing attitudes of regulatory secrecy are felt in the context of the supervisory returns, since these contain substantial financial information which is not currently included in the published accounts of banking institutions. As has been explained above, the Bank requires the submission of bank accounts and other information for statistical and supervisory purposes on a more detailed and frequent basis than that required under general company law. Nonetheless, banks are not required to disclose the same information to the public, and the incorporation of this information in their published accounts is not part of the "true-and-fair-view" approach; nor does the Bank disclose the supervisory assessments which are made on the basis of the supervisory returns. In this sense, the regulatory process relies primarily on information which is intentionally withheld from the market.

The culture of regulatory secrecy is legally entrenched in the form of statutory restrictions on the disclosure of regulatory information by the Bank and its officers, servants or agents. The intention is to encourage people in possession of relevant information to communicate it fully and frankly to the Bank on the certainty that it will not be further disclosed. Strict observance of confidentiality by bank regulators is also required under Community law. The duty of regulatory confidentiality is

453 See Penn, Banking Supervision..., op.cit., n.41, pp.145-151; also Morison, Tillett and Welch, op.cit., n.351, pp.68-71. The public duty of confidentiality owed by the supervisors must not be confused with the private duty of confidentiality owed by bankers to their customers, which obliges the former not to disclose information relating to the affairs of the latter acquired through the keeping of bank accounts. On the ambit of bankers' duty of confidentiality, see Tourner v. National Provincial and Union Bank of England [1924] 1 K.B. 461; and R. Grandison, "England", in F. Neate and R. McCormick (eds.), Bank Confidentiality (1990); cf. White Paper "Banking Services: Law and Practice" (Cm. 1026, Mar. 1990), Ann.2.

454 Art.12 of the First Banking Directive, as replaced by art.16 of the Second Banking Directive, imposes a strict duty of professional secrecy on bank regulators (but without prejudice to contrary provisions of criminal law). It permits exceptionally the exchange of information between banking and other financial regulators, auditors, bodies involved in the liquidation and bankruptcy of credit institutions and bodies administering deposit-guarantee schemes, but only to the extent that the recipients of the information are subject to the same obligations of confidentiality. The provision also permits disclosures of regulatory information to central government departments responsible for financial legislation, but "only where necessary for reasons of prudential control"; art.12(7). In response to the lessons of recent experience, the recent Directive on the Reinforcement of Prudential Supervision, or Post-B.C.C.I. Directive, art.4, amends these provisions and widens the "gateways" to include certain other bodies which play a role in the investigation and punishment of corporate wrongdoing, especially the disciplinary bodies of the accountancy profession and the persons having responsibility for the investigation of breaches of company law, including external company inspectors. The Directive must be implemented by the Member States by 18 July 1996; art.6.
imposed on any person who in the course of carrying out supervisory functions under the Banking Act 1987 receives information relating to the business or other affairs of another person, or who subsequently receives information obtained in this manner. Protected information may not be disclosed without the consent of the person to whom it relates or by whom it is received.\textsuperscript{455} Breach of this duty is a criminal offence.\textsuperscript{456} The prohibition on disclosures does not apply to publicly available information or to non-specific, summary information, in particular information of a statistical nature.\textsuperscript{457} It is also subject to numerous exceptions, providing "gateways" for the disclosure of information for the purposes of: facilitating the discharge by the Bank of its regulatory and monetary functions; assisting other persons (including the Board of Banking Supervision, inspectors, auditors or reporting accountants, and the Deposit Protection Board) in carrying out their functions under the Act; instituting or assisting criminal proceedings, enforcement proceedings under the Act, or insolvency proceedings concerning authorised institutions and disqualification proceedings concerning their directors; and also, for the purpose of facilitating the discharge by various other financial regulatory authorities, domestic and foreign, of their functions.\textsuperscript{458} Information disclosed to other financial regulators must not be used by them for any other purpose, otherwise a criminal offence is committed.\textsuperscript{459} Although disclosure of information by the Bank to the Treasury is exceptionally allowed where this appears

\textsuperscript{455} Banking Act 1987, s.82(1). S.86, as replaced by the Banking Coordination (Second Council Directive) Regulations 1992, S.I. 1992/3218, reg.41, extends the duty of confidentiality to include information supplied to the Bank by overseas supervisory authorities. Where the information has been received from the regulatory authorities of another Member State or through the Bank's own "on the spot" investigations in another Member State, the same provision also restricts its further disclosure by the Bank to other U.K. regulatory authorities without the consent of that Member State's regulatory authorities, even in circumstances where disclosure of information acquired by the Bank domestically would be permitted under s.84. See also s.87, as amended by S.I. 1992/3218, reg.42.

\textsuperscript{456} S.82(3).

\textsuperscript{457} S.82(2). On the basis of Lightman J.'s judicial interpretation of s.179 of the Financial Services Act 1986 (which by use of very similar terms imposes on the Securities and Investments Board a statutory duty of confidentiality with regards to information obtained by it for the purposes of, or in discharge of, its regulatory functions under that Act), it would appear that the Bank is free to express opinions and deductions based on supervisory information, provided that these do not amount to the disclosure of the information itself. The Bank would also appear to be entitled to disseminate information relating to its own investigations, inquiries and other actions, and not to the business or affairs of its regulatees, since these types of communication are not covered by the statutory duty. Moreover, the Bank has no duty to refrain from procuring or inducing persons who happen to possess relevant information and who are not subject to the same restrictions on disclosure to make that information publicly available, even though it could not lawfully do so itself. Melton Medes Ltd. v. Securities & Investments Board [1995] 3 All E.R. 880 (Ch.D.), pp.891-894.

\textsuperscript{458} Ss.83-85, as amended, in particular by S.I. 1992/3218, reg.38-40. The range of permissible "gateways" is strictly restricted under European law; see supra, n.454.

\textsuperscript{459} S.83(8)-(9), added by S.I. 1992/3218, reg.39(4).
to the Bank to be necessary for the protection of depositors, a broader defence of
disclosure in the public interest does not seem to be available. In particular, it
would not be acceptable for the Bank or its individual officers to release to the
public information relating to the business of a specific person or institution. Nor
could the public-interest defence assist an individual employee of the Bank who,
having committed a criminal offence by disclosing such information, invokes the
defence in the context of civil proceedings, so as to avoid his dismissal for breach of
confidence.

It is interesting to note that, even though the public disclosure of confidential
information on the part of the Bank is strictly prohibited, the information itself may
be discoverable at the hands of the authorised institution to which it relates. In a
recent case, Mrs. Justice Arden rejected a claim that confidential reports disclosed
voluntarily by a bank to the Securities and Futures Authority ("S.F.A.") (a
regulatory body of which the bank was a member for the purposes of the Financial
Services Act 1986) and providing full and frank accounts of its affairs were covered
by public-interest immunity as a class, so that their production could not be
requested in litigation commenced by the bank's clients. Her Ladyship felt entitled to
depart from a contrary earlier decision concerning the correspondence of another
self-regulatory organisation in the securities field, because in the meantime the
House of Lords had established that a new class claim to public-interest immunity
would be justified only if the proper functioning of the public service required the
withholding of the whole class. Insofar as reports to the S.F.A. were concerned,

460 S.84(5), as replaced by S.I. 1992/3218, reg.39(2).
461 The general exception of s.83(1), which permits disclosures "for the purpose of enabling or
assisting the Bank to discharge (a) its functions under this Act; (b) its functions as a monetary
authority; or (c) its functions as a supervisor of money market and gilt market institutions",
should cover reasonable disclosures, not only to other authorities or to auditors, liquidators, etc.,
but also to private parties who may be able under the circumstances to assist the Bank in
assessing the relevance of confidential information or in any other manner. See R. v. Monopolies
and Mergers Commission, exp. Elders IXL Ltd. [1987] 1 W.L.R. 1221 (Q.B.D.). However,
European law appears to preclude such disclosures to private parties, regardless of their
usefulness for the performance of the Bank's regulatory functions. At any rate, the general
exception cannot justify a policy of public disclosure of information relating to the regulated
institutions with the aim of promoting market discipline, since such a policy would render the
regulatory duty of confidentiality redundant.
462 For a critical account of the broader situation, see Y. Cripps, "Disclosure in the public interest:
463 But cf. Cripps, ibid., pp.612-613, who seems to suggest that the two matters, i.e. the violation
of a criminal provision and the availability of the defence in private law, should be addressed
separately.
464 Kaufmann v. Credit Lyonnais Bank, The Times, 1 Feb. 1995 (Ch.D.). See also M. Andenas,
"Regulators, the regulated and private litigants: public interest privilege against disclosure?"
the argument was that, if the documents were not immune, regulatees would be extremely cautious when voluntarily providing information to regulators and that this could have grave consequences for a body such as the S.F.A., which relied on information received by the regulatees in discharge of its functions and did not have the resources for conducting its own investigations in all cases. This argument failed for a number of reasons: a communication might only cover matters that a regulated firm was at any rate under an obligation to disclose, in which case questions of confidentiality would not enter into the calculation of the firm, whose overriding motive would be to comply with the rules in order to preserve its authorised status; a communication might be untrue or misleading, in which case a class immunity would facilitate the deception; and a class immunity would be open to abuse by those who would include in their reports all sensitive information affecting impending civil litigation. Accordingly, immunity could only be claimed if a need for withholding information in a report could be specifically demonstrated.

(c) The Bank's relationship with auditors and reporting accountants. In the absence of a system of regular bank inspections or examinations, the attempts to ensure the quality and accuracy of the information provided by the management of authorised institutions to the Bank have resulted in an increasingly close involvement of bank auditors in the supervisory process, with major implications for the nature of the audit function and the professional responsibilities of the accountancy profession in the area of banking.

As has been already explained, until 1987 banking supervision relied primarily on prudential returns and other disclosures made voluntarily by the management of authorised institutions. This practice, however, was wide open to abuse. Bank auditors did not audit the prudential returns, nor did they prepare special reports for the Bank. As for their formal annual report, this might not give sufficient warning of detected shortcomings, because of the aforementioned reluctance of auditors to qualify bank accounts. The collapse of Johnson Matthey Bankers attracted attention to the possibility of auditors' failure to conduct detailed inquiries regarding the quality of bank loans or the quality and the effectiveness of internal controls, and proved that in certain cases the Bank's reliance on bank auditing in these areas and its confidence as to the accuracy of prudential returns could be totally unjustified. In view of this lesson, and in order to ensure increased accuracy of regulatory information, more detailed statutory arrangements were introduced, opening the way

for a direct involvement of bank auditors in the supervisory process, in the effective role of surrogate bank examiners.469

At the simplest level, the Banking Act 1987 imposes a duty on authorised institutions to notify forthwith the Bank if they intend to replace their auditors or if the latter have resigned. A similar obligation has been imposed on bank auditors themselves to notify the Bank if they decide to resign, not to seek re-appointment or to qualify an institution's accounts.470 The notification of all changes of bank auditors is necessary, because, once it is taken into consideration that bank auditors may prefer to resign from their position rather than issue a qualified report, such changes can serve as a very important warning signal that a bank is in trouble.

Much more significant, however, is the Bank's power under the Banking Act to require authorised institutions to produce reports prepared by an approved accountant or other professional person and covering specific matters of regulatory interest.471 Since 1987, the Bank has placed increasing reliance on this power. Although technically the reporting accountant or professional is appointed and instructed by the institution in question, which also bears all related expenses, he is nominated or approved by the Bank.472 Any aspect of the institution's business can form the subject of an ad hoc report. In practice, however, the Bank uses this power as a tool for broadening the scope of bank auditing by requiring the production of certain reports on a regular basis. Thus, regular reports are required (a) on the accounting and other records and internal control systems of authorised institutions,473 and (b) on the accuracy of the regulatory returns on which the Bank

---

469 The closer relationship between bank supervisors and auditors reflects a broader trend in financial regulation; see Building Societies Act 1986, s.82(8)-(9); Financial Services Act 1986, s.109(1)-(2) and (5); Insurance Companies Act 1982, s.21A(1)-(3) (inserted by the Financial Services Act 1986, s.135(1)); and Friendly Societies Act 1992, s.79(8)-(9).

470 S.46. The provision applies also to former authorised institutions.

471 S.39(1)(b). The production of similar reports may be demanded from applicants for authorisation as a means of verifying the information provided by them to the Bank; s.8(5).

472 S.39(2). It would appear that the Bank approves the appointment only of accountants coming from a very selective list of accountancy firms, especially the largest ones. The focus seems to be on the firms themselves, rather than on the individual partners responsible for the auditing work.

473 Reporting accountants must form an opinion on whether the relevant institution's records and control systems are maintained in appropriate fashion, in accordance with the Bank's interpretation of the statutory requirements. They must make an overall assessment of the control environment for the business area that they are asked to examine on the basis of an identification of the key risks faced by the institution and the key controls in operation. The Bank does not expect the reports (which must be made in a standard form) to be unqualified. Instead, they must point to any matters which have come to the accountants' attention. Especially, they must draw attention to the non-existence of particular records and systems that should exist in the accountants' opinion, to significant weaknesses in, or failures of, certain records and systems during the period examined or to the presence of factors that prevent the accountants from forming an opinion on particular matters. The reporting accountants are not expected to assess the quality of the institution's management and banking decisions, since this is a matter for the Bank. Reports on records and systems are required at least annually from all institutions. In the
relies for its regulatory decision-making, and which would not otherwise be subject to auditing requirements. In normal situations, the auditors of authorised institutions are expected to double as reporting accountants, because most institutions would not be content with the involvement in their affairs of a second firm of accountants, but also because the auditors have greater familiarity and a better understanding of an institution's business than outside accountants. In this manner, a parallel system of bank auditing is put in place, for the specific purpose of assisting the Bank's supervisory work.

The attempt to use auditors as surrogate bank examiners transforms the traditional relationship between auditors and their clients, and sets the ground for an extension of professional liability. It is implicit in the statutory arrangements that auditors and reporting accountants should raise with their clients points of concern regarding compliance with the regulatory requirements of which they have become aware in the performance of their professional duties, and that they should press them to communicate such points to the Bank; failing that, they should communicate their concerns directly to the Bank. For this reason, and to remove any doubt that

---

474 Reporting accountants are required to report whether, in their opinion, the information contained in the returns reflects in full the information contained in the accounting and other records, is accurate, prepared in accordance with the Bank's instructions and, in the case of domestic institutions, prepared using the same accounting policies as those used for the latest statutory accounts. For this purpose, they must have a proper understanding of the Bank's general reporting instructions and policy notices and any further rulings agreed in writing between the Bank and the individual institution in question. Currently, reporting accountants are not required to form an opinion on the quality of the information contained in the institution's records. However, they must be aware of the requirement for institutions to maintain adequate records and control systems, as well as of the most recent reporting accountants' report on such records and systems. If they conclude that the returns contain material errors or omissions, they must invite the management to bring the matter to the attention of the Bank. Failing that, they must bring directly the matter to the Bank. All relevant types of returns are examined over a period of time, which will vary from one institution to another. In determining the frequency and timing of examinations, the Bank takes into consideration the cost to the institution in terms of management time and accountants' fees. After consultation with the institution, the Bank will specify in writing the particular returns that it wishes to have examined in each case and the level of materiality that should be taken into account in the report. "Guidance Note on Reporting Accountants' Reports on Bank of England Returns Used for Prudential Purposes" (BSD/1987/3, Oct. 1987).

might exist in common law as to the position with regard to disclosures in the public interest,476 the Banking Act 1987 removed the auditors' duty of confidentiality to their client institution in connection with the communication by them in good faith (but not maliciously or in bad faith) to the Bank,477 whether or not in response to the latter's specific request, of any information or opinion of which they have become aware in their professional capacity and which is relevant to the Bank's regulatory functions.478

From the supervisors' standpoint, a significant limitation of the provision in its original form was that it did not impose a positive duty to make such communications,479 although there was a clear expectation that auditors would cooperate with the Bank in regulatory matters. In fact, the statutory solution entailed a compromise between the Bank's interest in ensuring effective cooperation by the accountancy profession and the latter's justified fear of liability resulting from a fully fledged statutory duty.480 It was envisaged that the accountants' part of the compromise would be enforced through self-regulation, by means of non-statutory guidelines issued by their professional bodies.481 Nonetheless, to cover the possibility that the self-regulatory rules or guidance issued by these bodies would prove to be unsatisfactory, the Banking Act vested a residual rule-making power on the Treasury to issue regulations, after consultation with the Bank, the bodies representing the accountancy profession and the authorised institutions, and subject to approval by

476 During the discussion of the relevant clause of the Banking Bill in the House of Lords, Lord Denning observed that "[i]t is in the nature of the duty of auditors that sometimes they have to break the confidence they owe to their client in order to further the ends of justice. [...] In law they are adequately protected by what lawyers call 'qualified privilege'; they are only liable for actions for defamation if they abuse that privilege by virtue of malice without reasonable cause. However, [...] it may be that they also need protection against unfounded claims for negligence"; H.L. (5th. Series) Vol.486, col.1263.

477 Paradoxically, the common law may be more liberal than the Act in this respect, because it permits disclosures of information to the regulatory authorities by persons subject to a duty of confidentiality even when the latter are motivated by malice, on the ground that there is a superior public interest in the detection of possible breaches of the regulatory system and of similar legal requirements; Re a Company's Application [1989] 2 All E.R. 248 (Ch.D.).

478 S.47(1)-(2). The provision also applies to the auditor's of former authorised institutions. See also ss.83(2) and 85(1)(b), with regard to the communication of confidential supervisory information by the Bank to bank auditors and reporting accountants.

479 It must be noted, however, that auditors and reporting accountants who would actually provide, either directly or indirectly, false or misleading information to the Bank knowingly or recklessly, were always subject to the criminal sanctions of s.94. Furthermore, bank auditors, as any other person connected with an authorised institution, were always under a duty to cooperate with an investigation under s.41; s.41(5).


481 This implied the subjection of auditors who fail to make communications in appropriate circumstances to disciplinary measures. Under the original s.85(1)(g), the Bank had the power to pass information to the relevant professional body with a view to facilitate disciplinary proceedings against inadequate auditors, but this power was removed by S.I. 1992/3218, reg.40(1), so as to bring disclosure "gateways" in line with E.C. requirements.
both Houses of Parliament, specifying the circumstances in which the communication of matters of supervisory interest by accountants to the Bank would be mandatory.\textsuperscript{482}

In March 1989, the Auditing Practices Committee\textsuperscript{483} issued its guideline on bank auditing,\textsuperscript{484} with the approval of the Bank and the Treasury.\textsuperscript{485} In fact, the guideline was phrased in very similar terms to the Bank's notices on the subject, and in many cases repeated them verbatim; its practical effect was to transform these notices into an accepted professional practice and to make compliance with them a disciplinary matter. Initially, this was considered sufficient, and the imposition on auditors of a positive duty to report was avoided. However, following the B.C.C.I. debacle the authorities reconsidered their position as part of a broader "toughening" of supervisory practices. Although it was recognised that a professional duty to report in appropriate circumstances was already in existence as a result of the guideline, the imposition of a positive statutory duty to this effect was recommended by Lord Justice Bingham in his report on the affair, and accepted by the government and the Bank.\textsuperscript{486}

Secondary legislation introducing a duty to report apparent irregularities under appropriate circumstances came into force on 1 May 1994.\textsuperscript{487} The U.K. developments anticipated by a full year the imposition of a duty on similar lines at the European level, with the adoption of the new Directive on the Reinforcement of Prudential Supervision.\textsuperscript{488} Under the new domestic provisions, bank auditors and reporting accountants are obliged to report to the Bank their concerns whenever they have reasonable cause to believe that any of the minimum criteria for authorisation as a deposit-taker has been breached in respect of their client institution and that the matter is likely to be of "material significance" for the exercise of the Bank's regulatory functions. A similar duty to alert regulators to the existence of detected irregularities has also been imposed, under separate statutory instruments, on the auditors of all regulated institutions of the broader financial sector, \textit{i.e.} building societies, financial-services firms, insurance companies and

\textsuperscript{482} S.47(5)-(6).
\textsuperscript{483} Now the Auditing Practices Board.
\textsuperscript{484} Auditing Guideline 307, \textit{loc.cit.}, n.475.
\textsuperscript{485} \textit{Ibid.}, Preface.
\textsuperscript{488} Directive on the Reinforcement of Prudential Supervision (the Post-B.C.C.I. Directive), art.5 (inserting, inter alia, a new art.12A to the First Banking Directive). The new European duty must be transposed in the national laws of the Member States by 18 July 1996; art.6.
friendly societies, on the ground that it would be wrong to treat differently auditors' duties in each regulated area, when in practice many institutions are active across sectional lines.

Significantly, the new duty is framed in terms that do not necessitate an expansion of the scope of the audit in a more proactive direction, e.g. by implying a duty to actively seek out evidence of fraud. Moreover, irregularities are reportable, not when they are merely relevant to the observance of the authorisation criteria, but only when they appear to the auditors to be of material significance to regulators. This leaves the effective interpretation and individuation of the duty primarily to the discretion of the accountancy professional bodies and of individual bank auditors.

The Auditing Practices Board has published a Statement of Auditing Standards, which provides guidance to auditors regarding the application of the new duty.

The duty is enforceable by the accountancy bodies as a disciplinary matter. Conceivably, auditors who fail to comply may also be exposed to criminal liability for breach of a public duty, although the position in this regard is not clear. In

---


491 ibid., paras.16-19 and 30.

492 Statement of Auditing Standards 620, "The Auditors' Right and Duty to Report to Regulators in the Financial Sector" (Mar. 1994). The Statement applies to the auditors of all regulated companies of the broader financial sector. According to the Statement, the auditors of regulated firms should prepare for the audit by obtaining an understanding of their client company's current activities, the scope of its authorisation and the effectiveness of its control systems (including its organisational structure, methods for assigning authority and responsibility, ways in which its management operates, functions of its board of directors, and methods used for its internal controls and internal audits). They should also acquire sufficient understanding of regulatory requirements to enable them to identify reportable matters. When they discover apparent breaches of these requirements, the auditors must obtain the available evidence in order to assess the implications for their reporting duties. If they determine that the breaches are of material significance, they must report promptly the matter in a way that will facilitate appropriate action by the regulators. Normally, they must first inform the directors of their client company and ensure their agreement; but if they have doubts about the integrity or competence of the directors, they must make their report to the regulators without notifying them. The specific implications of the duty in the context of each of the five statutory frameworks are the subject of further elaboration in separate practice notes. Practice Note 3, "The Auditors' Right and Duty to Report to the Bank of England" (Mar. 1994), which replaces paras.171-191 of Auditing Guideline 307, loc.cit., n.475, concerns the circumstances under which an auditor or reporting accountant should report matters of concern to the Bank. The Note provides guidance to auditors for the assessment of an authorised institution's compliance with the criteria for authorisation of Sch.3 of the Banking Act and states that an infringement of the criteria is normally reportable if, due to its nature or impact on the institution's financial position, it is likely to require investigation by the Bank. The final judgement on whether a matter is reportable is left to the relevant auditor or reporting accountant, but the Note gives examples of situations where a report should be made.
contrast with the Financial Services and Insurance Companies Acts, under which the Securities and Investments Board and the Secretary of State for Trade, respectively, can disqualify an auditor from being employed by firms authorised under these statutes, the Banking Act does not provide statutory sanctions. There is a view that auditors who fail to report a matter to the Bank in appropriate circumstances could be liable in negligence.\(^{493}\) Nonetheless, in view of the restrictive judicial approach to auditors' professional liability, it is not clear who could bring an action for this type of breach of professional duty. Depositors and other creditors would probably not have a cause of action, because auditors owe a duty of care only to their client company and the general body of shareholders, but not to third parties.\(^{494}\) Such persons could only recover if it were accepted that the new reporting duty has been established for their specific private benefit, rather than for the benefit of the supervisory process or in the general public interest\(^{495}\); this, however, appears unlikely. However, even an action by the client bank could stumble on questions of causation, since the failure of auditors to disclose to the regulatory authorities information that could lead to the withdrawal of authorisation is not necessarily a source of loss for the institution concerned.

The prudential returns of authorised institutions and the meetings between their senior management and supervisors remain the Bank's main sources of information. However, the Bank expects bank auditors and reporting accountants to play a direct role in the regular supervisory process. This role is performed through: the preparation by reporting accountants of reports on the accounting and other records and control systems, prudential returns or any other aspect of their client institution's affairs, according to the Bank's directions; the participation of auditors and reporting accountants in trilateral discussions with the Bank and the management of the institution for the purpose of discussing, respectively, that institution's statutory accounts and the auditors' report thereon, or the reporting accountants' reports and the scope of the following year's examination of records and accounts; and, exceptionally, the direct reporting to, and bilateral discussion with, the Bank of matters of concern, either with or without the institution's knowledge, including the reporting of irregularities of material significance in compliance with the statutory duty.\(^{496}\) Insofar as trilateral contacts are concerned, in addition to the regular

---

\(^{493}\) See \textit{ibid.}, para.23; and McGuire, \textit{loc.cit.}, n.452, p.684.

\(^{494}\) See \textit{Caparo Industries PLC v. Dickman} [1990] 1 All E.R. 568 (HL); and Bingham Report, \textit{loc.cit.}, n.302, paras.3.40-3.42.


meetings, ad hoc meetings can take place on the request of any party whenever this appears appropriate. After each trilateral meeting, the Bank prepares minutes which are confirmed by the other parties and where the points of agreement regarding the future conduct of the institution and its auditors are set out.\footnote{Ibid., paras.9-10.}

Although the Banking Act leaves the door open for direct bilateral communications between bank auditors and the Bank, the Bank recognises that accountants should not be asked to act in ways that would undermine their professional relationship with their clients. Accordingly, it continues to place the primary responsibility for conveying any relevant information to the authorised institutions themselves. If the auditors or reporting accountants feel that there are matters that need to be reported to the Bank, they should normally ask their client institution to bring these matters to the Bank itself. This could be the case, for instance, where the auditors or reporting accountants come across evidence of breaches of the institution's capital-adequacy or liquidity requirements, of weaknesses in its systems and controls which hinder the effective monitoring and control of significant risks, or of imprudent managerial decisions.\footnote{Ibid., paras.16-18 and 23-25.}

Only in exceptional circumstances, where the interests of depositors require that the institution's management should not be informed in advance, should the auditors or reporting accountants communicate directly to the Bank matters of concern, without first notifying the management. In particular, the direct reporting of their concerns will be appropriate if they have lost confidence in the integrity of the institution's directors or senior managers, or in their competence to conduct its business in a prudent manner; or if the institution has failed to inform the Bank of a particular matter, even though it was advised by the auditors or reporting accountants to do so.\footnote{Ibid., paras.20 and 22.}

With regard to the performance of their professional tasks, the Bank does not expect auditors and reporting accountants to change the scope of their examination or to actively seek out potential instances of reportable misconduct. Only when they discover in the ordinary course of their auditing work an occurrence that raises concerns as to the fulfilment of the authorisation criteria, are the auditors expected to make detailed enquiries, in which case they must keep in mind the statutory provisions and the likelihood that the reporting of the matter to the Bank may be appropriate.\footnote{Ibid., paras.15 and 19. On the professional tasks of bank auditors and reporting accountants, see also Auditing Guideline 307, loc.cit., n.475, paras.16-65, and paras.66-170, respectively; in paras.77-88, the differences between expressing an opinion on records and control systems for auditing and reporting purposes are explained.}
In spite of the marked reluctance to resort to direct bilateral contacts between auditors and supervisors, it remains the case that the regulatory arrangements superimpose on the normal professional duties of the auditors of banks and other firms of the broader financial sector special responsibilities of a public nature. In general company law, notwithstanding the trend towards more comprehensive disclosures in financial statements and the recognition that such statements may have a broad range of users, it is clearly established that the professional duties of accountants are owed exclusively to their client company, i.e. to the general body of shareholders or to its liquidators, and not to its creditors, bondholders, customers, employees, or any other person.  

In comparison, in the financial sector the auditing function has acquired a new dimension, through the imposition of supervisory reporting requirements and the attempt of regulatory agencies to allocate to auditors responsibilities relating to the monitoring of regulated institutions. There are potential tensions between the duty owed by auditors to their clients and the primary concern of the regulatory system for the interests of third parties, such as customers and depositors. The recent supervisory arrangements seek to transpose the focus of auditors' duties and produce a fundamental alteration of their professional role and their relationship to their clients, which used to be founded on strict duties of confidentiality.

However, the new system allows auditors a considerable degree of autonomy in defining their own responsibilities in relation to the supervisory process. The statutory provisions do not impose on auditors an obligation to actively police the observance of the regulatory requirements, but merely to report irregularities that are detected in the course of their ordinary audit work. There is also a significant discretionary element in the duty to report, since the question regarding the

501 In this context, the common law addresses the auditing function from a strictly internal perspective as a mechanism for assisting the shareholders in exercising corporate control; see Al Saudi Banque v. Clarke Pixley [1990] Ch. 313 (Ch.D.); and Caparo Industries PLC v. Dickman [1990] 1 All E.R. 568 (HL). The prevailing judicial approach is not necessarily supported by the historical evidence, which suggests that auditing is intended to play a role in sustaining orderly markets in shares. However, it reflects a well-grounded reluctance to subject the accountancy profession to indeterminate liability and a desire to close the "expectations gap" between the public's and the accountancy profession's perceptions of the role of audit by lowering the expectations of the former. Nonetheless, there are significant pressures for the expansion of the professional responsibilities and liability of auditors, to bring their legal position closer to the expectations of accounts-users. See, e.g., the discussion document of the Auditing Practices Board, "The Future Development of Auditing" (Nov. 1992); M.J.B. Hall, Handbook of Banking Regulation and Supervision (2d. ed., 1993), pp.179-186; and H. Cohen, "Auditors' liability for negligence: a time for reform?" (1993) 8 J.I.B.L. 133.

materiality of detected breaches of the statutory criteria is left to the judgement of the auditors. The guidelines of their professional organisations play an important role in the interpretation of the relevant provisions. In this manner, the increase in the liability of auditors as a result of the introduction of the new duty may be relatively modest. Thus, the delegation to auditors of supervisory functions of a public nature does not remove their professional control over the scope of their work, but merely increases their autonomy with regard to their clients. In terms of the quality of the auditing function, this could be counterproductive, since in some cases the links with the supervisory authorities could make the management of regulated institutions distrustful of their auditors and less willing to co-operate with them.503

Significantly, the transformation of the auditing function does not form part of a broader policy aimed at improving the quality of published financial information and the contribution of auditing to it. Instead, the authorities converge with the management and auditors of regulated institutions in legitimising secrecy, on the ground that this is necessary for the preservation of "market confidence". This is inconsistent with the proper aims of company accounting and the deepening of market discipline, and shows that the primary aim of the authorities' effort to get auditors involved in the regulatory process is simply to shift the costs of supervision and the responsibility for their discretionary regulatory judgements.

Moreover, it should be noted that the nature of the practical auditing work does not always address the concerns of regulators. Auditors are largely restricted to the verification of data concerning a past financial period, visit their client firms only sporadically, and are not required to comment on the competence or behaviour of their management. For these reasons, they may not be effective in the role of bank examiners, especially insofar as the detection or prevention of fraud is concerned. There is a danger that the tendency to transfer to auditors supervisory responsibilities, especially through the introduction of the new duty to report detected shortcomings of prudential concern, can result, by overemphasising the practical ability of auditors to prevent financial wrongdoing, in a new expectations gap.

(d) The Bank's role in prosecutions and enforcement proceedings under the Banking Act. The Banking Act punishes a wide variety of regulatory infringements with criminal sanctions. Offences created by the Act include: the violation of the restriction on the acceptance of deposits by unauthorised persons, as well as the

making by them of false statements as to authorised status; the failure of authorised institutions to comply with any requirement or prohibition imposed on them in the form of a restriction on their authorisation, or with a direction given by the Bank in connection to the revocation or surrender of their authorisation; the acquisition of controlling interests in authorised institutions without the Bank's consent; the contravention of advertisement regulations and directions; the making of fraudulent inducements to make deposits; the contravention of the restriction on the use of banking names and descriptions by unauthorised persons, or of names to which the Bank has objected by authorised institutions; the contravention of various notification and disclosure requirements imposed on authorised institutions, their controllers and significant shareholders, or their auditors; the failure of authorised institutions, suspected unauthorised deposit-takers, or any other person in possession of relevant information, to comply with a requirement to provide information or produce documents to the Bank or its appointed investigators without reasonable excuse, as well as the intentional obstruction of investigators exercising rights of entry or the tampering with of documents relevant to an investigation; the provision of false or misleading information to the Bank; the contravention by overseas institutions with representative offices in the U.K. of certain notification and other requirements or the use by such offices of corporate names to which to which the Bank has objected; and the disclosure of confidential regulatory information without the consent of the person to whom it relates or from whom it was received. If an offence has been committed by a body corporate, and a director, manager or other officer has consented to it or has contributed to it through neglect of his duties, that person is also liable. It is, however, a defence for any person charged for an offence under the Act to prove that "he took all reasonable precautions and exercised all due diligence to avoid the commission of such an offence by himself or any person under his control".

504 Ss.3(2), 18(3).
505 Ss.12(6), 19(6).
506 S.25(1), (3).
507 Ss.32(3), 33(6), 34(3).
508 S.35(1).
509 S.73.
510 Ss.25(1)-(2), 36(4), 36A(3), 37(3), 37A(3), 38(9), 45(2), 46(5).
511 Ss.39(11), 40(3), 41(9), 42(4), 43(5), 44(1).
512 S.94(1)-(4).
513 S.81.
514 S.82(3). This offence will generally be committed by the Bank's own officers and agents.
515 S.96(1)-(2). See also s.98(6)-(7), with regard to unincorporated associations.
516 S.96(4).
The Bank has been given a decisive prosecutorial role in the enforcement of the Banking Act's criminal provisions. Criminal proceedings for any offence under the Act can only be instituted by, or with the consent of, the Bank or the Director of Public Prosecutions. When an infringement of one of the major statutory offences appears to have been committed, the Bank can also apply for an injunction freezing the assets of suspected contravenors. Preventively, the Bank can apply to the High Court for an injunction restraining the commission of these offences. The court will grant the injunction if there is a "reasonable likelihood" that a contravention will be committed, particularly in cases of threatened recidivism.

In cases where the commission of unauthorised deposit-taking has been established, the Bank can apply to the High Court for an order requiring the repayment of the deposits by the deposit-taker or any other person who appears "to have been knowingly concerned in the contravention", or appointing a receiver to recover them. In deciding if and on what terms to make an order, the court must take into consideration the possible impact on the solvency of the person concerned and on his ability to satisfy his other creditors. Moreover, the Bank can apply for an order to compel the payment of any profits from the unauthorised deposit-taking into court or to an appointed receiver. On an application of this type, as a means of determining the amount of the profits, the court may require the person concerned to furnish it with accounts and other relevant information. Any amount recovered in pursuance of such orders is distributable to the depositors according to the directions of the court.

A claim of ultra vires could be used in appropriate circumstances as a defence in enforcement proceedings brought by the Bank under the Banking Act. For instance, on a criminal prosecution for violation of a direction given by the Bank, the defendant institution could claim that it had no obligation to conform because the direction had been given invalidly; on a prosecution for contravention of an

---

517 S.96(5)(a).
518 I.e., the contravention of the statutory prohibitions on unauthorised deposit-taking, false statements as to authorised status, fraudulent inducements to make deposits or the illicit use of banking names and descriptions; or the contravention of an advertisement regulation or of a direction given by the Bank in the context of the revocation or surrender of an institution's authorisation.
520 S.93(1), (3).
521 S.48. One can be "knowingly concerned" in a contravention of s.3 without being involved as principal (owner or manager) in the deposit-taking business. For instance, a solicitor who assists the unauthorised business may be liable for the repayment of deposits. See Securities and Investments Board v. Pantell S.A. (No. 2) [1991] 4 All E.R. 883 (Ch.D.).
522 S.49.
advertisement regulation, that the regulation was illegal; and, on a prosecution for
the obstruction of Bank-appointed investigators exercising rights of entry, that there
were no reasonable grounds for the search. Also, on an application by the Bank for
an order for the sale of the shares of a person who, in contravention of its objection
to his fitness, has become or remains a shareholder controller of an authorised
institution, this person could dispute the objection's validity.\footnote{523}

Nonetheless, the defence must be genuine and substantive, \textit{i.e.} it must be claimed
that, as a consequence of the invalidity, the actions of the defendant do not amount
to a criminal offence or civil wrong, as alleged by the Bank. Accordingly, the
invalidity of the Bank's decision to commence a prosecution cannot be relied upon
by the defendant in the ensuing proceedings, because it does not provide a defence
"in the true sense" of a defence on the merits, but is only a preliminary challenge in
public law, which should be conducted by way of judicial review.\footnote{524}

Although \textit{O'Reilly v. Mackman}\footnote{525} establishes that normally judicial review is the
only appropriate procedure for raising public-law issues, raising such issues as a
defence is an exception to the rule.\footnote{526} In \textit{Wandsworth London Borough Council v. Winder},\footnote{527} in civil proceedings brought by the council for arrears of rent and
possession of the defendant's flat, the latter raised by way of defence the claim that
the resolutions and notices concerning an increase of his rent were \textit{ultra vires} and
that this entitled him to refuse to pay. The House of Lords, distinguishing \textit{O'Reilly},
unanimously accepted that it was proper for the defendant to challenge the conduct
of the administration, even though the question of invalidity was not merely a
collateral matter, but the whole basis of his defence.\footnote{528} Although the challenge could
have been brought by way of judicial review, the defendant's behaviour could not be
regarded as an abuse of process, because he had not selected the procedure, but
merely sought to defend himself.\footnote{529} Furthermore, it was thought that the defendant
was vindicating a pre-existing private-law (contractual) right to continue to occupy
his flat and, as a general principle, any private-law right that a litigant invokes should
not be adversely affected \textit{sub silentio} by a procedural requirement to proceed by

\footnote{523 The defence could even be available against the Bank's applications for interlocutory relief in
relation to enforcement proceedings, but at that stage a strong \textit{prima facie} case of invalidity may
be necessary for its success. See \textit{Hoffman-La Roche v. Secretary of State for Trade and Industry}
[1975] A.C. 295 (H.L.).}

\footnote{524 \textit{Waverley Borough Council v. Hilden} [1988] 1 W.L.R. 246 (Ch.D.), pp.259-260; approved in

\footnote{525 [1983] 2 A.C. 461 (H.L.).}

\footnote{526 See C. Emery, "The \textit{vires} defense - 'ultra vires' as a defense to criminal and civil proceedings"
(1992) 51 C.L.J. 308.}

\footnote{527 [1985] A.C. 461 (H.L.).}

\footnote{528 \textit{Ibid.}, p.508.}

\footnote{529 \textit{Ibid.}, p.509.}
way of judicial review. 530 The relationship between the two grounds for the decision in Winder is not clear. Thus, it is questionable whether the invocation of some pre-existing private right which is defeated by the allegedly invalid decision 531 is a necessary element of the defence or whether the defence is, instead, based simply on an unqualified right of citizens to defend themselves against unfounded claims by every means available.

The raising of vires issues by way of defence has also been questioned in criminal cases, but the judicial responses are contradictory. In one case concerning the carrying on of a business without the necessary license, the court endorsed the narrow approach and rejected a defence based on the invalidity of the decision that refused the defendant his license: until successfully impugned in judicial-review proceedings, licensing decisions should be presumed to be validly made unless they were invalid on their face. 532 In other cases, however, it has been accepted that, even where no infringement of the defendant's pre-existing private rights has taken place, the raising by way of defence against a criminal prosecution of the invalidity of the delegated legislation or bylaws on which that prosecution is based, is still possible 533 - at least to the extent that the grounds for the invalidity are substantive and not merely procedural. 534

---

530 Ibid., p.509-510. Nonetheless, it is doubtful whether the defendant in Winder had indeed a private right, as alleged. His "right" to occupy his flat was contingent on the payment of such rent as was determined by the authority in its managerial capacity. In this sense, the position was comparable to that in Cocks v. Thanet District Council [1983] 2 A.C. 286 (H.L.), where it was held that, where an administrative decision in the applicant's favour is necessary for the creation of a private right, a decision rejecting the application may only be attacked by way of judicial review. See also Ali v. Tower Hamlets London Borough Council [1992] 3 All E.R. 512 (C.A.). For criticism of Winder, see Sir Harry Woolf, "Public law - private law: why the divide?" [1986] P.L. 220, pp.233-235.


213
Chapter 3

Regulatory Policies and Residual Discretion of the Bank of England

Growing formalisation has been one of the most important trends in banking regulation since 1979. The legislative overhaul of 1987 and the national implementation of the European banking directives, by means of secondary legislation and notices issued by the Bank of England, have been instrumental in this context. Even in areas where general rules have not yet emerged, the Bank's discretionary power has been structured to a considerable degree through the elaboration of increasingly detailed prudential policies (section 1).

Nonetheless, the retention of discretion in relation to certain matters of strategic importance enable the Bank to exercise, in the course of translating its key prudential policies into concrete decisions affecting individual institutions, a substantial degree of control over the latter's general conduct and viability, with little fear of external review of its actions. In this connection, the determination of the precise financial requirements that must be observed by authorised institutions demands special attention (section 2). The Bank enjoys an even wider power to resolve whether bank controllers, managers and directors are "fit and proper persons" to hold their positions (section 3).

As a rule, the Bank does not attempt to exert influence over the details of the conduct of business or to regulate the transactions of authorised institutions. A close day-to-day control of banking activities could not be easily justified on statutory grounds and would probably encounter considerable resistance on the part of regulatees. The major exceptions in this area relate to the Bank's insistence that authorised institutions comply with anti-fraud policies - especially, policies aiming at the eradication of money laundering - and to the prevention of misleading deposit advertisements (section 4).

Ultimately, the Bank has power to determine the survival of banking institutions, either de jure (by deciding whether or not to withdraw their authorisation or present a petition for their winding-up) or de facto (by means of the selective provision of
emergency support or organisation of rescue operations for ailing institutions) (section 5).

Taking into consideration the magnitude of the Bank's discretion in such crucial matters and the dearth of entrenched legal standards to which those wishing to challenge its decisions could appeal, it is perhaps surprising that few concerns are voiced about this state of affairs. A partial explanation can be sought in the Bank's "participatory" style of regulation, which affords opportunities to the banking industry as a whole to influence the development of the broader regulatory policy and to each institution individually to negotiate the specific prudential requirements that should apply to it.

However, due to its lack of transparency, a régime of informal regulator/regulatee co-operation and negotiated enforcement is open to two important forms of abuse. First, the co-operative approach to the determination and application of prudential standards can easily degenerate into the capture of the regulatory system by the regulated industry.\(^1\) Second, it can conceal selective enforcement and, possibly, the arbitrary, discriminatory or particularly harsh treatment of less significant regulatees. If so, its informality and intimacy, by impeding meaningful review of the regulatory decisions against publicly observable standards, could worsen the position of those regulatees who are the victims of discrimination or have other genuine grievances.

1. The legal status of the Bank's policy pronouncements

Under the Banking Act 1987, the Bank is responsible for: (i) determining whether the applicants for authorisation satisfy the statutory criteria; (ii) ensuring that all persons already authorised by it to take deposits continue to comply with these criteria; and (iii) in the event that an authorised institution appears not to satisfy the criteria and thus to threaten the interests of depositors, of deciding on the preferable course of remedial action. In all these cases, the determinations of the Bank concern individual cases. The Act does not contain provisions for the

\(^{1}\) Indeed, the Treasury and Civil Service Committee of the House of Commons has recently expressed a view that the B.C.C.I. and Barings debacles "have given rise to serious concerns as to whether the Bank, as supervisor, is sufficiently divorced from the culture of the banking industry to enable it to operate as a genuinely independent supervisor and regulator"; Treasury and Civil Service Committee, Sixth Report: "The Regulation of Financial Services in the U.K.", H.C. (1994-95) 332-I, para.108.
delegation to the Bank of a power to promulgate secondary rules of law, applicable to deposit-taking institutions as a class.

Nevertheless, when, as in the case of the Banking Act, administrative powers are delegated under broad and imprecise mandates, as a result of the statutory provisions' lack of semantic entrenchment, the decision-maker is left with the responsibility of specifying and articulating the goals and standards for his actions. His power is not confined to the quasi-judicial resolution of the particular cases before him, but extends to the making of discretionary policy judgements. In situations of this type, the elaboration of general policies as guides for the determination of all particular cases to which they are relevant is appropriate.²

It would be unrealistic - and plainly undesirable - to require public bodies to consider each individual case in isolation, directly applying the statutory provisions to the factual circumstances and reaching genuinely ad hoc decisions. Elementary reasons of decision-making coherence and rationality, internal hierarchical control and convenience and practicability compel public bodies to follow consistent interpretations of their mandate and to dispose of their caseload by applying general policies.³ Such policies serve, not only the internal operational needs of the bureaucracy, but also the broader values of good administration.⁴ Provided that they are accessible to the persons affected by them, unsanctioned administrative rules, policies and practices promote certainty and predictability, by bringing to light the considerations and standards employed by the official decision-makers. At the same time, they structure and constrain the effective discretion of the latter, by restricting their ability to depart without good cause from their own practices on particular occasions; this hinders the arbitrary, discriminatory or oppressive treatment of individual cases. Moreover, the open promulgation of policies invites public scrutiny, facilitating potential corrections of the general direction of the administrative process. In contrast, the concealment of the unavoidably patterned character of public action under the pretext of "case-by-case" decision-making impedes meaningful accountability.

The courts have been sensitive to these considerations and have encouraged public bodies to formulate and openly declare general principles in accordance with

⁴ See the classic apology of administrative rule-making by K.C. Davis, Discretionary Justice: A Preliminary Inquiry (1969).
which they propose to exercise their functions. Insofar as the announced policies do not purport to affect matters which are beyond the relevant body's attributed powers, do not reverse or contradict its statutory objectives, but only seek to explain, amplify or supplement them, and are not discriminatory, they can provide a valid basis for the making of formal individual decisions.

In the case of the Bank, the need for transparent policy-making is recognised in the Banking Act itself, which explicitly requires the publication by the Bank of its general regulatory policies in the form of a statement of the principles in accordance with which it intends to interpret the criteria for authorisation specified in Schedule 3 to the Act and grounds for revocation specified in section 11 and to exercise its powers to grant, restrict or withdraw authorisation.

Supplementing this statement, more detailed policies on various matters of prudential interest are set out in notices issued by the Bank's Banking Supervision Division and, following the internal reorganisation of the Bank in July 1994, the Supervision and Surveillance area of the Financial Stability wing. These documents are addressed to the authorised population and are intended to describe the Bank's general approach to particular supervisory issues without, however, committing it to any specific dispositive rules for the determination of individual cases.

In situations where an agency has statutory responsibility for the making of individual determinations, as distinct from a formal rule-making power, the old doctrine against the fettering of administrative discretion prevents the predetermination of its decisions through advance formulation and inflexible application of unsanctioned policies or rules, however appropriate these may appear in the light of the relevant statutory provisions. The origins of the doctrine can be traced to the cases of R. v. Holborn Licensing Justices, ex p. Stratford Catering Co. Ltd. (1926) 136 L.T. 278 (K.B.D.), p.281; R. v. Criminal Injuries Compensation Board, ex p. Ince (1973) 1 W.L.R. 1334 (C.A.), p.1345 per Megaw L.J.; Padfield v. Minister of Agriculture, Fisheries and Food (1968) A.C. 997 (H.L.); Laker Airways Ltd. v. Department of Trade (1977) 1 Q.B. 643 (C.A.).

The Bank published an original statement in May 1988. A modified and updated version appeared in 1993, to which was appended the analogous statement which the Bank is required to make under Sch.3, para.5, of the Banking Coordination (Second Council Directive) Regulations 1992 and which sets out its intentions concerning the exercise of the remedial powers that it retains against European institutions, i.e. institutions from other Member States which carry on business in the U.K. on the basis of their home authorisation; "Statements of Principles: Banking Act 1987; The Banking Coordination (Second Council Directive) Regulations 1992" (May 1993).

traced to an archaic strong distinction between the delegation of legislative functions, on the one hand, and that of discretionary decision-making powers, requiring the appreciation of the concrete circumstances of each particular case, on the other. Under this theory, discretionary decision-makers should not be allowed to "pursue consistency at the expense of the merits of individual cases". Although today it is well-established that this cannot impede the formulation of unsanctioned administrative policies or rules as to the future exercise of discretion, the doctrine continues to exert its influence by imposing an obligation on every discretionary decision-maker, before applying his policy, to afford an opportunity to any person directly affected by this application to make representations, providing reasons why the policy should be abandoned or the particular case should receive exceptional treatment. In one case, Lord Reid, after noting that the adoption of administrative rules is justifiable and desirable and that, in this respect, there is no real difference between a policy and a rule, went on to render the content of this obligation more precisely:

"What the authority must not do is to refuse to listen at all. But a Ministry or large authority may have had to deal already with a multitude of similar applications and then they will almost certainly have evolved a policy so precise that it could be called a rule. There can be no objection to that, provided the authority is always willing to listen to anyone with something new to say - of course I do not mean to say that there need be an oral hearing."  

There is nothing in the Act to suggest that the Bank's position is different in this respect. The Bank may promulgate regulatory rules, the breach of which could justify the taking of corrective action. The effect of its rules, however, can only be presumptive, and possible peculiarities which warrant a modification or exception in specific cases must be accommodated. The exception is the promulgation in notices issued by the Bank, as the responsible national authority, of hard rules where this is necessary for the national implementation of Community provisions on banking regulation.

16 Although this method of implementation has been used repeatedly, its validity must be questioned. For the correct national implementation of Community measures it is essential that the instrument of implementation fully satisfies the requirements of legal clarity and certainty. It is not enough that a Member State complies with the Community obligations by means of mere administrative practices, which by the nature can be changed at the will of the authorities and which do not receive wide publicity; Case 300/81, Commission of the European Communities v. Italian Republic [1983] E.C.R. 449 (E.C.J.); Case 301/81, Commission of the European
Evidently, a regulatory policy tainted by illegality will be unable to form the basis of valid decisions relating to the authorisation of deposit-taking institutions. Indeed, its illegality will constitute a ground for impugning any decision made in pursuance of it. A more difficult question is whether the policies are reviewable per se, as distinct from being reviewable indirectly at the point of their application. In principle, only "decisions" in the sense of acts of the administration purporting to affect the legally recognised interests of third parties can be the subject of judicial review. In his landmark judgement in Council of Civil Service Unions v. Minister for the Civil Service, Lord Diplock defined the limits of the jurisdiction:

"The subject matter of every judicial review is a decision made by some person (or body of persons) whom I will call the 'decision-maker' or else a refusal by him to make a decision. To qualify as a subject for judicial review the decision must have consequences which affect some person (or body of persons) other than the decision-maker, although it may affect him too. It must affect such other person either (a) by altering rights or obligations of that person which are enforceable by or against him in private law or (b) by depriving him of some benefit or advantage [...]".  

In certain cases, however, the courts have exercised their supervisory jurisdiction in situations which did not involve the final and dispositive determination of the applicant's case. In particular, the promulgation of defective interpretations of statutory provisions, or of advice contrary to the law, in circulars issued by the central government and addressed to local or non-departmental authorities or to the public at large has been found to be reviewable. Despite the fact that purely

Communities v. Kingdom of Belgium [1983] E.C.R. 467 (E.C.J.). It is not certain that the Bank's notices, which do not have the formal characteristics of secondary legislation, satisfy the requirements.
17 [1985] I A.C. 374 (H.L.). Although Lord Diplock's dictum provides some direction, the concept of an administrative decision in English law lacks theoretical refinement, precision and certainty. On the difference between abstract decisions and their factual implementation by means of an act of the administration, including its incorporation in a formally executed legal instrument, see D. Oliver, "Void and voidable in administrative law: a problem of legal recognition" (1981) 34 C.L.P. 43, pp.54-58.
18 Id., p.408.
19 Royal College of Nursing v. Department of Health and Social Security [1981] A.C. 800 (H.L.); Gillick v. West Norfolk and Wisbech Area Health Authority [1986] A.C. 112 (H.L.). In his speech in Gillick, pp.192-193, Lord Bridge defined the jurisdictional dilemma faced by the courts when asked to review informal documents containing erroneous legal opinions and outlined the emerging solution: "My difficulty is more fundamental. [...] The memorandum itself has no statutory force whatever. It is not and does not purport to be issued in the exercise of any statutory power or in the performance of any statutory function. It is purely advisory in character and practitioners in the National Health Service are, as a matter of law, in no way bound by it. [...] But I think it must be recognised that the [Royal College of Nursing] decision (whether or not it was so intended) does effect a significant extension of the court's power of judicial review. We must now say that if a government department, in a field of administration in which it exercises responsibility, promulgates in a public document, albeit non-statutory in form, advice which is erroneous in law, then the court, in proceedings in appropriate form commenced by an applicant or plaintiff who possesses the necessary locus standi, has jurisdiction to correct the
advisory documents cannot by themselves have any legal effect, they can lead to the commission of unlawful acts by the recipients. In order to achieve legal certainty and to prevent illegal conduct, the courts will intervene in this case to impede erroneous views from acquiring the aura of official pronouncements. It is not certain that this principle can be extended directly to the internal informal policies of an administrative body: while the defective public pronouncements of the central government which purport to authorise or approve an unlawful result are self-contained and can have independent effects of their own, the flexible policies that public authorities adopt for the disposal of their caseload presuppose the need of concrete application in the form individual decisions whose final outcome they do not formally purport to predetermine, since they allow for ad hoc exceptions. In practice, however, such policies exert considerable normative power and have a substantial effect on the actual decisions and, indirectly, on the interests of those affected by them. For this reason, where they are based on inappropriate considerations, they should be amenable to review at an early stage, independently of any particular decisions made in pursuance of them.

If informal policies, enunciated in the Bank's Statement of Principles or regulatory notices, can provide reasons for regulatory action, the question arises whether they can, conversely, be relied upon by the regulatees as a ground for challenging decisions which are inconsistent with them. It could be generally maintained that unsanctioned policies do not produce independent legal effects, because they are not fully dispositive and lack formal recognition. This could mean that they are not binding on the authorities promulgating them, which can depart freely from them. The courts, however, have been willing to enforce in appropriate
circumstances the consistent and correct application of announced, and not withdrawn, policies. Of course, an authority may decide to abandon an earlier policy, provided that it does so on the basis of relevant considerations - otherwise its discretion would be fettered. Nonetheless, it cannot do so without acknowledging the new position.

A discretionary decision-maker can be bound by his own policies on two grounds. If the decision-maker has undertaken to follow a particular procedure or apply certain criteria in reaching his decisions, the law will protect the legitimate expectations of those benefiting from his undertaking and placing reliance upon it. An authority whose policies contain such undertakings is not permitted to depart from them "except after the most serious consideration and hearing what the other party has to say: and then only if they are satisfied that the overriding public interest requires it". Although the existence of legitimate expectations does not prevent prospective policy changes, these must not without good cause affect adversely the beneficiaries of a previous *intra vires* policy.

Although the doctrine of legitimate expectations primarily serves the value of fairness and has evolved from cases concerning the requirements of natural justice, the second ground on which authorities may be kept within their announced policies is intimately connected to the internal consistency and rationality of administrative decision-making. It has been expounded by Dunn L.J. in an immigration case, concerning a decision of the Home Secretary to refuse admission in the country to an alien person on the basis of a condition not mentioned in a circular issued by him and setting out the conditions for entry clearance:

221
"Although the circular letter did not create an estoppel, the Home Secretary set out therein for the benefit of applicants the matters to be taken into consideration, and then reached his decision on a consideration which on his own showing was irrelevant. In so doing [...] he misdirected himself according to his own criteria and acted unreasonably."^31

This argument expands the doctrine of legitimate expectations, because it is not confined to the withdrawal of some pre-existing advantage, but affects every case of misapplication or arbitrary abandonment of announced policies.

Keeping authorities within their policies in this manner can promote objectivity and impartiality in administration. The danger is that, in response to the increased judicial willingness to enforce informal administrative rules against the authorities making them, the latter will resort to less specific and more imprecise policy formulations in order to avoid justiciability.^32 Lack of precision is, indeed, the main problem with the Bank's policies.

For the Bank, the proper function of law in the area of banking regulation is to enhance its own authority by providing a formal jurisdictional basis for its regulatory actions without attempting to define in any detail its relationship with its regulatees or the substantive standards to be applied.^33 This limited conception of the role of law is actually reflected in the Banking Acts of 1979 and 1987. The statutory provisions are intended to ensure that, even in situation where its de facto authority as central bank is not sufficient, the Bank has the necessary leverage to demand from the commercial banking institutions compliance with its regulatory requests. On the other hand, the statutory standards are deliberately vague, so as to allow the Bank the widest freedom of action.^34

The Bank is careful not to sacrifice this freedom by committing itself to exceedingly specific policies. The legal effect of regulatory pronouncements depends on the use of sufficiently precise language. For the most part, however, the regulatory notices of the Bank do not consist of clear and complete rules, not even of a presumptive character. Although they set out regulatory requirements, such notices are framed in broad terms only and, to become fully operative, need to be adapted to the circumstances of each regulated institution. Insofar as capital and other financial requirements are concerned, detailed and uniformly applied methods for the measurement of the financial position of authorised institutions have been

---

^31 Ibid., p.52. On his part, Parker L.J. approached the issue as raising essentially issues of fairness; p.46.


devised, while the harmonisation of prudential controls means that uniform minimum capital requirements and large exposures limits, having the full force of law, are now in operation throughout the Community. Beyond these minimum requirements, however, there are no general rules setting precise levels of capital, provisions and liquidity that must be observed, and each institution must negotiate with the Bank the specific standards applicable to it. In other matters, the Bank's policy documents are either silent or provide only general and imprecise guidance. This is, in particular, the position with regard to the standards that must be met by the controllers, managers and directors of authorised institutions.

The advocates of informality and anti-legalism contrast the "flexible", "personalised" and "participatory" elements of the present regulatory system, which are supposed to guarantee its effectiveness, with the supposed inflexibility of an "over-legalised" system of regulatory rules. Twenty years ago, when the present framework of prudential regulation was just beginning to take form, Jack Revell, observing that the effective choice was between administrative rule-making and discretion, put forward two main arguments in support of the latter: that its flexibility makes possible the immediate adaptation of regulatory policy to the changing circumstances; and that bank safety and soundness depend on intangible factors, such as the quality of management and the reputation of the institution in the market, which cannot be quantified and formalised in rules.

Similar arguments are still employed in defence of the discretionary system. Their plausibility is derived from the fact that Bank's responsibility is not to set norms of good banking behaviour as such, but to determine whether the regulated institutions are safe and sound. Essentially, this involves the making of complex predictions about the future performance of these institutions. The purpose of regulatory norms in this context is primarily to facilitate this task by formalising the most telling indicators of expected performance. Reliance on hard-and-fast rules for this purpose is not an optimal strategy, because the preselected general indicators will frequently fail to reflect the critical peculiarities of individual institutions. Moreover, precise rules invite their technical avoidance. An attempt to make the rules more comprehensive would involve immense practical difficulties, without guaranteeing increased predictive value. For these reasons, the exercise of discretionary judgement is said to be more efficient than the application of hard rules as a method of screening banking institutions, especially as the relatively limited

35 The very specific requirements for country-debt provisioning are an exception, which is explicable in terms of the politically sensitive nature of the issue. See infra, text and n.193.
37 Solvency and Regulation of Banks: Theoretical and Practical Implications (1975), pp.129-132.
number of such institutions means that discretionary, individualised decision-making
does not put a great strain on regulatory resources.\textsuperscript{38}

On this analysis, flexible norms or policies contribute in making the regulatory
criteria known by the regulatees and also serve as triggers for the preliminary
screening of the regulated institutions. However, they cannot altogether exclude the
use by the supervisors of personal judgement, analogous to that applied by a banker
in assessing the creditworthiness of his commercial borrowers. In the words of
Revell:

"The basis of a sound regulatory system is seen to be the collection by the
authorities in an aggregated form of the kind of information on which the
management decisions of the credit institution were based; in other words,
the successful supervision of the prudential conduct of credit institutions
depends on the vicarious participation by the supervisors in management
decisions to the greatest extent possible."\textsuperscript{39}

To succeed in this exercise, the supervisors must form a considered opinion about
the institution's financial position, including matters that cannot be subjected to
mandatory balance-sheet ratios. Such matters would include the portfolio structure
of its assets and liabilities and its projected cash-flows, the competence of its
management, the adequacy of its control systems and procedures and the quality of
its decision-making in assuming risk - all factors which require subjective evaluation.

The Bank subscribes wholeheartedly to this theory of the supervisory function,
rejecting the notion that a system of fixed regulatory rules could provide a functional
basis for the enforcement of minimum prudential standards in banking. Thus, in its
policy notices the Bank does little more than set out general principles, whose
specific consequences for individual institutions are only spelled out after special
assessment. For the individualised application of the principles, an institution's track
record is compared to that of other institutions with a similar business profile ("peer-
group" approach). However, the Bank refuses to promulgate common rules even at
peer-group level, on the ground that it does not wish

"to stamp all our variegated institutions with a standard range of
supermarket categorisations, each group clearly distinguished from each
other, with identical labels for capital, liquidity, overall size or area of
activity."\textsuperscript{40}

Instead, the precise requirements for each institution are determined only after
discussion with its senior management, at which point specific capital ratios,
guidelines for credit exposures, limits to the maturity mismatching of assets and

\textsuperscript{38} See C.S. Diver, "The optimal precision of administrative rules" (1983-4) 93 Yale L.J. 65, pp.79,
83-88.

\textsuperscript{39} Op.cit., n.37, p.4.

\textsuperscript{40} W.P. Cooke, "The role of the banking supervisor" (1982) 22 B.E.Q.B. 547, p.548.
liabilities, and similar matters are usually agreed upon through negotiation, rather than unilaterally dictated by the Bank.

For the Bank, this approach has indisputable benefits: it permits the operation of a consistent monitoring system, based on uniform financial measurement methods, and the development in practice of internal routine criteria for peer-groups, but at the same time leaves ample room for negotiation regarding the exact prudential requirements for each particular institution and their enforcement and, insofar as the taking of remedial action is concerned, makes the Bank's decisions less vulnerable to legal challenges, because it removes the need for proving that some specific norm has been violated.

Significantly, the discretionary system finds wide acceptance in the financial community too, because it provides opportunities for the voice of the industry to be heard at all stages in the regulatory process and prevents outside political and judicial interference with the affairs of the City. The Bank itself has repeatedly and openly stressed its aim of securing the weight of banking opinion behind its policies and, as a general rule, avoids intrusive and detailed interventions in the activities of authorised institutions. The elaboration of new prudential policies passes through protracted and detailed consultations with the industry, while over the years the Bank has made no attempt to block the expansion of banks into non-traditional lines of business, such as hire-purchase, mortgage lending and, last but not least, securities trading. Moreover, each particular institution has the opportunity to influence the Bank's individualised construction and enforcement of the prudential standards. A more prescriptive statute would not permit this type of regulatee involvement.

Despite the broad consensus in favour of flexibility and anti-legalism, however, in reality the advertised virtues of the discretionary system cannot make up for its hidden defects. The situation is particularly unsatisfactory from the standpoint of the rule of law. The position of the Bank in relation to its regulatees is essentially free of legal constraints, and there is no effective way of bringing it to account for its decisions. Supposedly, this is the necessary price for ensuring the benefits of non-statutory regulation, which, as explained above, is claimed: (i) to be able to address the distinctive characteristics of each case; (ii) to generate high standards which are honoured, not only in the letter, but also in the spirit; and (iii) to be more readily adaptable to new circumstances. However, it is doubtful whether the realities of

---

42 "Supervision and central banking", loc.cit., n.34, p.382.
discretionary decision-making conform to this idealised picture or whether a system of rules cannot be equally flexible and command as much support.\textsuperscript{43}

In terms of their actual quality, it is not evident that the supervisors' subjective judgements can live up to their promise. Supervisors do not necessarily make good managers, and their "vicarious participation" in the running of the regulated institutions cannot guarantee sounder conditions of operation than could be achieved under general rules, because their ability to make correct evaluations is constrained by mistakes, lack of information, limited resources, bureaucratic slack, \textit{etc.} In a paper based on interviews conducted within the Banking Supervision Division in the mid-1980s, J.L. Metcalfe observed that

"[q]uality of management, rather than adherence to prescribed financial ratios, is the yardstick supervisors prefer. However, quality of management remains a nebulous concept that is far from being defined operationally. The supervisors' emphasis on quality of management is partly due to their desire to avoid second-guessing the decisions of commercial banks. But even though they avoid claiming to make better commercial judgements than commercial bankers, they are claiming a more sophisticated and abstract competence, the ability to judge the managerial skills of commercial bankers."\textsuperscript{44}

Admittedly, many of the obstacles faced by supervisors in making subjective evaluations about the fundamental soundness of an institution can also stand in the way of the effective enforcement of rule-based standards. Nonetheless, the uniformity of such standards ensures at least a modicum of competitive equality, while the discretionary supervisory determinations result in divergence in the treatment of individual institutions on grounds whose consistency and reasonableness cannot be assessed.

Moreover, the decision-making process may be less individualised than usually assumed. Operational criteria are necessary for the day-to-day direction of low-level supervisors and the exercise of internal control by the managers of the Banking Supervision Division. Accordingly, an internal system of managers' guidelines is in place for the benefit of the Division's operational groups.\textsuperscript{45} Standardisation of the regulatory requirements is achieved through the definition of peer-groups in the guidelines and the making of inter-group comparisons. According to Metcalfe, "there is an acknowledged need to go beyond the question-begging cliché that every case should be treated on its individual merits. Norms are being generated inductively. Supervisors build up notions of best practice by

\textsuperscript{45} Interview with officials of the Banking Supervision Division (A. Boxall and P. Hatton), 5 Oct. 1990.
comparing the experiences of similar institutions and by comparing over time the track records of individual organisations. As yet, this structure of comparative reference groups is fragmentary and localized.\textsuperscript{46}

This, however, implies that \textit{ad hoc} departures from the rules of thumb that apply to each group must be attributed to the Bank's inability to refine the supervisory criteria and devise satisfactory objective norms, not to the supposed superiority of a system of discretionary subjective judgements. At any rate, there can be little justification for keeping secret the internal guidelines for the various peer-groups.

The present system is often praised for its flexibility and anti-formalism. Nevertheless, under a system of open and objective regulatory rules, adaptation to the changing circumstances of the market could easily be achieved to the extent compatible with the requirements of good administration by means of the swift amendment of the rules as soon as new material considerations are identified. Of course, an increase in the formalism of the regulatory system could encourage the regulated institutions to adjust their compliance efforts to the explicit requirements, disregarding the spirit of the regulatory principles. This threat could be minimised if the rules were carefully drafted. On the other hand, formalisation could have benefits which are rarely acknowledged.

The discretionary system places at the hands of the supervisors extensive power over the fate of individual institutions - power which they may not always exercise wisely or properly. This sort of power can have untoward psychological effects and makes more likely the taking into account of illegitimate considerations in the making of regulatory decisions.\textsuperscript{47} In this climate, the reputation of the Bank's officials for professionalism provides the main guarantee that its statutory powers will not be abused for improper, oppressive or discriminatory purposes. Unfortunately, this may not be enough. Well-established institutions, which are likely to co-operate smoothly with the Bank, may have little to fear from the lack of entrenched legal criteria for its determinations and may consider the practices of negotiated enforcement advantageous. New or smaller institutions, however, for which it may be psychologically more difficult to convince the supervisors of their fundamental soundness, under a system of open rules would enjoy greater certainty and a more meaningful ability to challenge unreasonable regulatory actions.

A final defect of the present system concerns its considerable lack of transparency. Banking regulation takes the form of a private discussion between the Bank and the authorised institutions. The technical framework for the measurement of an institution's capital and liquidity positions is certainly known, but otherwise the

\textsuperscript{46} Loc.cit., n.44, p.136.

regulatory process is to a large extent closed to outside scrutiny. The precise financial standards required from authorised institutions are kept secret, and it is not clear what other prudential requirements are made in practice. Whether or not discretion is necessary, this situation undoubtedly hinders public debate about the regulatory system and the policies of the Bank.  

2. Capital and liquidity standards

To satisfy the minimum criteria for authorisation of Schedule 3 of the Banking Act 1987, a deposit-taking institution must conduct its business in prudent manner. An institution will not be regarded as meeting this very broad requirement unless it fulfils a non-exhaustive list of more detailed standards, which require it, on the one hand, to be in sound financial condition by maintaining adequate capital, liquidity and provisions against losses and, on the other, to have in place appropriate accounting and other records and control systems.

For the purposes of monitoring compliance with these standards, the elaboration of universally applied frameworks for the measurement of the capital and liquidity adequacy of authorised institutions provides the most striking example of the regulatory system's evolution towards greater formality and transparency. Nonetheless, within these general frameworks, gaps remain in the most critical junctures. In particular, while the measurement of the financial position of the regulated institutions has been thoroughly standardised, the exact level of adequacy that must be met by each institution continues to be the subject of ad hoc determination. The absence of objective rules in relation to this strategic matter consolidates the Bank's discretion regarding the final assessment of each institution's compliance with the statutory criteria for authorisation. Thus, the crystallisation in this area of incomplete regulatory rules reflects probably the practical need for consistent and operational tools for the monitoring of regulated institutions, rather than an attempt to set objective legal standards that would depersonalise the regulatory process.

---

49 Sch.3, para.4, as amended by S.I. 1992/3218, reg.27.
50 Ibid., sub-paras.(2)-(6).
51 Ibid., sub-paras.(7)-(8).
(a) Absolute minimum capital requirements. Schedule 3 prescribes an absolute minimum capital requirement, which has now been brought in line with the relevant Community standard.\(^{52}\) Thus, to be eligible for authorisation an applicant institution must have initial capital equal in value to ECU 5 million or more, irrespective of the currency of denomination.\(^{53}\) An equivalent minimum level of own funds must also be maintained at all times following authorisation.\(^{54}\)

The rationale for this requirement rests on the presumption that enterprises of a large scale tend to be more credible, partially due to the commitment of substantial owners' funds. An additional benefit, from the standpoint of administrative convenience, is that it eliminates the supervisory burdens, and potential loss of control, inherent in the oversight of large numbers of small firms. Nevertheless, the requirement cannot easily be justified on grounds of efficiency. On the contrary, economic theory tends to interpret size requirements as barriers to entry whose effect is to reduce the contestability of markets, because they increase sharply the up-front costs of entry and so dissuade potential competitors. The impact of this reduction in competition on the efficiency of the banking system can be negative, although for existing institutions this can be translated into higher levels of profitability and smaller numbers of failures. Furthermore, despite the non-rebuttable statutory presumption, the requirement does not appear to be relevant to the question whether a bank is conducted in a prudent manner or not, because the required minimum amount of capital cannot be rationally related to the operational needs for financial resources faced by authorised institutions, which are specific to the particular mix and scale of business carried on and the risks faced by each institution. For this reason, its regulatory value is very limited, making the search for other indicators of viability and prudence necessary.

(b) The assessment of capital adequacy. According to the criteria of Schedule 3 of the Banking Act, the business of an institution will not be regarded as being conducted prudently unless it maintains

"own funds which, together with other financial resources available to the institution [...]", are -
(a) of an amount which is commensurate with the nature and scale of the institution's operations; and
(b) of an amount and nature sufficient to safeguard the interests of its depositors and potential depositors, having regard to [(a) the nature and scale of the institution's operations; and (b) the risks inherent in those

\(^{52}\) Second Banking Directive, arts.4 and 10.
\(^{53}\) Sch.3, para.6, as replaced by S.I. 1992/3218, reg.27(4).
\(^{54}\) Sch.3, para.4(3A), inserted by S.I. 1992/3218, reg.27(2). On the meaning of own funds, see infra, text and n.92.
operations and in the operations of any other undertaking in the same group so far as capable of affecting the institution] and any other factors appearing to the Bank to be relevant."

This provides the statutory basis for the regulation of capital adequacy, which in recent times has become, domestically as well as internationally, the main focus of the regulatory process.

The purpose of capital, in the sense of permanent owners' funds, is to support a banking institution's fixed investments and also to provide a "cushion" for the absorption of unexpected losses that cannot be met out of current earnings. Accordingly, the purported aim of regulatory capital requirements is to ensure the institution's continuing operation as a going concern or, at the very least, the full repayment of its deposit liabilities upon liquidation. This raises the question why regulation should be necessary for this purpose in the first place. In theory, a free market would spontaneously achieve the desired result, because the maintenance of sufficient capital resources, in verifiable form, would be vital to every bank as a means of signalling to the market its soundness and, thus, of attracting deposits.\footnote{Sch.3, para.4, sub-para.(2) in combination with sub-para.(3), as amended by S.I. 1992/3218, reg.27(1)-(2). (The words in brackets appear in sub-para.(3).)}

As things actually stand, bank owners often find it feasible to economise on capital. The most probable explanation for their ability - and willingness - to do so, is that the existence of credible public safety-nets, whether explicit or implicit, removes the incentive of depositors to demand high capital as a guarantee of repayment. Once the protection of deposits is undertaken by the state, depositors can ignore questions of bank safety and concentrate exclusively on considerations of price. In this situation, a bank with low capital resources can fund itself by offering marginally higher interest rates than its competitors. Indeed, it can be rational for bank owners to tie up as little of their own money as possible in the bank: this will increase exponentially their returns from leverage and contain their personal exposure to the risk of loss in case of failure, while shifting the residual costs - which can be very substantial - to the safety-net. From this standpoint, mandatory solvency standards appear as a means of counteracting the moral hazard created by the safety-net.\footnote{Alternatively, a bank with low capital would be able to attract deposits by offering to potential depositors higher rates, which would incorporate the appropriate risk premium. This would be consistent with the Modigliani-Miller theorem, which demonstrates that a firm's liability structure (i.e. the mix of equity and loan funds by which it is funded) does not affect its overall funding costs, which is determined under conditions of complete information by "objective" considerations of asset risk; F. Modigliani and M.H. Miller, "The cost of capital, corporation finance and the theory of investment" (1958) 48 Am.Econ.R. 261.}\footnote{See N. Arshadi, "Capital structure, agency problems, and deposit insurance in banking firms" (1989) 24 Fin.Rev. 31; and A.M. Santomero, "The bank capital issue", in C. Wihlborg, M.}
Capital standards perform this role by affecting the incentives of bank owners and managers. The point is emphasised in an O.E.C.D.-commissioned report on prudential supervision:

"From the standpoint of bank safety, the fundamental raison d'etre of bank capital is to instil discipline on management. [...] R]egulators are empowered to impose standards on the level and composition of capital and its relationships to risk factors. Thus, by acting on the required level of capital adequacy, supervisors are in a position to impose constraints by setting definite boundaries on the potential for expansion of the bank's business and, according to the modalities of measurement adopted, on the relative cost factors of the various activities".58

By increasing the participation of owners in the financing of risky activities, the regulatory capital standards maximise their exposure to potential losses and dissipate the abnormal returns on equity from highly leveraged risk-taking. Moreover, in the case of risk-related standards, which require higher levels of capital cover for high-risk assets than for safe ones, the additional capital component increases the funding cost of the former, because capital cannot be raised at a risk-free rate, as publicly-guaranteed deposits could. In this manner, the standards exercise a powerful negative influence on the banks' relative demands for high-risk assets.

In short, capital standards act as a financial "charge", with potentially critical consequences for the economic viability of banking activities. For this reason, considerations of competitiveness and profitability play a central role in their design.

In the U.K., the capital positions of banking institutions as a proportion of their deposit liabilities (gearing ratios) or of their assets (capital-to-assets ratios) kept declining during the first half of the 20th century.59 The accounts of the clearing banks show a fall in average gearing ratios from 6-7% in the aftermath of the Great War to 3% by 1941, and then to as low as 2.5% by the early 1950s. The trend is explicable by the primary emphasis placed at the time on liquidity. The maintenance of a high proportion of liquid assets reduces bank riskiness. It also strengthens confidence, because an institution's ability to honour its obligations promptly out of its liquid assets sends to the market a signal of its fundamental solvency. In this sense, despite the decline of capital ratios, the banking system was extremely safe, with a fall of advances-to-deposits ratios from around 50% to less than 17% in the period 1931-45. After this period, they started to rise again, with a corresponding

---

dramatic increase in the banks' holdings of public debt. Moreover, the real capital position was superior to the reported one, because banks kept hidden reserves.\textsuperscript{60}

In the following period, the accelerating shift away from government securities and eventually into longer-term lending was paralleled by a reinforcement of capital positions. Published capital ratios rose sharply, from about 6\% in 1968 to 8.5\% on a consolidated basis, after the abolishment of hidden reserves and full disclosure of profits and asset values by the clearing banks in 1969. Free-resource ratios (\textit{i.e.} capital resources, excluding resources tied up in intangible and fixed assets and participations in non-banking entities, to current liabilities) stayed at 4\% or less in the following decade, but at the same time banks strengthened their balance sheets by issuing substantial amounts of subordinated loan stock - a form of funding which, even though it may not have the necessary permanence to support an institution's general infrastructure, can nevertheless offer to its depositors and other unsecured creditors a cushion against losses in the event of insolvency.

Until the early 1970s, the question of capital hardly existed as an active concern.\textsuperscript{61} With the eruption of the secondary banking crisis, however, it was brought in the forefront of regulatory policy.\textsuperscript{62} The crisis proved that the nature and scale of the banking industry's risk-taking had undergone a fundamental transformation. The 1970s were characterised by a sharp upsurge in the volatility of the economic environment and unprecedented levels of inflation. Simultaneously, the collapse of the restrictive practices and market divisions, which had formerly ensured stability, triggered the intensification of competition, while the growing reliance on interbank funding and liability management led to lower levels of liquidity, a preponderance of advances to the private sector in the composition of asset portfolios and increased interdependence among commercial banks. Although these developments implied greater efficiency in intermediation, they also exposed banks to additional risk and, after adjusting for risk and inflation, to reduced profit margins.\textsuperscript{63} This was a major source of concern to the Bank, since the acceptance of unrestricted risk-taking would result either in the underwriting of the new risks out of its own funds in the form of rescue operations of unpredictable scale, as with the Lifeboat, or in frequent bank failures, with unpleasant consequences for the Bank in terms of loss of institutional status and political recriminations. This made necessary

\textsuperscript{60} This practice found legal recognition in Sch.8 of the Companies Act 1948.
\textsuperscript{61} By 1975, J. Revell would observe that, as a result of lack of serious banking crises in the U.K., "[a] search through current English texts on banking finds hardly any reference to solvency and capital adequacy"; \textit{op.cit.}, n.37, p.2.
the introduction of prudential capital and liquidity standards for banking institutions, as a means of arresting and reversing the trend of increasing risk-taking.

The development of capital standards was not an easy or uncontroversial affair. The Bank's philosophy on issues of capital regulation was set out in a statement by George Blunden, the head of the its newly-established supervisory section.

"We should relate capital and reserves [...] to the purposes for which they are required. [...] In assessing capital adequacy we need therefore first to ensure that shareholders' funds provide full coverage for investment in fixed assets and investment in subsidiaries and related trading companies; depositors' funds should not be used for these purposes. There should then be a margin of shareholders' funds available to provide coverage, in addition to the coverage provided by current earnings and by past provisions, against risks of loss. In assessing a bank one needs to relate these three sources of protection against loss to the volume of risk assets and contingent liabilities. The extent to which such risk assets and contingent liabilities should be covered by current earnings, provisions and free shareholders' funds must be a matter for individual assessment in each case. There can be no inviolable figure or proportion that must apply to every bank. In judging the degree of cover appropriate in each case, past experience must be the most important factor, but one must also consider whether changes outside the control of the bank itself (for example, in recent times the collapse of the property market) are likely to mean that future experience of loss is going to be significantly different from past experience. And for newly-emerging or fast-growing banks where there is likely to be inadequate guidance available from past experience, the experience of similar banks may be useful. The quality of management must also be a very important factor in judging the cover required."^64

This analysis indicates that the development of capital standards has three aspects: (a) the definition of "capital" as a regulatory concept^65; (b) the development of a method for relating capital to risk; and (c) the determination of the extent of cover which is actually appropriate. Ideally, the quantification of all dimensions of risk and their expression through a unique function, that would capture each institution's overall exposure, would permit the determination of a mandatory common capital ratio for all institutions. From the beginning, however, the Bank pointed to the almost insurmountable difficulties involved in the development of a fully

^64 Loc.cit., n.36, p.193.
^65 "Capital" is an ambiguous concept. From the point of view of their economic functions, the different classes of liabilities form a continuum. However, legal and accounting conventions introduce a sharp distinction between capital and non-capital liability items, with serious consequences for their treatment in terms of reporting requirements, insolvency, tax and regulatory law, as well as the interpretation of financial data. To arbitrage resulting distortions, the market often introduces hybrid liability instruments. On the different meanings and functions of "capital", see P.F. Pope and A.G. Puxty, "What is equity? New financial instruments in the interstices between the law, accounting and economics" (1991) 54 M.L.R. 889; and J.J. Norton, "Capital adequacy standards: a legitimate regulatory concern for prudential supervision of banking activities?" (1989) 49 Ohio St.L.J. 1299, pp. 1302-1315.
comprehensive framework of risk-measurement. It pressed, instead, for a uniform system of measurement that would allow capital to be expressed as a function of the volume of risk undertaken by banking institutions, while leaving to the Bank wide discretion with regard to the determination of the specific ratio that is appropriate for each particular institution.

A first step in this direction was taken in 1975, with the publication of the conclusions of the Joint Working Party that the Bank and the clearers had established at the end of the previous year for the purpose of reviewing accepted standards of behaviour and recommending new prudential practices. The Working Party's paper set out the nucleus of the modern regulatory system, bringing the issue of capital adequacy to the centre of concern. The paper emphasised the significance of two capital ratios, the free-resource (gearing) ratio and a new risk-asset ratio, as monitoring tools. The introduction of precise mandatory standards of general applicability was resisted, on the ground that these would constitute an inflexible straitjacket, irrelevant to the circumstances of particular institutions. However, it was envisaged that broad numerical standards would develop as yardsticks for different groups of institutions.

The risk-asset ratio was adapted from risk-based bank-examination techniques that had been developed in the U.S. in the 1950s, but which had since fallen in desuetude. It was intended to relate the resources available for the absorption of losses to the susceptibility of the main categories of assets to loss in situations of debtors' default (credit risk) or forced sale of tradeable instruments at distressed prices (trading risk). In the following years, this ratio would become the focus of regulatory efforts, both on a domestic and on an international basis.

Following extensive consultations with the banking community, the new approach was revised and clarified on a number of points. A more formalised method for the measurement of capital was set out in a policy paper published on 5 September 1980. Once more, however, the Bank refused to prescribe precise numerical ratios, which could legitimise overtrading in certain cases, while being harmfully restrictive in others, by aggravating the loss of confidence and hindering the raising of fresh capital precisely when an institution is most in need. Consistently with the approach of the Basle Committee, the paper endorsed the principle that supervision should take into account of all bank branches and subsidiaries on a world-wide basis (consolidated supervision) and confirmed that the

68 Ibid., paras.4 and 10.
primary responsibility for the capital adequacy of international banks belonged to the
regulators of the head office (home regulators).  

The paper confirmed the significance of the gearing and the risk-asset ratios and
defined their respective objectives. The former was aimed at ensuring that an
institution's capital position is acceptable to its depositors and other creditors and
the market in general and was, for this reason, computable on the basis of publicly
available information. The latter had the purpose of testing the adequacy of capital
in relation to the risk of potential losses and required sophisticated information, "an
important part of which is likely to be available only to the supervisory authority and
the institution itself." Characteristically, the possibility that such information should
be disclosed as a means of strengthening market discipline, was not explored.

Insofar as the exact definition of an institution's capital base was concerned, it
was evident that the fully-paid common share capital, which was non-redeemable
and made no contractual claim on earnings, should be included. With regard to other
items having funding and loss-absorbing characteristics similar to those of
shareholders' equity, the Bank insisted that they might be included in the regulatory
definition only if: (a) they carried no obligation for repayment and were available to
absorb losses; (b) they provided evidence of long-term commitment to the
institution; and (c) they normally contained no obligation to repay interest. Although
most loan funds could not qualify under these criteria, fully-subordinated long-term
debt instruments could be admitted subject to limitations, because (i) in the medium-
to-longer term they cannot aggravate an institution's situation, and (ii) they are
available to meet depositors' losses upon insolvency. General provisions against
losses could also be included, but not specific provisions which cannot provide
protection against future unidentifiable losses. Finally, minority interests in a banking
group's consolidated subsidiaries could be included, because they are available to
support the activities of these subsidiaries. However, as such interests do not
provide support against losses elsewhere in the group, the Bank would examine
carefully all cases in which minority interests contribute significantly to an
institution's consolidated capital base.

Regarding the risk-asset measurement, the 1975 paper had not been explicit as
to gradation of assets according to their risk characteristics. Under the 1980 policy,
all bank assets and those contingent liabilities (guarantees and documentary
financing commitments) which serve as substitutes for direct lending were classified

69 Ibid., para.5.
70 Technically, the 1980 gearing ratio had several differences from its 1975 free-resource
    predecessor; see ibid., paras.25-28.
71 Ibid., paras.6-8 and 12.
72 Ibid., paras.11-24.
in terms of the identity of the counterparties and form of the exposure and weighted by a particular factor, ranging from 0 to 2 (with advances to the private sector serving as a benchmark and being assigned a weight of 1, i.e. being taken into account at their full nominal value), which served as proxy for the corresponding level of riskiness. The risk-asset ratio was calculated by comparing the capital base, as adjusted by the required deductions of fixed and intangible items and investments in associated companies, with the risk-adjusted value of total assets, which was found by multiplying each balance-sheet item by its corresponding weight.73

The risk-asset ratio was designed to reflect only credit, investment or forced-sale risks. No effort was made to incorporate other risk factors, including the degree of concentration of risk exposures and operational risks, on the ground that this could lead to an excessively elaborate model whose appearance of accuracy could be dangerously misleading. These other factors should, instead, form the basis of the qualitative judgements of the Bank regarding the appropriate "target" (i.e. desirable) and "trigger" (i.e. minimum acceptable) ratios that should be observed by each individual institution. As an example, the paper stated that

"the large institution with a well diversified spread of high quality lending will inherently be less exposed to risk, and, therefore, requires relatively less capital cover against its assets, than a small specialist institution with a narrower customer base".74

The 1980 framework for the measurement of capital adequacy was refined in certain respects in the following years. In particular, the conditions for the admission of subordinated debt as an element of capital were specified in greater detail.75 At the same time, the Bank made public its concern for the growth of off-balance-sheet risks, not all of which were captured by the measurement.76 In 1985, obligations arising from note-issuance facilities and revolving underwriting facilities, which represent a long-term credit risk for the underwriting bank were brought within the

---

73 Ibid., paras.29-34 and App.A.
74 Ibid., para.33.
75 "Subordinated Loan Capital Issued by Recognised Banks and Licensed Deposit-Takers" (BSD/1986/2, Mar. 1986). This paper provides a description of the circumstances under which subordinated debt can be included in the capital assessment and requires the deduction of holdings of other banks' subordinated debt from the capital base (subject to specific underwriting or market-making concessions for institutions trading in other banks' capital issues), to ensure that the same capital is not used by more than one institution to support its operations. In its latest guidance notice on the subject, "Subordinated Loan Capital Issued by U.K. Incorporated Authorised Institutions" (BSD/1994/3, May 1994), the Bank insists that, in the event of liquidation or other insolvency proceedings, the subordinated creditor must not be entitled to receive or retain from the institution any amounts in respect of the subordinated debt until all unsubordinated creditors have been paid in full. It must be noted that certain commentators have raised the question whether a debt instrument could validly contain provisions under which the subordinated debtor waives his statutory rights of set-off; see R. Bethell-Jones, "Contracting out of set-off rights" (1994) 9 J.I.B.L. 428.
76 See "Innovation in international banking" (1986) 26 B.E.Q.B. 225.
risk-asset calculation, receiving the same treatment as other contingent liabilities. The following year, concurrently with the circulation of a statement on the same subject by the Basle Committee, the Bank issued a consultative paper initiating the reassessment of the treatment of off-balance-sheet risks. The paper solicited views as to the comparative decrees of risk of contingent liabilities and other off-balance-sheet activities (commitments, foreign-exchange contracts and interest-rate-related contracts) and expressed concern about the emerging techniques of asset securitisation.

Pursuant to the review of the methods by which the sale of loan assets can be achieved, the legal implications and the effect in terms of risk, a final policy on asset transfers was made in February 1989. The policy covers both the sale of single loans and the securitisation of loan pools, as well as the transfer of risk under subparticipation agreements. Transfers by novation and assignments duly notified to the borrower, provided that there are no rights of set-off between the borrower and the seller, are regarded as clean transfers and the relevant assets are excluded from the calculation of the seller's risk-asset ratio and included in the buyer's. Less favourable treatment is reserved for transfers by silent assignments (without notification to the borrower) and subparticipations (which do not involve the legal transfer of the rights and obligations under the original loan but are an entirely


80 Asset-backed securities were introduced in the U.K. in 1985. Although the market for securitised lending represents only a small proportion of the total credit provided by the domestic financial system, it ranks second in the world, after that of the U.S. On the development of securitisation and the unbundling of credit services in the U.K., see M. Pryke and C. Whitehead, *Mortgage-Backed Securitisation in the U.K.: A Wholesale Change in Housing Finance?* (1991); C.I. Twinn, *Asset-backed securitisation in the United Kingdom* (1994) 34 B.E.Q.B. 134; and on the legal aspects of securitisation, I. Falconer, *Securitisation in the United Kingdom* (1989) 4 B.J.I.B.&F.L. 105 (pt.1) and 258 (pt. 2). In securitisation, the role of the lending bank is analysed in a number of functions (loan origination, underwriting, credit insurance, management and ultimate financing by holding the securities as a longer-term asset). Through securitisation, the bank can ensure a source of fee income, while disposing of assets which should otherwise be held to maturity. However, at certain points the bank may still bear considerable credit risk from the securitised assets. The risk will be permanent if the bank has accepted legal or "moral" responsibility for the performance of the securities. See T.H. Donaldson, *Credit Risk and Exposure in Securitization and Transactions* (1989); M.K. Lewis and K.T. Davis, *Domestic and International Banking* (1987), pp.125-127; and I. Swary and B. Topf, *Global Financial Deregulation: Commercial Banking at the Crossroads* (1992), pp.354-358. Swary and Topf observe that "[t]he basic question involves the nature of the transaction - is it a sale of assets or a form of collateralized borrowing?"; p.356.

81 See the Bank's consultative document, "Loan Transfers and Securitisation" (Dec. 1987).

separate back-to-back non-recourse funding arrangement): the transfers are disregarded and the assets included in the seller's ratio if the Bank is not satisfied that the full risk has effectively passed to the buyer and that the latter has no recourse to the seller. With regard to securitisation, the policy warns the banks originating or servicing the securities against the assumption of residual "moral" obligation to support losses incurred by the buyers of the securities and draws attention to the operational risks.

Because of the critical impact of capital standards on the competitiveness of regulated institutions, capital soon became the primary issue in the international convergence process. The achievement of convergence in this area had particular urgency for the Bank of England. By the mid-1980s, the Bank had adopted internally an uncompromising stance, which was reflected in the formalisation and entrenchment of the risk-based measurement; at the same time, however, it was anxious to protect the competitiveness of the British banking industry. Its increasingly strict requirements had put U.K.-incorporated banks at a disadvantage even in the domestic markets, because the supervision of the capital adequacy of overseas banks was normally left to their home authorities. From this perspective, the development of uniform and transparent capital standards for all internationally active banks appeared necessary for ensuring competitive equality between British institutions and their foreign competitors. Voicing the interests of one of the three leading financial centres of the world, the Bank had the ability to exert enormous influence in this direction, both on the work of the Basle Committee and on the E.C. harmonisation process.

To precipitate action by the Basle Committee, which had been unable for some time to agree on common capital standards, the Bank combined its forces with the Federal Reserve Board. In 1987, a bilateral agreement for the adoption of a reformulated version of the 1980 risk-asset ratio was reached between the Bank and the U.S. supervisory authorities, which a year earlier had indicated their intention to proceed with the formulation of their own risk-based standards. As the primary

---

83 On the reservations of the banking industry regarding the unfavourable treatment of non-clear sales for capital adequacy purposes, see J. Barratt and P. Haslam, "Securitisation - Sale of Loan Assets: the Bank of England's consultative paper of December 1987" (1988) 3 J.I.B.L. 49. However, the current treatment of subparticipations is more lenient than that envisaged in the 1987 consultative paper.
85 See supra, ch.1, section 3.
purpose of the agreement was to put pressure on the other members of the Basle Committee - especially Japan - to endorse common standards, its implementation was postponed for a year, while it was made clear that any international bank that failed to comply with the proposed standards would be kept away from the U.S. and U.K. markets.

The real impact of this threat is subject to speculation, but the fact is that in July 1988 agreement was finally reached in the Basle Committee.87 The Basle Accord set out a common risk-based system for the measurement of capital and required the application of a minimum ratio of 8% on all internationally active banks. Although the Accord lacked the characteristics of a formal treaty, it was immediately received as a legitimate international norm ("soft law"). The Bank implemented the Accord without delay.88 The scope of the implementation was extended to cover all authorised institutions, even if their business was purely domestic. The transition from the 1980 framework to the new system was completed by the end of 1989. Almost immediately, however, additional technical changes became necessary as a result of the formal adoption by the E.C. of the standards enunciated in the Basle Accord, with minor modifications.

The harmonised application, subject to certain national discretions, of these standards to all credit institutions within the Community was required by two directives, the Own Funds Directive89 and the Solvency Ratio Directive.90 The Own Funds Directive is a technical directive which determines what items may be included in the calculation of a bank's capital ("own funds"). The Directive distinguishes between items having all the attributes of capital, such as share capital, accumulated reserves and general provisions (original own funds or, in the terminology used by the Bank, Tier 1 or core capital), and items of a lower quality which can provide protection against insolvency but cannot guarantee the continuing survival of the institution, such as revaluation reserves, value adjustments and subordinated debt (additional own funds or, in the Bank's terminology, Tier 2 or supplementary capital). The latter may be included in the calculation of the own funds only in amounts which do not exceed 100% (and in the case of subordinated

because the supervisory authorities of the two countries did not have authority to create legally binding international obligations.

87 Basle Committee, "International Convergence of Capital Measurement and Capital Standards" (the "Basle Accord") (July 1988).
89 Council Directive 89/299/EEC of 17.4.89 on the own funds of credit institutions (the "Own Funds Directive").
debt alone, 50%) of the former. The Solvency Ratio Directive establishes common rules for the risk-weighting of assets and off-balance sheet items and imposes a minimum ratio of 8% of own funds to the risk-weighted total. It requires the calculation of solvency ratios on a consolidated basis at least twice per year. In the case of foreign subsidiaries, it requires also the calculation of ratios on a subconsolidated or solo basis by the authorities of the host Member State. However, the authorities of the home and the host Member State may arrange, on the basis of bilateral agreement, the delegation of the responsibility for the supervision of the capital adequacy of the subsidiaries by the home supervisor.

The current framework for the assessment of capital adequacy is set out in the regulatory notices by means of which the Bank has implemented the E.C. directives. Insofar as the composition of capital is concerned, the Bank recognises the following items as core capital: (a) permanent shareholders' equity; (b) disclosed reserves arising from the appropriation of retained earnings, share premiums and other surplus; (c) published interim retained profits; and (d) minority core-capital interests arising on consolidation; but requires the deduction from their total of: (e) goodwill and other intangible assets; (f) current year's unpublished losses; and (g) equity issued by the capitalisation of property revaluation reserves. The following items are recognised as supplementary capital, up to an overall limit of 100% of the core capital: (a) undisclosed reserves and unpublished interim retained profits; (b) reserves arising from the revaluation of fixed assets; (c) general provisions against loss up to 1.25% of total risk-weighted assets (but not special provisions); (d) hybrid capital instruments, *i.e.* perpetual cumulative preferred shares and perpetual subordinated debt; (e) long-term (having a maturity of over five years) subordinated debt under certain conditions and only up to 50% of the core capital; (f) minority supplementary-capital interests arising on consolidation; and (g) equity issued by the capitalisation of property revaluation reserves. Finally, the following items are deducted from the total of core and supplementary capital: (a) investments in unconsolidated subsidiaries and associates; (b) connected lending of a capital nature; and (c) all holdings of other credit institutions' capital instruments (subject to

---

91 Exceptionally, credit institutions whose activities are confined almost exclusively to the interbank and public-debt markets and which fulfil, jointly with the central bank, the function of systemic liquidity regulator, are exempted from the scope of the Directive pending the harmonisation of capital requirements for trading risks; art. 1(4). The exemption is specifically aimed at exempting the British discount houses.

specific underwriting or market-making concessions for institutions trading in other banks' capital issues).

For the measurement of the risk-asset ratio, one of five risk-weights (0%, 10%, 20%, 50% or 100%) is assigned to each asset, depending on the category of the counterparty. The weights are supposed to reflect the credit risk inherent in exposures to different counterparties. A 0% weight is given to practically riskless assets, such as: (i) cash or claims collateralised by cash; (ii) claims on the governments or central banks of "Zone A" countries (members of the O.E.C.D., together with countries which have concluded special lending arrangements with the I.M.F. associated with its General Agreement to Borrow, the latter description being currently satisfied only by Saudi Arabia; to be included in Zone A, a country must not have rescheduled its external sovereign debt in the previous five years) or on the European Communities; or (iii) claims on the governments and central banks of "Zone B" countries (the rest of the world) denominated and funded in the local currency. Most holdings of long-term Zone A government securities and interbank claims get a weight of 20%. Loans to the private sector fully secured by a first mortgage are weighted by 50%, while the vast majority of claims on the private sector, as well as claims on Zone B sovereign borrowers which are not denominated in the local currency, by 100%. Off-balance-sheet risks (commitments and contingent liabilities) are converted into credit-equivalent amounts by applying conversion factors of 0%, 20%, 50% or 100%, according to the degree to which the relevant off-balance-sheet instrument functions as a substitute for a direct bank loan; the risk-weights are then applied to the credit-equivalent amounts, depending on the category of counterparty. Finally, interest-rate and foreign-exchange contracts (derivative instruments, including swaps, options and futures) are converted into credit-equivalent amounts, on the basis of either the "replacement-cost method" or the "original-exposure method", and then weighted by counterparty weights.94

Under the Bank's policy, the 8% standard of the Basle Accord and the Solvency Ratio Directive is considered only as an absolute minimum, not as a general rule.


94 Certain aspects of the ratio's calculation permit the employment of "creative" accounting as a means of reducing the regulatory burden. For instance, loans may be disguised as swaps, thus attracting a more favourable treatment in the calculation of the credit-risk exposure; see P. Goris, "Creative accounting and capital adequacy: the swap-loan dilemma" (1994) 9 J.I.B.L. 150. The Bank demands the disclosure of disguised credit exposures in the prudential returns, but the lack of precise definitions leaves room for doubt as to the practical effects of this requirement.
Thus, individual trigger and target ratios, often far above the 8% mark, continue to be agreed with each authorised institution, at both the consolidated and the solo (unconsolidated) levels. In this respect, as well as in terms of the more onerous treatment of certain items than what is necessary under the directives, the Bank's policy continues to place heavier burdens on British banks than those borne by their foreign competitors.

The solvency ratio was designed to capture only credit risk and the interest-rate and currency risks from derivative instruments and, in its present form, does not address directly the market risks faced by banks which undertake securities-trading activities. In an attempt to achieve the incorporation of these risks in the measurement of capital adequacy and, more importantly, to ensure greater equality of treatment between credit institutions and securities and investment firms, which compete directly against one another in the securities markets, the Capital Adequacy Directive, which was adopted in 1993, applied uniform requirements on both types of institutions regarding the minimum capital cover for their trading activities. The Directive's requirements - which must be implemented by 1 July 1995, with the national provisions becoming effective by 1 January 1996 at the latest - are based on the allocation of a credit institution's holdings of financial instruments (i.e. transferable securities, units in collective investment schemes, money-market instruments, futures contracts, forward interest-rate agreements, interest-rate, currency and equity swaps, or options to acquire or dispose any of the above) between the so-called "trading book" and the non-trading, or banking, book. Only proprietary positions in financial instruments held for resale or for short-term benefit from price changes and exposures due to unsettled transactions, free deliveries and over-the-counter derivative instruments can be included in the trading book, while the allocation of items between the two books must take place on the basis of

---

95 BSD/1990/3, loc. cit., n.93, paras.3-4. The Directive requires supervision only on a consolidated basis, but the Bank applies capital standards on a solo basis in exercise of the U.K.'s national discretion under the Directive for the purpose of ensuring the reasonable distribution of capital within a group.


99 Art.2(5) and Investment Services Directive, Ann., Section B.
objective and consistently applied criteria. The regulated institutions must "mark to market" (i.e. calculate the current market value of) their trading books on a daily basis.

All institutions are required to support their trading-book positions and their foreign-exchange exposures, wherever in their business these may arise, with capital. Under the "building-block" approach which is set out in detail in the Annexes to the Directive, appropriate amounts of capital cover are calculated separately, as a fraction of the nominal value of the underlying contract or exposure, for the various identifiable risks inherent in the holding of trading positions, and the overall capital requirement is found by adding these amounts. In particular, common standards are developed for: (i) specific (related to changes in the price of the particular instruments) and general (related to broad market-wide movements) position risks arising from holdings of traded debt and equity instruments, including derivatives, as well as underwriting risks arising from the underwriting of such instruments; (ii) counterparty and settlement or delivery risks arising from uncompleted securities transactions; and (iii) foreign-exchange risks. Although in theory the trading-book risks must be covered out of an institution's capital base as defined in the Own Funds Directive, the Capital Adequacy Directive gives national authorities the discretion to permit the use for this purpose only of a modified definition of capital, which includes additional (Tier 3) items, that is: (a) an institution's net trading-book profits net of charges or dividends, less net losses on its other business, provided that these have not been already included in the calculation of the capital base; and (b) subordinated debt having an initial maturity of over two years; but the national authorities may deduct from the total reached in this manner (c) the institution's illiquid assets. Exceptionally, credit institutions may continue to apply the capital requirements of the Own Funds and Solvency Ratio Directives if their trading activities are negligible in both absolute terms and as a proportion of their total business.

Significantly, despite the very detailed character of the harmonised European standards, in the notice implementing the Capital Adequacy Directive in the U.K., the Bank states unequivocally its intention to set higher requirements for individual

---

100 Art.2(6).
101 Art.6(1).
102 Art.4(1).
103 For an explanation of the "building-block approach", see O'Neill, loc.cit., n.97, p.148.
104 Capital Adequacy Directive, Ann.I to III, respectively.
105 Ann.V.
106 Art.4(6).
institutions. Thus, for comparative purposes, published risk-asset ratios will be calculated in future as the relationship between total eligible capital items and the sum of the risk-weighted assets in the banking book and the notional risk-weighted volume of the trading book; the latter will be obtained by multiplying the minimum capital that is required to cover all trading-book risks taken together according to the provisions of the Capital Adequacy Directive by 12.5, thus mirroring the 8%, or 1:12.5, relationship between the Solvency Ratio Directive's minimum capital cover and the risk-weighted assets at the banking-book side.\(^{108}\)

For supervisory purposes, however, authorised institutions will be subject to separate trigger and target ratios for their banking and trading books. The minimum capital requirement for the banking book will be calculated by multiplying the risk-weighted assets by the banking-book trigger, and for the trading book by multiplying its notional risk-weighted volume by the trading-book trigger. The actual eligible capital of the institution will then be expressed as a percentage of the sum of these requirements, so that an institution will be meeting its minimum capital requirements for supervisory purposes if the relationship is 100% or more. Target capital requirements will be calculated by replacing the trigger with the target ratios in the previous calculations.

The banking-book triggers will continue to be set according to the individual characteristics of authorised institutions. In comparison, in recognition of the comprehensiveness of the building-block approach insofar as the coverage of trading-book risks is concerned, the trading-book triggers for institutions with diversified trading books and good internal risk-management systems will be generally set close to the minimum 8%, and in most other cases they will remain under 12%.\(^{109}\)

Gradually, a formal framework for the measurement of capital adequacy has been constructed over the years. In J.J. Norton's view, "as the public significance of bank capital adequacy unfolded, so also did the multitude of complexities involved in defining capital and its composition, in selecting a proper measurement test, and in determining institutional coverage. This also lent itself to a greater need for uniformity and transparency, and in obtaining these goals to a greater degree of formality or legalism in the regulator's approaches."\(^{110}\)

Among the factors that fostered formalisation, one should single out: (a) the needs of bureaucratic rationalisation, since a consistent framework for the reporting and comparative analysis of bank capital positions is essential for the day-to-day

\(^{108}\) Ibid., ch.9, paras.13-16.
\(^{109}\) Ibid., ch.9, paras.17-20.
\(^{110}\) Devising International Bank Supervisory Standards, op.cit., n.62, p.95.
operation of the regulatory system; (b) the demand of regulated institutions for transparency and equality in the application of the regulatory standards, whose effect on the cost of doing business and on the terms of competition can be dramatic; and (c) the exigencies of the international convergence process, which requires for its success the transparent and uniform implementation of harmonised rules by the regulators of every country. The international entrenchment of the risk-based approach, in particular, has redefined the Bank's role in this context. With the formal adoption of minimum standards at E.C. level, strict limits have been set on the capacity of national authorities to develop their own capital-adequacy policies.

The crystallisation of specific standards in this area has raised wide ranging objections. Frequently, mandatory capital-adequacy requirements are criticised as being inherently arbitrary: no matter how high they are set, there will always be situations where a bank's losses will be so heavy that the capital cover will be insufficient to avert insolvency. Even as indicators of actual riskiness, capital ratios may be of limited value, since reported capital positions do not capture the real causes of most bank failures. Banks usually fail because of fraud or the fast depletion of their resources as a result of a collapse in the prices of marketable assets. Accordingly, a bank's safety depends primarily on sound management and healthy profitability, as well as on a robust macroeconomic environment, and not on the maintenance of high levels of capital.

Although these arguments are not groundless, they are not decisive, because the true purpose of capital-adequacy standards is to affect the incentives of bank managers, not to make insolvency impossible. On the other hand, several major

---


112 Even pieces of primary legislation can now be reviewed, at the instance of persons or organisations having sufficient locus standi, insofar as the question of their compatibility with Community law is concerned; R. v. Secretary of State for Employment, ex p. Equal Opportunities Commission [1994] 1 All E.R. 910 (H.L.).

113 See, e.g., M.P. Flammia, "Bank capital requirements: placebo or cure?" (1988) 7 Ann.Rev. Banking L. 485, pp.491-498. In one American case, First National Bank of Bellaire v. Comptroller of the Currency, 697 F.2d 674 (5th Cir., 1983), the Comptroller attempted to establish that the bank's 5.28% capital-to-asset ratio was unsafe and should be raised to 7%, even though the bank was otherwise well-managed and profitable. The Federal Court of Appeals for the Fifth Circuit recognised the Comptroller's power to intervene when an institution engages in "conduct deemed contrary to accepted standards of banking operations which might result in abnormal risk or loss to a banking institution or shareholder", but set aside his order requiring the increase in capital levels, maintaining that "even if the Comptroller had proved capital inadequacy, it would not necessarily indicate the Bank was in any danger"; pp.685-687. Soon afterwards, the enactment of the International Lending Supervision Act of 1983 provided an explicit statutory basis for the promulgation and enforcement of federal capital adequacy standards.
objections can be raised against the structure of the capital-adequacy standards actually in force.

First, the international minimum ratio of 8% appears, indeed, to lack any theoretical justification. The reason that this benchmark was adopted in the Basle Accord is probably that by 1988 this was the average capital position of U.K. and U.S. banks. The great merit of the 8% ratio is its capacity to serve as a conventional universal standard, which legitimises the convergence process and ensures a modicum of competitive equality between banks of different national origins. Nonetheless, this ratio does not have any particular significance in terms of its effect on the actual risk incurred by the depositing public - or, for that matter, by the national deposit-guarantee scheme or lender of last resort.

Second, for all its complexity, the risk-related measurement of banks assets is deeply flawed and causes significant distortions in the relative demand for bank assets. The current risk-weights and conversion factors exercise a strong influence on pricing, but the criteria of asset categorisation are dubious. The risk-weights create a strong incentive for banks to hold public-sector liabilities, which require little or no capital cover; they also ensure the favourable treatment of interbank exposures, which can be a potential source of contagion. On the other hand, there has been no attempt to devise risk-weights that could reflect and quantify the wide variance in risk among exposures to the private sector, or to take the portfolio-structure and risk-correlations of assets into account.

Third, with banks being now in direct competition with investment firms insofar as securities activities are concerned, the imposition of capital burdens on banks alone erodes their ability to compete. The Basle Committee's attempts to ensure the consistent treatment for capital-adequacy purposes of the trading activities of both banks and non-banks, as a means of levelling the playing field, have not yet yielded fruit, but the Capital Adequacy Directive has achieved this result within the E.C. Nonetheless, the Directive's building-block approach, without necessarily providing a highly accurate measure of risk, is characterised by great technical complexity, so that compliance with the new requirements will be costly. At the same time, the Directive introduces distortions of a new type: the required capital cover for exposures on a bank's trading book is much lower than that for lending exposures of similar nominal value to the same counterparties. In addition, the calculation of capital for trading-book purposes may include components which are not allowable in the case of the banking book. Thus, banks will henceforth maintain strong incentives to expand their securities activities rather than engaging in traditional lending business. Where possible, this will be achieved through the repackaging and securitisation of bank loans, which may give banks the ability to economise on capital without reducing the riskiness of their underlying assets. Moreover, in the
new regulatory environment, banks will probably enjoy a comparative advantage over non-bank investment firms because, while capital requirements will be brought in line for both groups, banks will continue to have preferential access to cheap deposit funding.\(^{114}\)

Essentially, each step in the development of risk-based standards has been the source of intractable new problems. The measurement of risks is fraught with conceptual difficulties, and each regulatory definition raises questions of accounting consistency and accuracy and competitive equality. The regulators’ attempt to incorporate into the standards non-banking risks arising anywhere in a bank’s group, increases the complexity of their task to the same measure that it broadens the scope of their interference. As Norton has observed, while capital adequacy arose as one of many examination tools,

"this tool really has been transformed into a broad regulatory objective with a life of its own. Instead of the tool helping to understand the problem, the regulators have created an ever-increasing framework for trying to understand the tool.”\(^{115}\)

The whole exercise has unexpected perverse effects, because it interpolates regulatory considerations in the determination of the relationship between risk-taking and profit margins, thus changing the relative demands for assets. The risk-based framework is justifiable to the extent that it sets a conventional common basis for international and domestic competition. On the other hand, as risk-weights are determined in practice by political expediency, credit risk is treated in the most arbitrary fashion and diversification is ignored, the current framework does not appear to achieve its primary purpose, which is the containment of risk-taking by bank managers.

As operated by the Bank, capital-adequacy requirements have the additional disadvantage that they do not even attain transparency and equality of treatment for domestic banks. The increasing formalisation and specificity of the measurement techniques have not led to transparent rules regarding the level of capital that is actually required: the Bank does not confine its supervision to the enforcement of the minimum ratio of 8%, but expects individual institutions to observe varying capital ratios, which in the case of certain small institutions with a limited range of business are reputed to be as high as 25%. As previously mentioned, even following the implementation of the Capital Adequacy Directive, the Bank will continue to require certain institutions to maintain the capital cover for their trading-book activities up to 50% above the minimum.


\(^{115}\) "Capital adequacy standards...", loc.cit., n.65, p.1361.
The Bank insists that flexibility in the setting of the requirements is necessary, because no single ratio can incorporate the full range of considerations which determine capital adequacy. Purportedly, the system of ad hoc capital requirements makes possible the taking into account of risk-factors that are not reflected in the formal measurement of capital, especially those involving the institution's past record of profitability, quality of management, correlation of risks, maturity profile and quality of assets. Although it uses peer-group analysis for the determination of individual ratios, the Bank refuses to prescribe common rules even for groups of institutions sharing similar characteristics, claiming that this could lead to arbitrary and inflexible "supermarket categorisations".

Rejecting the desirability of objective or transparent common standards, the Bank reserves for itself the right to be the final arbiter on the matter. This cannot, however, be easily accepted. Assuming that its assessment of relative overall riskiness, on which the final determination of the required capital ratios depends, is made on the basis of verifiable and consistently-applied criteria, it would be appropriate for these criteria to be formalised and incorporated in a transparent matrix that would reflect both the scale and correlation of risks. If, one the other hand, the determination is not based on specific and verifiable criteria, but merely on subjective "qualitative" judgements of its supervisors, the wisdom of flexible standards must be questioned, since there is no evident reason why the apprehensions of supervisors regarding complicated questions of safety should be expected to provide an accurate measure of riskiness.

At any rate, the retention by regulatory authorities of broad and practically unreviewable power is in itself a cause of concern, since it leaves the regulatees vulnerable to the possibility of arbitrariness and discrimination. Through the determination of capital ratios, the Bank exercises tremendous influence over the competitiveness and business behaviour of authorised institutions, without any safeguard or mechanism of accountability. The non-justiciability of its decisions is further ensured by the practice of formally presenting the ratios as the outcome of discussion and mutual "agreement" between the Bank and the senior management of the institutions concerned, which the Bank then simply confirms in a memorandum of the meeting. This system of standard-setting is clearly unsatisfactory from the perspective of the protection of the subject.

---

117 See supra, text and n.40.
118 A similar system is used in the U.S., where the supervisory authorities give numerical ratings to banks for five different variables, i.e. capital, (quality of) advances, management, earnings and liquidity ("C.A.M.E.L." ratings).
(c) **Consolidation.** Under the provisions of Schedule 3, the Bank must assess capital adequacy by taking into account, not merely the risks undertaken by the authorised institution as a distinct corporate entity, but also the risks faced by the institution's group as a whole. An authorised institution can be contaminated by the financial difficulties of the non-deposit-taking members of its group, either as a result of its inability to recover illiquid equity holdings or other exposures to its affiliates or simply because of the market's inability to distinguish the credit standing of the different components in the group. To prevent this situation, financial performance is supervised, not only at the level of the bank as a separate company ("solo" supervision), but also at group level, especially on the basis of the group's consolidated balance sheets.

The principle of consolidated supervision has been endorsed internationally by the Basle Committee, while, at the European level, the Second Consolidated Supervision Directive provides a detailed framework for the consolidated supervision of banking groups, that the Member States are obliged to implement.

Under the Directive, every credit institution having subsidiaries which are also credit institutions or financial institutions (i.e. undertakings whose principal activity is to acquire holdings or to carry on certain banking activities without, however, accepting deposits from the public), or holding participations of more than 20% of the voting rights or capital in such institutions, is subject to supervision on the basis of the group's consolidated financial situation. The same applies to every credit institution which is the subsidiary of a financial holding company (i.e. a financial institution).
institution whose subsidiaries include at least one credit institution and are exclusively or mainly credit or financial institutions). 123

Full consolidation of the accounts of the entities concerned is required when the relationship between them is that between parent and subsidiary. 124 On the other hand, pro rata consolidation will be enough for minority participations in non-group entities, provided that the liability of the participant member of the group is limited to its share of those entities' capital. 125 The consolidated supervision of banking groups must cover the adequacy of the group's own funds to cover the risks from the group's credit and market activities, including the risks from large exposures, and the quality of internal control systems to the extent necessary for the production of consolidated supervisory returns. 126

Since the different entities within a banking group may be based in more than one Member State, the allocation of responsibility for the consolidated supervision of the whole group to a single regulator is necessary for the avoidance of regulatory overlap. 127 The Directive contains detailed provisions to this effect. If the group's parent is a credit institution, the group will be supervised by the parent's home regulator. If the group is headed by a financial holding company, it will be supervised by the home regulator of the group's credit institution subsidiary. In the latter case, if the parent financial holding company has subsidiaries authorised as credit institutions in different Member States, it will be supervised by the home regulator of that subsidiary which is incorporated in the same country as the parent or, where no such subsidiary exists, by one of the home regulators responsible for the group's credit institution subsidiaries, who must be chosen by common agreement; otherwise, by the home regulator of the subsidiary with the largest balance-sheet total. 128 However, the competent supervisory authorities may agree amongst themselves to allocate supervisory responsibilities on a different basis. 129

123 Art.3(1). "Financial holding company" is defined in art.1.
124 Art.5(1). Member States have the discretion to permit pro rata consolidation if the parent undertaking's liability is limited to its share of the capital, provided the liability of other shareholders is clearly established and their financial situation is satisfactory.
125 Art.5(2). The national authorities will determine whether and how consolidation shall be carried out in cases where a credit institution exercises a significant influence over other credit or financial institutions without, however, holding a participation, where two or more institutions are under common management or are governed by bodies in which the same persons constitute the majority; art.5(4).
126 Art.3(5)-(6).
127 Regarding groups which also include non-E.C. institutions, negotiations with third countries may be initiated by the Community for the purpose of reaching agreements regarding the means of exercising consolidated supervision; art.8.
128 Art.4(1)-(2). There are also provisions for the co-operation and exchange of regulatory information between the authorities of the Member States concerned; art.7.
129 Art.4(3)-(4). Nonetheless, it is unlikely that the group's home regulator would be willing to relinquish responsibility, since this would do little to enhance his prestige. The Directive also
Consolidated supervision does not automatically supersede solo supervision. However, if the home regulator of a particular bank is also responsible for the consolidated supervision of that bank's group, he has the right to waive the application of solo supervisory requirements, provided that he is satisfied that capital resources are distributed adequately within the group. On the other hand, the regulators of foreign subsidiaries must continue to supervise them on a solo or subconsolidated basis, unless their responsibility has been delegated by bilateral agreement to the group's home regulator.

The principle of consolidated supervision is reflected in the Banking Act 1987. In order to ensure that the Bank has the authority to conduct supervision in this manner, the Act gives it the power to request information and the production of documents from all undertakings which belong in the same corporate group as an

permits the delegation of the responsibility for the solo supervision of a locally-incorporated banking subsidiary from the host authority to the group's home regulator, art.3(9). S. Smith, "Consolidated supervision of banking groups: Basle or Brussels?" (1992) 7 J.I.B.L. 402, maintains that the limitations on competence of the host regulator under the European régime are irreconcilable with the Basle Committee's "Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishments" (Jun. 1992), which insists on the need for host authorities to exercise prudential control even in cases where the matter is, in principle, within the responsibility of the home regulator, if the latter fails to carry out effectively his supervisory work. The conflict of the two régimes can have practical consequences. As the B.C.C.I. case has proven, the authorities of the different Member States are not all equally well equipped, in terms of sophistication and manpower, for the effective supervision of banks under their jurisdiction. In particular, the allocation to every national authority of responsibility for the consolidated supervision of the foreign subsidiaries of its domestic banks may be unrealistic, if not actually counterproductive. The incompatibility of the two régimes, however, should not be exaggerated. Unlike European legislation, the regulatory work of the Basle Committee does not rest on firm legal foundations. This means that the substantive incompatibility of the standards is not a legal conflict. Furthermore, the mutual recognition of regulatory standards is the price that had to be paid for the construction of a Community-wide integrated market in banking services. From this standpoint, the internal market should be recognised as a single entity in the international arena, which is not affected directly by the Basle Committee's pronouncements insofar as relationships between the Member States are concerned. Finally, the substantive risks from the allocation of responsibility in the Directive are minimised by the recognition of the principle that regulatory discrepancies should not be actively exploited by banks and that forum-shopping should be prevented; see Second Consolidated Supervision Directive, preamble, 5th recital; and European Parliament and Council Directive 95/26/EC of 29.6.95 amending Directives 77/780/EEC and 89/646/EEC in the field of credit institutions, Directives 73/239/EEC and 92/49/EEC in the field of non-life insurance, Directives 79/267/EEC and 92/96/EEC in the field of life assurance, Directive 93/22/EEC in the field of investment firms and Directive 85/611/EEC in the field of undertakings for collective investment in transferable securities, with a view to reinforcing prudential supervision (the so-called "Post-B.C.C.I." Directive), preamble, 6th and 7th recital, and art.3(2) (inserting new art.3(2a) in the First Banking Directive).

130 Art.3(7).
131 Art.3(8)-(9).
authorised institution or are owned by that institution's shareholder controllers.\textsuperscript{132} The Second Consolidated Supervision Directive has necessitated the technical amendment of the relevant provisions.\textsuperscript{133} For the most part, however, the Directive's implementation has taken the form of a notice issued by the Bank.\textsuperscript{134} The notice applies to all U.K.-incorporated authorised institutions and in some cases expands the scope of the Bank's previous policy on consolidated supervision,\textsuperscript{135} which reflected the more limited requirements of the repealed First Consolidated Supervision Directive of 1983.

The Bank uses consolidated returns and other information to assess the strength of an authorised institution's group as a whole, in order to evaluate the potential contagion risks from other group affiliates. In doing so, it also takes into account the situation of those entities, \textit{e.g.} industrial or insurance undertakings, which are not included in the consolidation because the nature of their business is such that their consolidation would not be meaningful. For this purpose, it relies on discussions with the group's management.\textsuperscript{136}

The method of consolidation follows generally the rules set out in the Second Consolidated Supervision Directive. However, the Bank approaches the requirements of the Directive as comprising only minimum standards and is ready to require wider consolidation where, in its opinion, this will result in a more accurate picture of the risks facing an authorised institution.\textsuperscript{137} Furthermore, the Bank normally requires the full consolidation of minority participations, even though the Directive demands only \textit{pro rata} consolidation.\textsuperscript{138} It also requires the consolidation of companies over which a banking group exercises a "dominant influence" without, however, formally holding a participation.\textsuperscript{139} On the other hand, unless the Bank decides otherwise, the non-financial subsidiaries of a banking group are excluded from its consolidation, in which case the assessment of the group's capital adequacy

\textsuperscript{132} S.39(6)-(7), as replaced by S.I. 1992/3218, reg.36. On the Bank's power to require the production of information of supervisory relevance, see supra, ch.2, section 3(a).
\textsuperscript{133} \textit{Ibid.}; and Sch.3, para.4(3)(b), as replaced by S.I. 1992/3218, reg.27(2).
\textsuperscript{134} "Implementation in the United Kingdom of the Directive on the Consolidated Supervision of Credit Institutions" (BSD/1993/1, Feb. 1993).
\textsuperscript{136} \textit{Ibid.}, para.3. Where the preponderance of a group's business is of a non-banking nature, so that consolidation is inappropriate, the Bank will still collect regulatory information from the group's parent and his other subsidiaries and, if the parent is an insurance company, will also wish to liaise with his supervisors; paras.29-30.
\textsuperscript{137} \textit{Ibid.}, para.11.
\textsuperscript{138} \textit{Ibid.}, para.19.
\textsuperscript{139} \textit{Ibid.}, para.18.
takes place by deducting at book-value from the consolidated capital the capital investment in these subsidiaries.\textsuperscript{140}

Where an authorised institution belonging to a group with banks in different European countries is subject to consolidated supervision by another Member State's supervisory authorities, the Bank may agree, following discussion with these authorities, to forgo consolidation of the institution's domestic subgroup, on the ground that full responsibility for consolidated supervision should fall to the home supervisor of the group's principal bank.\textsuperscript{141} Where the parent of a domestic institution is incorporated outside the E.C., consolidation of the whole group will normally be unnecessary, although subconsolidation of the institution's own subsidiaries will be required.\textsuperscript{142}

Despite supervision at the group level, the authorised institution remains the focus of supervision. The activities of other group entities are taken into consideration only to the extent that they may influence its reputation and financial soundness. Nor can consolidated supervision provide a substitute for solo supervision, since intragroup exposures that may put at risk the authorised institution can only be revealed by solo supervision. For the same reason, the Bank will set capital requirements both at the solo and at the consolidated levels.\textsuperscript{143} Nonetheless, in situations where the group is managed as an integrated banking business by a U.K.-incorporated principal bank and its capital resources are freely transferable between its members, no capital cover will be required at the solo level for intragroup exposures to consolidated entities.\textsuperscript{144} In addition, those subsidiaries of an authorised institution which function in practice as its internal divisions can be consolidated with it for the assessment of capital adequacy at the solo level.\textsuperscript{145}

\begin{flushright}
\textsuperscript{140}Ibid., para.14. \\
\textsuperscript{141}Ibid., para.15. \\
\textsuperscript{142}Ibid., para.16. \\
\textsuperscript{143}Ibid., paras.4-5. Normally the consolidated capital ratio for a group will be the same as the capital ratio of its principal bank, although different risk considerations, including the location of capital in the group, the degree of risk diversification of the group's assets as compared to those of the bank or the existence of risks at the group level which are not reflected at the solo level, can suggest a different treatment for the group; other banks in the group will be required to meet the capital ratio which is appropriate for institutions with a similar profile of range and scale of business; ibid., paras.25-26. The assessment of capital adequacy at the consolidated level follows the same rules as for independent banks. Exceptionally, pending implementation of the relevant E.C. measures on capital adequacy for market risks, the Bank intends to employ for the market risks incurred by the non-bank entities in a group a special interim system, which explained in the notice; essentially, group entities supervised with regard to their securities business under the Financial Services Act 1986 are required to satisfy the capital-adequacy rules of their self-regulatory organisations; paras.7-8, 20-23. \\
\textsuperscript{144}Ibid., para.27. \\
\textsuperscript{145}Ibid., para.28. 
\end{flushright}
Large exposures. By diversifying its assets, a bank minimises its exposure to the credit or market risk inherent in holding claims on any single counterparty or group of counterparties sharing the same risk-characteristics. Excessive concentrations of risks, allowing a single default or other damaging occurrence to wipe out much of an institution's total value, are well-documented causes of bank failures. Concentration of risks defeats the risk-pooling role of banking intermediation, which is premised on the law of large numbers (i.e. the statistical principle that, the larger the number of independent risks in a portfolio, the more stable and predictable the proportion of those risks that will materialise at any given time - and, accordingly, the more able the risk-bearer to take precautions against potential losses).

Beyond the simpler cases of exposures to a single borrower, however, the identification of shared risk-factors as a basis for the classification of assets in groups of connected risks is a complicated and ambiguous task. Assets can be classified, with regard to credit risk, by grouping together all exposures to borrowers belonging to the same corporate group, economic sector, geographic location or country of origin; and with regard to market risks (i.e. the risks from holding positions in marketable instruments or open foreign-exchange positions), by taking account of the potential impact of uncertain market events, such as movements in asset prices, interest rates or exchange rates, on the value of the bank's portfolio. Any classification on the basis of such factors will necessarily rely on rough conventions. For example, a classification on the basis of geographic areas or economic sectors will always appear arbitrary, as different areas and sectors cannot be distinguished in a neat, self-evident way, while the specific risk of individual assets within an identified class may vary more than the average risk of different classes. Furthermore, some degree of concentrated risk-taking is unavoidable, and even desirable, as a corollary of specialisation in the assessment and monitoring of borrowers and projects. The prudence of assuming sectoral exposures of a particular scale will also vary, depending on the size, business characteristics and experience of each institution.146 Because of these problems that hinder the precise identification of classes of assets subject to common risks, the regulatory monitoring and control of connected exposures focuses primarily on the more tractable issue of large exposures to individual borrowers or groups of affiliated borrowers.

146 Accordingly, smaller institutions may have to adopt a more closely defined and detailed approach to sectoral classification; see Leigh-Pemberton Committee, "Report of the Committee set up to Consider the System of Banking Supervision" (Cmdn. 9550, Jun. 1985), para.5.9.
The Banking Act 1979 did not contain specific provisions on large exposures, although the concentration of lending to the commercial-property market was a major cause of the secondary banking crisis. Nonetheless, in the early 1980s a number of bank failures in the U.K. and abroad, including the collapse of Johnson Matthey Bankers, brought the matter to the forefront of regulatory concerns. An additional reason for concern was the inordinate expansion of concentrated lending to sovereign borrowers, whose vulnerability became apparent during the Third-World debt crisis of the same period. In early 1983, the Bank adopted a restrictive policy on large exposures. It threatened to respond to undue risk concentrations by increasing the capital requirements for the guilty institutions. It also started to monitor all exposures to single persons or groups of connected persons that exceeded 10% of an institution's capital base. The new policy was endorsed by the Leigh-Pemberton Committee and the White Paper that paved the way for the Banking Act 1987.

The introduction of specific statutory limits on large exposures was rejected. It was claimed that, if such general rules were put in place, the authorised institutions could respond by innovating around them or by interpreting them as an encouragement to trade up to the specified limits. Furthermore, the argument from flexibility was used once more: a general statutory rule would prove to be arbitrary and inflexible when applied to institutions having different business profiles or undertaking different types of exposures. Accordingly, the matter was left to regulation by flexible guidelines within the broader context of the Schedule 3 requirement that a bank must keep adequate capital resources to support its operations and meet risks. However, a statutory requirement was imposed on U.K.-based institutions to report their large exposures on an unconsolidated basis. The cut-off level for reportable exposures was set at 10% of an institution's capital base (with exposures of more than 25% of the capital base requiring prior notification), although for some institutions the Bank may demand a lower reporting threshold.

In terms of limits on risk-taking, the Bank's general policy originally precluded exposures to non-bank counterparties of more than 25% of an institution's capital base "in other than the most exceptional circumstances", but the determination of

147 Ibid., para.5.1.
148 Untitled notice on connected lending; accounts; large exposures; fraudulent invitations; floating charges (BSD/1983/1, Apr.1983), para.3.
149 Leigh-Pemberton Committee, loc.cit, paras.5.4 and 5.6.
150 S.38. The Bank's own reporting requirements go beyond the statutory ones, to include the large exposures of banking groups on a consolidated basis as well as the large exposures of branches of overseas banks. See supra, ch.2, n.366.
precise limits for each institution was left open for negotiation on an individual basis.\(^{152}\)

The regulatory restriction of large exposures in this manner clearly created a competitive disadvantage for internationally active U.K.-based banks. For this reason, the U.K. has been particularly interested in the harmonisation of law in this area. At the Basle level no final policies have been adopted in this direction, although in the early 1990s a recommendation on the lines of U.K. practice was issued, in response to fears that the almost exclusive preoccupation with issues relating to the capital-adequacy standards set out in the 1988 Accord could lead to an underestimation of the dangers involved in the concentration of risks.\(^{153}\) On the other hand, a degree of harmonisation has been achieved at the European level, where an earlier (and more lenient) recommendation\(^{154}\) was replaced in 1992 by the binding Large Exposures Directive,\(^{155}\) whose requirements reflect generally the U.K. approach.

The Directive harmonises the regulation of large credit exposures to single or connected borrowers, leaving the control of exposures to market risks at the discretion of Member States. It includes reporting requirements for large exposures, which are defined as exposures of more than 10% of own funds.\(^{156}\) It further prohibits exposures in excess of 25% of own funds to a single client or group of connected clients, unless these are covered in full by own funds,\(^{157}\) and sets an additional limit of 800% of own funds for all the large exposures of a credit institution taken together.\(^{158}\) Member States may impose more stringent limits, but they may also take advantage of an extensive range of national discretions in order to apply more relaxed limits to their national institutions.\(^{159}\) Transitional arrangements also allow the application of less burdensome limits until the end of 1998 and permit the gradual reduction of excessive exposures incurred before the introduction of the Directive until the end of 2001 at the latest.\(^{160}\) The Directive


\(^{153}\) "Measuring and Controlling Large Credit Exposures" (Jan. 1991).


\(^{156}\) Art.3.

\(^{157}\) Art.4(1). For exposures to members of a bank's own group (defined in terms of control, \(i.e.\) excluding minority participations) which are not included to its consolidated supervision, the limit is set at 20% of own funds, but an exemption can be made if intragroup exposures are subject to monitoring by the authorities by other means; art.4(2).

\(^{158}\) Art.4(3).

\(^{159}\) Art.4(4)-(11).

\(^{160}\) Art.6.
requires that the supervision of large exposures on a consolidated basis by the home regulator of a banking group, but also on an individual or subconsolidated basis by the host regulator in the case of bank subsidiaries authorised in another Member State.161

Even though the Directive establishes mandatory general limits on large exposures, including a new aggregate limit, its general affinity to the Bank's approach and its provision for extensive national discretions have allowed the Bank to continue to apply its prior policy with limited modifications only.162 In its present form, the policy applies mainly to U.K.-incorporated institutions, but the exposures of branches of overseas authorised institutions (but not of European institutions, since the supervision of large exposures is the responsibility of the home regulator) are also monitored.163 The policy applies at both the consolidated and solo levels.

This policy is concerned with a worst-case situation. Accordingly, exposures are measured as the maximum possible loss for the bank in the event of default by the relevant counterparty, which is generally estimated as the full book-value of the transactions involved.164 Nonetheless, in certain cases where the nominal amount of the transactions carries little relationship to the actual size of risk, this is estimated roughly on the basis of special rules. This is especially the case with regard to certain trading risks.165

The measured exposures to an individual counterparty or to a group of closely related counterparties are compared to the capital base of the institution and expressed as a proportion of own funds.166 Consistently with the Large Exposures Directive, explicit general limits on the size of such exposures have been introduced. A limit of 25% of own funds is set for exposures to any particular counterparty,

---

161 Art.5.
163 Ibid., paras.4 and 43.
164 Normally no risk-weightings or conversion factors are applied; ibid., para.11, and Ann.1, paras.1-8.
165 Although the calculation of large exposures is essentially confined to credit risks associated with particular counterparties, exposures from trading activities which are principally subject to market risks (and which involve credit risk only to a minimal extent, due to the generally good credit standing of issuers of tradable securities) are included in the calculation together with other exposures pending implementation of the Capital Adequacy Directive, which must be completed by 31 Dec. 1995; ibid., para.7. Exposures from securities trading are calculated as the net long position in a particular security; Ann.1, para.8. The policy also takes into consideration risk exposures arising from derivative instruments (interest-rate and foreign-exchange contracts, equity and commodity derivatives), which are estimated by converting the notional principal amounts of these instruments into credit-equivalent amounts on the basis of prescribed formulas; Ann.1, para.3.
166 Ibid., Ann.1, para.10.
while the aggregate of all large exposures cannot exceed 800%. The limits, however, do not apply to a significant range of "exempt exposures". The exemptions include: (i) short-term interbank exposures, which are considered as being normally liquid and involving only a low degree of risk; (ii) exposures to the central governments and central banks of Zone A countries (basically, the O.E.C.D. members); (iii) exposures to the governments of Zone B countries (the rest), but only insofar as these are principally subject to market risks or denominated and funded in the local currency; (iv) exposures secured on cash or Zone A government securities; and (v) exposures undertaken by subsidiary banks which are guaranteed by a parent bank, provided that the group is subject to consolidated supervision, that the exposures are within the terms of a policy agreed by the parent bank and that guarantees acceptable to the Bank have been provided.

In addition to monitoring and imposing general limits on large exposures, the Bank is also concerned with the appropriateness of the authorised institutions' strategic decisions and the quality of their control systems. Accordingly, each authorised institution must state in writing its internal policy on large exposures. In the case of domestic institutions, this written statement must be formally adopted by the board of directors. The policy should take into consideration particular characteristics, such as the standing of the institution's counterparties, the nature of its relationship to them, the nature and extent of any security taken against the exposure, the maturity of the exposure and the institution's expertise in transactions of the particular type, and satisfactory reasons must be given to the Bank for its adoption. The relevant control systems must be clearly specified and monitored by the board. The institution must adhere to its stated policy. Any significant breach raises questions regarding the institution's compliance with the minimum criteria for authorisation, while changes in the policy cannot be effected without prior discussion with the Bank.

Although the negotiated policy statements may reflect the Bank's views more than those of its regulatees, they appear formally as internal documents of the latter. By influencing their content, the Bank can exercise indirectly managerial control and superimpose on the generally applicable limits on large exposures additional ad hoc requirements, without, however, being obliged for this purpose to issue unilateral directions, which could be regarded as reviewable "decisions", opening the way to

---

167 Ibid., paras.13-15. For institutions subject to further consolidation, the Bank may in exceptional circumstances agree to waive these limits at the solo or subconsolidated level. This decision is taken on a case-by-case basis.
168 Ibid., para.25 and Ann.1, paras.21-27 and 31.
169 Ibid., paras.33-36.
170 Ibid., paras.8-10.
potential challenges. Under this system, the regulatees can challenge the Bank only if the latter takes remedial action against them. At that point, however, an institution which is in breach of its internal policy on large exposures (as distinct from one who has failed altogether to "justify" its policy to the Bank, i.e. to negotiate successfully a policy) will have to meet a considerable additional burden, because the breach can be held in itself against it, regardless of the prudential merits of this policy.

Even allowable large exposures may lead the Bank to impose higher capital requirements than would otherwise be the case. It is the Bank's practice, where a bank has a number of large exposures - and, in particular, when their total exceeds 100% of own funds -, to consider whether an increase in the capital requirements is necessary. To reach a conclusion, the Bank will consider the acceptability of the exposures in the context of the institution's internal policy, its particular characteristics, including the nature of its business and the experience of its management, as well as the number, size and nature of its exposures. Where a non-exempt exposure exceeds the prescribed general limit of 25% of own funds, however, the Bank will require significantly higher additional capital cover than for smaller exposures. The existence of such an exposure in other than the most exceptional circumstances will also call into question the institution's continued authorisation.

A special régime applies to large underwriting exposures. These are not included in the limits of the Large Exposures Directive and can, therefore, be exempted. The Bank's policy, however, covers underwriting exposures from discrete issues of securities (but not from revolving or continuing commitments), which are calculated by translating the underwritten stock into credit-equivalent amounts. In this context, the Bank discriminates between "expert" and "non-expert" underwriters. The designation of "expertness" is granted by the Bank on a discretionary basis. To qualify as experts, underwriters must demonstrate to the Bank's satisfaction that they have the necessary experience and skills and that they keep in place systems that ensure a capacity to properly monitor and control the relevant risks. The underwriting exposures of institutions which are considered to be non-experts are treated in the same way as other exposures, while for expert underwriters individual guidelines are agreed. This gives the Bank the effective power to decide who can engage in underwriting business in a financially viable way.

171 Ibid., para.37.
172 Ibid., paras.38-39.
173 Ibid., para.7 and Ann.2; and the more detailed treatment in the notice "Large Underwriting Exposures" (BSD/1987/1.1, Feb. 1988). The underwriting of securities can be the source of losses if the underwriter is forced to actually take up the unsold remainder of the underwritten issue, whose market price will have declined. The credit risk of new issues is generally low.
Significant modifications in the policy described above must be effected by 1 January 1996 in implementation of the Capital Adequacy Directive's special provisions relating to large exposures from trading-book activities. Under these provisions, exposures to individual clients which arise on the trading book must be calculated as the sum of (a) the positive excess of an institution's long positions over its short positions in all securities issued by the relevant counterparty; (b) net exposures from the underwriting of that counterparty's debt or equity securities, discounted by 100% for Working Day 0 (i.e. the working day on which the institution becomes unconditionally committed to accepting the securities at an agreed price) to 25% for Working Day 5, but taken at full value thereafter; and (c) exposures to that counterparty arising from unsettled transactions and undelivered securities. The sum must be added to the total nominal exposures arising on the banking book (net of items fully covered by a deduction from the own funds) to reflect the maximum potential loss from the counterparty's default or from the realisation of his securities at a distressed price.

The overall exposures to individual clients and groups of connected clients will be subject to the 25% limit of the Large Exposures Directives. However, the competent national authorities may allow credit institutions to exceed the limit, provided that the excess is attributable in its entirety to exposures arising on the trading book and that the excess is covered with additional capital. For the first 10 days after the occurrence of the excess, the additional capital requirement is set at double the capital cover against specific risk of those trading-risk items by which the exposure exceeds the limit and which attract the highest specific-risk requirements. When 10 days or more have elapsed, the additional capital requirement increases at an incremental scale, depending on the size of the excess as a percentage of own funds; thus, the requirement for those components of the exposure which amount up to 40% of own funds is set at double the cover against their specific risk, from 40 to 60%, at three times, and so on, with the requirement for items raising the exposure above 250% of own funds being set at nine times the cover against specific risk. Trading-book exposures to single clients or groups of connected clients should in no case exceed during the first 10 days 500% of an institution's own funds, while the total aggregate of excesses which have persisted for more than 10 days should not exceed 600%.

---

175 Art.5(2) and Ann.VI. The Bank's proposals regarding the U.K. implementation of these provisions are set out in the consultative document "Implementation of the Capital Adequacy Directive...", loc. cit., n.107, ch.7.
177 Ibid., paras.6 and 8.
Significantly, the Directive provides a special exemption from the limits for short-term trading-book exposures to investment firms, bringing their treatment in line with the preferential treatment of interbank exposures under the current policy.  

Credit exposures to connected counterparties, such as companies affiliated to the lending bank or its senior management, are an evident source of potential conflicts of interests. Likewise, they can increase the lending bank's vulnerability to contagion from the failure of non-bank members of its corporate group. For this reason, the Bank generally discourages such exposures, which should be undertaken only for the clear commercial advantage of the lending bank and, even then, be negotiated and agreed at arm's length. If their economic nature is that of a capital investment in the connected entity or they are made on concessionary terms, they must be deducted from the own funds for capital-adequacy purposes. The size of the exposure is irrelevant in this case.

For the purposes of consolidated supervision, all exposures to unconsolidated connected counterparties taken together should not exceed 25% of own funds, but certain exposures may be excluded from consideration if it can be shown to the Bank's satisfaction that the relationships with the relevant counterparty are at arm's length.

At the unconsolidated level, exposures to subsidiaries which operate as effective divisions of their parent bank and are supervised with it on a solo-consolidated basis are exempted from the 25% limit. In circumstances where a bank acts as treasurer for its group as a whole, it may negotiate with the Bank a special concession for exposures resulting from central risk-management functions on behalf of its affiliates, provided that the group is subject to consolidated supervision. Even where a bank does not perform group treasury functions, it may be allowed in exceptional cases to engage in short-term lending of surplus liquid funds in excess of 25% of own funds to another bank which controls it. Exposures to other connected banks incorporated within the E.C. are considered on a case-by-case basis. Intragroup exposures not covered by any exemption are subject to an overall limit of 25% of own funds.

For reasons already explained, the identification and estimation of exposures to assets which, while involving different counterparties, relate to the same sector,

---

178 Ibid., para.7.
179 BSD/1993/2, loc.cit., n.162, paras.16-18 and Ann.1, paras.15-16. The resulting exposures can be higher than the 20% limit of the Large Exposures Directive; see supra, n.157.
180 Ibid., paras.26-32 and Ann.1, paras.28-30.
region, etc., or are otherwise subject to common risk-factors, is an inherently ambiguous exercise. Accordingly, the Bank does not set general limits on sectoral or regional exposures. Instead, it monitors individual institutions in order to ensure that the sectoral break-down of lending in their management reports, their lending policies and their internal controls are appropriate and carefully analyses the sectoral exposures reported in the prudential returns.181

Country exposures, which not only merit special consideration but are also easily defined, are treated separately within the general framework of the policy on large exposures. The Third-World debt crisis of the mid-1980s was a reminder that overexposure to country risks can have disastrous consequences for the lending bank.182 In the event of repudiation by a sovereign counterparty of its international financial obligations, the lending banks may have virtually no redress. Country risk can also be a source of losses on loans to foreign private-sector counterparties, if the latter's country faces difficulties with regard to its international payments.

While vast differences in the debt-servicing prospects of particular countries make the imposition of a common limit on all aggregate country exposures unreasonable, the publication of explicit guidelines for acceptable levels of exposure to individual countries would stumble on "[[legitimate concern about political sensitivities].183 Instead, the Bank expects that the authorised institutions will set their own internal limits on country exposures on the basis of their own risk assessments, with the Bank reserving for itself a monitoring role.184

A final aspect of the Bank's approach to concentrated risk-taking concerns the treatment of foreign-currency exposures. The events of the mid-1970s, especially the collapse of Bank Herstatt, proved that exposures to adverse movements in foreign-exchange rates are a major source of risk in international banking, since they can lead to very heavy losses in a very brief period of time. To contain this risk, the Bank adopted as early as 1975 a policy of setting limits to banks' foreign-exchange positions.185

---

181 Ibid., paras.41-42.

182 The regulatory response to the crisis provides an example of potential inconsistency between the macroeconomic and supervisory aims of the Bank. As central banker, the Bank stood behind the efforts for the refinancing of the debt, in order to avert a major breakdown of the international financial system; at the same time, as supervisor, it insisted on increased capital and provisions against country exposures. In the Bank's opinion, the tension was only apparent, because increased provisioning was necessary in case things went wrong, while continuing lending was encouraged to ensure that this would not happen; "Supervision and central banking" (1987) 27 B.E.Q.B. 380, p.384.

183 Leigh-Pemberton Committee, loc.cit., n.146, para.5.8.


The policy, which was revised a few years later, addresses specifically the problem of those uncovered foreign-currency and bullion positions that arise from a bank's normal day-to-day trading operations ("dealing" positions), as distinct from longer-term exposures of an investment nature ("structural" positions), including exposures from foreign-currency option contracts. The Bank demands frequent reporting by all institutions of their currency positions.

In the case of domestic institutions, the Bank also agrees with each institution individually, on the basis of the institution's business characteristics and level of experience, guidelines on currency exposures. As a rule, an institution experienced in foreign-exchange business will be expected to work within guidelines setting a limit of 10% of its own funds on the net open dealing position in any one currency, with an additional requirement that total short open positions in all currencies taken together do not exceed 15%. This amounts to an effective maximum limit for currency exposures.

(e) Provisioning. Banking institutions are required under the Companies Act 1985 to make provisions for depreciation or diminution in the value of their assets, for liabilities which will or may fall to be discharged and for operating losses which are certain or likely to occur. In particular, they must make provisions against bad or doubtful debts and projected losses on their contingent liabilities. Compliance with this requirement is also necessary as a minimum criterion for their authorisation.

In this regard, the Bank expects authorised institutions to accurately valuate their assets and recognise all liabilities and losses in accordance with accepted accounting standards, as embodied in the Statements of Standard Accounting Practice and Financial Reporting Standards. For the assessment of the adequacy of actual provisions, the Bank takes into consideration an institution's provisioning policy, including its methods and systems for identifying problem loans, the frequency with

187 Ibid., paras.6-8, 10-11.
188 "Foreign Currency Options" (Apr. 1984). The valuation of exposures from option contracts must be on a "worst view" basis. If, however, the Bank is satisfied that the authorised institution has developed a more precise method for calculating its exposures in a mathematically valid way and that its operating systems for conducting business and controlling its options book are adequate, it may exercise its discretion to permit the institution to use its own formula.
189 Ibid., paras.18-23.
190 Ibid., paras.12-13. The Bank also monitors the positions and control systems of the U.K. branches of foreign institutions. When it is not satisfied with the controls on exchange operations by the foreign institution as a whole or with the monitoring arrangements of its supervisor, the Bank may set special guidelines for the branch; paras.16-17. It seems doubtful, however, whether a branch can be ring-fenced in this manner from the overall currency risks facing the bank as a single corporate entity.
191 Banking Act 1987, Sch.3, para.4(6).
which provisions are reviewed and its policies and practices regarding the taking of
security.\(^{192}\)

A special policy applies to provisioning against exposures to counties experiencing debt servicing and repayment difficulties. The policy, which is intended to discourage lending without necessitating the politically uncomfortable public identification of problem countries or setting of specific country guidelines by the Bank, imposes general provisioning requirements for sovereign and other country-risk exposures in the form of the so-called "matrix". The matrix identifies a set of objective indicators of repayment difficulties and assigns numerical weights, or scores, to the different degrees of intensity of each indicator. The higher the overall score resulting from the application of the matrix to a particular country, the higher the level of provisions that the lending institution must keep against its total exposure to that country as a proportion of that exposure, unless it can satisfy the Bank that a particular claim or class of claims will be repaid in full and can, accordingly, be exempted from the requirements.\(^{193}\)

It must be noted in this context that, despite its insistence on country-debt provisioning, the Bank discourages banks from making provisions "where this has more to do with gaining a short-term publicity advantage than with the longer-term interests of shareholders".\(^{194}\) This is difficult to reconcile with the general tendency of its policy. Moreover, the very distinction that the Bank seeks to draw is highly questionable: resting as it does on the assumption that a bank could indulge in posturing on the basis of superficial indicators even when this is detrimental to the interests of their own shareholders, it betrays a fundamental distrust of commercial rationality.

**(f) Liquidity requirements.** Under the provisions of Schedule 3 of the Banking Act, the prudent conduct of an institution's business depends on the maintenance of

---


\(^{193}\) The current matrix is set out in the Bank's letter on the "Country Debt Provisioning Matrix" (26 Feb. 1993), which is addressed to the U.K.-incorporated authorised institutions with exposures to countries experiencing debt servicing and repayment difficulties. A similar policy was adopted for the first time in Aug. 1987, but, in addition to technical modifications, subsequent reviews of the policy have also resulted in significant tightening of the provisioning requirements. In the past, officials of the Bank had expressed reservations about the formalisation of provisioning requirements, on the ground that this could not reflect factors of great importance, such as lender confidence and the political will of the borrowing country, and had also disputed the significance of the market price for foreign debt as an indicator of the value of loan assets for a bank which intended to hold them to maturity, concluding that the responsibility for taking a decision on the appropriate level of provisions should rest primarily with an institution's management, although the supervisor should ensure that the management approaches the question responsibly; B. Quinn, "Supervisory aspects of country risk" (1984) 24 *B.E.Q.B.* 235.

\(^{194}\) *Annual Report under the Banking Act for 1987-88*, p.20.
adequate liquidity. Liquidity adequacy must be judged on the basis of: the relationship between the institution's liquid assets and its actual and contingent liabilities; the maturity profile of its liabilities; the nature and scale of its operations; the risks inherent in its operations and in the operations of any other member of its group, insofar as these are capable of affecting the institution; and any other consideration that would appear, in the Bank's opinion, to be relevant.195

Liquidity has always been one of the primary banking concerns, reflecting the funding risk inherent in deposit-taking. By the mid-1970s, however, when the Bank sought to establish a comprehensive framework of banking supervision, the traditional methods for the measurement of liquidity, which were generally based on a simple comparison of an institution's deposit liabilities with its holdings of certain categories of short-term or "liquid" assets, had become outdated.

Starting in the 1960s, the development of the interbank market and sophisticated financial techniques of active asset and liability management created an environment in which opportunities for the acquisition of earning assets (loans and investments) could be exploited by raising additional wholesale deposits, usually of a shorter maturity, in the interbank market. Conversely, when the rates were favourable, new liabilities could be accepted and subsequently deployed in the acquisition of marketable assets.196 The banking difficulties of the mid-1970s, occurring at a stage when the appreciation of the prudential implications of the new practices was yet limited, illustrated the dangers from the increased interdependence of banking institutions as a result of wholesale funding and impressed the need for appropriate policies of liquidity management to ensure the minimisation of funding risks. In particular, these policies should include close control of, and limits on, mismatches between the maturity profile of assets and liabilities and the expected cash-flows thereof, diversification of funding sources, securing of safe supplementary sources of liquid funds and hedging against interest-rate risk.

In the aftermath of the secondary banking crisis, the Bank attempted to incorporate the lessons of recent experience into the design of the new prudential requirements.197 The Working Party which was established by the Bank and the clearing banks for this purpose, in addition to raising for the first time the issue of capital adequacy, also stressed the continuing significance of liquidity. Liquidity was

195 Sch.3, para.4(4).
197 See M.J.B. Hall, "Managing liquidity", in Wilson (ed.), ibid., pp.60-64. Initially, the emergence of prudential liquidity controls did not affect the reserve-asset ratio that banks were required to observe for monetary control purposes. This was only abolished in 1981, signifying the total abandonment of direct monetary controls. See supra, ch.1, section 2(c).
necessary for meeting increases in the demand for the repayment of deposits or the extension of advances under lending commitments, shortfalls in anticipated inward cash-flows and unexpected operating expenditures and losses. Observing that the liquidity demands of each institution depend on its type of business and historical experience, the Working Party expressed the belief that reliance on wholesale funding and maturity mismatching increased the vulnerability of banks and created the need for greater liquidity. The Working Party concluded that banks should achieve this goal through a combination of maturity-matching their assets and liabilities, holding a stock of liquid assets and securing stand-by funding facilities, setting the ground for a cash-flow-based regulatory approach to the measurement of liquidity.198

Following the enactment of the Banking Act 1979, the Bank pursued the elaboration of liquidity standards for deposit-taking institutions with the release of a consultative document,199 which affirmed its commitment to ensuring that every bank would be capable to deal with any shortfall, whether anticipated or not, in cash inflows, but also that the banking system as a whole would stay liquid. The Bank proposed that all licensed institutions should in the future hold a liquid-assets cover calculated as a percentage of both "gross maturity-uncertain liabilities" (i.e. demand deposits) and the net liability positions from mismatched maturity-certain liabilities and assets. The cover should vary depending on the remaining time to maturity, declining from 90% of net liabilities in the one-to-eight-days band to 5% in the over-one-year band, with an additional 100% cover for gross interbank deposits maturing within one month and undrawn irrevocable standbys given to banks, since these liabilities served as secondary liquid assets for the counterparty institutions, and 25% for maturity-uncertain liabilities. Part of the cover, amounting to an average of 40% of an institution's total sterling deposit base, should be in the form of high-grade liquid assets, including cash, balances at the Bank or paper eligible for rediscount with the Bank, which were designated as "primary liquidity".

The proposed standards were condemned by the banking world as arbitrary. There were fears that they would be covertly used for monetary control purposes; worries that, if extended to foreign-currency business, they would drive business out of London; protestations by the non-clearing banks that the rules would penalise them, because they relied largely on wholesale deposits, while the clearers had a large retail-deposit base of uncertain maturity; doubts about the precise market effect of the designation of certain assets as primary liquidity; and warnings that the

rules would distort the wholesale markets by raising the relative cost of interbank lending over non-bank wholesale deposits and issues of certificates of deposit.200

In the face of these criticisms, the Bank reacted by abandoning its plans for specific liquidity requirements and praising instead the advantages of a case-to-case approach, although it expressed its continuing willingness to see the achievement of a generally applicable basis for the measurement of liquidity.201 This materialised in 1982, with the publication of a final policy paper,202 which is still in force.

The Bank insists on the need for banks to maintain an assured capacity to meet their obligations, including those arising under deposits and commitments to lend, when they fall due. Its policy recognises that this capacity can be attained by a combination of three lines of protection: (a) by holding cash or readily realisable assets, although the quality of marketable assets, in terms of their sensitivity to price movements and forced-sale discounting, will vary; (b) by securing matching expected cash inflows from maturing assets, subject to the qualification that shortfalls may occur in practice if borrowers are unable to repay; or (c) by maintaining an adequately diversified deposit base, in terms both of maturities and of bank and non-bank counterparties, which could provide the institution concerned with the ability to bid for new funds at reasonable cost, subject to its standing in the market and the general liquidity condition of the banking system as a whole.203

The Bank's declared objective in this connection is to ensure that each institution has in place a policy which provides for a prudent mix of these sources of liquidity (i.e. a mix which does not expose the institution to the risk of rising costs from the forced liquidation of assets or from bidding for deposits) and that this policy is applied consistently with the help of appropriate control systems. The institution must formulate a statement of its liquidity management policy, which forms the basis for the Bank's regular discussions with the senior management. In assessing the prudence of an institution's policy, the Bank takes into consideration its particular characteristics and its position in the banking system.204

A common method for the measurement of liquidity, based on a cash-flow approach, has been adopted for all authorised institutions,205 with the intention that

200 See M. Blanden, "How the Bank's liquidity controls will bite" (Jul. 1980) 130:653 The Banker 25; and Hall, loc.cit., n.197, p.62.
203 Ibid., para.2.
204 Ibid., paras.3-4; and Statement of Principles, "Banking Act 1987: Section 16", loc.cit., n.10, paras.2.20-2.21.
the resulting quantitative profile will provide the first step for an eventual individualised qualitative assessment and discussions with management.\footnote{Ibid., paras.5 and 8.} For the purposes of the measurement, all liabilities and assets, regardless of their currency of denomination, are inserted in a "maturity ladder", with five maturity bands (sight to eight days, eight days to one month, one to three months, three to six months and six months to one year). The net mismatch positions in the successive time bands are accumulated as a means of reflecting the overall extent of liquidity risks, although in analysing and discussing the results particular attention is paid to the earlier maturities. Marketable assets are placed in the first maturity band, rather than in that corresponding to their maturity date, but are subject to discounts which represent their different degrees of marketability and price volatility. The treatment of loan assets which are only nominally repayable on demand must be agreed individually with the Bank, while assets of doubtful value are excluded completely or treated on a case-by-case basis. Insofar as liabilities are concerned, deposits are included according to their earliest maturity, but the stability and diversification of an institution's deposit base is taken into account by establishing special guidelines. Firm lending commitments are included as liabilities in the appropriate time bands, but outstanding stand-by commitments, which are unlikely to have to be met in full, are only partially included in the first band, with the remainder being excluded. Finally, contingent liabilities are excluded, unless they are likely to be triggered.\footnote{Ibid., paras.8-12 and Ann. 1 and 2.}

Although the Bank insists on limits to the size of mismatches in the two shortest maturity bands (up to eight days and up to thirty days), there is no overall norm. In practice, the Bank may accept a negative mismatch, e.g. of 10%, for the liabilities maturing within the first band, provided that the institution concerned has a reliable depositor base, is able to predict with accuracy the proportion of lending commitments that may be drawn in a period of time, etc. Peer-groups of institutions with similar balance-sheet structure are identified and the behaviour of those with a good record is adopted as a standard for their group.\footnote{B. Quinn, "The management of liquidity" (1988) 28 B.E.Q.B. 236, p.239.}

The consolidated measurement of liquidity may be required from banks having subsidiaries operating mainly in the U.K. Consolidation will often be of little help for banks with foreign subsidiaries, or even branches, due to the different local conditions and regulatory requirements, but in this case the Bank will attempt to ensure its prudential objectives in another way, e.g. through the examination of internal arrangements for the management of the banking group's world-wide liquidity needs.\footnote{"The Measurement of Liquidity", loc.cit., n.202, para.13.}
Despite the fact that its original proposals for generally applicable liquidity requirements met stiff resistance, the Bank continued to be preoccupied with the need for cover against the risk of short-term market-wide disturbances, which is not reflected in the cash-flow approach to the measurement of liquidity. From July 1986 until 1989, another attempt was made for the introduction of common mandatory standards. At first, the Bank proposed that authorised institutions cover at least 12% of their short-term sterling liabilities by holdings of prescribed liquid assets, with daily shortfalls being liable to notification to the Bank.\textsuperscript{10} Although the industry accepted the need for some form of coverage, it rejected the 12% minimum (which implied an even higher average) as unnecessarily restrictive and distortive. Two more consultative documents appeared in 1988, proposing the introduction of a requirement for the holding of a two-tier "stock of high-quality liquidity" in the range of 10 to 25% of one-to-eight-day gross liabilities.\textsuperscript{21} The publication of these papers was followed by an extended, but unfruitful, consultation period. Under the pressure of the banking community, which objected both to the rationale of the proposals and to the costs that the imposition of the stock requirement would involve, the Bank decided to abandon its attempt, pending convergence at the Basle or E.C. level.\textsuperscript{212} This episode illustrates the continuing ability of regulatees to influence the development of regulatory policy.

3. The regulation of bank ownership, control and management

The first requirement that must be satisfied by an institution under the provisions of Schedule 3 of the Banking Act is that its individual directors, controllers and managers are fit and proper persons to hold their particular positions.\textsuperscript{213} The

\textsuperscript{10} "Sterling Liquidity for Institutions Authorised under the Banking Act 1979" (Jul. 1986).
\textsuperscript{21} "Proposals for a Stock of High Quality Liquidity" (25 Mar. 1988); "Revised Proposals for a Stock of High Quality Liquidity" (Dec. 1988).
\textsuperscript{212} "Banking Act 1987: Annual Report under the Banking Act for 1989-90", p.17. Although the Basle Committee has been concerned with the issue of liquidity at least since 1985, the efforts to devise a common framework for measurement have floundered, because the difficulties involved in defining and measuring liquidity and setting appropriate requirements are more substantial than those concerning capital. Furthermore, the liquidity needs of banks depend on the special characteristics of the national monetary system, making harmonisation difficult. See Quinn, "The management of liquidity", \textit{loc. cit.}, n.208.
\textsuperscript{213} Sch.3, para.1(1). The authorised institution is under an obligation to give notice to the Bank of any change in the persons of its directors, controllers and managers within fourteen days from becoming aware of the relevant facts; s.36. It is also required to submit an annual statement, naming the persons who are, to its knowledge, its shareholder controllers and giving particulars of their interest in it; s.36A, inserted by S.I. 1992/3218, reg.33.
statutory definition of "directors" includes all persons occupying, whether formally or de facto, the position of a director in the institution, while that of "managers" includes persons who, under the immediate authority of a director or chief executive, exercise managerial functions or are responsible for maintaining the institution's accounts and records. The definition of "controllers" includes the chief executive, managing director and significant shareholders of the institution or its parent company, as well as indirect controllers, i.e. persons in accordance with whose directions the directors, managers or shareholders of the institution are accustomed to act. Shareholder controllers, in particular, are subdivided in categories depending on the size of their holding either in the deposit-taking institution itself or its parent company.

In situations where the Bank is not satisfied that a director, manager or non-shareholder controller is a fit and proper person, it can take formal action against the institution, by refusing, revoking or restricting its authorisation, but cannot act directly against that person.

A formal power of objection is available to the Bank only against individual shareholder controllers. Thus, any person intending to acquire an interest in an authorised deposit-taking institution or in its parent company or to increase an existing interest, must notify in advance the Bank of this intention, if by virtue of the acquisition he is to become a controller or, in the event that he is already a controller, to increase his holding above the thresholds of 10%, 20%, 33%, 50% or 75% of the total shares or voting rights in the relevant company. The notification must include the information specified by the Bank, but the Bank can make additional enquiries in particular cases. After receiving notification or any additional information that it may have requested, the Bank has three months in which to object, by way of formal notice, to the acquisition.

The Bank may object to the new or increased control if it is not convinced that the person concerned is fit and proper to become a shareholder controller of the particular description, that his likely influence will not impede the continuing

---

214 S.105, as amended by S.I. 1992/3218, reg.43.
215 S.105(4), as substituted by S.I. 1992/3218, reg.43(2), distinguishes between 10%, 20%, 33%, majority and principal shareholder controllers (persons who, either alone or together with associates, hold, respectively, from 10% to 20%, from 20% to 33%, from 33% to 50%, from 50% to 75%, and 75% or more of the shares or voting rights) and minority shareholder controllers, who exercise de facto a significant influence over the institution's management even though their holdings are below the minimum threshold of 10%.
216 Ss.21-26. The statutory provisions have been amended by S.I. 1992/3218, reg.31, insofar as this was necessary for ensuring full consistency with the equivalent provisions of art.11 of the Second Banking Directive.
217 The provisions apply also to persons intending to become indirect controllers.
218 S.21.
fulfilment of the minimum criteria of authorisation and that the interests of the relevant institution's depositors will not be otherwise threatened by the change in ownership. Before taking a final decision on the matter, the Bank is required to give to the prospective controller written notification of the fact that it considers making a notice of objection against him, specifying the nature of its concerns and providing reasons. The controller has a right respond to the preliminary notice by way of written representations, which must be taken into account by the Bank in its final decision. However, the Bank can refuse to give reasons if this would require, in its opinion, the disclosure of confidential information, with possible prejudicial consequences for third parties. A power of objection is also available, under similar procedural safeguards, against existing shareholder controllers, where it appears to the Bank that these are not, or are no longer, fit and proper to be controllers of the particular description.

Originally, the Bank's powers of objection were exercisable against the controllers of U.K.-incorporated institutions only. Following the implementation of the Second Banking Directive, however, prior clearance by the Bank is now required for the assumption of new or increased control in any authorised institution, although the Bank's power of objection to existing controllers is still confined to domestic institutions. As a result of the change, take-overs or other changes in the control of third-country banks authorised in the U.K. could in principle be blocked by the Bank, notwithstanding the views of the responsible home regulators. In practice, however, this is unlikely to happen, since the Bank would probably choose to withdraw the U.K. authorisation instead of attempting a direct extraterritorial intervention.

Regarding the enforcement of these rules, any person who knowingly fails to give notice of his prospective acquisition of a controlling interest, as required by the Act, or acquires that interest before the end of the three-month period in which the Bank can issue its objections, is guilty of an offence, punishable by a fine. Heavier penalties, including imprisonment, are available against a person who becomes or remains a shareholder controller after being served with a notice of objection. In addition, the Bank can give to any person who becomes, or continues to be, a

---

219 S.22. In situations where the prospective shareholder controller of an authorised institution is a credit institution authorised in another Member State, or a parent of such an institution, and proposes to acquire a majority interest, the Bank must consult the supervisory authorities of that Member State before reaching a decision on whether to serve or not a notice of objection; s.22(1A), inserted by S.I. 1992/3218, reg.31(2).

220 S.24.

221 Cf. the original s.21(1) with the amended version of reg.31(1) of S.I. 1992/3218.

222 S.25. It is also an offence, punishable by fine, to knowingly cease to be a shareholder controller of a particular description without giving prior notification to the Bank; s.37A, inserted by S.I. 1992/3218, reg.35.
shareholder controller in violation of a notice of objection, a direction prohibiting the
transfer of the relevant shares, the exercise of voting rights in respect of the shares,
or the payment of dividends or capital from the institution on the shares, except
upon the institution's liquidation. The Bank may also apply to the High Court for an
order requiring the forced sale of the relevant shares.\textsuperscript{23}

\textit{(a) Fitness of bank owners and directors as a criterion of authorisation.} The
major difficulty with regard to the screening of bank directors, controllers and
managers arises from the lack of an objective and entrenched test of fitness. An old
maxim maintains that fit to execute an office (in the Latin terminology, \textit{idoneus}) is
that person "\textit{qui melius et sciat et possit, officium illud intendere}". Accordingly, a
fit person must have three attributes: honesty, knowledge, and, in the words once
used by Lord Coke, "ability, as well in estate as in body, that he may intend and
execute his office, when need is, diligently, and not for impotency or poverty neglect
it".\textsuperscript{24} In a modern regulatory context, an ability and willingness to comply fully and
substantially with relevant regulatory requirements should be added as a fourth
element. Furthermore, the question of fitness is confined in principle to whether the
applicant has the appropriate personal attributes for holding his particular position.
An inquiry into the particular manner in which the applicant conducts, or proposes
to conduct, his business is not part of the question, at least as long as the business is
not carried on in a manner which indicates an absence of proper and effective
control on his part.\textsuperscript{25} Although the above shed some light on the meaning of fitness,
they are too general and abstract to provide an operational test for the purposes of
regulatory practice.

More detailed criteria for the individuation of the fitness requirement for the
immediate purposes of the Banking Act are set out in Schedule 3. Accordingly, to
determine a person's fitness, the Bank must consider whether this person displays
probity, competence and soundness of judgement which may allow him to meet the
responsibilities of his particular position, and diligence in the performance of those
responsibilities. The Bank must also take into account any other factor by virtue of
which the occupation by this person of the particular position may have a negative
impact on the interests of depositors.\textsuperscript{26} Special regard must be paid to a person's
past record. In particular, any evidence suggesting to the Bank previous engagement
in illegal, fraudulent or otherwise objectionable business conduct can be critical. This

\textsuperscript{223} S.26.
\textsuperscript{224} Stroud's Judicial Dictionary of Words and Phrases (5th ed., by J.S. James, 1986), Vol. II,
pp.989-990.
\textsuperscript{226} Sch.3, para.1(2).
will be the case, in particular, if the person has committed fraud or other offences involving dishonesty or violence; if he has breached any statutory provision of company, banking, insurance, financial-services or insolvency law enacted for the purpose of protecting the financial interests of the investing public from dishonesty, incompetence or malpractice; if it appears to the Bank that he has engaged in deceitful, oppressive, improper or disreputable business practices; or if he has "engaged in or been associated with any other business practices or otherwise conducted himself in such a way as to cast doubt on his competence and soundness of judgement." 227 Interestingly, the statutory provisions do not require the existence of any particular formal qualifications, degrees, length of previous experience, etc.

Although the criteria appear to be detailed, in practice they mainly concern issues of qualitative evaluation, which are left to the Bank's judgement. The subjective element is particularly strong insofar as questions concerning a person's competence and soundness of judgement, his involvement or association with practices which "cast doubt" in this regard, or the existence of unspecified potential threats to the interests of depositors, are concerned. In view of the Bank's ample margin of subjective evaluation and of the fact that, once some reasonable basis for suspecting breach of the statutory criteria of authorisation can be invoked, the burden of disproving it shifts to the regulatees, the evidential threshold for a finding of unfitness may be crossed easily, if the Bank has made up its mind to remove somebody from the banking industry. 228 This situation increases the risk of discriminatory or arbitrary treatment of specific individuals, raising a potential threat to the freedoms of employment and economic activity in the field of banking. Conversely, even where the Bank has formed an opinion that the person concerned does not meet the criteria, it is not bound by its finding of fact. Even a criminal conviction for offences directed against the interests of the investing public does not lead to automatic disqualification.

An indication of the Bank's own approach to the issue of fitness can be found in its Statement of Principles, which, in pursuance of section 16 of the Banking Act,

227 Sch.3, para.1(3). S.95 of the Banking Act restricts the Rehabilitation of Offenders Act 1974, with the effect that even spent convictions for offences involving fraud or other dishonesty, or offences under legislation relating to companies (including insider dealing), building societies, industrial and provident societies, credit unions, friendly societies, insurance, banking or other financial services, insolvency, consumer credit or consumer protection, can be taken into account as evidence of a person's unfitness to be a director, controller or manager of deposit-taking institutions.

228 As the British Bankers' Association has noted in relation to the vetting of shareholder controllers, "the prospective controller must satisfy the Bank that he is suitable, which could impose a significant burden of proof on him. In practice this may mean that the Bank enjoys considerable freedom to make objection and argue about it afterwards."; The Banking Act 1987: A Commentary (Oct. 1987), p.24.
sets out the principles guiding its interpretation of the criteria of Schedule 3 and the exercise of its powers regarding authorisation.\textsuperscript{229}

Drawing a distinction between questions of ability or competence, on the one hand, and probity, on the other, the Bank makes it clear that the skills, knowledge, soundness of judgement and diligence required from bank directors, managers and non-shareholder controllers, \textit{i.e.} chief executives and managing directors, vary considerably, depending on the precise position held by each of them and the nature and scale of the institution's business. The standards can be particularly high for those having the main responsibility for the conduct of the institution's affairs. In contrast, the level of probity and integrity required will tend to be the same for everybody, irrespective of position. Significantly, the Bank is prepared to form an opinion regarding such inherently indeterminate, relative or subjective matters as the "reputation and character" or the decision-making "balance, rationality and maturity" of the persons concerned. Actions indicating imprudence or having the potential of prejudicing the interests of depositors are taken into consideration cumulatively. Accordingly, taken together, several instances of imprudent conduct may lead the Bank to the conclusion that a person is unfit, even though separately they might not justify this conclusion.\textsuperscript{230}

For shareholder controllers, the required standard of fitness generally depends on the degree of influence that these exercise on the conduct of the deposit-taking institution's affairs. For example, the requirements will generally be higher for shareholders owning a 20-33\% holding than for those owning 10-20\%. But, if a controller's real influence exceeds that implied by the size of his shareholding, the required standard will be adjusted accordingly. Where a controller does, or is likely to, exercise close control, the Bank will require the skills, knowledge and soundness of judgement that would be expected from an executive director; this will not be the case for those shareholder controllers who have a passive role only. A related consideration is whether the controller's influence can be a source of conflicts of interests. This could be the case, for instance, if the controller were closely involved in the conduct of another company, which is a client of the deposit-taking institution. The second factor of relevance for the fitness of shareholder controllers is the likelihood that their financial situation, reputation or conduct may affect the institution through "contagion". The financial difficulties of an institution's holding company or majority controller can lead to loss of confidence to that institution. The Bank maintains that contagion can also occur as a result of non-financial events, \textit{e.g.} adverse publicity arising from illegal or unethical conduct by persons belonging to

\textsuperscript{230} \textit{Ibid.}, paras.2.44-2.49.
the institution's group. It must be noted in this context that both the authorised
institutions and their individual controllers are expected to inform the Bank of any
material developments which may put in doubt the controllers' continuing fitness and
propersness or raise concerns for the interests of depositors.

Less obviously, the Bank follows a practice for which there is no support in the
statutory provisions, of requiring the shareholder controllers of U.K.-incorporated
authorised institutions to provide it with letters of comfort, recognising their moral
responsibility to support their institutions should these run into difficulties. This
practice commenced in the mid-1970s, with the Bank seeking letters of comfort
from foreign banks with shareholdings in domestic institutions, and has since been
extended to non-bank and domestic large shareholders. After obtaining a letter of
comfort, the Bank continues to monitor the foreign bank for the purpose of ensuring
that it has the financial resources that may be required, if need be, for the honouring
of its commitment.

A long distance separates this system of pre-emptive evaluation of the personal
fitness of bank directors and controllers from the very limited and purely reactive
legal remedies that are available against dishonest or incompetent directors of
ordinary companies. Company directors are not required to prove in advance any
particular ability or diligence, and the degree of skill that they must display in the
performance of their duties depends on their subjective knowledge and
experience. Provided that they are not guilty of dishonest acts, e.g. by
misappropriating funds belonging to their company or defrauding its creditors (in
which case they may be exposed to criminal prosecution), and do not flagrantly
neglect their duties, they may have little to fear.

A more exacting standard of conduct is expected from company directors only
when their company approaches insolvency. Thus, upon a company's winding-up,
the insolvency court may order those directors who appear to have conducted the
company's affairs with an intent to defraud the company or its creditors to make a
compensatory contribution to the assets. Even when there is no sign of fraudulent
conduct, however, the directors of a company that has gone into insolvent

231 Ibid., paras.2.50-2.55.
232 Ibid., para.2.59.
233 On comfort letters, see Leigh-Pemberton Committee, loc.cit., n.146, paras.8.2-8.4; and Bank of
234 See Re City Equitable Fire Insurance Co. Ltd. [1925] 1 Ch.407 (C.A.). On whether the
common law is moving in the direction of more strict duties for directors, see C.A. Riley,
"Directors' duties and the interests of creditors" (1989) 10 Co.Law. 87.
235 Insolvency Act 1986, ss.212-213. While the criminal liability of directors for fraud will be
subject to the criminal standard of proof, the civil standard applies to fraudulent trading under
these provisions of the Insolvency Act.

275
liquidation may be ordered by the court to make a contribution to its assets, if they knew, or ought to have concluded, that their company had no reasonable prospect of avoiding insolvency, but failed to take "every step with a view to minimising the potential loss to the company's creditors". Whether a director ought to have reached certain conclusions or taken particular steps will be determined by what may be reasonably required of a person in his position or, where a higher standard may be required of persons having the director's general knowledge, skill and experience, by that standard.236

Under the Company Directors Disqualification Act 1986, in certain circumstances a person may be prohibited by court order for a period of up to fifteen years from holding the position of company director, liquidator, administrator or receiver or from being concerned in any way, whether directly or indirectly, in the promotion, formation or management of a company.237 Backed by serious criminal and civil consequences,238 a disqualification order makes further employment in the corporate sector, even in a subordinate capacity, particularly difficult, because it covers a very wide range of activities relating to the management of companies.239 On the other hand, the grounds for the making of such an order are very narrow, with the procedure of disqualification preserving always a reactive, quasi-penal element, despite the fact that its primary purpose is the protection of the public, especially potential creditors of companies, from financial loss.240 Usually, disqualification will follow a criminal conviction or other official finding that the person concerned has abused the institutions of company law, especially that of


238 Company Directors Disqualification Act 1986, ss.13, 15.


240 Conflicting views have been expressed, both from the bench and in academic writings, regarding the precise nature of the disqualification procedure. In certain cases, the courts, accepting that the purpose of the relevant provisions is forward-looking and protective, have focused on the question, whether the director's misbehaviour appears likely to reoccur in the future; see, e.g., Re Arctic Engineering Ltd. [1986] 1 W.L.R. 686 (Ch.D.); Re Lo-Line Electric Motors Ltd. [1988] Ch.477 (Ch.D.), p.486; Re Sevenoaks Stationers (Retail) Ltd. [1991] Ch. 164 (C.A.), p.176. Other decisions, however, have placed greater emphasis on the reactive, punitive elements of disqualification; see, e.g., Re Stanford Services Ltd. (1987) 3 B.C.C. 326 (Ch.D.), p.336; R. v. Young [1990] B.C.C. 549 (C.A.), pp.553-554. See Hicks, loc.cit., n.239, p.246; J. Dine, "The disqualification of company directors" (1988) 9 Co.Law. 213; idem, "Disqualification of directors" (1991) 12 Co.Law. 6. The best view is that disqualification is indeed a protective measure, although not a proactive one: its availability is restricted to cases of proven delinquency only in recognition of the freedom of citizens to participate in ordinary commercial life and to pursue the livelihood of their choice unconstrained by regulatory interference, unless and until they have actually abused this freedom or shown that they are absolutely incapable of exercising it responsibly. See Re Lo-Line Electric Motors Ltd. [1988] Ch.477 (Ch.D.), p.486.
limited liability. Thus, an order can be made against persons guilty of offences involving misconduct in connection with the management of a company, breaches of rules of company legislation, or fraud or breach of duty which have been discovered upon a company's winding-up.\textsuperscript{241} An order can also be made in conjunction with a declaration that a director is liable to make a contribution to the assets of an insolvent company under the Insolvency Act's provisions on fraudulent and wrongful trading outlined above, while undischarged bankrupts are subject to automatic disqualification.\textsuperscript{242}

Significantly, there are two provisions under which a disqualification order can be made on the ground of unfitness.\textsuperscript{243} The first provision requires the disqualification for a minimum period of two years of a former director of a company which went into insolvent liquidation, if "his conduct as a director of that company (either taken alone or taken together with his conduct as a director of any other company) makes him unfit to be concerned in the management of a company".\textsuperscript{244} This is the only situation where it is mandatory for the court to make the order once the requisite finding of fact has been made, although the indeterminate and evaluative character of the word "unfit" leaves ample scope for covert judicial discretion. Under the second provision, a director may be disqualified on a public-interest application by the Secretary of State for Trade following an investigation into the affairs of a company under the Companies Act 1985,\textsuperscript{245} if the court is satisfied "that his conduct in relation to the company makes him unfit".\textsuperscript{246} While the former provision, which complements the provisions on wrongful trading, is intended primarily to protect the creditors of smaller trading companies from insolvency, the latter appears to be directed mainly at the protection of the shareholding public from abuses committed by the directors of larger public corporations, since most investigations concern precisely the affairs of such corporations.\textsuperscript{247}

\textsuperscript{242} Company Directors Disqualification Act 1986, ss.10-11.
\textsuperscript{243} See F. Fitzpatrick, "Disqualification of a director on grounds of unfitness" (1992) 142 N.L.J. 596.
\textsuperscript{244} Company Directors Disqualification Act 1986, ss.6-7.
\textsuperscript{245} The application may follow a report made to the Secretary under ss.437 by inspectors appointed under ss.431-432 of the Companies Act 1985 or the collection of relevant information under ss.447-448 of that Act.
\textsuperscript{246} Company Directors Disqualification Act 1986, s.8.
\textsuperscript{247} See \textit{Re Samuel Sherman plc.} [1991] 1 W.L.R. 1070 (Ch.D.), p.1085. This was the first decision on a case brought under s.8.
The possibility of disqualification for unfitness affects indirectly the standard of competence and care which is required from company directors. However, the question of fitness in this context is much narrower than when the authorisation of financial institutions is concerned. The decision on disqualification must be reached upon consideration of the director's conduct in relation to the particular companies which are the subject of the insolvency proceedings or the investigation and, generally speaking, matters that must be taken into account are only those providing positive evidence of deliberate wrongdoing and dishonesty on the director's part or, at least, gross negligence or a marked failure to appreciate the moral responsibilities attendant to a directorship or to comply with mandatory provisions of company law. On the other hand, ordinary commercial misjudgement cannot justify disqualification, even though an order could be made in extreme cases of complete incompetence.

In contrast, the requirement of fitness in the Banking Act encompasses a very broad range of matters going to a person's reputation and character, competence and professionalism, or, in the case of controllers, financial standing, and can even extend to conjectural threats to the interests of depositors. This type of requirement is peculiar to the regulatory arrangements of the financial sector. Its statutory origins can be traced to provisions first enacted in 1967, authorising the Secretary of State for Trade to refuse the authorisation of, or restrict the conduct of business by, insurance companies whose officers, parent companies or controllers are unfit to be associated with such companies.

Even though a regulatory finding of unfitness does not formally entail the disqualification or immediate removal from his position of the person against whom it is made, its consequences can be devastating: insofar as the finding provides a ground for action, not only against his current institution, but also against any other institution he may wish to join in the future, it can taint him irreparably and bring his professional life in the field of banking to a premature end. The weight of the consequences creates the need for sufficient safeguards, especially since arbitrary and unjustifiable regulatory invasions of the rights of the providers of banking

---

248 See Drake, *loc.cit.*, n.237, pp.483-484; K. Wardman, "Directors, their duty to exercise care and skill: do the provisions of the Company Directors Disqualification Act 1986 provide a basis for the establishment of a more objective standard?" (1994) 15 *Bus.L.Rev.* 71. In principle, however, the potentially higher standard may not be relevant in the context of directors' civil liability.


251 Companies Act 1967, ss.64 and 68(1)(d). See now the Insurance Companies Act 1982, ss.7(3) and 60-61.
services cannot be said to contribute to the attainment of the statutory purpose, that is, the protection of the depositors. 252

An early case from the field of insurance illustrates the importance of procedural protections. 253 The case concerned action taken by the Department of Trade against a company which, immediately after receiving authorisation, embarked upon a course of business which had not been disclosed in the business plan that the company had submitted to the Department in partial fulfilment of the authorisation requirements. The grounds for the Department's action were, first, that misleading information had been provided and, second, that one of the company's directors was not a fit and proper person to be a controller of an insurance company. 254 Relying on the latter ground, the Department further proposed to take action against another company in which the director was involved and to disclose its finding of unfitness to the Institute of Actuaries, of which he was a member, unless he revealed that he was resigning as actuary from every company. Lacking a statutory right of appeal, the director, whose reputation and livelihood had suffered serious harm, referred the matter to the Parliamentary Commissioner for Administration. His complaint was that the Department had acted unjustifiably and excessively in declaring him unfit, that it had not considered certain oral representations and that one of the officials concerned had been biased. The Parliamentary Commissioner did not express a view on the director's fitness, since the responsibility for making this finding belonged to the Department. A fundamental premise of the latter's policy was that is should be able to rely with full confidence on the good faith of its regulatees; however, the alteration of the company's business policies within a few days from authorisation indicated either deliberate deception or inadvertent deception through seriously incompetent control. Nonetheless, the observance of certain basic principles of fairness was necessary if the application of the departmental policy were to be free of arbitrariness. In the present case, the director had not been given a clear

---

252 In debates concerning the disqualification procedure, the view is sometimes expressed, that the appropriate degree of procedural protections depends on the question, whether disqualification is akin to criminal sanctions, in which case company directors should be entitled to procedural protections equivalent to those provided by criminal law to defendants, or a mere "removal of the privilege of trading with limited liability, rather than the loss of a livelihood", in which case natural justice should still apply, but without the stringent safeguards of criminal law; Dine, "The disqualification of company directors", loc.cit., n.240, p.218. The level of procedural protections, however, should depend on the severity of the potential harm to the individuals concerned, not on conceptual pigeon-holing. See Re Lo-Line Electric Motors Ltd. [1988] Ch.477, p.486; the dissenting opinion of Nourse L.J. in Secretary of State for Trade and Industry v. Langridge [1991] Ch. 402 (C.A.), p.422; and Re Southbourne Sheet Metal Co. Ltd., The Times, 6 Aug. 1992 (C.A.).


254 The action was taken under the Insurance Companies Amendment Act 1973, s.13.
indication of the allegations against him and had not been invited to comment on all
the relevant issues. His representations had not received full and adequate
consideration. Moreover, although the departmental officials had formally based
their recommendation to the Secretary of State for Trade on a specific event, they
had been clearly influenced by earlier events, admitting in writing that "whereas we
have suspected that [the director] might turn out to be unfit we have hitherto never
had any real basis for such a view".255 They had not put to the director all the
evidence taken into consideration and had made subjective judgements, which were
not backed by evidence. For these reasons, the Parliamentary Commissioner
concluded that the case should be further reviewed.

To prevent the occurrence of similar situations in the area of banking regulation
and ensure that the Bank's findings of unfitness are fair and considered, the Banking
Act requires the prior notification of the person concerned whenever the Bank
proposes to take action against an institution on this ground by refusing, revoking or
restricting its authorisation and gives to that person a right to make representations,
contesting the allegations against him, before a final decision is made.256 If this is
negative, the Bank is required to provide reasons, and the person whose fitness is
disputed is entitled to challenge that finding (but not the decision's operative part,
insofar as this is directed against his institution) by way of appeal to the Banking
Appeal Tribunal.257 Despite these procedural protections, however, the built-in
elements of subjective evaluation in the determination of unfitness and the very low
evidential threshold that must be established by the Bank set substantive limits to the
effectiveness of the statutory safeguards.

The fitness of the owners/directors of a small bank, Mount Banking Corporation
Ltd., was the central question in the only case until now where appeals brought
under the Banking Act have been contested to the end.258 The original intervention
of the Bank in the affairs of Mount Banking was in response to allegations made by
Standard Chartered Bank that the institution was guilty of laundering the proceeds

255 Para.42.
256 Ss.10(3)-(4), 13(4)-(5).
257 Ss.10(5), 13(7), 27(2), 29(5)-(6). Equivalent procedural protections are available in the case of
objections to prospective or existing shareholder controllers; ss.22(3)-(4), 24(3)-(4), 27(3). In this
case, the appeal is against the objection itself, not merely against the finding of unfitness; the
same applies where the effect of a restriction on an institution's authorisation is to require the
removal of the appellant from his position as director, managers or controller; s.29(1)-(2), (5)-
(6).

258 Mount Banking Corporation Ltd. (in administration) v. The Governor and Company of the
Bank of England, 13 Oct. 1993, Banking Appeal Tribunal, unreported; and, on appeal from the
Tribunal, Navinchandra Bhagwanji Shah v. The Governor and Company of the Bank of England,
29 July 1994, Ch.D., unreported.
from a large fraud committed against Standard Chartered on the Indian Stock Exchange and of other serious misconduct. For the examination of these allegations, the Bank appointed investigators under section 41 of the Banking Act. Shortly afterwards, it petitioned the court for the winding-up of Mount Banking on grounds of public interest, citing among other reasons the institutions presumed involvement in money laundering; there was no suggestion that the institution, which was particularly active in India and among the Asian community of East Africa, was insolvent. In the event, the Bank consented to an alternative petition for an administration order brought by Mount Banking's directors. The order was made on 19 October 1992.

The report of the investigators was received the following month. It contained certain reservations which appeared to corroborate the allegations, but no firm evidence of wrongdoing was found. Nonetheless, the Bank's review committee, which included senior officials of the Banking Supervision Division, after considering the report and making additional inquiries, recommended the revocation of Mount Banking's authorisation on different grounds, namely that the institution was not conducted in a prudent manner and that its two co-owners/directors, the brothers S. and N. Shah, appeared to the Bank not to be fit and proper persons to hold their positions. The matter was referred to the Board of Banking Supervision, which concurred with the review committee's recommendation. This opened the way for the servicing by the Bank on 29 January 1993 of notices to the institution and the Shahs, informing them of its intention to revoke authorisation. Following representations by all recipients, the Bank notified them on 25 February of its final decision to impose a short time limit of three months on Mount Banking's authorisation. The administrators of Mount Banking appealed against this decision in the institution's name, seeking to reverse the time limit.259 On their part, the Shahs brought separate appeals challenging the findings of unfitness made against them.

Significantly, from the time of the initial petition for Mount Banking's winding-up to the final decision to restrict its authorisation, the factual allegations made against the Shahs had changed dramatically.260 This gave plausibility to the appellants' contention that, having embarked upon a course of intervention, the Bank had found it embarrassing to back down, despite the fact that its original suspicions

259 See the Banking Appeal Tribunal's decision, 13 Oct. 1993, transcript, pp.44-51; and infra, section 5(b).
260 Of twenty-two allegations that formed the subject of informal representations made by the Shahs on 12 November 1992, only nine were mentioned in the notice informing them of the Bank's intention to revoke authorisation, along with nine new allegations. Following written representations by the institution and the Shahs, more allegations were dropped. Nonetheless, the finding of unfitness was confirmed. See judgement of Vinelott J. in the High Court, 29 July 1994, transcript, p.10.
had proved to be unfounded, and had for this reason sought to justify intervention on substitute grounds, which did not however warrant the severity of its action. Nonetheless, after reconsideration of the evidence upon which the Bank based its findings of unfitness, the Banking Appeal Tribunal rejected the Shahs' appeals.

With regard to S. Shah, the chairman and 50% owner of Mount Banking, despite secondary reservations or disagreements on specific points, overall the Tribunal found itself in positive agreement with the Bank as regards the existence of reasons of sufficient seriousness to justify a finding of unfitness. Several factors pointed to the appellant's lack of general competence and soundness of judgement as a banker. For instance, the appellant had caused the intermingling in the account of one of his private companies of monies belonging to these companies with customers' monies, without keeping proper records; he had accepted a very large cash deposit (U.S.$140,000) without obtaining an explanation about its exact origin; he had given instructions for the return to a customer of counterfeit notes which proved to be included in a deposit; and although he had been asked by the Bank to cause Mount Banking to obtain legal advice about the possible need for authorisation under the Financial Services Act before purchasing substantial volumes of foreign-government securities in its own name, but partly on its own behalf and partly on that of customers, he had not only failed to act in this direction, with the result that the advice was not sought until the closing date for the business, but had also asked the institution's lawyers to backdate written advice, so that the Bank would not notice the delay. Moreover, the appellant had displayed a propensity to exercise dominance in banking matters, overriding in certain cases the judgement of the immediately responsible officers of Mount Banking. Thus, he had accepted the aforementioned large cash deposit over the head of the institution's general manager; he had also attempted to grant guarantees and overdrafts in contravention of the institution's procedures. The undesirable effects of his practices were evident in the conduct of the institution's Cayman Islands subsidiary, Mount Bank Cayman Ltd., which was set up in 1990 and for whose supervision on a consolidated basis the local authorities looked to the Bank. Although local managers had been appointed in the subsidiary, these relied heavily on the appellant insofar as the acceptance of depositors was concerned. Significant weaknesses in the subsidiary's internal controls had been identified on several occasions in 1991 and 1992 by the institution's auditors, who were particularly concerned by the lack of adequate documentation for many substantial transactions, which they attributed to the appellant's insufficient attention to legal formalities, and by the fact that considerable control over its management was exercised by him from his base in Kenya.

---

261 See the decision of the Banking Appeal Tribunal, 13 October 1993, transcript, p.17.
auditors' concerns and the subsequent attempts of the institution to remedy the situation in the subsidiary had been made known to the Bank. Regardless of the remedial steps, however, the Bank made the point that the deficiencies, which impeded the effective monitoring of the group's business as a whole by the institution's London management and its supervision by the Bank, reflected badly on the appellant's competence and soundness of judgement. Last but not least, there were justified doubts about the openness and probity of the appellant, who had concealed from a London manager of Mount Banking that he was the owner of the company in whose account customers' monies were intermingled, as explained above, and had even falsely denied to the Bank's investigators that he owned another firm, only to admit so after being presented with contrary evidence. While accepting that isolated shortfalls or shortcomings by an institution's controllers, directors or managers should not be regarded as affecting fitness, the Tribunal concluded that, for all these reasons, in the appellant's case the conditions for a finding of unfitness had clearly been established.262

Insofar as the second appellant, N. Shah, was concerned, the Tribunal was faced with a much weaker case. While owning the institution's other 50% and being unquestionably involved in its management at the most senior level, with the title of deputy chairman, N. Shah was not on the audit committee or the credit committee and was not involved in the day-to-day control of lending, which was at the hands of his brother and another director. However, he attended board meetings and prudential meetings with the Bank and had correspondence with the institution's lawyers. The thrust of the Bank's criticisms against him was, in effect, the reverse of those against S. Shah: whereas the latter was criticised for positive conduct falling short of the requisite standard of behaviour, N. Shah was criticised for failing to ensure that the business was properly managed and for being aware of certain improprieties on the part of his brother but doing nothing to put an end to them. The Tribunal rejected outright several of the Bank's allegations of omissions by N. Shah and found only the most general grounds of criticism in connection to others. For example, even though the appellant was present in the meeting in which the Bank demanded the obtainment of legal advice regarding the acquisition of the foreign-government securities, in the Tribunal's view the fact that he did not pursue the matter himself could provide no basis for specific criticism against him, since it was his brother who actually handled this affair. Nonetheless, the Tribunal accepted that there were substantial reasons for criticising the appellant's conduct in at least three respects. Firstly, in August 1985 the appellant became actually aware of, but did not object to, the giving by his brother of an unauthorised guarantee, which was

262 Ibid., pp.19-35.
withdrawn only after the intervention of Mount Banking's lending manager, who warned that the institution's authorisation would be suspended if the Bank saw the guarantee. Secondly, he was a director of Mount Bank Cayman and continued to act as such, even though he had probably ceased to be involved with its day-to-day affairs after moving to London from Nairobi in August 1991, and, accordingly, shared responsibility for allowing the serious situation which was identified by the auditors. Finally, a fax sent by N. Shah to his brother in May 1992 confirmed the closeness of the brothers day-to-day involvement and revealed that the former was concerned with the latter's style of conducting business, providing in this respect support for the Bank's contention that N. Shah must have been aware of at least some aspects of S. Shah's behaviour, for which he should bear some responsibility. Recapitulating, the Tribunal had this to say about the case against the second appellant:

"We are faced with a criticism put on a very general basis. It is exemplified by a limited number of specific matters which appear to have force: the 1985 guarantee; Mount Cayman; and the fax. The Bank's position at its most general is that if one of the two owners/controllers, the chairman of the Company, has conducted himself in relation to the Company's affairs in a way which shows that he has not been or may not have been a fit and proper person to be a director and controller of the Company, a natural inference is that the other owner/controller, the deputy chairman, is likely to have been sufficiently aware of what was going on to bear some share of responsibility. But even the low threshold prescribed by the Act, which is constituted by appearance of what 'may' have been, is not crossed by mere suspicion of what may have been, and examination of a considerable number of the specific instances put before us has not revealed any positive ground for criticism of Mr. N. Shah in relation to them."263

Despite these remarks, the Tribunal found that the few confirmed grounds of criticism were sufficient to justify the Bank's doubts regarding the appellant's fitness to be a director or controller in the context of Mount Banking. The Tribunal appeared to think that Mount Banking's small size and the fact that its affairs were effectively run by a small management team warranted particularly careful scrutiny of its owners/directors' fitness. However, the evidence suggested that, while N. Shah was not the institution's dominant figure and did not generally interfere with his brother's conduct of affairs, he did nonetheless participate in the institution's management at the highest level, in which capacity he had gone along with his brother's fundamentally unsound managerial conduct and practices. On this basis, the Tribunal upheld the Bank's finding against him.264

263 Ibid., p.42.
264 Ibid., pp.36-43.
Following the Tribunal's decision, both S. and N. Shah exercised their statutory right to commence further appeals on a point of law to the High Court. The appeal of S. Shah was eventually abandoned, but that of N. Shah was heard by Vinelott J. The ground of the appeal was that the Tribunal's decision "was not supported by any evidence and/or the evidence was inconsistent with and contradictory of the said determination and/or the true and only reasonable conclusion contradicted the said determination". What was alleged, in effect, was that, insofar as the Tribunal had rejected many of the Bank's findings and found others to provide nothing but the most general basis for criticism of N. Shah, the only possible conclusion that it could properly have reached was that the Bank had failed to justify its determination regarding the latter's fitness. As for the specific criticisms, it was said on the appellant's behalf: (i) that the irregularity relating to the 1985 guarantee had occurred many years ago, and the appellant was not himself guilty of giving any guarantee in violation of Mount Banking's procedures, while a subsequent tightening of these procedures would now prevent similar irregularities; (ii) that the deficiencies in Mount Bank Cayman were teething problems, which were addressed by the management in proper fashion in co-operation with the institution's auditors; and (iii) that the fax could not justify by itself a conclusion of unfitness. Vinelott J. was not impressed by these arguments. In his view, although the incident of the guarantee had occurred long ago and was not enough to justify a finding of unfitness, it should nonetheless be taken into account, especially in relation to the situation in the Cayman subsidiary; likewise, the fax, while insufficient in itself, was material insofar as it supported the conclusion that the appellant was aware of his brother's conduct. More importantly, Vinelott J. was of the opinion that the irregularities in the conduct of Mount Bank Cayman were serious and that, as its director, N. Shah should accept responsibility for the situation that had existed for almost two years, especially since he knew that his brother, who was the dominant voice in the subsidiary's affairs, had a propensity to act precipitately, to override subordinates and to fail to keep proper records. Overall, it could not be said that the

---

265 Banking Act 1987, s.31.
267 The formulation was intended to bring the appeal within the limited ambit of appeals on points of law. Apart of situations where the record of a determination reveals on its face an error of law, such appeals can also succeed where "the facts found are such that no person acting judicially and properly instructed as to the relevant law could have come to the determination under appeal", in which case the court "has no option but to assume that there has been some misconception of the law and that this has been responsible for the determination"; Edwards (Inspector of Taxes) v. Bairstow [1956] A.C. 14 (H.L.), p.36 per Lord Radcliffe.
Tribunal's decision was inconsistent with the only natural conclusion from the evidence before it. Accordingly, the appeal was dismissed.\cite{268}

Despite the failure of the appeals, certain doubts remain about the Bank's approach. From the beginning of its intervention to the final determination of February 1993, the Bank was obliged to abandon numerous allegations against the Shahs, but new ones kept being offered in their place. Insofar as N. Shah was concerned, even the final criticisms proved for the most part to be unfounded or tenuous, and the Bank's finding against him was finally upheld by the Tribunal and the High Court only on a small fraction of the suggested reasons. In the event, Vinelott J. found against N. Shah primarily on the basis of the situation in Mount Bank Cayman; however, although this situation was known to the Bank for some time, apparently it had not been considered to be serious enough to justify any particular action. It was only after the Bank's failure to come up with evidence of money-laundering or fraud that emphasis was placed on this issue.

It could be plausibly surmised that the Bank, having effectively closed down Mount Banking on the basis of its ready acceptance of unsubstantiated allegations made by a significant institution such as Standard Chartered, was simply trying to prove itself right after the fact. This would be precisely the type of predetermination of the issue that had been criticised by the Parliamentary Commissioner for Administration in the aforementioned case of the insurance executive.\cite{269} Another explanation for the Bank's strict approach could be that it was convinced that the Shahs were actually guilty of the more serious allegations made against them, but could not find positive proof. In that case, however, the Bank should at least have revealed its true concerns and the reasons for them; the existence of a reasonable basis for its suspicions would have been enough to satisfy the Banking Appeal Tribunal of the possibility that the fitness requirement may not be fulfilled, and this was all that was needed.

At any rate, the deferential approach of the Tribunal and the High Court, as expressed through their refusal to overturn the Bank's decision as long as even a few of its grounds were found to hold water, indicates that the appeal mechanism may be of limited practical help if the Bank is determined to defend a particular conclusion even on the weakest evidential basis.

This reinforces the possibility of discriminatory treatment. In particular, the Bank could have a propensity to require much stronger evidence before acting against the controllers or managers of well-established institutions than it did in the case of N. Shah. It is interesting in this connection to note that the Bank has been particularly

\begin{footnotesize}
\begin{enumerate}
\item Judgement of 29 July 1994, transcript, pp.30-31, 34-36.
\item Supra, text and n.255.
\end{enumerate}
\end{footnotesize}
cautious in its reaction to the collapse of Barings p.l.c. on 24-26 February 1995, as a result of huge losses on unauthorised derivatives trading by its Singapore operation. The affair revealed fatal weaknesses in the merchant bank's controls, and there was even evidence that some London officials had known of the extent of the trading exposure, but failed to respond.\textsuperscript{270} Curiously, more than two months later, despite the fact that Barings' new owners, Internationale Nederlanden Groep N.V., publicly criticised the Bank for taking too long to apportion responsibilities for the collapse,\textsuperscript{271} no action had been taken against any executive of Barings. In the event, rather than waiting for the Bank's eventual verdict, Internationale Nederlanden itself placed the blame on 21 executives and managers, who were forced to resign or were dismissed.\textsuperscript{272}

In situations of doubt about a person's suitability to be a bank director, controller or manager, it is not always necessary for the Bank to take formal action in order to achieve the removal of that person from his position; usually, informal pressure will be sufficient for this purpose. Few institutions would fail to dismiss or cause the resignation of a director or manager if incited to do so by the Bank, since this could open them to the risk of action against themselves for non-fulfilment of the fitness requirement. Even in the case of a shareholder or indirect controller, the Bank can use its suasion to ensure that the controller will cease to be involved in the direction of his institution or that the institution will not enter into new transactions with him.\textsuperscript{273} In this manner, however, the procedural protections of the Banking Act may be circumvented.

The situation is not comparable to the voluntary withdrawal of an application for authorisation or surrender of an existing authorisation. Although these events often follow informal indications that the Bank is prepared, in the former case, to refuse the application or, in the latter, to take formal action, it is always open to the institution concerned to ignore the signals and await the Bank's formal decision, in the hope of vindication on appeal. The individuals, however, whose removal may be demanded by the Bank, do not have this choice. Their position depends on the decisions of their institution, and this may have no incentive to stand up to the Bank in their behalf.

The case of Lord Spens, a merchant banker accused of fraud in connection with the Guinness insider-dealing affair but eventually acquitted of the charges made against him, illustrates this problem. Lord Spens lost his job because of informal pressure exercised by the Bank on his employer bank. He described the situation in the following terms:

"The Bank of England forced me to resign by threatening [the employer bank] with the loss of their licence [...] The Bank's own minutes showed that they threatened Ansbacher. They forced me to resign without bothering to inquire into the facts". 274

The Bank had purportedly acted in pursuance of its general responsibility under the Banking Act 1979 to ensure the prudent management of banks. However, even though a right of appeal was not available to individuals before the enactment of the 1987 Act, it would appear that the informal nature of the Bank's actions had effectively deprived Lord Spens of the opportunity to raise a challenge by way of judicial review. 275

Likewise, the fitness of bank controllers or managers may sometimes come under questioning following critical comments made against them in reports by company inspectors appointed under the Companies Act. In what is probably the most contentious case of this type, three managers of National Westminster were forced to resign in 1988 as a result of the investigation of the Blue Arrow affair. In reaction to this incident, strong reservations were expressed about the inclusion in inspectors' reports of adverse conclusions regarding the integrity and competence of individuals; the practice was said to be unfair, because the conclusions are practically unreviewable and can bring to an end long and successful careers without the protections of a formal disqualification procedure. 276 It would appear, however, that in the Blue Arrow case the immediate cause of the managers' removal was the Bank's insistence that certain individuals should be held responsible for the irregularities, not the inspectors' adverse conclusions. Had National Westminster been an ordinary commercial company, not subject to the jurisdiction of financial regulators, it could have chosen to ignore the adverse publicity generated by the inspectors' report and, provided that no disqualification order were made against them, the managers might have continued in their positions. Under the actual regulatory arrangements, even if the report did not contain but findings of facts,

275 Following his acquittal, Lord Spens brought an action against his former employer and the Governor of the Bank for the loss of his job. On the possibility that the Bank might be held liable in tort for inducement to breach of contract, see infra, ch.5, section 3.
without any commentary by the inspectors, the managers might still have to consider their resignation in the light of the Bank's attitude.\textsuperscript{277}

The loss of a formal opportunity to challenge the Bank's findings may make all the difference in cases such as the above. Particularly today, when unquestioning deference to the Bank's better judgement is largely a thing of the past, individuals whose fitness is in question can be expected to fight through the appeals procedure what can be a lifelong barrier to their professional involvement in the financial sector. In this context, continuing use of the practices of moral suasion seems unjustifiable, since it can clearly deprive the persons concerned of statutory procedural rights. At the very least, it would appear that, when a person's livelihood is put in jeopardy as a result of informal contacts between the Bank and his institution regarding specifically his position in the institution, this person has a right to be informed of any accusations made against him and to make representations for the purpose of challenging these allegations and vindicating his integrity and competence.\textsuperscript{278}

(b) Bank mergers and acquisitions. Matters of market structure are outside the Bank's statutory mandate.\textsuperscript{279} In the past, however, the Bank has sought to regulate bank mergers. In November 1972, guidelines on this issue were announced in a press notice issued with the opportunity of U.K.'s accession to the E.E.C.\textsuperscript{280} There, the Bank expressed its willingness to consider proposed bank mergers on their individual merits, but stressed that "[the Bank's] concurrence will be conditional in each case on the existence of amicable agreement between the parties concerned and on the satisfaction of tests relating to capital, management, reputation and future intentions. [...] It

\textsuperscript{277} Ibid., testimony of Lord Alexander of Weedon, qq.327-328. Unless a formal disqualification order has been made, the Bank is not bound by critical conclusions that may be contained in published reports of company investigations under the Companies Act. In appropriate cases, the Bank will take the contents of such reports into account for assessing the fitness of particular persons. In principle, however, it may reach different conclusions, based on its interpretation of the Banking Act's special requirements and any additional evidence that may be available only to itself. Ibid., Memorandum Submitted by the Bank of England (C.I. 18).


\textsuperscript{279} The control in the public interest of mergers and market structure in the field of banking, as in all other sectors, is a matter for the Monopolies and Mergers Commission and the Secretary of State for Trade; see the Fair Trading Act 1973.

\textsuperscript{280} "Banking mergers and participations" (1972) 12 B.E.Q.B. 452. The guidelines allowed acquisitions by British or E.C. banks of participations of up to 15% of the target bank's shares. However, where the acquisition of a larger holding was contemplated, the Bank should be notified before the starting of any formal negotiations.
is understood that banks [...] will accept the Bank's ruling in each case and take no irrevocable steps in the meantime."

In this way, the Bank reserved for itself the final judgement with regard to bank mergers. The insistence on the need for "amicable agreement" was remarkable, because it went clearly beyond the scope of prudential concerns, aiming, instead, at banishing from the field of banking the practice of hostile take-overs, which is otherwise considered to be a fully legitimate aspect of corporate governance.

The Bank's disapproval of hostile and/or contested take-overs and the requirement of prior clearance of all merger proposals were put to the test in 1981, when the Hongkong and Shanghai Banking Corporation, a foreign institution, proceeded with a contested bid for the acquisition of the Royal Bank of Scotland, a Scottish clearing bank, without first seeking the Bank's approval. The Bank took the matter very seriously. It utilised every possible reason for stopping Hongkong and Shanghai and even resorted to protectionist arguments, which, in the political context of the 1980s, appeared distinctively anachronistic. The real issue, however, was the lack of respect on the part of Hongkong and Shanghai for its customary authority.

Eventually, both the bid of Hongkong and Shanghai and that of its rival were referred to the Monopolies and Mergers Commission, which concluded that either of them would operate against the public interest, because of the adverse effect that a potential relocation of the Royal Bank's head office would have on the Scottish economy. During the hearings, the Bank presented evidence to the Commission against Hongkong and Shanghai's bid. The Bank asserted that, as central bank and supervisor, it had "a major role in ensuring that mergers between banks contributed to the stability and healthy development of the banking industry". Nonetheless, it had not sought statutory support for this role, "because it felt that supervision was best carried out within a minimum statutory framework". Instead, it had relied upon informal rules, "which were known to British banks in general, and in particular to those who were involved as advisers in merger situations". With regard to its specific objections to Hongkong and Shanghai, the Bank made a number of claims. First, although its attitude was liberal in allowing overseas acquisitions of U.K. banks, the acquisition of the ownership of a major banking institution, and in particular of a clearing bank, by a bank registered in a foreign jurisdiction and, as

---

281 Ibid.
284 Ibid., para.8.2.
such, beyond the Bank's supervisory control, would reduce the banking system's responsiveness to the economic, and especially monetary, policy of the U.K., and could also be detrimental to the maintenance of effective supervisory arrangements. Second, the supervisory system of Hong Kong did not guarantee the effective global control of locally registered institutions operating overseas. Third, the decision to go on with the bid despite the Bank's opposition, suggested that the institution would not always be prepared to accept the Bank's customary authority. The Commission found some of the Bank's arguments, including the likely loss of regulatory effectiveness and the fear that Hong Kong supervisory gaps might endanger depositors, unpersuasive. However, on the main issue concerning the transfer abroad of the ultimate control over a clearing bank, it accepted that there was a rebuttable presumption - which had not been rebutted in the present case by any overriding consideration - that such a transfer would have undesirable consequences, by opening up the possibility of divergence of interests which would not otherwise arise. The Commission expressed the view that Hong Kong and Shanghai's disobedience to the Bank proved the validity of this point.

"The fact that [Hongkong and Shanghai ("H.S.B.C.")]] proceeded with its bid, notwithstanding the Bank's clear indication that the bid would be unwelcome, may be seen as an example of the kind of divergence of interest that might arise and as an indication that H.S.B.C., if in control of a United Kingdom clearing bank, would not always be prepared to accept the Bank's customary authority in United Kingdom banking matters. A consequence of H.S.B.C.'s proceeding further with its bid is that the Bank's authority in this area would be seen by others to be weakened." The predicament of Hongkong and Shanghai illustrates the fundamental defect of the "flexible" and informal practices of "moral suasion". The review of regulatory decisions is impossible in this environment. Complete deference to the regulator, right or wrong, becomes necessary for the protection of his credibility and of the system's effectiveness. Accordingly, the mere refusal of the regulatees to conform to his whims is condemned as objectionable per se.

285 Ibid., paras.8.8-8.19.
286 Ibid., paras.12.20-12.29.
287 Ibid., para.12.29.
Probably the most important aspect of this affair, however, was that the Bank's objection had not sufficed to stop the bid, and that the intervention of the Commission had been necessary for this purpose; this illustrated how precarious the Bank's moral suasion has become in today's markets, especially in the face of powerful international players, who have sufficient leverage to resist its informal pressures without being ostracised from the financial community as a result. Even worse from the Bank's standpoint, taking formal action by withdrawing or restricting authorisation did not appear to be possible for the purpose of punishing Hongkong and Shanghai for disobeying the extra-statutory merger rules, whose legal status was uncertain and which did not have an evident prudential justification.\textsuperscript{289} In this sense, the Hongkong and Shanghai affair signalled the effective breakdown of the Bank's \textit{de facto} power in matters of banking structure.

Under the Banking Act 1987, the Bank's formal power of objection to changes in the control of authorised institutions can be used for blocking proposed takeovers.\textsuperscript{290} Nevertheless, the legitimate limits of this power are defined by the Act's prudential purpose. For this reason, the Bank has quietly abandoned its former insistence on "amicable agreement" as a prerequisite for its consent to bank mergers.

Thus, in April 1992, Hongkong and Shanghai made a friendly bid for one of the "Big Four" clearing banks, Midland, on the understanding that, if the acquisition were successful, the Bank would become the lead regulator of Hongkong and Shanghai's group as a whole. A few days later, an alternative hostile bid for Midland was launched by another clearing bank, Lloyds.\textsuperscript{291} Before the announcement of the second bid, Midland's chief executive had approached the then Deputy Governor of the Bank, Eddie George, in an effort to avert it. Nonetheless, the Deputy Governor had made clear that he was powerless to intervene, because the bid would not put at risk the interests of Midland's depositors: although the merger of two clearing banks could raise questions of public interest, these should be decided by the competition authorities.\textsuperscript{292} The Deputy Governor's reply signalled, not simply the Bank's conversion to a new, non-interventionist approach, but its recognition of the constraints imposed by the Banking Act on its power of objection.

\textsuperscript{289} The merger rules were assumed to remain in place even after the introduction of a statutory system of regulation in 1979; I. Morison, P. Tillett, and J. Welch, \textit{Banking Act 1979} (1979), p.60.

\textsuperscript{290} S.22, as amended by S.I. 1992/3218, reg.31(2); see supra, subsection (a).

\textsuperscript{291} The Lloyds bid was later withdrawn, because it was likely to be blocked by the Monopolies and Mergers Commission.

\textsuperscript{292} R. Peston, "The Bank is left on the sideline as two suitors make secret approaches", \textit{Financial Times}, 2-3 May 1992, 10.
The non-interventionist approach should apply equally to the acquisition of domestic institutions by foreign banks. There is nothing in the Banking Act to suggest that the Bank can validly object to the transfer of a banking institution's control to a foreign person on the ground that the preservation of British ownership is required in the national interest. There have been occasions in the past, where the Governor or Deputy Governor of the Bank expressed in official speeches the view that, although overseas investment in British banks and other financial institutions should be encouraged as contributing to the strengthening of their financial position, the City's openness should not be carried "to the point where control of the core of our financial system - the payments mechanism, the supply of credit - may pass into the hands of institutions whose business aims and national interest lies elsewhere". Such statements could be interpreted to mean that the Bank would be willing to intervene to block foreign take-overs of key domestic banking institutions, in particular of clearing banks. Nonetheless, Midland's eventual take-over by Hongkong and Shanghai shows either that the relevant remarks had always given a misleading impression of the Bank's true position or, at least, that the Bank's practical approach has softened considerably over the years, so that past protectionist statements should not be read as valid indicators of present policy.

293 In 1987, the prospect that the major British banks would be taken over by foreign (especially Japanese) institutions, dominated the discussion in Parliament of the Banking Bill. Many members of both Houses, and in particular the banking lobby in the Lords, insisted on the need for protective controls. Fearful that, if its record on questions of competition policy was any indication, the Conservative government would decline to intervene in favour of domestic ownership by referring future take-overs to the Monopolies and Mergers Commission on grounds of national interest, they sought the inclusion in the Bill of an unambiguous protectionist clause. The government, however, resisted their calls and defended its policy of free trade, emphasising, in particular, that engaging in trade wars could inflict serious harm on the City as an international banking centre which outperformed the rest of the economy in creating jobs and contributing to foreign earnings, and also pointing at the wider dangers of protectionism for a nation ranking second in the world in net overseas investments. See Lord Young's remarks, H.L. (5th Series) Vol.485, cols.557 and 560, and Vol.486, cols.26 and 821. Instead, the government introduced a reciprocity provision, which, without closing foreign investors out of the U.K. market, could be used for opening the doors of foreign markets to British institutions. See H.C. (6th Series) Vol.110, cols.1085-1108. Nevertheless, some parliamentarians expressed doubts about the effectiveness, and even the intrinsic merit, of the new provision. See, e.g., the speeches of D. Penhaligon, H.C. Vol.106, col.564, and of Viscount Chandos, H.L. Vol.485, col.551; in the opinion of the latter, the protection of the domestic banking system was preferable to the greater freedom of British banks to expand internationally.


295 In 1987, National Australia Bank bought Clydesdale, a small Scottish clearer, from Midland, making Clydesdale the first clearing bank to pass under overseas control. That same year, Hongkong and Shanghai bought a 14.9% stake in Midland (just below the threshold for becoming a "controller" under the original version of s.105(3) of the Banking Act 1987). The full take-over took place five years later.
The prevention of bank mergers and take-overs in the public interest is, of course, possible, even if these do not raise competition concerns. But this is a matter for the Monopolies and Mergers Commission and the Department of Trade, not for the Bank. In any event, the obligations of non-discrimination under Community law set strict limits on any U.K. authority’s ability to safeguard British ownership of the major domestic financial institutions.

Although its ability to regulate the structural development of the banking industry has diminished considerably, as explained above, nonetheless the Bank retains the power to prevent, and does prevent, bank mergers when this can be justified on apparently prudential grounds. The commercial rationale of the mergers can be a decisive factor in this context. The Bank has expressed clearly its disapproval of "sharp" financial practices, including "acquisitions of stakes designed to put banks 'into play', solely with a view to making a quick investment gain" or "bids whose purpose is to gain control so that the bank or the group of which it is a part may be sold or broken up in ways that may be detrimental to depositors' interests".

(c) Separation of banking and commerce. Although there are few express pronouncements on the subject, it would appear that the combination of banking with industrial and commercial activities is generally discouraged, unless it can be justified by special considerations.

One argument against the mixing of activities is that it can result in conflicts of interest and increased contagion risks, especially in situation where the group's bank acts as a financing vehicle for the other group affiliates. In addition, the inability of counterparties to differentiate between the various components of a mixed-activity group can make it impossible for a bank to decline responsibility for losses incurred elsewhere in its group, even if there is no formal exposure. For these reasons, the Bank has been reluctant to approve the acquisition of banks, especially significant ones, by commercial concerns.

The reverse situation, i.e. the making by banks of long-term investments in non-financial concerns, is also discouraged. Permanent shareholdings in companies outside its immediate sphere of activities may not involve per se credit or trading.

298 Ibid. An indication of the Bank's attitude is provided by its rejection in 1987 of an informal take-over proposal for Midland by Saatchi & Saatchi, an advertising group. See M. Reid, All-Change in the City: The Revolution in Britain's Financial Sector (1988), p.158.
risks for the investing bank, but leave it exposed to the risk of a decline in their net
value. For this reason, while the successive waves of mergers of banks with non-
bank financial institutions which marked the emergence of all-purpose ("universal")
banking in the U.K. had the Bank's approbation, the expansion of banks in other
sectors through the acquisition of large holdings in industrial and commercial
concerns, in the manner of certain continental banking systems, has been resisted.299

In the mid-1980s, a softening of the traditional reluctance of British bankers to
take long-term positions in non-banking companies led to a shift in the scale and
nature of the role played by banks in take-over and merger transactions. Certain
investment banks got involved in such transactions, not only as providers of
corporate-finance services, but also by arranging to acquire strategic holdings in
companies, or even whole subsidiaries of the groups involved. Reacting to this
development, the Bank set out a specific policy on the matter, requiring banks to
notify it in advance of any acquisitions of holdings and making clear that exposures
to companies and groups in the form of investments in shares, when taken together
with lending exposures, will not be normally considered prudent if they exceed 25%
of a bank's own funds. Moreover, in certain cases the acquisition of shareholdings
will be treated as an investment in unconsolidated subsidiaries, with the consequence
that the holdings' value will be deductible from the institution's capital base for
capital-adequacy purposes.300

Significantly, in Community law the treatment of mixed activities is rather
inconsistent. In principle, the choice regarding the range of permissible activities of
credit institutions is left to the discretion of the national authorities. However, mixed
activities are more likely to be conducted through distinct vehicles within a group
structure than through a single legal entity. At group level, the Second Banking
Directive discourages the undertaking through separate subsidiaries of mixed
activities by groups whose parent is a bank or a financial holding company. In
particular, credit institutions are not permitted to have a "qualifying holding", i.e. a
holding exceeding 10% of the target company's capital or making it possible to
exercise significant influence over its management, in non-financial companies
(excluding insurance companies), if the value of this holding amounts to more than
15% of their own funds. There is also an aggregate limit of 60% of own funds for all
qualifying holdings taken together. The limits, which must be observed on a
consolidated basis, may be exceeded only in exceptional circumstances. However,
shareholdings held only temporarily during a restructuring or rescue operation or
during the normal course of underwriting or on behalf of others, are not taken into

consideration. Instead of applying the limits as absolute ceilings, the Member States have the discretion to permit their banks to exceed them, but only if the value of qualifying holdings in excess of the limits is deducted from the own funds for the calculation of capital adequacy. While these provisions restrict the carrying on of non-financial activities by a bank's downward affiliates, the opposite situation is not regulated. Thus, the question of bank ownership and control by non-financial enterprises is left to the discretion of the home-country regulators as part of the assessment of the suitability of shareholders with qualifying holdings in credit institutions.

\(\textit{(d) Reciprocity.}\) The authorisation of foreign deposit-taking institutions may be refused or revoked on grounds of reciprocity, if those institutions' home country restricts the access of U.K. banking and financial institutions to its domestic market. The acquisition by foreign persons of controlling interests in domestic institutions may also be precluded for similar reasons.

Before the Second Banking Directive, the safeguarding of reciprocity in the banking and financial sector was the responsibility of the Treasury. Accordingly, the Bank could not legitimatly take on its own initiative action under the Banking Act in pursuance of this aim. Nonetheless, as the resort to formal retaliatory actions could cause additional tension and embarrassment to the country's external relations, the Treasury preferred, instead of formally blocking the authorisation of foreign institutions, to have the Bank making the position known to them and dissuading them from persisting with their application.

The Second Banking Directive contains reciprocity provisions whose aim is to ensure access to the banking markets of third countries for all European banks.

\(301\) Second Banking Directive, art. 12. The term "qualifying holding" is defined in art. 1(10).
\(302\) See also J. Dermine, "The specialization of financial institutions: the E.C. model" (1990) 28 J.C.M.S. 219.
\(303\) Financial Services Act 1986, s. 183; Banking Act 1987, original s. 23 (now amended by S.I. 1992/3218, reg. 32(2)(b)). The Treasury could take retaliatory action for the purpose of securing reciprocal facilities even against persons carrying on financial activities of a different type than those affected by the restrictive foreign measures; Banking Act 1987, s. 91. The statutory provisions were intended mainly as a lever for the opening of Japanese markets to the leading U.K. banks. The Treasury's powers have never been put to formal use. See the remarks of the then Economic Secretary to the Treasury, P. Lilley, in the House of Commons, 9 Feb. 1989, H.C. (6th Series) Vol. 146, col. 1232; and S. Bevan, "Getting the blessing of the Bank of England" (Nov. 1986) 4:11 Banking World 27.
\(304\) Interview with officials of the Banking Supervision Division (A. Boxall and P. Hatton), 5 Oct. 1990.
\(305\) Second Banking Directive, arts. 8-9. The reciprocity provisions were the most controversial issue in the drafting of the Directive. See P. Vigneron and A. Smith, "The concept of reciprocity in Community legislation: the example of the Second Banking Directive" (1990) 5 J.I.B.L. 181, pp. 182-183. In the final text, reciprocity is defined in terms of both "effective market access comparable to that granted by the Community to credit institutions from that third country" and
The Directive requires the Member States to provide information to the Commission regarding the treatment of their credit institutions in third countries and the establishment of third-country banks in their jurisdiction. When a third country fails to meet the standards of reciprocity, the Commission is empowered, after obtaining the Council's approval, to start negotiations for the purpose of remediying the situation. The Commission and the Council may also direct the regulatory authorities of the Member States to resist applications for authorisation by the guilty country's banks and to block the acquisition of Community-based credit institutions by its nationals, pending the negotiations. However, the retaliatory measures cannot extend to the retrospective suspension or revocation of authorisation of institutions which are already established in the E.C. This weakens considerably the effectiveness of the reciprocity provisions, especially since most significant third-country banks hastened to establish European subsidiaries before the Directive's effective day (1 January 1993). Furthermore, under the G.A.T.S. agreement, which entered into force on 1 January 1995, if the specific commitments on liberalisation made by other countries prove acceptable to the E.C., the Commission may be willing to renounce future recourse to retaliatory action.

At any rate, following the implementation of the Directive, the Treasury can direct the Bank to refuse or defer an application for authorisation or to serve a notice of objection on a prospective parent controller on grounds of reciprocity only if this is required for the implementation of a direction issued by the Council or the Commission. Under the new régime, the Bank continues to have no discretion on the matter, and its role remains that of a passive conduit.

also *national treatment offering the same competitive opportunities as are available to domestic credit institutions*; art.9(3)-(4). On the ambiguities of this definition, see Vigneron and Smith, pp.183-184.

306 Art.8-9(1).
307 Art.9(3)-(5). The retaliatory measures envisaged by the Directive could be in conflict with the obligations of the Member States as signatories of the Code on the Liberalisation of Capital Movements, signed by the members of the O.E.C.D. See Vigneron and Smith, loc.cit., n.305, pp.188-190; and S. Hankey, "Pride, prejudice and reciprocity in the Single Market" (1989) 4 J.I.B.L. 161.
308 Art.9(4).
309 Under the pressure of several Member States, including the U.K., the original proposals of the Commission on the scope of potential retaliatory measures were weakened considerably during the drafting process. The British government's stance on the matter of reciprocity was clearly dictated by national, rather than European, considerations: resort by the Commission to retaliatory action in situations where the banks of other Member States are not offered reciprocal facilities, could be detrimental to London's position as an international financial centre, which is based on a policy of open access, and also to the interests of British banks with an international presence, which might be subject to countermeasures in the countries targeted by the Commission. See the remarks of the then Economic Secretary to the Treasury, P. Lilley, H.C. (6th Series) Vol.146, cols.1231-1232.
4. Conduct-of-business regulation

The Bank insists on the observance of prudential financial standards which operate at the level of the banking firm as a whole. In contrast, it is reluctant to address questions regarding the quality of particular assets or the inherent risk of engaging in specific activities, since this could entail a high degree of intrusion in the authorised institutions' business and, conceivably, in their relationship with individual clients, that might cause frictions. Only general admonitions are used for the purpose of encouraging banks to abstain from especially risky lines of business.

Furthermore, the Bank does not normally see it as being within its power or responsibility to regulate banking transactions for the purpose of protecting the users of the banking system from oppressive or unfair contracts or to act as arbitrator or mediator in individual disputes.\(^{311}\) Instead, various aspects of the provision of banking services are subject to rules of conduct policed by other regulators. This is, especially, the case with regard to the securities activities of banks, which are subject to the regulatory arrangements operated under the Financial Services Act 1986,\(^{312}\) and to their retail lending, which is governed by the Consumer Credit Act 1974.\(^{313}\)

Beyond these statutes, self-regulation plays an important role in this area. In particular, all retail banks adhere to the arrangements of the "Good Banking" code of banking practice, which is backed by the British Bankers' Association and which regulates their relationship with their personal customers, whether depositors or card-holders.\(^{314}\) Furthermore, some forty banks, whose combined customer base includes more than 99% of the individuals holding personal bank accounts, participate in the voluntary Banking Ombudsman Scheme.\(^{315}\) The Scheme was

---

311 "Banking Act 1987: Annual Report under the Banking Act for 1993-94", p.7. Exceptionally, however, the Bank, in pursuance of the Wholesale Markets Supervision Division's "London Code of Conduct: For Principals and Broking Firms in the Wholesale Markets" (May 1992), paras.22 and 91, is prepared to investigate complaints and arbitrate in disputes arising from transactions in the wholesale markets. On the Bank's regulation of wholesale markets, see infra, ch.4, section 2(b)-(c).

312 See infra, ch.4, section 1(b).

313 The Act subjects any arrangements such as overdrafts, loans and credit cards, by means of which banks provide credit of up to £15,000 to individuals (as defined in s.189(1)), to regulation. The banks must comply with the licensing requirements of pt.III of the Act. The administration of the provisions is entrusted to the Director-General of Fair Trading; pt.I.

314 "Good Banking - Code of Practice to Be Observed by Banks, Building Societies and Card Issuers in their Relations with Personal Customers", issued jointly the British Bankers' Association, the Building Societies Association, and the Association for Payment Clearing Services (2nd ed., Mar. 1991). The original version of the Code was issued in Dec. 1991.

315 See P. Morris, "The Banking Ombudsman - five years on" [1992] Lloyd's Mar.&Com.L.Q. 227; and M. Seneviratne, R. James, and C. Graham, "The banks, the Ombudsman and complaints
created in 1986, partly in recognition of the fact that internal procedures are not
even to address all client grievances and, at the same time, for marketing reasons,
but also as a strategy aimed at forestalling the introduction of statutory controls.316
The "Good Banking" code states that all banks subscribing to it "will be expected"
to join the Banking Ombudsman Scheme or another similar arbitration and
conciliation scheme (although it does not appear to impose a strict "obligation on
banks to do so).317

The Bank's responsibility in these matters is limited at ensuring that the business
of authorised institutions is conducted with appropriate skill and with integrity, as
required by the statutory minimum criteria for authorisation.318 The Bank considers
that contraventions of enactments designed to protect the members of the public
against financial loss due to dishonesty, incompetence and malpractice or serious
breaches of recognised ethical standards of conduct may raise doubts regarding the
fulfillment of this requirement. Among the ethical standards, whose observance the
Bank is prepared take into consideration in assessing the situation, are those
embodied in the "Good Banking" code and various other self-regulatory codes of
conduct promulgating best-practice rules.319 In most cases, however, the existence
of complaints will not be considered to raise wider concerns about the institution as
a whole. On the other hand, the Bank will probably be concerned by any indication
of banking fraud or money laundering.

---

316 In its report on banking services, the Jack Committee recommended the replacement of the
industry-backed Scheme by a statutory one, which would have greater credibility; The Review
Committee on Banking Services Law (Jack Committee), "Banking Services: Law and Practice"
(Cm. 622, 1989), paras.15.15, 15.24-15.26. The government, however, rejected this proposal,
agreeing with the industry's view that the voluntary system was working well in practice; White
Paper "Banking Services: Law and Practice" (Cm. 1026, Mar. 1990), para.3.7.

317 Loc.cit., n.314, paras.7(4), 22(4). When the code intends to create a positive obligation, it uses
merely the word "will". The code requires, however, all banks to put in place appropriate internal
complaints procedures; paras.7(1), 22(1).

318 Banking Act 1987, Sch.3, para.5.

319 Statement of Principles, "Banking Act 1987: Section 16", loc.cit., n.10, para.2.38, which
specifically mentions the "London Code of Conduct" for the wholesale markets, loc.cit., n.311,
the Joint Money Laundering Working Group's guidance notes on money laundering (see infra,
text and n.330), the "Good Banking" code of banking practice, loc.cit., n.314, and the Take-over
Code, but not the "Code of Conduct for the Advertising of Interest Bearing Accounts" (see infra,
p.19.
(a) **Fraud.** The Bank is particularly clear about its insistence on measures designed to eradicate banking fraud.\(^{320}\) The perpetration of fraud, especially when a bank's senior management is involved, is a common cause of bank failure. This justifies the Bank's prudential concern with the issue, even though fraud is a common commercial risk to which all enterprises, not only banks, are exposed. There may be, however, additional political reasons for regulatory preoccupation with fraud. As the Bank knows only too well, any banking fraud will tend to be attributed to a failure of the regulatory system.

"[N]o system [...] can be guaranteed to prevent fraud. But any regulatory system, statutory or non-statutory, official or self-regulatory, will be weakened if confidence is lacking in the ability of the prosecuting authorities and the courts to bring the fraudulent to justice. [...] To some critics and commentators any financial fraud is City fraud, and no effort is made to distinguish between fraud on a financial institution, fraud by an institution, and fraud on others committed by customers of an institution. Failure to make distinctions of this kind has been particularly evident in the reporting of the case of Johnson Matthey Bankers."\(^{321}\)

This misunderstanding of the limits of supervision, which results from an expectation that the regulatory system will protect all parties from any deficiency in the conduct of banking institutions,\(^{322}\) creates evident political difficulties for the Bank as the responsible authority and forces it to take a serious view of all forms of fraud, whether they actually raise prudential concerns, in the precise sense, or not.\(^{323}\)

In this regard, the collapse of B.C.C.I. as a result of systematic fraud of an unprecedented scale made it clear that the Bank's co-operative style of monitoring was ill-adjusted to the task of detecting fraud and malpractice. While its overall approach to supervision has not changed as a result of this affair, the Bank, in response to criticisms regarding its lack of vigour in pursuing signals of fraud in B.C.C.I., has proclaimed its determination to be more alert in the future to suggestions of malpractice and more aggressive in their investigation. For this purpose, it has formed a Special Investigation Unit, consisting of experts recruited from the relevant professions, whose responsibility is precisely to pursue any

---


\(^{323}\) In particular, the Bank, fearful that authorised institutions, especially smaller ones, could be approached by unknown persons suggesting participation in very substantial business, often with fraudulent intent, asks to be informed of all dubious offers, so that appropriate warning may be given to other institutions on a confidential basis; untitled notice on connected lending, accounts, large exposures, fraudulent invitations and floating charges (BSD/1983/1, Apr. 1983), para.4.
indication of fraud or other criminal activity affecting the Bank's regulatees. The Unit participates in the new machinery, the Financial Fraud Information Network, which has been established by the government in order to facilitate exchanges of information between the authorities responsible for detecting and prosecuting fraud and other financial crime and to coordinate their responses.

(b) Money laundering. In letters to its regulatees, the Bank has expressed its belief that the Basle Committee's statement on money laundering reflects existing best practice and made clear that all authorised institutions are expected to demonstrate that their policies in the area are consistent with it. The Basle Committee's paper sets out four principles, the observance of which by banking institutions can contribute to the eradication of money laundering - i.e. the use of the banking system with the intention of hiding the source and beneficial ownership of funds, so as to conceal the fact that such funds derive from criminal activities (including dealing in drugs, but also robbery, terrorism, fraud, etc.). The principles require: (i) the identification of customers; (ii) compliance with the law and conformity with high ethical standards, including a duty not to provide active assistance in suspect transactions; (iii) co-operation with law-enforcement agencies, to the extent permitted by customer-confidentiality laws; and (iv) the adoption of operational policies consistent with the previous principles and the establishment of appropriate systems and records. In addition to the above, the Bank demands from all institutions to be able to demonstrate that their policies, records and systems are at least up to the standards set out in the Guidance Notes issued by the ad hoc Joint Money Laundering Steering Group (which is chaired by the Bank and includes representative of the banks, the building societies and the law-enforcement


327 Letter to the President of the British Bankers Association (6 Jan. 1989) and letter to the authorised institutions who are not B.B.A. members (12 Jan. 1989); and letter to the authorised institutions on "Money Laundering" (10 Nov. 1989), drawing attention to the relevant statutory provisions, i.e. the Drugs Trafficking Offences Act 1986, s.24, and the Prevention of Terrorism (Temporary Provisions) Act 1989, ss.11-12.


The Bank may request the inclusion of a review of the control systems and accounting records which reflect adherence to the principles on money laundering as part of the reporting accountants' reports that authorised institutions are regularly requested to make under section 39 of the Banking Act. Failure to install or maintain adequate systems will be taken into account in considering whether the minimum criteria for authorisation are fulfilled. Indeed, the Bank's decision to take action against Mount Banking has been triggered by the suspicion that that institution was used as a vehicle for money-laundering activities.

Following the Bank's regulatory pronouncements on the matter, the introduction of new legislation has transformed the taking of appropriate measures for the prevention of money laundering into a fully-fledged statutory duty. This has been a consequence of the Money Laundering Directive, which provides for the prohibition of money laundering throughout the Community. Under the Directive, the Member States are required to ensure that credit institutions are under an obligation: (i) to require identification of their customers and to take reasonable measures to establish the real identity of the beneficiaries of transactions and accounts; (ii) to examine carefully unusual transactions and refrain from entering into suspect operations; and (iii) where relevant facts are discovered, to inform the judicial or law-enforcement authorities responsible for combating money laundering; and to maintain appropriate systems and controls. Although the directive provides that the supervisory authorities must inform the law-enforcing authorities of any evidence of money laundering that they have discovered in the course of inspections carried out in credit institutions, it does not give them any special responsibility for ensuring compliance with the requirements. The matter is presumably left to the discretion of the Member States. In the U.K., the directive was implemented by the Criminal Justice Act 1993 and the Money Laundering Regulations 1993. The Regulations impose on financial institutions a requirement, underpinned by criminal

---

331 On reporting accountants' reports, see supra, ch.2, section 4.
332 Letter to authorised institutions on "Money Laundering" (10 Nov. 1989).
333 On the circumstances of that case, see supra, section 3(a).
335 Art.2.
336 Arts.3-9 and 11.
337 Art.10.
338 Which creates various offences in relation to money laundering and exempts disclosures of suspect transactions to the police from any confidentiality requirements, ss.29-32, and gives powers to prosecute offenders to the Commissioners of Customs and Excise, s.35.
339 S.I. 1993/1933.
sanctions, to maintain certain procedures with a view to forestall or prevent money laundering. Satisfactory steps for the identification of applicants for business must be taken, and records of the identification evidence must be kept for five years. Within each institution, a compliance officer must be identified as the person responsible to receive any information giving rise to employee suspicions of money laundering and, after having considered such information, to make reports to the police authorities where he also forms the view that money laundering may be taking place. Financial supervisors, including the Bank, are also required to report to the police authorities any information indicative of money laundering that they may have obtained while carrying out their functions. Accordingly, under the implementing legislation the Bank is not given any policing, prosecuting or regulatory powers in the matter of money laundering.

This raises the question whether the regulatory enforcement of policies designed to combat money laundering is a legitimate function for the Bank. The administrative costs of such policies can be very significant for the banks observing them. Although the carrying-on of a banking business "with integrity" is recognised in the Banking Act as one of the minimum criteria for authorisation, it is not evident that a bank which merely fails to undertake what is essentially a policing role - as distinct from one which knowingly or recklessly abets money laundering - lacks integrity. Furthermore, there is no necessary connection between these anti-crime policies and the recognised purposes of the Bank's functions under the Act, which focus on the protection of the interests of depositors. Essentially, money laundering should be the exclusive concern of the appropriate police and prosecuting authorities.

An argument that money laundering is a genuine regulatory concern has been put forward at the European level to legitimise the adoption of the Money Laundering Directive. In accordance with the doctrine of attributed powers, the institutions of the Community can only act in matters that are delegated to them under the Treaty. The harmonisation of criminal law, however, is outside the Community's legal competence. For this reason, the Money Laundering Directive is presented as justifiable by considerations relating to the construction of the internal market. In particular, in the Directive's preamble it is maintained that


341 Sch.3, para.5.

"when credit and financial institutions are used to launder proceeds from criminal activities [...] the soundness and stability of the institution concerned and confidence in the financial system as a whole could be seriously jeopardised, thereby losing the trust of the public".343

It is also maintained that this concern cannot be resolved at the national level, because, without coordination at the Community level, the measures adopted by the various Member States "for the purpose of protecting their financial systems" could prevent the completion of the single market.344 On this basis, the taking of Community action is brought within articles 57(2) and 100A of the Treaty.

Analogous assertions that the public's confidence and trust in banks can be undermined by adverse publicity following their inadvertent association with criminal activities, or that banks may open themselves to direct losses from fraud as a result of negligence in their screening procedures or corruption of their officers' integrity through association with criminals, have been used by the Basle Committee - and, implicitly, by the Bank - in support of regulatory involvement in this area.345 Unless the validity of these assertions is accepted at face value, the Bank should not be allowed to make compliance with the related rules of conduct a prerequisite of authorisation.

(c) Deposit advertisements. The Banking Act delegates to the Treasury and the Bank specific powers relating to the regulation of advertisements for deposits. The statutory definition of deposit advertisements is very wide. It includes any invitation to make a deposit or information intended to lead, even indirectly, to the making of a deposit, irrespective of the means of bringing such an invitation or information to the notice of the recipients.346 Letters addressed to particular persons or other personal communications could be within this definition.347

Under the statutory provisions, if the Bank considers that any deposit advertisement issued or proposed to be issued by, or on behalf of, an authorised institution is misleading, it has the power to direct in writing that institution to desist from issuing advertisements of a specified kind or substantially repeating the offending advertisement or to modify or withdraw, as far as practicable, from display such advertisements.348 In addition, the Treasury is vested with a power, exercisable

343 Money Laundering Directive, preamble, 1st recital.
344 Ibid., preamble, 2nd recital.
345 Basle Committee, "Prevention of Criminal Use...", loc.cit., n.328, preamble, paras.3-4.
346 Ss.32(5) and 33(7).
348 S.33(1)-(2). Before giving a direction, the Bank must give notice of its intention to the institution concerned, stating the reasons, and the institution may make written representations, which the Bank must take into account in reaching its final decision; s.33(3)-(4).
after consultation with the Bank and the Building Societies Commission, to make "regulations for regulating the issue, form and content of deposit advertisements". The contravention of either the Treasury's advertisement regulations or the Bank's directions gives rise to criminal liability.

The Treasury has exercised its rule-making power by issuing the Banking Act 1987 (Advertisements) Regulations 1988. However, these only apply to deposit advertisements which invite the making of deposits outside the territorial limits of the E.C. Advertisements for domestic deposits are not covered by the regulations and are only subject to the remedial power of the Bank to issue directions. Nonetheless, conformity with the standards of the Advertising Standards Authority and, in particular, with the special self-regulatory "Code of Conduct for the Advertising of Interest Bearing Accounts" should be a relevant consideration for deciding whether the Bank's power is exercisable. The Code requires the specification in the advertisements of the rates of interest on the basis of a standardised calculation and the clear indication of charges for withdrawals and certain other terms. It also stresses the need for advertisers to ensure that members of the public are fully aware of the nature of any commitment into which they may enter. The Bank has advised all authorised institutions that they are expected to adhere to the Code, whether they are members of the associations which have issued

---

349 S.32(1)-(2). The Treasury may also make "regulations for regulating the making of unsolicited calls [... with a view to procuring the making of deposits"; s.34. The concern with misleading advertisements is not confined to deposit-taking, but extends to other aspects of banking, i.e. investment services and lending. The Consumer Credit Act 1974, s.44(1), provides that the Secretary of State for Trade shall make regulations regarding the form and content of the advertisements of the providers of consumer credit. These regulations are intended to ensure that such advertisements convey a fair and reasonably comprehensive indication of the nature of the credit or hire-purchase facilities offered by the advertiser and of their true costs to the borrower. See now the Consumer Credit (Advertisements) Regulations 1989. In R. v. Secretary of State for Trade and Industry, ex p. First National Bank plc., [1990] C.O.D. 221 (C.A.), it was held that, while s.44(1) imposed a duty on the Secretary to make the appropriate regulations, it did not impede the inclusion in them of provisions going beyond what was expressly required, provided that these were not unreasonable or in conflict with the section's purposes. The rule-making power of the Treasury under s.32 of the Banking Act 1987 is even wider, because it is discretionary and not explicitly directed to a particular purpose. However, the overall protective purpose of the Act as a whole, i.e. the protection of depositors, may set limits to its legitimate exercise.

350 S.32(3) and 33(6). Since this is a matter of criminal law, the prosecuting authorities will not be entitled to ask the court to adopt the "purposeful" construction of these instruments; see National Westminster Bank plc. v. Devon County Council, The Independent, 25 Aug. 1993; The Times, 16 Jul. 1993 (D.C.).


352 Ibid., reg.2(1)-(2). It must be noted that the Channel Islands and the Isle of Man are within the regulations' territorial scope.

it or not. It is unclear, however, if breaches of the Code will be taken into account by the Bank merely for the purpose of deciding whether an advertisement is misleading, or also for that of assessing whether the relevant institution's business is carried on with integrity and skill, as required by the minimum criteria for authorisation. In an attempt to prevent implications in deposit advertisements to the effect that the Bank implicitly guarantees the obligations of the institutions authorised by it or that all authorised institutions are above suspicion, the Bank insists that attention to the advertiser's authorisation can only be drawn by use of the phrase "(an) authorised (institution) under the Banking Act 1987", but without any reference to the Bank. Similarly, a standard form of words must be used for referring to the protection provided to depositors by the Deposit Protection Scheme.

The Act prohibits, on threat of criminal penalties, the making of fraudulent statements, promises or forecasts for the purpose of inducing other persons to make (or refrain from making) deposits. The prohibition is directly operative, and does not depend on Treasury or Bank discretion. Nonetheless, as in the case of unauthorised deposit-taking, the Bank is given the power to investigate suspected offences and to apply to the court for injunctions restraining the continuation of contraventions and freezing the assets of suspected offenders.

5. The Bank's role in the termination of authorised institutions

The Bank can terminate the activities of regulated institutions in either of two ways: by revoking or restricting their authorisation; or by commencing proceedings for their winding-up. Conversely, it can use its financial resources and de facto power as central bank to provide last-resort support or organise rescue operations for ailing institutions. Ultimately, it is this combination of its formal discretionary powers regarding bank termination with the practical ability to get banking...
institutions out of the most serious difficulties, which guarantees the Bank's position as final arbiter of the fate of these institutions.

(a) Restructuring policies, bank rescues and regulatory incentives. In practice, the Bank is reluctant to let deposit-taking institutions go under. Even where an institution fails to establish to the Bank's satisfaction that it meets the minimum statutory criteria for authorisation, the Bank normally encourages the institution to take adequate remedial steps and only moves to revoke or restrict its authorisation if it fails to do so or if there is an imminent threat to the interests of depositors. In the words of the Bank's former Governor, Robin Leigh-Pemberton:

"It is the policy of the Bank of England as far as possible to preserve banking institutions in the interests of depositors. [...] We take the view that it must be right except in an overwhelming case to try to preserve rather than to try to terminate a banking institution."

The Bank's case against automatic termination rests on the fact that revocation of authorisation is a two-stage process: once grounds for revocation are found to exist, the Bank must reach a decision, whether the taking of formal action is in the interests of depositors. In the Bank's view, in situations where there is commitment to adequate remedial action on the part of the institution, it would be indefensible and contrary to the purposes of the Banking Act to revoke authorisation if this would result in major losses to depositors. To ensure that the institution will correct the deficiencies within reasonable time, the Bank may restrict its authorisation by imposing pertinent conditions. A restriction of authorisation may also be appropriate as a temporary safeguard in circumstances where the Bank thinks that the statutory criteria for authorisation may have been breached, but its information is incomplete. In comparison, a time limit on the authorisation will generally be imposed as a substitute for outright revocation, to facilitate the orderly termination of the institution's activities and the smooth repayment of deposits in situations where the sudden loss of authorisation could result in liquidity pressures.

In the wake of the B.C.C.I. failure, the Bank's approach became the subject of severe criticisms. The Bank had deferred action in the face of serious irregularities, even though the corrective measures taken by B.C.C.I. were neither adequate nor speedy; it had disregarded indications of misconduct and lack of probity on the part

of the institution's management, as opposed to financial problems, and had only acted when overwhelming evidence was brought together. The apparent reasons for its procrastination were an unjustifiable fear that the institution might bring a successful appeal, which, if the Bingham Report is to be believed, "loomed much larger than it should in the Bank's mind", causing it to refrain from taking action, and an undue concern to preserve, rather than terminate, banking establishments.

The Bank's answer to the criticisms was that its policy of pursuing remedial action, whenever this is feasible, had proved very successful over the years: in the period 1986-1992, 35 authorized institutions had implemented remedial programs, involving changes to their business, management and shareholders. At the same time, the Bank insisted that it had not hesitated to take formal action where it believed that the situation could not be remedied: since 1986, there had been 17 revocations and 28 restrictions, while in 18 cases the prospect of formal action has caused institutions to surrender their authorizations; over the same period, 14 institutions had gone into liquidation, receivership or administration.

Despite the Bank's protestations, it remains true that its incentive structure does not always favour aggressive enforcement. This has less to do with its supposed fear of losing an appeal, which would be inexplicable, since legally most challenges to its decisions are predestined to fail due to the very heavy burden on the appellant, and more with its eagerness to maintain a co-operative relationship with the regulated population, which can facilitate its monitoring function, and to minimise perceptions of malaise and crisis in its field of responsibility. The eruption of problems of sufficient severity to cause the termination of banking institutions reflects badly on the Bank's supervisory performance - and, when the problems are linked to the macroeconomic environment, also on its performance as central bank. Thus, even where an institution's situation does not objectively justify hopes of rehabilitation, the Bank may be particularly reluctant to contemplate immediate closure, if this will trigger a large-scale insolvency and the infliction of heavy losses to their depositors: since a revocation of authorisation before insolvency is clearly unavoidable will certainly cause recriminations, the Bank may be inclined to adopt an overoptimistic view of the institution's prospects and postpone the final decision, with the unavowed hope that a solution will emerge in the meantime.

Similar incentives are in operation when the failure of an institution is imminent. In this situation, however, the Bank will often refrain from coming to the rescue of the institution, because its strong interest in avoiding conspicuous bank closures, especially those involving the loss of depositors' funds, may be superseded by the imperative of combating moral hazard by validating the possibility of failure; the unpredictability of its decisions is of primary importance for the latter purpose. However, if the ailing institution is deemed to be "too big to fail", or if there is a possibility of multiple failures, the Bank may choose to intervene.\(^{368}\)

The Bank is always careful to limit its financial exposure to the minimum. Before launching a rescue operation, it seeks to prevent the failure by asking the ailing institution's major shareholders to refinance it or by arranging its assumption by a stronger institution, and only considers to commit its own funds if support from another party is not forthcoming.\(^{369}\)

The Bank maintains that, in principle, it refuses to bail out institutions which are known to face solvency problems, although it admits that it is not often easy to discriminate between mere illiquidity and insolvency. However, as the Bank's present Governor, Eddie George, recognised in a speech given while he was still Deputy Governor, at least in the period 1979-87 there were no examples of the Bank organising liquidity support for a clearly solvent but illiquid institution, while on a number of cases, most notably that of Johnson Matthey Bankers in 1985, the Bank had salvaged insolvent institutions for systemic reasons, although never with the intention of protecting their shareholders or managers.\(^{370}\) Thus, the truly critical question is whether the provision of assistance is necessary for the protection of the banking system as a whole from contagion. On this issue, the Bank may tend to take a exceedingly wide view of what can constitute a potential systemic threat, and its evaluations are not universally approved, as shown by the acrimony surrounding the Johnson Matthey rescue.\(^{371}\)

In recent years, however, a more restrictive approach appears to prevail. Thus, in 1990-91, several small banks came under pressure as the result of the economic recession, which caused asset values, in particular those of commercial and residential property, to decline and arrears in consumer lending to rise. In response, the Bank placed around forty small institutions, especially ones strongly dependent

\(^{368}\) See "Extract from a speech by the Governor" (1971) 11 B.E.Q.B. 224, pp.227-228.


\(^{371}\) See supra, ch.1, section 2(d).
for their funding on wholesale deposits or giving rise to other concerns, under close supervision, helping them to restructure their business and, in the worst cases, to wind down their affairs in an orderly manner. In early 1991, three small institutions - Chancery, Edington and Authority - were forced to close their doors, after suffering significant losses on loans and a consequent drain of deposits, but the Bank, not yet convinced that there was any tangible threat to the system as a whole, did not intervene. However, the situation deteriorated further, especially following the collapse of B.C.C.I. later in the year, which led to a tightening of wholesale funding due to the withdrawal of local-authority deposits. At that stage, the Bank decided, with the government's knowledge but without its guarantee, to provide liquidity support to a number of institutions for the purpose of ensuring that their problems would not have wider destabilising effects. The rescue operation was the largest since the secondary banking crisis of the mid-1970s. By 1993, the Bank's provisions against its support rose to approximately £115 million. Many of the banks concerned were able to secure fresh longer-term sources of funding on a commercial basis or to scale down their activities to the level justified by their reduced sources of funding. Despite the easing of the pressure after 1993, however, a number of other institutions were obliged to surrender their authorisation. Eleven institutions disappeared during the financial year 1993-94 alone. The termination of several of them was precipitated by their inability to meet the Bank's capital and provisioning requirements or to reorganise their group structures, where these impeded effective consolidated supervision.

More recently, over the weekend of 24-26 February 1995, the Bank made an attempt to organise a rescue package in order to prevent the collapse of Barings p.l.c., the City's oldest merchant bank. Recognising, however, that this was not a problem that could affect the City as a whole, but could at most the small group of British merchant banks by damaging their collective reputation, it support the rescue with public money, and when a deal failed to materialise it let Barings fail, despite the fact that this could expose numerous illustrious clients of the institution, including the Queen as well as several charities, to considerable losses. Thus, Barings went into administration, and the losses to its depositors were averted only because of its eventual assumption with court approval, at total loss to the

shareholders, by the Dutch bank Internationale Nederlanden Groep N.V. a week later.

In all cases, the Bank tries to ensure that its support is provided on penal terms, so as to eliminate the subsidisation of unsound banking and discourage moral hazard: the replacement of the institution's management is generally demanded, and the support is structured in ways that the risk of losses is borne first by the shareholders, while potential profits accrue first to the Bank. The Bank also seeks to ensure that its involvement does not become an open-ended commitment, but that either the institution's health is restored under its surveillance within reasonable time, through the restructuring or downsizing of its operations, or it is wound down.

(b) Insolvency proceedings against banking institutions. As an alternative to the revocation of authorisation, the Bank has the power of commencing insolvency proceedings against problematic institutions. In particular, the Bank can present under a petition for the winding-up of an authorised institution, a "former authorised institution" (i.e. an institution which has lost or surrendered its authorisation but continues to have a liability in respect of deposits that it accepted while it was authorised\textsuperscript{376}) or an unauthorised deposit-taking institution, in which case the court may exercise its discretion to wound up the institution concerned if the latter is unable to pay its debts\textsuperscript{377} or if it appears to the court that winding it up would be "just and equitable".\textsuperscript{378} The most notable example where this procedure has been used instead of revocation, was against B.C.C.I. in 1991.

The court may decide to give control of an institution's business and assets to provisional liquidators, postponing for a more appropriate time the final decision on whether a winding-up order should be made. The Bank will sometimes refrain from withdrawing or restricting authorisation while provisional liquidators are responsible for the conduct of an institution. However, the making of a final winding-up order will lead automatically to the revocation of authorisation.\textsuperscript{379}

Where the immediate liquidation of a U.K.-incorporated authorised institution or former authorised institution does not seem fitting, the Bank may present to the court a petition for the making of an administration order. In cases where such a petition has been presented by another party (whether the authorised institution

\textsuperscript{376} The term "former authorised institution" is defined in s.106(1).
\textsuperscript{377} Within the meaning of s.123 or ss.221-224 of the Insolvency Act 1986.
\textsuperscript{378} Banking Act 1987, s.92. The court's power to make winding-up orders extends to all companies, regardless of their place of incorporation.
\textsuperscript{379} Ibid., s.11(6)(a).
itself, a director or a creditor), the Bank must be serviced with the petition and has a right to be heard in the ensuing proceedings.380

Before petitioning the court for a winding-up or administration order, the Bank will consider whether this is required for the protection of the interests of depositors. Regulatory information collected and reports commissioned under the Banking Act may be used as evidence in support of the Bank's petitions.381

Concerning the grounds for the making of an order, a failure to repay any sum due and payable in respect of a deposit is sufficient proof that the defaulting institution is unable to pay its debts.382 In Re Goodwin Squires Securities Ltd.,383 the Bank had brought an application for the winding-up of a former licensed institution under the equivalent provision of the Banking Act 1979,384 on the ground that it was unable to repay sums due and payable to its depositors or able to repay them only by defaulting on its obligations to other creditors. It was held that, if a deposit-taking institution facing an immediate demand for the repayment of all deposits currently due had to rely on being able to defer payment for however brief a period while assets were realised, then a case was made out for its winding-up. The only question was whether in the exercise of the court's discretion a winding-up order should be made. In answering this question, the court thought that weight should be given to the Bank's concern for the protection of depositors and its interest to see that the maximum amount was repaid, so as to limit claims on the Deposit Protection Fund and to ensure the speedy settlement of claims by the depositors. However, the conception of solvency as an ability to settle immediately all debts currently due which underlines this decision, is unsatisfactory in the case of banking institutions,

380 Banks (Administration Proceedings) Order 1989, S.I. 1989/1276. Since the conduct of a banking business on a going-concern basis depends entirely upon the market's confidence, the publicity that a petition for an administration order can attract to an institution's difficulties could make its survival impossible; in this manner, one of the alternative statutory purposes for which such an order may be made, would be thwarted. For this reason, uncommon secrecy and speed in bringing the petition and reaching a decision upon it may be necessary. The Bank and the judiciary may be willing to co-operate for ensuring these conditions. For example, administration orders ought usually to be made only after due consideration and after some time has been given for all parties concerned to make their voices heard. In Re Chancery Ltd. [1991] B.C.C. 171 (Ch.D.), however, in circumstances where a petition had been presented by the directors of an authorised institution, the Bank agreed on a hearing at short notice and the judge, being satisfied that no third party was entitled to appoint an administrative receiver, heard immediately the petition in camera; the whole proceedings were completed within a few hours. One ground for the decision was that even an interval of a few days would have made it impossible for the directors to perform their duty: the directors would have grave doubts about the propriety of receiving deposits (including the receiving of cheques for the credit of ordinary accounts), there would be a serious risk of wrongful trading and, finally, extremely serious difficulties would be caused to the institution's customers.

382 Banking Act 1987, s.92(1); and Insolvency Act 1986, s.8(1A), inserted by S.I. 1989/1276.
384 S.18(1)(a).
whose role as intermediaries depends on maturity transformation, \textit{i.e.} the transformation of short-term deposit resources into longer-term earning assets, whose immediate realisation may be economically and legally impossible. Essentially, banking involves the practical ability to meet repayment demands as they are actually made in normal circumstances, not the theoretical ability to repay the full deposit base of the institution immediately. Accordingly, the legal concept of insolvency should be confined to situations where an institution's net present economic value is negative or where the institution has been unable to repay debts which have actually been called for repayment. Significantly, under the recently amended section 59 of the Banking Act 1987, the latter concept of bank insolvency now applies for the purpose of activating compensatory payments to the depositors of failed institutions under the Deposit Protection Scheme. At any rate, the practical effect of different technical definitions of insolvency may be limited, because the discretionary judicial judgement, whether a winding-up order institution should be made, will turn primarily to more pragmatic concerns regarding the interests of the institution's depositors and creditors.

Similar considerations will also dominate the determination of the question whether it is "just and equitable" that an institution should be wound up. This ground may be applicable whether or not an institution is solvent and even if it does not have any more outstanding deposit liabilities. It may be enough that, by carrying on deposit-taking activities in the past, the institution had shown disregard for the interests of its depositors and engaged in illegal, unethical or unprofessional conduct. In this situation, the rationale for the petition is that "by winding up the company the court would be expressing, in a meaningful way, its disapproval of the company's conduct. In addition to being a fitting outcome for the company itself, such a course had the further benefit of spelling out to others that the court would not hesitate to wind up companies whose standards of dealing with the investing public were unacceptable."\textsuperscript{385}

For this reason, past misconduct may be critical, even when the present situation of the institution suggests that the interests of the public are not any more threatened by its continuing operation. This can be especially important if a change of control or management has occurred in the meantime.

\textsuperscript{385} Re Walter L. Jacob and Co. Ltd, The Times, 29 Dec. 1988 (C.A.). The decision notes that the only distinctive element of "public-interest" insolvency petitions brought by regulatory authorities, such as the Secretary of the State under the Companies Acts or the Bank under the Banking Act, consists in the nature of reasons that the petitioner puts forward; for the rest, as in every petition for winding up, the court must carry out a balancing exercise. The public interest requires that financial institutions should maintain at least the generally accepted minimum standards of commercial behaviour, and institutions falling below those standards should have their activities stopped. That the company in that case had ceased to carry on the relevant type of business immediately before the petition was presented, did not make a critical difference.
Other considerations, however, and in particular the financial interests of depositors and other creditors, may override the need to make an example out of delinquent institutions by terminating them. Paradoxically, where both objectionable past conduct and economic insolvency are found to exist, the institution may stand a better chance of being allowed to survive following its restructuring, especially if this would increase its creditors' prospects of recovery. Difficult questions concerning the effect of the institution's liquidation, as compared to continuation, on recovery by the various classes of creditors (insured depositors, uninsured creditors, or even creditors by way of subrogation, such as the Deposit Protection Fund) whose interests may not always coincide, as well as the timing of prospective payments under each alternative, can influence the exercise of the court's discretion. The Bank may put forward the position of domestic depositors in particular, but in reaching its decision the court will consider the interests of all creditors world-wide, trying to balance them against each other.

In *Re Bank of Credit and Commerce International S.A.*,\(^\text{386}\) on a petition by the Bank for the winding-up of the institution, the owners applied for adjournment, for the purpose of gaining time for the exploration of the possibilities for a rescue plan that would result in a financially viable institution, whose management would be beyond reproach. The adjournment was opposed by the Bank, on the ground that, unless and until a winding-up order were made, no payment could be made to depositors out of the Deposit Protection Fund, nor could employees receive redundancy payments. Nonetheless, the court thought that, if an interim compensation scheme could be put together, a long adjournment for the purpose of pursuing the institution's restructuring could be tolerated, since the prospects of recovery by the creditors as a whole would improve with a successful restructuring. For this reason, a short adjournment was given in order that the matter could be investigated.\(^\text{387}\)

Soon afterwards, an interim compensation scheme was presented, under which the great majority of the insured depositors would be better off than under an immediate winding-up, since they would receive immediately exactly the same amount as under the Deposit Protection Scheme while retaining an additional chance of recovering the rest of their deposits in the event of successful restructuring. Nevertheless, the Bank continued to oppose the application for adjournment, claiming that the winding-up should go on for a variety of reasons: under the proposed scheme some insured depositors would not get the same level of protection as under the statutory scheme; the institution was insolvent; the most

serious allegations of widespread fraud had been made against the institution; and no firm proposals had been put forward as to the terms of the rescue. The court rejected the Bank's arguments. Avoiding the issue of insolvency on the ground that it had not been proven at that preliminary stage, it emphasised that a winding-up order would affect the institution's world-wide operations and would make its assets applicable for its world-wide creditors. It was the interest of all these creditors that the court ought to consider, not only the interest of a minority of English sterling creditors - and the best hope for substantial recovery by the creditors as a whole lay in the long-run success of the restructuring proposals. If the allegations against it were true, the institution had been conducted in a scandalously fraudulent way, and putting an end to it would be in the public interest; however, it was not necessary in the public interest, or in the interest of depositors, for the Bank to demonstrate immediately that banks so conducted cannot survive. An adjournment did not entail any danger of further fraudulent dealing by B.C.C.I., because provisional liquidators were already in charge. As for the lack of firm restructuring proposals, the adjournment was necessary to provide sufficient time for them to materialise.  

The decision is based on the assumption that, even if the restructuring were to succeed during the adjournment, the Bank could still renew its petition for the dissolution of the reformed bank and the court might exercise its discretion to make a winding-up order at that stage. Nonetheless, this assumption was highly unrealistic, since, as a matter of practical reality, participation of the institution's ownership in a restructuring program could only be forthcoming on the basis that, if successful, this would absolve the bank from any past misconduct. In this sense, the B.C.C.I. case illustrates the inherent tension between the primary economic function of insolvency proceedings, which aim at ensuring satisfaction of creditors, protection of owners' residual value and, where possible, continuing survival of the firm as a productive unit, and the use of winding-up orders as a penalty against delinquent institutions.

The tension between the purposes of insolvency proceedings and the regulatory objectives of the Bank cannot be resolved simply by revoking an institution's authorisation instead of petitioning the court to wind up. In this case, the conflict is merely removed at another plain.

For instance, the statutory purposes of an administration order include: (a) the survival of the company as a going concern; (b) the approval of a voluntary arrangement; (c) the sanctioning of a compromise or arrangement; and (d) a more advantageous realisation of assets than would be possible if the company were

---

wound up.\textsuperscript{389} When the company in question is a bank, the revocation of its authorisation can frustrate these purposes, especially the continuing survival of whole or part of the company or the realisation of its assets on favourable terms. On the other hand, exactly as in cases of petitions for winding-up, the Bank may favour revocation as a means of penalising past misconduct or of accelerating the repayment of deposits.

The issue was raised before the Banking Appeal Tribunal, in connection to an appeal brought by the administrators of Mount Banking against the Bank's decision to restrict that institution's authorisation by imposing a short time limit of three months.\textsuperscript{390} At the time when the restriction was issued, Mount Banking was already in administration in pursuance of a petition presented by its owners and supported by the Bank. Even though the existence of an administration order is in itself a statutory ground for the revocation or restriction of authorisation,\textsuperscript{391} the Bank, having supported the order, did not use it as a basis for its decision to set the time limit; instead, it relied on past misconduct by the institution's owners-managers.

The administrators submitted that the Bank should have taken into consideration the new situation that had emerged as a result of the administration régime - something that it had failed to do when it imposed the time limit for the purpose of ensuring the protection of depositors. It was alleged, in particular, that the Bank's decision was unreasonable, because the administration was sufficient for the protection of existing depositors, while the acceptance of new deposits was prohibited under other restrictions imposed by the Bank.

Since it was within the Bank's discretion to decide, after balancing all the relevant considerations, what was the most appropriate course of remedial action, the essential question before the Tribunal was whether the Bank's decision-making was so flawed as to render its decision invalid. Although the Bank recognised that some points of criticism might be justified, it maintained that overall there were no critical flaws in its decision.

Following the making of the administration order, the Bank had formed the opinion that Mount Banking's owners-managers were unfit and, in addition, that the institution was unlikely to have a viable future without them. Although they did not necessarily disagree with the latter conclusion, the administrators wanted to explore the possibility of maintaining Mount Banking in life or selling all or part of its business as a going concern. Loss of authorisation would make their task much more

\textsuperscript{389} Insolvency Act 1986, s.8(3).
\textsuperscript{391} Banking Act 1987, s.11(8).

316
difficult. For this reason, the Bank had agreed to impose a three-month restriction on the institution's authorisation, instead of revoking it outright, concluding that it was in the interests of depositors to give the administrators "the best possible chance of achieving the purposes for which the administration order was made". Nevertheless, the Bank refused to give the administrators more than the minimum time required for testing the situation, on the ground that, even though the administration could guarantee the safety of the deposited funds, the depositors had an additional interest to receive repayment as soon as possible. The limitation of the authorisation to three months only reflected this concern. On the other hand, the Bank had indicated that it would be willing to consider future requests by the administrators for the extension of the authorisation, up to the statutory maximum of three years, provided that some progress would have been made in the meantime.

The administrators, convinced that the sale of Mount Banking's business or deposit base could not be completed within three months and fearful that the prospect of eventual withdrawal of authorisation would irreparably taint the business in the eyes of potential buyers, challenged the time limit. A related concern of the administrators was that, if they requested the authorisation's extension at some later point, they would be left without any right of appeal against the Bank's refusal to entertain their request.

The Banking Appeal Tribunal rejected the administrators' arguments. The non-availability of rights of appeal at a later point was a consequence of the statutory provisions which was irrelevant for the purpose of determining the validity of the Bank's present decision. The Bank had considered the situation and had apparently reached the conclusion that the risk of additional taint of the institution's business from the three-month limit was either minimal or outweighed by other factors, including its concern for speedy resolution of the matter. It was within the Bank's discretion to engage in a balancing exercise of this type. To dispel all doubts regarding its own appreciation of the merits of the decision, however, the Tribunal expressed *obiter* its view that, taking into consideration the possibility of future reassessment of the situation, some time limit on the authorisation, probably in the range of three to six months, was indeed appropriate.

The *Mount Banking* case illustrates the potential difficulty of balancing the purposes of administration, including the survival of the institution in question, against the more specific regulatory purposes pursued by the Bank, which may point to its termination. It also shows that the Bank's power of revocation can shift the focus and structure of the relevant decision. Thus, on a petition for an institution's winding-up or the making of an administration order, the final responsibility belongs

---

392 Transcript of the Tribunal's decision, p.47.
to the court; however, if the institution is put in provisional liquidation or administration, the responsibility for deciding on the continuation or revocation of its authorisation passes to the Bank, whose specific statutory duty is to protect the interests of depositors, regardless of the impact on other parties. This can lead in certain cases to the *de facto* overriding of the insolvency court's attempt to reach a balanced solution.

Finally, when an institution is in provisional liquidation or administration, the question arises, who can exercise the right of appeal against the Bank's decision to revoke or restrict its authorisation. It is by no means certain that there is identity of interest between the administrators and the owners or directors of the institution on this matter. For instance, when the prospects of success are not particularly strong, the administrators may be unwilling to bring an appeal lest costs be awarded against the institution, to the detriment of its creditors. In the *Mount Banking* case, the administrators essentially accepted the Bank's findings about the institution's past conduct, and their appeal against the restriction of its authorisation was on unrelated grounds, concerning the purposes of the administration; it was left to the owners/directors to bring personal appeals challenging the Bank's finding that they were unfit, but these appeals could not cover other allegations against the institution or lead to the restoration of full authorisation.\(^{393}\)

The question of *locus standi* was raised explicitly in the context of appeals brought in 1993 against the revocation of the authorisation of Roxburghe Bank Ltd. The appeals were withdrawn before being heard by the Banking Appeal Tribunal, but only after the Chairman of the Tribunal had made preliminary rulings on a number points, including a ruling to the effect that the conduct of an appeal rests with an institution's administrators, not with its directors, shareholders or their representatives. The Chairman's interpretation can be particularly prejudicial for the interests of bank owners, who may be left without an effective remedy.

\(^{393}\) See *supra*, section 3(a).
Chapter 4

The Bank of England's Regulatory Activities outside the Banking Act

The Banking Act 1987 provides the primary basis for the regulation of banking. Nonetheless, the examination of regulatory arrangements in this field would be incomplete if, by confining its focus on the functions of the Bank under that Act alone, it disregarded the other ways in which the Bank can exercise control over the conduct of banking institutions. In many cases, the Bank derives an effective ability to regulate from other statutory sources and even from its de facto financial power as central bank.

As a result of the breakdown of the restrictive practices that traditionally impeded their entry into the principal U.K. securities markets and the strong competitive pressures which force them to diversify their lines of business, in recent years banking institutions have become deeply involved in securities activities. In this manner, they have come within the ambit of the regulatory framework of the Financial Services Act 1986, which governs such activities (section 1). The prohibition on unauthorised "investment business" under that Act has important, even though indirect, consequences for the regulatory powers of the Bank. Thus, the whole system of prudential regulation operated under the Banking Act is founded upon the statutory prohibition on unauthorised deposit-taking; however, conceptually at least, if not in actual practice, wholesale banking is not affected by the precise terms of this prohibition.\textsuperscript{1} Despite the apparent gap in its statutory jurisdiction, the Bank is in fact able to exercise an equivalent degree of regulatory control over the organisation of wholesale markets and the behaviour of the participating institutions by relying in part on the provisions of the Financial Services Act (section 2).

Beyond the network of powers conferred upon it expressly or implicitly under statute, the Bank has tremendous leverage over the structure and operation of the banking industry through its power to enter into contracts from a position of

\textsuperscript{1} Supra, ch.2, section 1.
dominance. This power, which can be exercised informally in private law, also plays a part in the arrangements for the regulation of the wholesale markets, especially where the acceptance of financial institutions as the Bank's direct trading counterparts in the discount and gilt-edged markets is concerned. It is also expressed in the Bank's ability to grant or refuse financial support to institutions in difficulties, thus determining their survival, to provide credit lines to institutions participating in the payments mechanism, or to open operating accounts for interbank settlements, etc. The discretionary and discriminatory exercise of this power can have a critical impact on the conditions of competition and the viability of individual banking institutions (section 3).

The Bank's involvement in extrastatutory regulatory activities raises significant legal questions regarding the reviewability of its decisions. When the Bank exercises statutory functions, its decisions are subject to appeal or judicial review. The same applies when it acts on behalf of the Treasury under primary or secondary legislation, e.g. in situations involving the exceptional re-introduction of exchange controls or the freezing of the financial assets of countries subject to international trade sanctions. When the Bank's regulatory functions are exercised de facto, however, through reliance on its private power to enter into contracts or through the application of informal pressure, difficulties arise with regard to the jurisdictional possibility and potential grounds of review of its actions (section 4).

1. The reform of the securities industry and investor protection under the Financial Services Act ("F.S.A.")

Over the last three decades, the general trend towards institutional diversification and market integration has eroded the historical lines of demarcation between the various types of financial intermediaries. At present, there is increasing functional overlap among institutions of traditionally different operational backgrounds, especially among banks and securities intermediaries, both of which have been gradually transformed into multi-service firms. The public authorities have accepted, if not actually encouraged, the breakdown of the division of functions among the separate market structures of banking and securities finance.³

---

³ See D.T. Llewellyn, "Structural change in the British financial system", in C.J. Green and D.T. Llewellyn (eds.), Surveys in Monetary Economics, Vol. 2: Financial Markets and Institutions (1991); and R. Dale, International Banking Deregulation: The Great Banking Experiment (1992), ch.6. Dale, p.107, summarises the attitude of the authorities (which will be discussed in greater detail in the following pages) in these terms: "The interesting point is that the co-mixing of banking and securities business in the U.K. was not the result of a carefully deliberated policy
(a) Market reform. The reform of the Stock Exchange, culminating in the so-called "Big Bang" of October 1986, was the most significant development in the direction of market integration and the emergence in the U.K. of a financial system in which banking and securities activities are carried on within the same institutions ("universal banking"). Although the domestic banks had never been legally prevented from engaging in securities business, they had been traditionally reluctant to build trading positions in securities as a type of investment, preferring instead to employ their assets mainly in short- to medium-term lending to commercial enterprises in need of trade and working-capital finance. More importantly, until the early 1980s the restrictive membership rules of the Stock Exchange in practice guaranteed the functional separation of banking from securities finance. Originally, the rules permitted the organisation of member firms only as partnerships of individual members. When in 1969 they were allowed to become limited companies, the acquisition of controlling interests in them by outside corporate entities was precluded by a 10% ceiling on shareholdings by non-members. This institutional isolation of the securities industry was underpinned by the absence in the U.K. of significant over-the-counter markets in domestic securities.

During the 1960s and 1970s, the banking sector found a new willingness to diversify as a result of competitive pressures, changing perceptions and, particularly, the growing presence of foreign banking institutions actively interested in expanding into new markets. In addition, the formal distinctions between banking and securities markets became increasingly blurred as long-term fixed-rate bond finance was replaced by floating-rate lending, wholesale deposits were accepted under marketable instruments, the certificates of deposit and bankers' commercial paper, and bank assets were issued in securitised form. However, the restrictive arrangements of the Stock Exchange continued to impede banks from entering the field of securities intermediation per se, at least as far as sterling issues were concerned. At the same time, these arrangements led to the ossification and relative decline of the Stock Exchange itself.4 The membership rules impeded the adequate capitalisation of the securities industry with outside participations. More importantly, the prevailing system of market organisation effectively eliminated price competition and imposed significant unnecessary costs on the users of the Stock Exchange. There was a strict division of functions between two categories of members ("single decision, any more than the previous separation had been the product of government edict. Rather, financial conglomeration was an accidental consequence of a change in the competition rules and the scale and suddenness of the ensuing structural revolution was evidently not entirely to the liking of the U.K. authorities" (emphasis in the original).

capacity): the brokers, who as agents executed the trading orders of end-investors in the Stock Exchange; and the jobbers, who engaged as principals in market-making in listed securities and who could not enter directly into contractual relationships with non-members. All transactions were subject to fixed minimum brokers' commissions. Market fragmentation was completed by the fact that the underwriting of new securities issues was carried out separately by the merchant banks outside the Stock Exchange.

These factors reduced considerably the competitiveness of the U.K. securities industry, at a time when the importance of securitised finance relative to bank lending was rising internationally. Especially following the abolition of minimum commissions on Wall Street in 1975, the securities of the major U.K. corporate groups were traded in the New York Stock Exchange in the form of American Depository Receipts at lower cost than in London. When the new Conservative government lifted exchange controls in the summer of 1979, the consequences were felt particularly strongly as institutional investors not only turned to investment opportunities abroad, but even started to use the services of the U.S. financial system in connection with their trading in domestic securities.

By 1983, this evidently unsustainable state of affairs had led to the convergence of public institutions and important private interests on the cause of reform, despite the residual resistance of the members of the Stock Exchange who had a vested interest in preventing deregulation. Amongst private market-participants, the attitude of large institutional investors, such as mutual and pension funds and insurance companies, which are the major users of the Stock Exchange, was an important factor. The members of the Exchange ensured in the past the tolerance of institutional investors towards minimum commissions through the provision free of charge of collateral services, in particular regarding research and portfolio valuation, and also through the cultivation of a good relationship with their management, often by making available personal benefits such as travel facilities. However, once the financial costs of the status quo became more pronounced with the abolition of exchange controls, the institutional investors withdrew their politically crucial support. At the same time, aggressive financial groups whose existing markets were gradually saturated, wanted to enter the securities business. This was the case of many international institutions, but also of the British merchant banks which, facing

---


strong foreign competition, moved increasingly from their customary mix of short-term acceptance-credit and advisory activities to the provision of fee-earning services related to the issuance of securities.

The reform of the financial system was also desirable from the government's perspective. Despite its ties with Stock-Exchange interests, the Conservative party was ideologically committed to the cause of free competition. The major earlier enactments in this area, the Restrictive Trade Practices Act 1956 and the Fair Trading Act 1973, which extended anti-cartel controls to the provision of services, were the work of previous Conservative governments, whose example the new one followed by enacting the Competition Act 1980. From a political standpoint, making an exception to this commitment for the benefit of the Exchange's members could not be easily justified. In addition, important sections of the City, having considerable influence on the government, were in favour of reform. The decisive factor, however, was one of broader economic strategy. Maintaining and increasing the international competitiveness of the City was central to the government's aims during the 1980s. In the previous two decades, the City had flourished as an "offshore" banking market by attracting foreign institutions, especially American and later Japanese, through its liberal régime for non-sterling financial transactions. The conditions of the domestic financial markets, in comparison, were restrictive, with an emphasis on their capacity to deliver credit for industrial investment. However, as the belief that the dynamism of the British industry could be revived with the help of financial controls was replaced by a more realistic assessment of the country's long-term industrial decline and a renewed interest in the financial sector as an important sector in its own right, the value of ending the restrictive practices in terms of international competition became more apparent. Inaction would lead to the erosion of the City's position, while deregulation and an emphasis on a competitive market environment would create the conditions for considerable expansion and aggressive internationalisation of the financial sector. This would result in increased invisible earnings, since a large proportion of the sector's profits would be generated from cross-border activities, as well as in the creation of a great number of new jobs, particularly for qualified persons, at a time of declining employment in most other sectors. The reform of the Stock Exchange was at the centre of this strategy. Simultaneously, a revival of the Exchange would have the political benefit of

---

7 See ibid., ch.1; Moran, op.cit., n.5, pp.1-7, 55-56.
8 See Reid, op.cit., n.5, p.18; and J. Toporowski, "The financial system and capital accumulation in the 1980s", in F. Green (ed.), The Restructuring of the U.K. Economy (1989). According to Toporowski, pp.243-244, employment in banking and finance rose by 16% between June 1979 and June 1986, while overall employment in financial services broadly defined (including insurance) increased by 32%. In comparison, the increase in services generally was 6.6%, while total employment decreased by 6.2%.
encouraging popular share ownership - a development strongly desirable from the government's standpoint. The privatisation of state enterprises would also be facilitated by the deepening of the securities markets.

The Bank found it not less necessary to reappraise its previously complacent, if not outright supportive, attitude regarding the restrictive practices. In conjunction with broader considerations relating to the wealth-generating potential of the securities industry, the paramount concern animating the Bank's "fresh strategic thinking" was the need for the City to defend its international position by adjusting to the new environment before its foreign competitors became entrenched both internationally and domestically. This was an immediate priority for the Bank as an institution because it affected its own standing. In the words of M. Moran,

"the necessity to defend London's preeminent position was an almost unthinking tenet of public policy in the 1980s. In the transnational hierarchy of financial regulators the Bank of England enjoys, by virtue of London's eminence, a place at the very top - a position quite beyond the normal expectations of the central bank of a declining industrial power with an insignificant world currency. London's importance as an international financial centre offers the state elites of this declining power one of the few remaining opportunities to play a leading international role."

The Bank's distancing from the Stock-Exchange interests was not impeded by the type of allegiance that would have played an important role in the past. Almost four decades after nationalisation, the senior bureaucrats in the Bank did not feel a particular obligation to act as the City's spokesmen. Instead, the initiation of innovatory policies was consistent with their career needs. In particular, David Walker, the Bank's director concerned with City organisation, displayed a keen interest in market modernisation. Finally, the Bank had a more specific reason to desire reform. By 1983, only six jobbers dealt in gilt-edged securities, of which two accounted for 80% of the total volume of transactions. The Bank needed to control the gilt-edged market in order to secure advantageous public financing and to be capable of influencing the level of interest rates and the money supply. For its purposes, an opening of the market to all suitable institutions for competitive tender, provided that a number of firms remained in British hands, was desirable because it would lead to lower commissions and more fine prices for government securities and the avoidance of "gilt strikes", i.e. the situation where the market, expecting an interest-rate increase, refused to take the securities before the increase was effected.

---

The Bank's abandonment of the status quo was instrumental in securing reform and setting the agenda for the changes. It should be noted, however, that the Bank and the government neither initiated themselves the reform process nor exercised complete control over it. While the urgency of the reform can be attributed to the abolition of exchange controls, the immediate catalyst was a major legal challenge against the Stock Exchange's rule-book commenced in the days of the last Labour government by the Director-General of Fair Trading. The challenge was launched under the Restrictive Trade Practices Act 1976, which created a presumption that agreements between competitors operated against the public interest. Although the Secretary of State for Trade had the power to intervene by granting an exemption from the statutory provisions, this had not been done. One reason was the Labour party's traditional distrust of the City and its more recent conversion to consumerism, but the Exchange's lack of experience in matters of political lobbying and public relations also played a part. The Office of Fair Trading, a regulatory body whose contacts with the Stock Exchange were confined to the particular issue and which accordingly had little reason to be accommodating, had targeted the Exchange perhaps because of its lack of popularity in the country and continued to pursue aggressively this high-profile case even after the change of government. From the perspective of the Bank, the continuation of the proceedings was particularly detrimental. Depending on the outcome, the judicial resolution of the challenge by the Restrictive Practices Court could result either in the legal sanctioning, and thus in the entrenchment, of the status quo or in the immediate collapse of the prevailing system of market organisation, without time for an orderly transition. Since either of these options was undesirable, the Bank came into contact with the Treasury and the Department of Trade and Industry in an attempt to find a negotiated solution to the case. On 27 July 1983, having secretly agreed with the leadership of the Exchange that minimum commissions should be abolished by the end of 1986, the government intervened to stop the Office of Fair Trading's case. New legislation exempted the Stock Exchange from the anti-cartel provisions of the Restrictive Trade Practices Act.14

At the time, the deal appeared to be the result of political compromise and was met with hostile criticism from outsiders as a betrayal of consumerism and an accommodation by the government of its City supporters. Apparently, even its protagonists had underestimated the extent of the changes that it would necessitate.

---

13 See Plender and Wallace, op.cit., n.5, pp.90-100.
14 Restrictive Trade Practices (Stock Exchange) Act 1984 (eventually repealed and replaced by the Financial Services Act 1986). The governmental intervention did not please the Office of Fair Trading: "it was the biggest case it had ever had and it was most upset at the prospect of being deprived of it"; Gower, loc.cit., n.5, p.3.
When the full implications were understood, however, it became evident that the single-capacity system was not viable without minimum commissions and that the new broker-dealers would need adequate capital resources to be able to perform market-making functions in the new environment of free and international competition. This necessitated an end to the restrictions on membership and a huge capitalisation of the market. Initially, non-members were allowed to participate by taking up to 29.9% of member firms. In June 1985, however, the members of the Stock Exchange, realising that further restructuring was inevitable, voted in favour of new rules allowing for full external ownership of member firms. Following a spate of mergers and acquisitions by banks and foreign securities houses which resulted in much greater capitalisation, the market was ready for the introduction of a fully computerised dual-capacity trading system. The transition into the new system, which became known as the "Big Bang", took place within a single day, 27 October 1986. As a result of the reform, the place of London as one of the three major financial centres in the world was secured. Parallel to these events, the Bank engineered an overhaul of the gilt-edged market. The market was opened to more market-makers, while a system of inter-dealer brokers was instituted with a view towards facilitating the distribution of risk between them. The retailing of gilt-edged securities from market-makers to institutions was left to money brokers. The whole system was not separated from the Stock Exchange, but it was separately capitalised.

(b) The regulatory framework of the F.S.A. To the extent that it removed the restrictive rules and practices that characterised the old system, the dramatic overhaul of the securities markets described above constituted a form of "deregulation" - especially if the word is used in a broad sense to cover arrangements of non-governmental origin, including the rules of self-regulated markets such as the Stock Exchange. Nonetheless, the shift towards more competitive, unrestricted and international markets did not actually result in an overall reduction in the volume of financial regulation. Instead, precisely at the time when the reform was reaching its climax, the enactment of the Financial Services Act 1986 ("F.S.A.") introduced a complicated and pervasive regulatory framework for securities-related financial activities with the aim of protecting investors as the consumers of financial services.

The new system of investor protection was not directly necessary for the structural reform, even though many interpreted it as proof of the view that net deregulation is impossible because regulation is essential for the functioning of financial markets. It is certainly conceivable that, at least at the client/intermediary

---

15 "Changes in the structure of financial markets...", loc.cit., n.4.
level, the reformed securities markets could operate on the basis either of strict freedom of contract or of the pre-existing legal rules which left the conduct of financial business largely unregulated. Nonetheless, public policy in this field was forged under the influence of a heterogeneous set of assumptions. As a matter of principle, the extensive new regulatory intervention, based on the unquestioned premise that investors need a special degree of protection that the general law is unable to ensure, was incompatible with the government's professed fundamental belief in free markets and unrestricted private enterprise. As A.C. Page and R.B. Ferguson have observed,

"[a] striking feature of current public policy in this regard is its failure to spell out in any detail why exactly it is that, in the words of the Financial Services Act White Paper, 'caveat emptor alone is not enough'. To the extent that any justification is offered for the provision of protective regulations, it is commonly couched in terms of the need to maintain or restore the confidence of investors. [...] The problem with such psychological justifications, however, is that they can be invoked to justify any and every measure of investor protection - from the most liberal to the most paternalistic. They do very little, therefore, to enhance our understanding of the rationales underlying particular measures."

The absence of any specific and coherent economic or social justification for the introduction of a special system of investor protection leads to the conclusion that this was the result of a political compromise. In other words, the F.S.A. was born out of a combination of consumerism and the Conservative government's political need to satisfy a reluctant public opinion that the reformed financial markets would be suitable and safe for small investors and scandal-free.

The major impetus behind the regulatory movement has been the growing popular concern with real or apparent abusive behaviour by financial intermediaries. The general increase of sensitivity to consumerist issues provides a partial reason for the elevation of this concern into an important public issue which politicians can ignore only at their own peril. Even more significant, however, is the emergence during the post-War years of growing prosperity of a wide social class of smaller

---

16 In particular, the Prevention of Fraud (Investments) Act 1958 (repealed by the F.S.A.).
18 Ibid., p.33.
19 Consumerism is the political expression of the public's strong risk-aversion and its main expression is the demand for risk-proof precautionary standards. It also involves, however, the demand for public safety-nets for the victims of misfortune. Significantly, even people who consider the unequal accrual of benefits as a necessary characteristic of economic action refuse to accept catastrophic results as a possible outcome of participation in the marketplace. On the asymmetrical social attitudes to the gains and losses of others - a form of social risk-aversion which is not identical with the subjective risk-aversion of persons facing a risk themselves -, see A. Ryan, "Good luck to life's winners", The Times, 21 Apr. 1992, 10.
personal investors, for whom the safety of financial assets is an immediate and important priority which overrides any conflicting general consideration of economic efficiency or suggestion that, as a matter of principle, they should accept the residual risks of their voluntary decision to enter the financial marketplace. The demand of such investors for effective protection has profoundly transformed the prevailing ideologies regarding the legitimate forms of market behaviour and has turned the collapse of financial institutions into events of political significance.

In the late 1970s, certain widely-reported cases of financial fraud involving especially small investors as victims had fuelled the sense of widespread wrongdoing in the market. In this context, the non-transparent supervisory and disciplinary arrangements of the Stock Exchange and Lloyd's, in particular, reinforced the impression that the revealed instances of misconduct were only the tip of the iceberg. The tendency of the self-regulatory clubs to deal with problems privately and informally, so as to preserve confidence and prevent outside interference, frequently raised to the general public the suspicion of a cover-up and reinforced the perceptions of "scandal". This situation gave urgency to the demand for governmental intervention. In July 1981, Professor L.C.B. Gower was appointed to review the regulatory framework for the protection of private and commercial investors and to make recommendations for its improvement. Gower, who was strongly in favour of a regulatory system similar to the U.S. one, was very critical of the existing arrangements. Instead, he concluded that there was general consensus regarding the need for the introduction of a comprehensive system of investor protection. He proposed that this system should operate within a statutory framework and be subject to governmental surveillance but that day-to-day regulation should be carried out so far as possible by self-regulatory agencies.

At about the same time, the more specific preoccupations of the Conservative government provided another source of pressure towards the increase of prudential regulatory requirements in the securities field. By itself, the government's original intervention in the affairs of the Stock Exchange with the purpose of sustaining the City's international competitiveness created the expectation of a broader and continuing involvement of the state in this field. More importantly, however, the

---

22 Gower Report, "Review of Investor Protection", Part I (Cmnd. 9125, Jan. 1984). Explaining his report's underlying consumerist philosophy, Gower expressed the view that a cost/benefit analysis of the regulatory proposals in terms of market efficiency was unnecessary, since "inevitably there is a tension between market efficiency and investor protection which often pull in different directions" which necessitates a value judgement on their relative weight, and endorsed the rather meaningless principle that regulation in the interest of investors "should be no greater than is necessary to protect reasonable people from being made fools of"; para.1.16.
23 See Clarke, *op.cit.*, n.20, ch.7.
achievement of wide public participation in the securities markets was a political goal of the government in its own right. The expansion of share ownership to large segments of the British public would not only be beneficial in terms of economic investment, but would also have significant political repercussions in the direction of reconciling the electorate with the institutions of a capitalist economy and forging long-term links between the Conservative party and the new mass of smaller shareholders who would retain a vested interest in the continuation of pro-business policies. In this sense, the governmental emphasis on the overhaul of the securities markets included elements of "political entrepreneurship". A corollary was the need to protect as far as possible the new shareholders from risk. Public confidence could quickly collapse and the political costs could far exceed the potential benefits if investors were lured by the government to the marketplace only to suffer major losses at the hands of highly specialised, better informed and aggressively profit-seeking operators. The introduction of a new régime of investor protection simultaneously with the opening of the stock market can be interpreted in these terms. On the other hand, by playing the consumerist card, the government contradicted its rhetorical insistence on the self-correcting properties of markets. In this manner, however, it created the conditions for a permanent source of political concern. In the words of M. Clarke,

"[t]he danger of creeping consumerism for the state is that the state is in fact induced to take on risks that, if private enterprise is private, should be taken by the investor or depositor. [...] The government's strategy has been to attempt to get the City itself to absorb as much of the burden as possible, by emphasizing continuing self-regulation and independent responsibility to investors, with state oversight." 25

The F.S.A. turned the unauthorised carrying on of securities activities into an offence and created the legal basis for the establishment of an elaborate institutional structure comprising a central regulatory authority, the Securities and Investments Board ("S.I.B."), and a number of Self-Regulating Organisations ("S.R.O.s") formed by the various types of securities intermediaries which operate under its supervision. The new arrangements, which aimed generally at the protection of consumers at the individual level and put strong emphasis on conduct-of-business rules, were adopted without a proper cost-benefit analysis or the support of a clear theory about their specific purposes. 26 Although during the legislative process the financial-services

---

24 But see the qualification in the White Paper "Lifting the Burden", loc.cit., n.17, para.1.3: "But [deregulation] must be done with care. The line between liberty and licence is fine and can easily be crossed. We have to bring about the conditions to promote growth but not abuse."

25 Ibid., p.183

26 The taking into account of the costs of compliance with the regulatory rules was made a requirement for the designation of the S.I.B. as the primary regulatory agency and for the
industry was reasonably successful in obtaining a number of amendments to the original bill, it did not affect the basic structure of the proposed system.27

The belief that the new system would consist in "self-regulation within a statutory framework" was crucial for its acceptance by the financial sector, especially since the threatened alternative of subjection to outright regulation by a department of state or a special statutory authority modelled on the U.S. Securities and Exchange Commission could prove much more intrusive and detrimental to its autonomy. With the encouragement of the Bank which had taken an active part in organising self-regulatory institutions, the financial world had always seen self-regulation as much preferable to statutory controls. Nonetheless, important differences separated the new S.R.O.s from the self-regulatory clubs of the past. The latter were associations formed and operated by the financial community alone in the context of its traditional isolation from national politics. Their freedom from outside interference and the pressures of public accountability was ensured, with the Bank playing the role of mediator between the political and the financial system. To a much greater extent than the Banking Act 1979 and despite the vestiges of self-regulation, the F.S.A. signified a break with this type of arrangements. The new compromise includes a measure of participation in the regulatory institutions by the users of the financial system. More importantly, it contains important elements of outside control by the government and the courts over the S.R.O.s, in particular in relation to their rule-making power.28

For these reasons, the introduction of the new system engendered considerable disappointment that it is not as self-regulatory as originally expected and presented.29
However, this was probably necessary from the point of view of the authorities. To achieve its protective aims, the regulatory system should be able to set and enforce consistent conduct-of-business rules and to innovate in pace with market developments. The traditional self-regulatory approach had proved unable to guarantee this result. Its structural preconditions, i.e. the relatively small membership, cultural homogeneity and convergent interests of the financial community, had disappeared, thus impeding the voluntary adoption of pre-emptive reforms that could deflect criticism and avert external interventions. Furthermore, genuine self-regulation could only be feasible if the regulatory aims were compatible with the general interests of the relevant sector. This was not necessarily true in the present case.

Despite the government’s repeated pronouncement that regulation should be kept to the necessary minimum, it is impossible to determine what precisely that minimum should be, especially as the vagueness of the legislative purposes does not permit an evaluation of the regulatory means in terms of their ultimate ends. In practice, however, the new safety-driven settlement involves the external imposition on the securities industry of a vast amount of regulatory requirements and the increasing formalisation, juridification and politicisation of the system. Although for the major financial groups, which would tend to use in any event sophisticated operational systems and internal controls, the new requirements may not have been particularly onerous, the net effect of the regulatory overhaul has been to increase significantly the costs of production of financial services, without transferring any appreciable benefits or economic "rents" to the regulated industry. Compliance is very complicated and expensive, especially for smaller firms and new entrants. The normative framework for the conduct of business has proved particularly unstable, uncertain and subject to the control of regulatory-minded professional groups,
including regulators, compliance officers, accountants and lawyers. Even the sense of crisis and scandal has been kept alive, if not intensified, as market events are brought to the attention of the people and interpreted by opposition politicians, the media and other proponents of consumerism and regulation. The most significant constraint to this trend is that regulation must not become so onerous as to drive business out of the jurisdiction.

The F.S.A. formally reflects the breakdown of the historical divisions between different types of financial institutions. As long as each market included only institutions with similar organisational characteristics which frequently belonged to a single trade association or self-regulatory club, regulatory requirements could be defined without much loss of efficiency by reference to the structural description of these institutions. As a consequence of the erosion of market barriers and the emphasis on unrestricted cross-sectoral competition, however, this is no longer practicable. Instead, as the example of the Banking Acts shows, an increasing reliance on functional formal definitions has proved necessary, so that common statutory licensing requirements and standards of market conduct may apply to all financial institutions, regardless of their broader institutional classification, to the extent that they engage in activities of a particular description.

33 See Moran, op. cit., n.5, pp.133-135.
35 For the distinction between "structural" and "functional" - or, in the terminology of the authors, "conduct"- regulation, see J. Kay and J. Vickers, "Regulatory reform in Britain" [1988] Economic Policy 285, pp.312-325. Although structural regulation can simplify the supervision of markets and the enforcement of norms, its continuation would require the regulatory underpinning of increasingly arbitrary and artificial market distinctions and would impede diversification and cross-sectoral competition. In fact, this type of regulation is intrinsically linked to barriers to the membership of particular industries and to limitations on the competitive activities of their members, i.e. precisely to those aspects of the old system that led to its ossification and eventual collapse. But this does not mean that the degree of interventionism is more limited under a system of functional regulation. By prescribing directly specific patterns for doing business, functional or conduct regulation can be more comprehensively intrusive than structural regulation. Kay and Vickers, p.314, think that "the weakness of conduct regulation is that to be effective it must be concerned with aspects of service provision that are readily measured; and these may be only loosely related to the issues of underlying concern. [...] The regulation of structure is designed to reduce or remove the opportunity for undesired conduct rather than to prohibit it from occurring." In their view, p.335, in the face of externalities, "the objective should be to achieve solutions that lean with market forces rather than replace them.

Structural remedies which influence the incentives that agents face will often be more effective and flexible than measures which bear directly on conduct". In particular, "[t]he most obvious remedy for market failures which result from information asymmetry is information disclosure". This framework can be used for the analysis of recent legislation. Thus, Kay and Vickers, pp.339-342, are critical of the F.S.A.'s emphasis on the enforcement of "best practice" over disclosure and system-wide confidence-boosting measures as well as of the replacement of functional separation with elaborate and difficult to enforce conflict-of-interest rules, even though they approve of capital-adequacy requirements.
The definitions of the regulated activities in the F.S.A. are of particular practical significance in this context because of their sweeping character. They are broad and vague and can attract almost every conceivable form of financial intermediation. Related regulatory statutes such as the Banking Act 1987, the Insurance Companies Act 1982 or the Building Societies Act 1986 have a more focused subject-matter and, despite the relative integration of markets, are largely confined to institutions of a particular traditional description. In comparison, the F.S.A. attempts to close every possible gap in the regulatory net. Its definitions are more aggressively overinclusive even than those of the Banking Act. As a result, many activities which are usually undertaken by bankers but which go beyond strict deposit-taking or the operation of the payments mechanism, are within the definition of "investment business" which require authorisation (or exemption) under the F.S.A. Although banking institutions are regulated separately as "deposit-takers" under the Banking Act, they are not generally exempted from the provisions of the F.S.A., because the aims of the two statutes are different. In particular, while the Banking Act focuses primarily on the overall safety and soundness of these institutions for the benefit of depositors and the stability of the financial system, it leaves their relationships with individual clients unregulated and does not contain specific conduct-of-business requirements.

Under a system of functional regulation, depending on its range of business, a single institution may be subject to more than one regulatory scheme operated by different regulators. Accordingly, the subjection of banking institutions to the financial and conduct-of-business requirements of securities regulators is an expected consequence of the adopted regulatory approach and, ultimately, a reflection of the multi-service nature of modern financial firms. A system of overlapping regulatory arrangements, however, involves potential tensions. The existence of multiple regulators can be inconveniencing in itself. But there are considerations other than convenience which militate against it. As R. Dale has rightly observed, "[t]he fundamental difficulty with the UK approach to regulating financial conglomerates in general, and mixed banking/securities businesses in particular, is that functional regulation does not coexist easily with a régime in which risks are assumed to flow freely between different parts of the same financial group."

---

36 F.S.A., s.3.
37 Although the "listed money-market institutions" of s.43 can be exempted as far as their wholesale activities are concerned. See infra, section 2(b).
38 In principle, the conduct of the consumer-credit business of banks is regulated separately under the Consumer Credit Act 1974. S.26 of that statute authorises the making of conduct-of-business regulations. However, the only regulations ever made under this provisions were those concerning credit reference agencies. In addition, s.44(1) requires the making of regulations regarding the form and content of advertisements by the providers of consumer credit; see now the Consumer Credit (Advertisements) Regulations 1989; and supra, ch.3, n.349.
To the extent that regulation goes beyond the enforcement of rules of conduct in the strict sense (i.e. that of rules relating to the manner in which isolated transactions are carried out) to cover broader prudential issues relating to the overall capacity of intermediaries to carry on their business on an ongoing basis, including in particular the adequacy of their financial resources or internal control systems, the regulators need to address the condition of the multi-function financial conglomerate as a structured whole. This means that multiple regulatory régimes will result in the duplication of measures affecting eventually the total firm, rather than a particular aspect of its business activities. While this may entail certain potential benefits in terms of enforcement, it creates serious problems of coordination between regulators and the potential for making conflicting demands on the firm. It also involves heavy administrative and compliance burdens. For this reason, and despite the fact that under the system of functional regulation each authority has separate responsibility for the supervision of specific activities, an informal mechanism has been developed for the division of the regulatory workload between the relevant authorities whenever an institution or group engages in a wide range of activities under multiple authorisations. In this situation, a college of regulators is formed and the regulator who is responsible for the main or characteristic line of business is appointed as the "lead regulator" with primary responsibility for the monitoring of the institution or group as a whole. If the different market functions are combined within a single institution, the lead regulator is also responsible for assessing the adequacy of its financial resources, although the requirements of the other regulators must be taken into consideration in this regard. The other authorities defer to the lead regulator's assessment on the basis of various "memoranda of understanding", agreed informally on a bilateral basis between them and dividing responsibilities for the regulation of overlapping sectors. Although legally each regulator remains under a duty to ensure independently that the requirements for the grant of a licence under its parent statute are observed, in practice these memoranda ensure that regulatees do not face conflicting regulatory demands and that undue duplication of reporting requirements is minimised. Under the relevant memoranda, the Bank retains responsibility as the lead regulator whenever a banking institution or group is involved, except when the latter's business consists almost exclusively in securities trading or is otherwise investment-related.40

2. F.S.A. and the regulation of wholesale markets by the Bank of England

The legal consequences of the F.S.A. for the conduct of the incidental securities activities of banks are not of immediate concern for present purposes. Nonetheless, it is necessary to examine how the extensive definition of "investment business" in that statute brings within the net of securities regulation certain traditionally banking activities, which for this reason require authorisation from the relevant regulators. Particularly important for a discussion of the regulatory activities of the Bank, however, is the fact that the F.S.A. provides the formal basis for the assumption by the Bank of regulatory functions to the wholesale money-markets.

(a) Statutory definition of "investments" and "investment business". The prohibition on unauthorised investment business in the F.S.A. is drawn in very wide terms. Although only those categories of assets which are specifically listed in Schedule 1 are regulated "investments" for the purposes of that statute, the categories themselves are very broad and bring within the concept most conceivable types of instruments documenting financial claims, including shares, debentures, warrants, contracts for differences, units of collective investment schemes, life-assurance contracts, options and futures, and even rights and interests in any of the above. Similarly, "investment business" is defined to include, subject to certain specific exemptions, not only dealing in any of these investments, but also arranging deals, managing investments, the provision of investment advice and the operation of unit trusts and collective investment schemes.

It should be noted that the present statutory definitions of "investments" and "investment business" must be brought in line with the definition of "investment services" in the Investment Services Directive, which harmonises the minimum regulatory requirements in this area to the extent necessary for permitting the mutual recognition of the national authorisation and prudential supervision régimes of the financial services industry.

---

41 For examinations of the F.S.A.'s impact on banks conducting securities business, see Andrews and Smouha, ibid., Pt.2; and Blair, Allison, Palmer and Richards-Carpenter, ibid.
43 S.1(1) and Sch.1, Pt.I. "In general terms, the Financial Services Act 1986 applies to all investments other than physical objects (such as antiques or, indeed, land) over which the investor has control"; Rider, Abrams and Ferran, ibid., p.59.
44 S.1(2) and Sch.1, Pts.II and III. But the definition does not include the buying and selling of investments by those principals which are the "end-users" of the financial-services industry and deal "in their own account", see Sch.1, para.17.
Member States, thus making possible the Community-wide provision by securities firms of financial services on the basis of their home Member State authorisation. The régime introduced by the Directive is similar to that of the Second Banking Directive, which it complements by extending the principle of the single licence to non-bank financial intermediaries. The national measures for the implementation of the Directive must come into force by no later than 31 December 1995. It would appear, however, that only limited amendments will be necessary for achieving the full alignment of the definitions of regulated activities in Schedule 1 of the F.S.A. with the provisions of the Directive. The view of the U.K. government is that the coverage of the statute in terms of instruments should be extended only insofar as this is necessary to cover shares in industrial and provident societies and certain classes of bills of exchange ("bank bills", i.e. bills of exchange accepted by a bank) and any analogous instruments which are normally traded on other Member States' money markets.

A question of particular relevance to bankers is whether certain ordinary forms used for the documentation of banking transactions are covered by the definition of investment business. The elusive concept of "debenture" plays a key role in this connection. For the purposes of the F.S.A., "debentures, including debenture stock, loan stock, bonds, certificates of deposit and other instruments creating or acknowledging indebtedness" are investments. On the other hand, it is specifically pronounced that the statutory term does not include instruments acknowledging indebtedness in consideration to an underlying commercial transaction (e.g. one involving the disposition of goods or the provision of services), certain instruments which are used in day-to-day commercial practice as means of payment (namely cheques, bills of exchange, banker's drafts, letters of credit) or statements showing the balance in banking accounts. Even though it is doubtful whether the broader distinction that the relevant provisions are supposed to draw between "financial" debentures and instruments issued in the context of ordinary "commercial"

---

46 Art.31. Under the same article, the Member States were required to adopt the laws, regulations and administrative provisions necessary for its national implementation by no later than 1 July 1995, but by 15 December 1995 the U.K. had not yet adopted the regulations necessary for bringing the F.S.A. in line with the Directive's provisions.


48 See Morris, op.cit., n.27, pp.51-54.

49 Sch.1, Pt.I, para.2. "Instrument" includes any record whether or not in the form of a document; para.28(1)(b). Accordingly, an electronic entry or a record of a debt kept by a bank in its books may be caught by the definition.

50 Sch.1, Pt.I, para.2. Note. However, as mentioned above, in the near future bills of exchange accepted by a bank ("bank bills") will have to be included in the scope of regulated investments, pursuant to the U.K. implementation of the Investment Services Directive.
relationships is tenable, their net effect is to exclude from the definition of investments the most important instruments under which the activities of the paying or collecting banker are carried out. In addition, it is clear that the creation by, or acknowledgement in, an instrument of a debt obligation under a loan, credit, guarantee or similar arrangement does not amount to dealing in securities for the person providing the credit. This brings the basic activities of the lending bank outside the scope of the F.S.A., whether the documentation of lending would otherwise be characterised as a "debenture" or not.

Conversely, certain forms of documentation of deposit-like bank liabilities may satisfy the definition of debenture. This is expressly the case for certificates of deposit, but probably also for every form of tradeable paper, including banker's commercial paper. The reason is that such instruments satisfy the core meaning of debenture, i.e. that of a transferable instrument. It is not clear whether other, non-transferable instruments "creating or acknowledging indebtedness" (e.g. in the form of a written confirmation of a wholesale deposit) would fall within the concept. However, even if certain bank liabilities are debentures within the statutory sense, the issuing bank does not become an investment business requiring authorisation merely for this reason. In particular, although dealing in investments as a type of investment business covers the buying and selling of investments, including any acquisition or disposal for valuable consideration, the issue by a company of its own debentures does not constitute a "disposal".

1 Sch.1, Pt.II, para.12, Notes, inserted by the Financial Services Act 1986 (Restriction of Scope of Act and Meaning of Collective Investment Scheme) Order 1988, S.I. 1988/803, art.2; see also para.13, Note (4), inserted by S.I. 1988/803, art.3.
3 In common law, it is accepted that "debenture means a document which either creates a debt or acknowledges it, and any document which fulfils either of these conditions is a 'debenture'; Levy v. Abercornis Slate & Slag Co. (1887) 37 Ch.D. 260 (Ch.D.), p.264 per Chitty J.; see also Edmonds v. Blaina Furnaces Co. (1887) 36 Ch.D. 215 (Ch.D.); Lemon v. Austin Friars Investment Trust Ltd. [1926] Ch. 1 (C.A.); R. v. Findlater [1939] 1 K.B. 594 (C.C.A.), p.599. In United Dominions Trust Ltd v. Kirkwood [1966] 2 Q.B. 431 (C.A.), pp.467-468 per Diplock L.J., it was thought that certain so-called "deposit receipts", which in truth were non-withdrawable promissory notes repayable at the end of the agreed period, were "debentures". In this context, the position under the F.S.A. may be different from that in common law. "The statutory definition [...] excludes instruments which under the general law are treated as being debentures if they are issued in connection with current commercial transactions or are used as currency or instruments for making payments"; Pennington, op.cit., n.42, p.57. The exclusion of statements of account and other instruments which would qualify as "debentures" in common law but also the overall policy of the F.S.A., which is an act for the regulation of securities business and not of debt instruments in general, raise the question of the correct legal interpretation of the statutory term "debenture". Should the term be read expansively or should be confined instead to the stricter core meaning of "transferable instrument"? Despite the uncertainty surrounding the issue, the latter view seems preferable as more consistent both with everyday usage and with the specific statutory context. Thus, "[t]he concept of a debt obligation is a 'debenture' but this is thought unlikely"; Rider, Abrams and Ferran, op.cit., n.42, p.60.
4 Sch.1, Pt.IV, para.28(3).
Generally, even though certain core banking activities (in particular deposit-taking, simple lending, payments services, bank guarantees, leasing and credit-card services) may escape the F.S.A. definitions, banks or their subsidiaries are very likely to engage in a number of other ways in investment business. This can be the result of their engaging in certain types of merchant banking business involving, for example, securitised lending,\textsuperscript{55} securities underwriting, corporate finance, investment management or asset-administration and trusteeship services, but also of their expansion into pure securities trading.\textsuperscript{56} Accordingly, even though they are authorised and regulated under the Banking Act, most banks need further authorisation for the purposes of F.S.A. This is often the case, despite the fact that many of their transactions involving investments are covered by one of the exemptions from the definition of investment business.\textsuperscript{57} The banks' intentions are also irrelevant.

"A significant number of banks found at the time when the F.S.A. was being introduced that, although they did not consider themselves to be involved in "investment business" in any common sense of the words, certain of their activities fell into a grey area of business whose regulatory status was not or could not be precisely defined. Particular difficulties arose and persist in respect of treasury activities and corporate finance."\textsuperscript{58}

The need for authorisation under the F.S.A. subjects banks to the relevant securities regulators' financial requirements and rules of conduct, which may include

\textsuperscript{55} The legal situation may be particularly complex with regard to the more sophisticated forms of credit provision. E.g., in certain cases, syndication arrangements might fall within the definition of "collective investment schemes" under F.S.A., s.75. On the other hand, s.75(6)(e) excludes generally from that definition arrangements such as syndicated lending, where a number of depositors or money-lending institutions contribute to a central fund deposits (or sums excluded from the definition of deposit by virtue of s.5(3) of the Banking Act), out of which loans are made; see also s.75(6)(b) and (n). Secondary trading of participations may also be "investment business". With regard to securitisation, the special-vehicle company's securities are likely to be "debentures", but the company will not be dealing just by issuing them. However, the persons who manage or market the issue may require authorisation, and must observe restrictions on cold calling and advertising.

\textsuperscript{56} Morris, \textit{op.cit.}, n.27, ch.13; and Blair, Allison, Palmer and Richards-Carpenter, \textit{op.cit.}, n.40, ch.3. According to Morris, p.180, a number of banks have not obtained authorisation under the F.S.A. (although the principal U.K. clearing or merchant banks have). Blair, Allison, Palmer and Richards-Carpenter, p.44, also observe that "nearly all banks, even those authorised to engage in investment business, find that the greater part of their business is outside the scope of the F.S.A.". However, as they note further, p.64, "[i]n practice most banks conducting banking business in the U.K. are listed institutions under s.43 [...] and, in addition, authorised pursuant to the F.S.A. for their investment business activities". On s.43, see \textit{infra}, section 2(b).

\textsuperscript{57} Frequently the transactions will be exempt because they are undertaken on the relevant institution's "own account" (i.e. they are made by the institution as principal but do not form part of a market-making activity and the institution neither holds itself out as being in the business of trading in such investments nor solicits regularly the public to enter into such dealing with it). In certain cases they may be exempt as being transactions between companies belonging in the same group. See Sch.1, Pt.III.

\textsuperscript{58} Andrews and Smouha, \textit{op.cit.}, n.40, p.67.
requirements to comply with specified procedures, to use written agreements before entering into a transaction, to include specific warnings in publicity material or to comply with particular advertising requirements. It must be emphasised that, while the statutory purpose of the Banking Act is apparently confined to "the protection of depositors", no similar restriction to a purely protective purpose can be found in the F.S.A. A systematic reading of the latter statute may lead to the conclusion that measures that are entirely unconnected to the preservation of good market order are not within its implicit purposes. Nonetheless, the type of market ordering which is authorised under the F.S.A. is not confined to measures directed to the protection of investors stricto sensu, but extends to the promotion and deepening of the markets themselves. Accordingly, under the F.S.A., in addition to being obliged to observe strict investor-protection requirements, banks may also have to conform to standard practices designed to ensure the operation of orderly and continuous markets in uniform instruments.

(b) Regulation of wholesale money market activities. Precisely because of its wide ambit, the F.S.A. closes in practice the regulatory gap left by the exclusion of interbank deposits from the statutory definition of "deposit-taking" in the Banking Act and makes it very unlikely that a wholesale banking intermediary would be able to escape regulation altogether. It is unlikely that a financial institution would remain economically viable if it attempted to arrange its business specifically with the purpose, since to avoid the authorisation requirements of both the Banking Act and the F.S.A. it would have to confine itself strictly within a very narrow range of activities - e.g. the accepting of wholesale deposits in the interbank market and the making of loans out of the funds thus collected.

The F.S.A. also provides the legal footing, upon which the Bank is able to assert its regulatory competence over the wholesale markets - a competence that is not delegated to it by the Banking Act. By virtue of section 43 of the F.S.A., the Bank may maintain an official list of wholesale money market institutions. Inclusion in the list exempts the listed persons from the general restriction on carrying on an unauthorised carrying investment business, but only in respect of certain specifically designated types of wholesale transactions. The Bank, with the approval of the Treasury, may impose conditions for inclusion in the list. On the

59 See supra, ch.2, section 1(a).
60 S.43(1) and (3).
61 S.3.
62 S.43(1) and Sch.5.
63 S.43(2). The conditions must be such as to secure that E.C. financial institutions benefiting from the Second Banking Directive's "passport" are not refused admission to the list, or removed from it, for reasons related to their fitness, financial standing or any other matter which under the
basis of this power, it can regulate the listed institutions, at least with regard to their wholesale activities.\(^{64}\)

The exemption of listed persons may cover transactions involving various wholesale instruments, provided that these are not governed by the rules of a recognised investment exchange and are not made on such an exchange. More specifically, the relevant instruments include: certificates of deposit and other short- and medium-term instruments issued by authorised deposit-takers or building societies; short-term debentures (to which non-bank commercial paper is included); short- and medium-term U.K. local authority debt; short-term public sector debt (including Treasury bills, but not gilt-edged securities); certificates representing the above securities; options and futures contracts made outside a recognised investment exchange and regarding the above, or the value of any currency, including sterling, or of gold and silver bullion; similar contracts for differences; and short-term sale-and-repurchase agreements and stock borrowing and lending involving debentures.\(^{65}\)

Transactions in such instruments may qualify as wholesale transactions and be covered accordingly by the exemption depending on their size and the capacity in which the listed persons act. Transactions between a listed institution as principal and another listed institution or the Bank either as principal or as agent qualify irrespective of their size.\(^{66}\) Transactions entered into by a listed institution with an unlisted person or as agent for an unlisted person qualify only if the first contract entered into with or on behalf of that person exceeds a monetary minimum, set at a value of £100,000 for traded debentures or an underlying nominal value of over £500,000 for contracts for differences and similar instruments. Provided that this condition is satisfied, any subsequent transactions of lower value entered into by the institution within the following eighteen months and involving the same unlisted person will also be within the exemption.\(^{67}\)

\(^{64}\) On the operation of s.43, see Rider, Abrams and Ferran, \textit{op.cit.}, n.42, pp.84-86; Andrews and Smouha, \textit{op.cit.}, n.40, ch.10; and Blair, Allison, Palmer and Richards-Carpenter, \textit{op.cit.}, n.40, pp.45-49, 81-84, 192-195.


\(^{66}\) Sch.5, Pt.I, para.1.

\(^{67}\) The reason for which the exemption extends to subsequent transactions of lower value is that, by having entered with open eyes in a first contract of this scale, the unlisted wholesale counterparties have displayed that they have the resources to safeguard their self-interest in similar transactions without reliance to the statutory protections. At the same time, the
The Bank is currently regulating listed institutions under the arrangements set out in its so-called "Grey Paper", which the "London Code of Conduct" is attached. Under the provisions of the Grey Paper, to be eligible for inclusion in the list applicants must be one of the following: "core principals", a category which includes banks, building societies or financial institutions which act as principals and are authorised under the F.S.A.; other institutions acting as principals whose main business is to engage in transactions of a wholesale nature in relevant instruments, and which are likely for this reason to be major players in (rather than customers or end-users of) the wholesale markets; or brokers in wholesale market instruments. Inclusion in the list gives access only to those wholesale activities specifically mentioned in the business plan that each listed institution has submitted to, and agreed with, the Bank. This restriction of permitted wholesale activities appears to be in direct conflict with the statutory terms of the exemption, since in section 43 of the F.S.A. it is stated that a person included in the list "is an exempted person in respect of [...] any transaction to which [the statutory description of wholesale transactions] applies".

Banks, discount houses, gilt-edged market-makers, as well as non-bank institutions and brokers have sought inclusion in the list on these bases. Two aspects of this regulatory régime, which is operated by the Bank's Wholesale Markets Supervision Division, require special attention in the present context.

market achieves greater flexibility, since smaller-scale transactions with these counterparties are permitted as a part of an ongoing relationship.

68 *loc.cit*, n.65.


72 S.43(1). It must also be noted that, while the exemption covers dealing, arranging deals and advising in relation to the relevant transactions, in the Bank's interpretation the statutory provision does not apply to the discretionary and advisory management services relating to wholesale investments that the listed institutions may happen to provide, because the provision of such services also covers matters which are not directly related to effecting of the particular transactions which are the object of the exemption; see Blair, Allison, Palmer and Richards-Carpenter, *op.cit.*, n.40, p.46.

73 The Wholesale Markets Supervision Division was created in November 1986 to effect s.43 of the F.S.A. See J. Townend, "Supervision of the wholesale money markets" (1988) 28 *B.E.Q.B.* 69. The Banking Supervision Division or an S.R.O. will be the lead regulator of most listed institutions with regard to their financial soundness, but the Wholesale Markets Supervision Division is the lead regulator of some non-authorised institutions of a predominantly wholesale nature. On the division of regulatory responsibilities within the Bank, see "Banking Act 1987: Annual Report under the Banking Act for 1987-88", pp.35-36. Following the internal reorganisation of the Bank, which took effect on 4 July 1994, all of the Bank's functions
The first concerns the relationship of the requirements for listing, as described in the Grey Paper, to the authorisation procedure under the Banking Act. The "fit-and-proper" test for inclusion in the list (which centres on matters of capital adequacy, systems and controls, etc.) closely parallels the prudential requirements of the Banking Act. Furthermore, the procedure for the acceptance of institutions to the list and their removal from it, albeit simplified and informal, consists mainly in a simplified and informal adaptation of the authorisation procedure of the Banking Act.\textsuperscript{74} On the other hand, the emphasis on the need for observance of standard practice, for homogeneity in the products traded\textsuperscript{75} and for continuity in the markets must not be overlooked, as it involves a significant change of emphasis from the prudential preoccupation of the Banking Act towards conduct-of-business regulation.\textsuperscript{76}

The second aspect demanding attention concerns the Bank's explicit assumption of regulatory functions in relation to wholesale trading in certain instruments which, on the Bank's own interpretation, do not qualify as investments for the purposes of the F.S.A. This include: sterling and foreign currency wholesale deposits; spot and forward foreign exchange; gold and silver bullion; and commercial bills, including

\footnotesize{\textsuperscript{74} Loc.cit., n.65, ch.1, para.17, as replaced by the Market Notice of 4 Jan. 1993, where the conditions and requirements for listing, as currently approved by the Treasury, are set out; see also the more detailed exposition of prudential requirements in ch.2, paras.2-33, and Ann.1 and II.}

\footnotesize{\textsuperscript{75} Unlike trading in debentures, issuing them in a primary market does not constitute investment business. Nonetheless, the issuing of debentures (including certificates of deposit, commercial paper and medium-term notes) must comply with the Bank's market guidelines. This is a result of the Bank's belief that "as great a degree of homogeneity as possible at the primary issuing stage in the short-term paper markets assists good order in those markets. It reduces the scope for investor confusion about the nature of the instrument being traded and thereby facilitates market trading"; London Code of Conduct, loc.cit., n.65, Ann.2. Notices issued by the Bank regulate the issuance of standard "London instruments"; see "Certificates of deposit and other short-term paper issues by deposit-taking institutions" (31 Mar. 1989); and "Commercial paper, medium-term notes and other financial instruments" (11 Jan. 1990). It must be noted that issues of standard "London" commercial paper and medium-term notes (issuable only by large companies quoted in the Stock Exchange or overseas public authorities in wholesale denominations) are also exempted from the prohibition on unauthorised deposit-taking; Banking Act 1987 (Exempt Transactions) Regulations 1988, S.I. 1988/646, r.13 (as substituted by S.I. 1990/20); see supra, ch.2, text and nn.80-82.}

\footnotesize{\textsuperscript{76} See Grey Paper, loc.cit., n.65, ch.2, paras.43-48; and London Code of Conduct, loc.cit., n.65. In the words of a supervisor, "Banking Supervision Division is primarily concerned with the protection of depositors, and with institutions for which lending (and the associated credit risk) has traditionally predominated [...] In contrast, our concern in the Wholesale Markets Supervision Division relates much more to the functioning and integrity of the markets themselves and to firms for which day-to-day position-taking in these markets is a prime source of the risks to which they are exposed"; Townend, loc.cit., n.73, p.69.}
banker's and other acceptances. Significantly, these are the core instruments of the
discount market and the interbank market in wholesale deposits. In its own words,
"the Bank will expect to see the same standards maintained by listed
institutions - in particular, adherence to the relevant parts of the Code of
Conduct - in trading all the instruments identified [...], whether or not this
activity would otherwise fall within the scope of the Financial Services
Act."

Institutions trading in such "non-investment" instruments will most likely require
authorisation under the Banking Act and/or the F.S.A. in respect of their other lines
of business and will be obliged to observe financial and other prudential
requirements. Even if this is the case, however, the incidental regulation of their
legally unrestricted types of wholesale business by their statutory supervisors appears
to be inconsistent with the purposes of the two statutes, neither of which brings
trading in the aforementioned wholesale instruments within the regulatory net, despite the close affinity of such trading to the activities that the two statutes seek to regulate. In particular, where prudential concerns are not involved, the supervision
of deposit-takers under the Banking Act should not indirectly open the road for the
enforcement by the Bank of standard market practices and similar market-ordering
measures regarding wholesale trading in the non-investment instruments, because the
Act only provides for the regulation of market conduct when this is material to the
protection of depositors.

The current arrangements for the supervision of wholesale money market
intermediaries under section 43 of the F.S.A. need to be amended in the immediate
future to ensure their consistency with the Investment Services Directive. As the
activities of wholesale money market intermediaries are within the definition of
investment services in the Directive, they are subject to the Directive's authorisation
requirements and cannot be exempted by means of listing. To achieve the
compatibility of the U.K. regulatory arrangements with the Directive with the
minimum possible alteration to the substance of the existing régime, the U.K.
government considers the replacement of the "exemption" of listed persons under

---

77 Grey Paper, loc.cit., n.65, Table 1.
78 Ibid., ch.1, para.6.
79 It might be thought that, in any event, the regulation of non-investment wholesale business by
the Bank pursuant to s.43 is unsupported by sanctions. But, in the words of a Bank official, "[t]he
sanction of removal from the list is a kind of nuclear weapon because although the firm would, as
a matter of law, be able to continue trading in non-investment products after such a decision, in
fact its reputation would be shot to pieces"; Treasury and Civil Service Committee, loc.cit., n.69,
q.381. It is noteworthy that the Bank can be so relaxed about the threatened use of an effective
"nuclear weapon" in connection to matters which it admits to be beyond its statutory powers.
80 See supra, n.46.
81 Investment Services Directive, art.3.
section 43 with a special authorisation régime, which will continue to be operated by the Bank. Under the proposed arrangements, the inclusion in the Bank's list, instead of exempting a firm from the requirements of the F.S.A. in respect of its wholesale business, will make it "authorised" to undertake such business. Authorisation for this purpose will be the responsibility of the Bank, even if the listed firm is also authorised by another regulator in respect of its other business. Before the Bank is able to grant listing, the minimum conditions for authorisation set out in the Directive, including: (i) the location of a firm's head office in the same Member State as its registered office; (ii) capital adequacy; (iii) the fitness and properness of its directors and controllers and the effective direction of its business by at least two persons; and (iv) the submission of a programme of operations setting out the firm's envisaged types of business and organisational structure, will have to be satisfied. The Bank will have to reach a decision on applications for listing within six months from their submission and to give reasons for any refusal. Furthermore, as a matter of Community law, its decisions will have to the right of the applicant to apply to the courts for their review.

The Bank will be required to ensure the prudential supervision of listed persons on a continuous basis and to draw up conduct of business rules consistent with the Directive's minimum requirements, whose applicability will extend to all firms operating in the U.K. wholesale markets, including incoming institutions authorised and supervised by another Member State. Since the professional nature of the person for whom the service is provided can be taken into account for the application of the conduct of business rules, it will be possible for the Bank to frame the rules in a manner that will reflect the special nature of wholesale business and, thus, to preserve the distinctive character of the existing system.

The Investment Services Directive imposes additional obligations on the regulatory authorities ("competent authorities") of the Member States. The decision as to who should be designated as a competent authority is left to the national discretion of the Member States. A list of the competent authorities and their respective duties must be submitted to the Commission. In the U.K., the designation of competent authorities will reflect the existing division of responsibility between the S.I.B., the S.R.O.s and the Bank under the F.S.A., subject to minor
While the Bank is not currently required to co-operate with other regulators in respect of its regulation of wholesale money market intermediaries under s.43, its designation as a competent authority for the purpose of the Directive will bring it under an obligation to co-operate closely with other domestic and European securities regulators for this purpose. It will also impose upon it a duty of secrecy with regard to regulatory information concerning the affairs of the latter.

(c) Regulation of the discount and gilt-edged markets. The Bank of England operates special regulatory arrangements for those institutions with which it maintains a direct dealing relationship in the context of its open-market operations. While in the case of the listed wholesale-market institutions of section 43 of the F.S.A. the statutory provision provides a formal justification for the Bank's regulatory role, these arrangements are not explicitly supported by legal provisions and depend for their enforcement at least as much on the Bank's practical power as a leading market player and capacity to insist on its own terms in its contractual relationships with other financial institutions as on the availability of formal administrative sanctions.

Its position as the ultimate supplier of liquidity to the banking system constitutes for the Bank a particularly important source of informal market leverage. The discount market is the conduit through which this leverage is exercised. More precisely, as payments are made by the public to the private sector and vice versa, cash is transferred between the Bank, acting in its capacity as the government's banker, and the commercial banks. Depending on the direction of the net balance of the transfers, at the end of each working day there is either a shortage or a surplus of cash in the commercial banking system. In the former case, to offset the shortage and preserve liquidity, the Bank provides additional cash to the system, mainly by buying Treasury bills, commercial bills guaranteed by an accepting bank or other short-term assets, but also through direct lending ("open-market operations"). Since the banking system relies upon this service on a day-to-day basis for its liquidity, the Bank is in a position to dictate the terms for the provision of the necessary funds. The rate at which the Bank stands ready to discount bills or to lend to the market exerts a powerful influence on other short-term interest rates and, through them, on the private sector's demand for money. Open-market operations are used in this manner as the main instrument of monetary policy.

90 H.M. Treasury, loc.cit., n.47, paras.33-36.
91 Investment Services Directive, art.23.
92 Art.25.
Unlike the central banks of other nations, the Bank does not normally conduct operations in the money market by dealing directly with the commercial banks. Instead, it is willing to maintain a dealing relationship only with a small number of specialist counterparties, the discount houses. These are separately capitalised financial institutions whose activities are strictly confined to the money market. Their liabilities are mainly wholesale deposits placed with them by the commercial banks and withdrawable at call, while their assets include large quantities of commercial bills and government securities. Whenever the commercial banks face a shortage of cash, they are able to restore their liquidity by withdrawing their deposits from the discount houses, which can in turn raise the necessary funds for the repayment of the deposits either by selling commercial or Treasury bills to the Bank or by drawing on their secured borrowing facilities with it.

The Wholesale Markets Supervision Division of the Bank operates special supervisory arrangements which apply to all institutions which have direct trading access to its discount facilities. Even though the Bank has not been given a specific statutory regulatory mandate with regard to these institutions unless they accept "deposits" as defined in the Banking Act, its de facto authority in this area has been traditionally accepted by them, not least because of the considerable benefits conferred on them as a result of their uniquely close relationship with the Bank.

In practice, all the discount houses are currently authorised under the Banking Act and, accordingly, are subject to the Bank's supervisory jurisdiction under that

93 In the past, the Bank would transact business in the sterling money market exclusively with the discount houses. In the last few years, however, it has been also willing to establish dealing relationships with those gilt-edged market-makers (i.e. institutions which undertake to make continuous markets in long-term government securities or gilts) who want to extend their range of activities to the money market; "Bank of England operations in the sterling money market" (1989) 29 B.E.Q.B. 92, paras. 1 and 13. The Bank currently maintains a direct dealing relationship in the sterling money market with the seven discount houses and with one gilt-edged market-maker.

94 The arrangements are set out in its so-called "Red Paper", which has been published officially as "Bank of England operations in the sterling money market", ibid., to which is appended Ann.3 of the earlier consultative paper "Bank of England operations in the sterling money market" (1988) 28 B.E.Q.B. 391, pp.403-409. See also M.J.B. Hall, Handbook of Banking Regulation and Supervision (2nd ed., 1993), App.1 and 2.

95 See Pennington, op. cit., n.42, p.90. On the definition of "deposit" and "deposit-taker", see supra, ch.2, section 1.

96 See supra, ch.1, text and n.44. Not only did the houses have the privilege of being the only institutions with which the Bank was ready to deal in the money-market, but also their funding was guaranteed by the fact that the deposits of the commercial banks with them counted as reserve assets. For a few years following the abolition of the reserve-asset ratio in 1981, the major commercial banks, whose acceptances were eligible for discount by the Bank, were required to make available to the discount houses funds representing around 6%, and later around 5%, of their eligible liabilities in order to ensure the continuing funding of the houses; "Monetary control: next steps" (1981) 21 B.E.Q.B. 38; "Monetary control - provisions" (1981) 21 B.E.Q.B. 347; and "Monetary control arrangements" (1983) 23 B.E.Q.B. 346.

346
statute's provisions, rather than in their capacity as the Bank's counterparties in the sterling money market.\textsuperscript{97}

Insofar as prudential matters are concerned, the houses are subject to requirements which are generally comparable to those for other authorised institutions. Special tests, however, apply for the evaluation of their capital adequacy and liquidity.\textsuperscript{98} A special régime of capital adequacy is necessary because, due to the nature of their activities, the discount houses are exposed primarily to trading ("position") risks caused by movements in interest rates, while the credit risk of their assets is generally low. Furthermore, the volume of their assets and liabilities is subject to large fluctuations, because the restoration of the liquidity of the commercial banks can only be achieved through sudden withdrawals of their deposits with the houses and, ultimately, through the liquidation of part of their asset portfolios. Accordingly, the discount houses are allowed to undertake higher degrees of leverage than other banks.\textsuperscript{99} The capital-adequacy tests for discount houses have been relaxed so as to approximate those applicable to securities intermediaries regulated under the F.S.A., although they remain generally more onerous than the latter. Thus, since July 1987, a house holding a portfolio of high-quality short-term marketable securities has been required to restrict its holdings within a multiple of eighty times its capital base. The permissible leverage decreases if the house holds

\textsuperscript{97} On the other hand, those of the Bank's money-market counterparties which are gilt-edged market-makers (see \textit{supra}, n.93) will need authorisation under the F.S.A. and will be members of the International Stock Exchange (and thus subject to the Exchange's, rather than the Bank's rules); "The future structure of the gilt-edged market" (1985) 25 \textit{B.E.Q.B.} 250 (known as the "Blue Paper"), para.8.

\textsuperscript{98} Bank of England "Statements of Principles: Banking Act 1987; The Banking Coordination (Second Council Directive) Regulations 1992" (May 1993), "Banking Act 1987: Section 16", paras.3.1-3.2. In the 1970s, the houses were required to observe simple multipliers relating their capital resources to their public liabilities, \textit{i.e.} gearing ratios, which were more generous than those applicable to banks; see J. Revell, \textit{Solvency and Regulation of Banks: Theoretical and Practical Implications} (1975), p.47. From 1982 onwards, they were subjected to more detailed prudential requirements; "Prudential arrangements for the discount market" (1982) 22 \textit{B.E.Q.B.} 209, and "Revised supervisory arrangements for the discount market" (1984) 24 \textit{B.E.Q.B.} 461. These requirements have since been replaced by the Red Paper, \textit{loc.cit.}, n.94.

\textsuperscript{99} Red Paper, \textit{ibid.}, Ann.I. The discount houses are exempted from the minimum solvency requirements that apply to other banks under Community law. In a provision intended to address precisely the situation of the discount houses, the Council Directive 89/647/EEC of 18 December 1989 on a solvency ratio for credit institutions (the "Solvency Ratio Directive"), art.1(4), exceptionally and pending further harmonisation of prudential roles relating to credit, interest-rate and market risks, gives to the Member States the discretion to exclude from the scope of the Directive credit institutions "specialising in the inter-bank and public-debt markets and fulfilling, together with the central bank, the institutional function of banking-system liquidity regulator", provided that these institutions constrain their activities to this role, hold assets to which the Directive assigns low risk-weights and are subject to appropriate supervision by the competent authorities with regard to the credit, interest-rate and market risks that they undertake. See also "Implementation in the United Kingdom of the Solvency Ratio Directive" (BSD/1990/3, Dec. 1990), para.3.
The houses are expected to monitor their positions continuously, updating the valuation of their assets and liabilities on a daily basis ("marking to market") and to report their exposures on a fortnightly basis.

In addition to supervising the houses' solvency, the Bank of England pays particularly close attention to the quality of their credit practices and liquidity management and to the adequacy of their internal systems and controls. Following the general tightening of banking supervision after the B.C.C.I. affair, the Bank has adopted a more active approach with regard to the monitoring of the discount houses, which was previously less intensive than that of most other authorised institutions. Accordingly, it now requests from all the houses routine reports under section 39 of the Banking Act 1987.

Even though the discount houses are subject to the supervisory régime of the Banking Act, the Bank openly recognises that "it is not strictly necessary for a money market dealing counterparty to be authorised under this Act. However, any separately capitalised money market dealing counterparty, whether or not it applied successfully for authorisation under the Banking Act 1987, would be supervised in the same manner as existing discount houses." The only probable legal ground upon which the Bank could establish its regulatory authority in the latter case seems to be the provision of section 43 of the F.S.A., the effect of which has been discussed earlier. Indeed, the discount houses are included in the list of wholesale-market institutions kept by the Bank.

The Bank itself appears to take the view that its regulatory functions in this field do not depend as much on any specific statutory authority, as on its de facto role in the discount market. In addition to the traditional voluntary acceptance of this role by its regulatees, the Bank can also rely on its contractual capacity, which allows it to select freely its counterparties and the terms on which it is willing to transact business. In implicit recognition of the significance of its financial dominance of the market, the Bank's regulatory arrangements are set out as a statement of "the Bank's intentions for the extension of its dealing relationships, including the obligations, structure and supervision of the Bank's money market dealing counterparties; the facilities the Bank will offer these counterparties; and the criteria for acceptability."
In other words, the arrangements comprise nothing more or less than a statement of the conditions under which the Bank is willing to establish contractual relationships.

The obligations of the Bank's potential money-market counterparties extend beyond the purely prudential to include: a readiness to accept wholesale deposits in the interbank market, in order to mop up the excess liquidity of the banking system on a day-to-day basis; the continuous making of markets in bills; and the underwriting the weekly tender of new Treasury bills, which ensures sufficient demand for the regular issues of public debt.\(^{105}\) Provided that prudential requirements and rules of conduct are observed and the obligations mentioned above are fulfilled, the Bank may accept an institution as its counterparty. In this case, beyond a general readiness to enter into contracts with it, the Bank undertakes to provide last-resort lending to the institution in the form of stand-by borrowing facilities, drawable against approved collateral.\(^{106}\) It also undertakes to treat the institution's liabilities favourably in the context of measuring banks' liquidity and capital adequacy, with a view to increasing their commercial attractiveness, and to secure from the Inland Revenue favourable tax treatment of its hedging transactions in gilt-edged securities.\(^{107}\) It is worth noting in this context the anomaly inherent in the creation by the Bank of expectations regarding the manner in which purely administrative functions will be exercised as an incentive aimed at influencing the behaviour of its potential contractual counterparties.\(^{108}\)

The Bank operates similar arrangements for the regulation of the gilt-edged market.\(^{109}\) Gilt-edged stocks or gilts are the long-term bonds which the government issues as a means of funding the public sector's borrowing requirements. As the government's agent in matters of public funding, the Bank is responsible for the sale of new issues of gilts in the primary market. For the most part, these are sold in auctions, but smaller quantities of new stock are kept by the Bank to be sold later "on tap", \emph{i.e.} directly on the secondary market in the course of its day-to-day operations when there is demand at satisfactory prices. The Bank's autonomy in this

\(^{105}\) \textit{Ibid.}, paras.6-11. The facilitation of public financing is not an evidently legitimate purpose of prudential regulation. In particular, despite the fact that the purposes of the F.S.A. are broad and imprecise enough to permit the regulatory adoption of market-deepening measures, it is at least conceivable that this statute cannot justify measures specifically designed to increase the demand for government securities.

\(^{106}\) \textit{Ibid.}, paras.20-23.

\(^{107}\) \textit{Ibid.}, paras.24-26.

\(^{108}\) The exercise of the Bank's contractual power for regulatory purposes also raises questions of Community law. Indeed, the power of the Bank as the central bank of the U.K. to choose its counterparties is recognised in Community law. However, this must be done on the basis of objective, non-discriminatory criteria. Investment Services Directive, preamble, 25th recital.

\(^{109}\) Blue Paper, \emph{loc.cit.}, n.97 (as amended). See also Hall, \emph{op.cit.}, n.94, App.2 and 3.
connection has been reduced recently. Under the new system, the Treasury is to set and make public an "annual remit" containing precise directions for the Bank's sales of gilts.\textsuperscript{110}

Gilts are also actively traded in a secondary market. The main dealers in the market are the gilt-edged market-makers. These are specialist firms which undertake to quote continuously prices at which they are prepared to buy or sell gilts (two-way prices). The gilt-edged market-makers are able to deal anonymously with one another through inter-dealer brokers.

Even more than in the discount market, the Bank's discrimination between potential counterparties appears to be the cornerstone of regulation in the gilt-edged market. The relevant regulatory arrangements came into effect before the enactment of the F.S.A. and do not form a part of the regulatory structure put in place by that statute. Although certain gilt-edged market-makers have sought inclusion in the list of wholesale-market institutions kept by the Bank under section 43, this is not necessary since trading in gilts is not a type of investment business that could qualify for exemption from authorisation under the F.S.A. by means of listing.\textsuperscript{111} Nor do these institutions engage in deposit-taking. Accordingly, provided that they confine their activities strictly to their main line of business, \textit{i.e.} trading in gilt-edged securities, and do not participate in the discount market,\textsuperscript{112} they have no immediate statutory reason to submit to the Bank's authority. If the Bank is nonetheless able to make its regulatory demands for gilt-edged market-makers effective, this is the result of an effective \textit{quid pro quo}.

Thus, the observance of the Bank's prudential requirements as well as the assumption of an obligation to make continuous and effective markets in gilt-edged securities\textsuperscript{113} are minimum conditions, in the absence of which the Bank will refuse to establish a direct dealing relationship in the secondary market for gilts with another financial institution.\textsuperscript{114} The incentive to conform is reinforced by the Bank's promise to ensure favourable tax treatment (subject to government approval) and to provide

\textsuperscript{110} "Annual remit for the Bank's operations in the gilt market" (1994) 34 \textit{B.E.Q.B.} 112; see infra, ch.6, section 2.

\textsuperscript{111} Public-sector debt instruments are included in the transactions subject to the exemption only if they are issued "on terms requiring repayment not later than one year [...] from the date of issue" - so that gilt-edged securities are \textit{ipso facto} excluded; Sch.5, Pt.1, para.2.2.(c). In practice, the gilt-edged market-makers are members of the Securities and Futures Authority, which delegates their supervision to the Bank of England; see Treasury and Civil Service Committee, First Report: "The Role of the Bank of England", H.C. (1993-94) 98, para.86.

\textsuperscript{112} See supra, n.93.

\textsuperscript{113} \textit{Blue Paper, loc.cit.}, n.41, paras.5-11 and Ann.1.

\textsuperscript{114} Although non-conformity will be fatal, conformity will not necessarily achieve the desired result, as the Bank retains the discretion to choose between applicants, if their numbers are large and may cause disorder; \textit{ibid.}, para.38. There are currently twenty-four gilt-edged market-makers.
financial and technical assistance, information and last-resort lending facilities in order to enable gilt-edged market-makers to perform this market-making role.\footnote{Ibid., paras.12-23}

It is noteworthy that the arrangements for the regulation of the gilt-edged market also extend "to those providing ancillary services to the market makers, \textit{i.e.} Stock Exchange money brokers and inter-dealer brokers",\footnote{Ibid., para.1.} who are nonetheless authorised under the F.S.A. and regulated as members of the Stock Exchange. Although the incentive of establishing a direct dealing relationship with the Bank does not play a part in this case, the Bank can effectively enforce its regulations upon these persons because it has the practical capacity to withdraw the "technical facilities necessary to enable them to act".\footnote{Ibid., paras.25 and 32. Even on the assumption that the power of the Bank to enter into contractual relationships on the terms of its choice cannot be subjected to judicial review, even if it is used as a regulatory instrument with regard to the market-makers (see \textit{infra}, sections 3-4), its effective power to withdraw "technical facilities" from the brokers, with whom it is not linked contractually, may still be reviewable on the principle of \textit{R. v. Panel on Take-overs and Mergers, ex p. Datafin plc.} [1987] 1 All.E.R. 564 (C.A.), which extended the supervisory jurisdiction of the High Court to non-statutory bodies exercising \textit{de facto} powers of coercion.} In justification of its role, the Bank affirms that its "responsibility to supervise [money] brokers derives from Section 43 of the Financial Services Act 1986", but admits that

"[b]rokers strictly do not require to be listed unless they broke investment instruments as defined in the Financial Services Act. Foreign exchange and deposits, for example, fall outside the scope of the Act. Encouraged by the Bank, brokers have nevertheless sought to be regulated and included on the Section 43 list even if their business is confined to non-investment wholesale business".\footnote{Bank's Memorandum, paras.2-3, in Treasury and Civil Service Committee, "Banking Supervision and B.C.C.I. ...", \textit{loc.cit.}, n.69.}

It is difficult to understand what this "encouragement" involves, if not the threat of withdrawal of the facilities mentioned above. Reliance on section 43 for the regulation of the brokers, but also of the gilt-edged market-makers themselves, creates a special problem, since it is not self-evident that it is within the statutory \textit{vires} of the Bank to include in the list persons which do not actually transact "investment business" for the specific purpose of bringing them under its regulatory jurisdiction. For instance, it would appear that the listing of car dealers for the same purpose would be unacceptable.

An effect of the U.K. implementation of the Investment Services Directive will be to bring the gilt-edged market within the European definition of a "regulated market".\footnote{Investment Services Directive, arts.1(13) and 16. It is the intention of the U.K. government to designate the gilt-edged market as a regulated market; H.M. Treasury, \textit{loc.cit.}, n.47, para.6.} National laws which limit access of investment firms properly authorised by their home authorities to a regulated market or which discriminate against such
firms are incompatible with the rights of establishment and cross-border provision of services guaranteed by the Directive. However, incoming European firms can still be required to comply with the rules of the regulated market relating to the market's constitution and administration and to the conduct of transactions, as well as to the rules and procedures for clearing and settlement, provided that these are justifiable in the interests of the general good and are applied on a non-discriminatory basis.

The examination of regulatory arrangements in the two areas under discussion leads to the conclusion that, overall, the combination of an indirect and imprecise statutory mandate for the regulation of wholesale markets with the Bank's position of dominance in the marketplace confers to the latter a very considerable margin of discretionary power, whose exercise under the rhetorical guise of "moral suasion" is subject to few legal or practical constraints.

In itself, the obscurity and lack of specificity of the relevant legal provisions is a factor which increases the Bank's autonomy as a regulator and impedes potential challenges to its actions. Even if the statutory and de facto aspects of the Bank's regulatory functions could be clearly distinguished, however, the conditions would still be generally unfavourable to legal challenges. To the extent that the Bank may derive its jurisdiction from the F.S.A., its activities must conform to the terms of that statute and are, in principle, fully reviewable. In practice, however, by failing to provide meaningful regulatory purposes and standards of performance, that statute confers to the Bank virtual law-making power regarding the regulation of wholesale activities and reduces drastically the possibility of review of the legality of its substantive decisions in this area, confining potential judicial interventions essentially to issues of natural justice. On the other hand, to the extent that the Bank may be willing to employ the very substantial amount of effective market power at its disposal as a lever for the discharge of regulatory responsibilities which are not specifically governed by statute, fundamental problems of legal control arise.

3. The legal status of the Bank's de facto regulatory activities

In carrying out its regulatory functions, the Bank does not rely only on its statutory powers. Equally important for its purposes is its informal "moral suasion" or, more precisely, its de facto capacity to ensure compliance with its will.

---

120 Preamble, 36th recital, and art. 15(1) and (4).
121 Preamble, 39th recital, and art. 15(2).
As a monetary authority, the Bank has a long tradition of reliance on moral suasion.\textsuperscript{122} The Bank's nationalisation in 1946 did not affect this situation. Although section 4 of the Bank of England Act 1946 provided that the Bank should have a general power to give directions to bankers, this power was never made fully operative.\textsuperscript{123} Accordingly, even following nationalisation, the direct legislative regulation of monetary matters remained confined to the issue of note circulation. The Bank has no statutory powers for the control of broad monetary circulation.\textsuperscript{124} Accordingly, if the Bank wants to impose monetary-control ratios or credit directions, it must insist that the commercial banking institutions comply with its informal "requests", whose legal validity is not derived from direct statutory authority.\textsuperscript{125}

Although the significance of moral suasion in matters of monetary control has been marginal for the last fifteen years as a result of the liberalisation of the banking system and the abandonment of direct credit controls, there are a number of other areas where the Bank continues to exercise its authority informally and without an explicit statutory mandate. The regulation of the discount and gilt-edged markets is probably the clearest example. The Bank is also active in promoting trade associations and setting up self-regulatory institutions in the financial sector, such as the City Panel on Take-overs and Mergers and the S.I.B., and in ensuring that the relevant arrangements are respected. It plays a leading role in the standardisation of

\textsuperscript{122} A significant degree of indifference to questions of legal form is characteristic of the volatile and politically contestable field of economic policy in general. The perceived necessity to influence economic performance concretely by means of selective interventions or macro-economic "management" overrides in this field the desire of subjecting public action to rules and dictates reliance on broad policy-making discretion.

\textsuperscript{123} See supra, ch.1, section 1. Otherwise, the Bank has no legal mandate to regulate banking institutions for monetary-policy purposes. A reference to monetary-control requirements in "Banking Act 1987: Banking Supervision Guide" (Sep. 1987), p.III/9, gives the false impression that this is a matter relevant to the exercise of its regulatory activities under the Banking Act. But monetary-control measures go beyond the powers of the Bank under that statute, whose purpose is clearly confined to prudential issues.

\textsuperscript{124} On the limited role of public law in monetary affairs, see T. Daintith, "The functions of law in the field of short-term economic policy" (1976) 92 L.Q.R. 64, pp.72-76. On the short-lived post-war attempts to subject certain forms of credit expansion to statutory regulation, see Borrowing (Control and Guarantees) Act 1946, s.1 (repealed by the Government Trading Act 1990), which imposed controls over non-bank borrowing of large sums, in particular in the form of stock and shares issues, and Emergency Laws (Re-enactments and Repeals) Act 1964, s.1, which authorised controls over the terms of a limited range of consumer-credit arrangements (all remaining controls were brought to an end by the Control of Hiring and Hire-Purchase and Credit Sale Agreements (Revocation) Order 1982, S.I. 1982/1034). See also supra, ch.1, section 1.

\textsuperscript{125} A widespread belief in the "legitimacy" of the Bank's power to insist on the observance of monetary-control "requests" does not transform them into \textit{de jure} exercises of administrative power; see, e.g., \textit{Entick v. Carrington} (1765) 2 Wils.K.B. 275. Echoing Diplock L.J., \textit{United Dominions Trust Ltd v. Kirkwood} [1966] 2 Q.B. 431 (C.A.), p.462, one could say that "this, in my view, is not an issue on which \textit{communis error jus facere potest}".

353
market practice and the adoption of rules of organisation, especially in the area of clearing and payment systems, where it is currently involved in the development of a real-time gross-settlement system for interbank money transfers and of a clearing book-entry system for the settlement of traded equities. The Bank also arranges rescue operations for troubled banking (and sometimes industrial) firms, for which it does not always put all the money itself, but shifts instead part of the burden to the major commercial banks. For instance, in the rescue of Johnson Matthey Bankers in December 1984, as M. Reid notes,

"[t]he most contentious point was that, in the effort to limit the cost falling on itself, the Bank pressed the little-connected clearing banks to take an important share of the indemnity burden for the broad purpose of sharing in the solution of a City problem. There was this difference compared with the secondary banking crisis - when the big banks were mobilised to provide cash-recycling aid - that the commercial banks were bound to lose something under the indemnity. In the secondary banking affair the clearers had essentially provided large credit, while the costly rescues involving the main losses had been financed by the Bank alone."

In addition, since all its profits from the note issue are paid over to the Treasury, in order to finance its operations the Bank effectively taxes the commercial banks by imposing on them an obligation to make available to it non-interest-bearing funds, known as "cash-ratio deposits" (currently set at 0.35% of a banks' deposit base),

---


The Bank justifies its approach by claiming that its role in this situation is that of a "honest broker" who helps the banking industry to organise a collective response to the problems facing it in circumstances where the pursuit of immediate short-term interest might prevent the individual institutions from making a contribution; see "Responsibilities of the private and public sectors" (1984) 24 B.E.Q.B. 500. However, this justification cannot easily apply to cases where the major banks are called upon by the Bank to participate in the rescue of institutions with which or with whose problems they have no direct involvement, as in the Johnson Matthey Bankers affair.

128 Op.cit., n.5, p.232. Addressing this issue, the then Governor of the Bank, Robin Leigh-Pemberton, predicted that in the future the Bank could face resistance if it were to request the participation of commercial banks in a rescue operation, since "any extra burdens placed on the banking system must necessarily affect the willingness of the banks and their shareholders to see their funds used in an essentially discretionary way to help sustain the system"; "Domestic financial markets: progress and problems" (1984) 24 B.E.Q.B. 472, p.473. In a recent speech, his successor, E. George, has also noted the growing unwillingness of U.K. banks to join in support operations for institutions facing financial difficulties, "as the degree of competition between them and accountability to shareholders have increased", P. Tehan, "U.K. banks unwilling to join 'lifeboats'", The Times, 27 Oct. 1995, 25. On the other hand, as R. Dale observes, "where London's reputation as a financial centre is at stake, as it was in the 1995 Barings crisis, industry support may be offered"; "Bank crises management: the case of the United Kingdom" (1995) 10 J.I.B.L. 326, p.331.
which it then reinvests in securities and advances.\textsuperscript{129} Finally, it provides guidance to
the banking community regarding best practice in problem areas, \textit{e.g.} the
restructuring of businesses which are in default of their debt obligations.\textsuperscript{130}

One reason for which the Bank is able to informally impose its views in these and
other matters is that ultimately any significant degree of resistance on the part of the
financial community can be addressed by the authorities by resort to legislation and
the coercive enforcement of their desired objectives. The "threat" of statutory
regulation, however, cannot by itself explain the financial community's traditional
readiness to comply with the informal demands of the Bank. From the perspective of
a regulated industry, the incentive to co-operate with a non-statutory regulatory
system exists only to the extent that a strategy of co-operation can bring benefits that
would not be made available to that industry under a statutory system. Otherwise, it
would be more reasonable for the industry to disregard the informal pressure of the
authorities and act accordingly to its own preferences until the moment that it comes
under a legal requirement to change its practices. As A.C. Page and R.B. Ferguson
note, for non-statutory regulation

\"[t]o be an effective substitute for legal coercion, the benefits offered, or the
denial of which is threatened, must be exclusive; \textit{i.e.} they must be
unobtainable in any other way. Moreover, they must exceed the costs
entailed by submission, otherwise firms may simply decline to submit; and the
benefits must continue to exceed the costs, otherwise firms may simply
defect.\"\textsuperscript{131}

This analysis points to the conclusion that the fundamental reason for which the
financial industry has almost always found it in its interest to accept the Bank's moral
suasion is that, through the conducting of its operations, the latter is in a position to
exert overwhelming influence on the market as a whole and also to confer benefits
on the individual market participants on a discriminatory basis.

Of course, the Bank's power to exclude altogether non-conforming institutions
from the marketplace, or otherwise to penalise them, has declined in recent years as
a result of the growing internationalisation of the City and the replacement of the
old-style cartels by more open and competitive arrangements. This has forced the

\begin{itemize}
\item \textsuperscript{129} Bank of England, "Report and Accounts for the Year Ended 28 February 1994" (12 May 1994),
pp.9-10. Until the early 1980s, the big clearing deposited some 1.5% of their liabilities with the
Bank free of interest. This served as a source of income and a fund for the money-market
operations. In an effort to split the burden more evenly, this requirement was replaced by the
"cash-ratio deposits" for which all banks are liable; "Monetary control - provisions" (1981) 21
\textit{B.E.Q.B.} 347.
\item \textsuperscript{130} "Corporate finance, banking relationships and the London Rules" (1990) 30 \textit{B.E.Q.B.} 511; and
P. Kent, "The London Approach: distressed debt trading" (1994) 34 \textit{B.E.Q.B.} 172. In this area,
however, the Bank attempts to act merely as a mediator, using advice and persuasion, but
refraining from dictating its views if these are not accepted by the parties.
\item \textsuperscript{131} Op.cit., n.17, p.81.
\end{itemize}
Bank to rely increasingly on its statutory powers under the Banking Act. Nevertheless, by virtue of its operations in the core domestic wholesale markets as the government's banker, its function as the provider of liquidity to the banking system on a day-to-day basis, its key role in the organisation of financial markets and clearing systems (partially as a result of the fact that it holds the operating accounts which the commercial bankers use for clearing purposes) and, last but not least, its capacity to provide last-resort assistance to problem financial institutions, the Bank retains a position of substantial dominance in the financial community. It is also an indispensable source of business and information for the institutions with which it retains direct dealing relationships on an exclusive basis, i.e., the discount houses and the gilt-edged market-makers. Its unique position in the markets can be employed in many cases as an effective regulatory tool.

In matters governed by statute, the validity of the Bank's actions depends on the construction of the relevant statutory provisions - although generally the terms of its regulatory mandate are as wide and imprecise as possible, with the intention of ensuring effective enforcement of its regulatory demands with the minimum loss of policy-making autonomy. In contrast, the Bank can formulate its policy free of legal constraints in areas lacking a specific statutory framework. In the latter case, its practical ability to carry out that policy depends only on the measure of informal pressure that it can apply effectively in the marketplace. The Bank appears to be conscious of the unique advantages that it enjoys in the performance of many of its regulatory functions as a result of the absence of a specific legal mandate. This, however, raises serious questions of legal control, which have very rarely received the appropriate attention.

(a) The "private" legal capacity of the Bank. The Bank was incorporated by Charter granted by Letters Patent dated 27 July 1694. Following its nationalisation, and in pursuance of section 3(3) of the Bank of England Act 1946, it was granted a new Charter, but its incorporation under the original Charter of 1694 remained in force. The original Charter authorises the Bank to have a common seal, to purchase and hold all types of real and commercial property, goods and

---

132 For Page and Ferguson, "[o]ne consequence of replacing the non-statutory system of banking supervision by one based on statute [...] has been to increase the Bank's capacity to enforce its own conception of proper standards of conduct through the exploitation of the latitude afforded it by the statutory provisions"; *ibid.*, p.87.

133 See the arguments made by Lord Richardson, a former Governor of the Bank, and Sir George Blunden, a former Deputy Governor, against statutory definition of the Bank's functions before the Treasury and Civil Service Committee of the House of Commons; *Treasury and Civil Service Committee, "The Role of the Bank of England*, *loc.cit.*, n.111, para.14.

134 See Bank of England Act 1694, s.19.

chattels, and to sue and be sued under its own name. As a body incorporated by Charter, the Bank has full contractual capacity and all other legal abilities that a private person would have under the general law of the land. In particular, any restrictions that might be found in its charter would not bind it or restrict its vires.\textsuperscript{136} In this respect, there is considerable difference between the Bank and public bodies which have been created under statute. Most public bodies which are not Crown agents belong to this category, and most of them are incorporated ("statutory corporations"). These bodies have only the powers which have been conferred upon them under the terms of their parent statute. The statutory constraints apply to their contracts as to all their other functions and activities.\textsuperscript{137} This does not seem to be the situation of the Bank, whose common-law legal capacity could be compared more appropriately to that of the Crown.

The central government, operating under the collective name of "the Crown", has in common law the ability to do anything that would be permissible to a private citizen or corporate body under the ordinary principles of private law. This "private" capacity of the government must be distinguished from the various public powers of unilateral and coercive decision-making which belong to the Crown by virtue of statutory legislation or as part of the royal prerogative (understood here in the strict

\textsuperscript{136} An early precedent, The Case of Sutton's Hospital (1612) 10 Co.Rep. 1, is authority for this approach to the vires of chartered corporations. In the hypothetical case that the Bank overstepped its objects under its charter, only the Treasury, as its stockholder, and the members of its Court of Directors, as its members under s.3(2) of the 1946 Act, would have standing to challenge the irregularity, although it would be always open to the government to forfeit its charter. Jenkin v. Pharmaceutical Society of Great Britain [1921] 1 Ch. 392 (Ch.D.), pp.398-400, where the following remark can be found, p.398: "A corporation created by charter can at common law do with its property all such acts as an ordinary person can do and bind itself to such contracts as an ordinary person can bind himself to, and even if the charter expressly prohibits a particular act the corporation can at common law do the act"; and Dickson v. Pharmaceutical Society of Great Britain [1970] A.C. 403 (H.L.), p.434 \textit{per} Lord Upjohn and p.430 \textit{per} Lord Hodson.

\textsuperscript{137} Ashbury Railway Carriage and Iron Co. v. Riche (1875) L.R. 7 H.L. 653 (H.L.). However, there is no need for express authorisation: "whatever may fairly be regarded as incidental to, or consequential upon, those things which the Legislature has authorized, ought not (unless expressly prohibited) to be held, by judicial construction, to be \textit{ultrà vires}"; Attorney-General v. Great Eastern Railway Co. (1880) 5 App.Cas. 473 (H.L.), p.478. If the object is authorised, the authority can make contracts for that purpose. In Hazell v. Hammersmith and Fulham London Borough Council [1991] 1 All E.R. 545, the House of Lords held that, although a local council had been incorporated by Royal Charter, the decisive factor was that the charter had been granted pursuant to the London Government Act 1963, s.1, which, on its true construction, intended that the legal capacity of every London local authority would be confined to powers conferred under statute and would not extend to the contractual capacity of a natural person. In general, where a statute authorises the grant of a Royal Charter, the range of the legal powers of the chartered corporation will depend on the construction and intent of the statute, and will not necessarily be those of a common-law corporation. See also Bonanza Creek Gold Mining Co. Ltd v. The King [1916] 1 A.C. 566 (P.C.), p.388. Looking to the original Charter of 1694 (as amended), which still governs the incorporation of the Bank, we can discover no ground for holding that this institution is vested with anything less than full contractual capacity.
sense, *i.e.* as including only those powers which are unique to the Crown and can override the general law of the land, but not other common-law abilities).

Significantly, by virtue of this capacity, the government is able in common law to "privately" apply its resources as an instrument for the attainment of its public-policy objectives. The government's *de facto* "power of the purse", for which the term "dominium" can be used, has gradually increased in proportion with the accumulation of vast organisational and financial resources at the hands of the state. To the extent that its use is left unchecked, it provides government with a powerful bargaining tool and an effective policy instrument by means of which it can avoid in many cases the need of resorting to coercive legal norms and measures, in other words on the paradigmatic command-and-control type of power which constitutes its "imperium". In this way, the government can also avoid the procedural strictures and protections of the subject which apply to its coercive actions.

When acting in this manner, the government faces the same limitations and legal constraints as any private person. But this formal symmetry may be deceptive.

---

138 Although this "private" legal ability of governmental authorities is sometimes classified under the prerogative, it differs from the special prerogative rights of the Crown, to the extent that it is not coercive or unique to the state, but belongs to the state as in all persons under private law. See B.V. Harris, "The third source of authority for government action" (1992) 108 *L.Q.R.* 626; and C. Turpin, *Government Procurement and Contracts* (1989), pp.83-84. The disputed doctrinal bases of this common-law ability - especially in view of the judicial opinion, expressed in *M. v. Home Office* [1992] 1 Q.B. 270 (C.A.), that the government does not have legal personality - are of no significance for the purposes of the present discussion.

139 See T. Daintith, "The executive power today: bargaining and economic control", in J. Jowell and D. Oliver (eds.), *The Changing Constitution* (2nd ed., 1989), pp.196-198. Daintith, p.197, uses "the term *imperium* to describe the government's use of the command of law in aid of its policy objectives, and the term *dominium* to describe the employment of the wealth of government for this purpose". It must be noted that the distinction between legal coercion and financial power as the two basic substantive modes of governmental action does not correspond strictly to the formal division between governmental actions carried out under statutory authorisation or on the basis of the prerogative *stricto sensu*, on the one hand, and those undertaken under the common-law "private" legal capacity, on the other. For example, a rule promulgated by statute may be aimed merely at affecting the citizens' incentives by making the provision of particular benefits contingent upon the voluntary adoption of a specific course of action, leaving the ultimate choice to the recipients of the relevant rules and abstaining from direct commands or coercion. In this sense, the real paradox concerns only those cases where the government's wealth or *de facto* dominant position in the marketplace is relied upon as an instrument of *public* policy under the forms of *private* law.

140 Where governmental action is in conflict with the pre-existing legal rights of citizens, it can only be undertaken on the authority of statute or the prerogative; see the case of *Proclamations* (1611) 12 Co.Rep. 74; and *Entick v. Carrington* (1765) 2 Wils.K.B. 275. In contrast, the "private" legal capacity of the state can be used to defeat legally unprotected interests of private persons, in other words interests that have not yet crystallised into full legal rights. See, e.g., *Malone v. Metropolitan Police Commissioner* [1979] 1 Ch. 344 (Ch.D.), where the tapping of telephones by the Post Office for use by the police was found to be permissible, as there was no law against it, nor had any property or contractual right of the plaintiff been breached; see now *Interception of Communications Act 1985*. However, considerations of public law (*e.g.* the creation, as a result of an express promise or uniform behaviour of the authorities, of a legitimate expectations that the relevant interest will be respected), may lead to a different conclusion; see
from a practical standpoint. The absence of a formal power to unilaterally determine legal relationships should not conceal the effective power to influence in the chosen direction the substantive outcomes of social interaction. Although *dominium* does not involve power in the former sense, it plainly does in the latter. The "private" use of the state's legal and financial resources, and in particular of government contracts and property, as effective policy instruments can take diverse forms, including: (i) the selective promulgation of information; (ii) the establishment of organisational structures or bodies with the purpose of pursuing various governmental aims; (iii) the dispensation of financial grants and aids; (iv) the informal application of pressure on private social actors with the intent of brokering "deals" with or between them and of persuading them to accept voluntary restrictions on their behaviour; or - what is probably the most important weapon at the hands of government - (v) the making of the state's willingness to enter into contractual relationships contingent upon the observance by the potential counterparties of requirements, which in certain cases may be unconnected to the main purpose of the relevant transactions.

There are no *a priori* limitations to the purposes to which the power of *dominium* can be put.\(^\text{141}\) In areas governed by statute, the capacity of the authorities to act will be circumscribed by the statutory purposes and the exercise of prerogative or common-law powers in a manner inconsistent with the expressed legislative will of Parliament will be unlawful.\(^\text{142}\) No similar restriction will apply, however, in areas where the statute law remains silent.

In having the legal capacity to employ its resources freely as long as this is not incompatible with its statutory responsibilities is concerned, the Bank is in a very similar position to that of the central state. From a practical point of view, however, the Bank has a much wider field in which to exercise its *de facto* power than a minister of a Crown, because few of its activities are specifically regulated by statute. The Bank of England Act 1946 did not delegate to the Bank specific regulatory duties and responsibilities, although it provided legal support to the existing *de facto*
arrangements by giving to the Bank the formal power to issue directions to the commercial banks - a power which has never been exercised. Of the Bank's regulatory responsibilities, only two are specifically regulated by statute, namely the supervision of deposit-takers under the Banking Act 1987 and the implementation of exchange rate policy and the management of foreign exchange reserves on behalf of the Treasury. With these important exceptions, the Bank's regulatory activities get only limited recognition in statute law and are carried out informally. For instance, as has been shown in the previous section, the F.S.A. recognises the supervisory activities of the Bank in relation to the wholesale markets, without however attempting to define or regulate them. This means that the exercise of informal pressure on the market participants through its power of the purse or its influence will be the main instrument used by the Bank for the performance of a variety of regulatory functions.

(b) The Bank's contractual power as a de facto regulatory instrument. Two basic techniques for achieving the "voluntary" compliance of the financial community with its policy are particularly important in connection to the Bank's financial leverage. The first consists in the selective award of advantages and aids on the basis of compliance with specific policy aims. This technique can be related to the Bank's capacity to provide financial support (in the form of lending of last resort or of a rescue package) to a troubled institution, to disclose vital commercial information to the market participants, etc. - or, on the contrary, to decline to do so, with a view to bending the resistance of non-conforming market participants. The
second achieves the regulation of certain fields of activity by making substantive compliance with a certain policy a prerequisite for the award of contracts, whether or not the subject-matter of the policy is in fact connected to the main mutual objectives of the parties. This technique of establishing contractual relationships only with counterparties which conform to the promoted policy and of "blackballing" non-conforming institutions rests on the Bank's capacity to choose freely its contractual partners and negotiate at will the terms of its contracts. The regulation of the discount and gilt-edged markets is a case in point.

In common law, there are few legal restrictions to the contractual freedom of government and those public bodies, like the Bank, whose powers are not derived from statute and, thus, are not subject to the implicit statutory limitations on contractual authority. Of course, as a matter of public law, the duty of public authorities to perform effectively their governmental functions may defeat contractual obligations which are inconsistent with it. Thus, an authority is not allowed to fetter its statutory or prerogative powers by assuming contractual responsibilities which effectively preclude the future exercise of its discretion with regard to these powers or by adhering strictly to inflexible policies relating to its precontractual behaviour and the award of contracts.

In the case of governmental departments, a major constraint on the exercise of dominium powers is built into the processes for the control of their financial regularity. Thus, as all expenditure out of public funds is subject to Parliamentary clearly distinguished from that of other banks on the basis of existing market information, so that a market-wide crisis was much less likely to occur. Nonetheless, the Bank provided a guarantee of its liabilities, making a significant contribution to the eventual survival of the Baring "name". See R.A. Batchelor, "The avoidance of catastrophe: two nineteenth-century banking crises", in F. Capie and G.E. Wood (eds.), Financial Crises and the World Banking System (1986).

See T. Daintith, "Regulation by contract: the new prerogative" (1979) 32 C.L.P. 41. Of course, the "private" freedom of contract of governmental authorities can be severely restricted by their public-law duties. Thus, in the context of judicial review, the blackballing of counterparties for illegitimate reasons may constitute an illegality or breach of a duty of fairness; see infra, text and n.218.


149 R. v. Inland Revenue Commissioners, ex p. Preston [1985] A.C. 835 (H.L.), p.862. Nevertheless, although a contract fettering discretionary public powers would be unenforceable in private law, the matter might in certain cases appear different from the standpoint of public law, where a decision taken in exercise of a discretionary power but being equivalent to a breach of contract or representation might be ultra vires on grounds of unfairness; ex p. Preston, pp.866-867. See also R. v. Inland Revenue Commissioners, ex p. M.F.K. Underwriting Agents Ltd. [1990] 1 W.L.R. 1545 (D.C.). Thus, the need to protect legitimate expectations will sometimes bind public authorities to their bargain or promise, even though this would amount to an effective limitation on their discretion.

150 See Daintith, "Regulation by contract...", loc.cit., n.148, p.47.
authorisation in legislative form, the formal appropriation of funds is needed before a contractual obligation assumed by government can be executed, although lack of it does not affect the validity, but only the enforceability, of the obligation. In this respect, the Bank enjoys much greater freedom, because it can rely on its "own" property which it can dispose of without Parliamentary authorisation.

With these limited exceptions, the contracts of governmental authorities are not subject to special legal principles, but are governed by the general contract law. This gives the authorities considerable leeway, especially as regards the precontractual stage, i.e. the choice of parties and the negotiation of terms. In particular, in private law, authorities owe no duty of care to prospective counterparties and are under no general obligation to act reasonably, fairly or in good faith towards them. Similarly, to the extent that there is no indication of abuse of their monopoly powers or of unconscionability, once a contract is formed their counterparties are bound by the terms of their bargain. These principles apply fully in the case of the Bank.

Even when the Bank exercises its contractual powers in manners which would appear prima facie to be inequitable, or even oppressive, its counterparties will rarely have a cause of action. A clear example is Burmah Oil Co. Ltd v. The

---

153 The authorisation of expenditure in legislative form originally aimed to subject government to Parliamentary control. It evolved before ministerial responsibility, at a time when the struggle between Parliament and an executive deriving its political authority from the King was still a central issue of constitutional law, opening the way for the potential impeachment of minister in the event of a violation. The first instance of such appropriation of supply occurs in the Subsidy Act of 1624, ss.xxxvii and xli. See also J.R. Tanner, English Constitutional Conflicts of the Seventeenth Century, 1603-1689 (1928), pp.50 and 269-270, on this enactment, and pp.65-66, on impeachment as a forerunner of ministerial accountability. In the present constitutional system of responsible Cabinet government, appropriations have lost much of their meaning and survive mainly as a formality. See Daintith, "The functions of law...", loc.cit., n.124, pp.67-72; and id., "The executive power...", loc.cit., n.139, pp.201-203.

154 Turpin, op.cit., n.138, pp.91-94. Even disapproval by Parliamentary resolution does not affect the validity of government action.

155 And, legally at least, without ministerial approval; but see infra, ch.6, section 3.

156 In practice, the contractual powers of the central government are subject to a considerable degree of structuring and regularity. The existence of guidelines concerning the award of contracts (which are normally allocated on the basis of value-for-money considerations and at arm's-length), the regular use of standard conditions and the antidiscriminatory effect of certain international obligations (especially in the framework of the E.C. and the G.A.T.T.) with regard to government procurement, public works and aids to industry, restrain reliance on dominium as a general policy instrument, even though the government retains always the ability to deviate from standard practice and negotiate special terms. See Turpin, op.cit., n.138, passim. In the case of the Bank, the partial structuring of its contractual discretion is effected through a few announced contractual policies, the most notable of which have been examined in the context of the regulation of the discount and gilt-edged markets.

157 Ibid., pp.213-214. But restitution may be available, if the government has obtained a benefit from a prospective contractor as a consequence of the eventually frustrated expectation of the parties that a contract will be awarded.
Governor of the Bank of England, a case concerning a scheme for the rescue of a non-financial enterprise, but which is equally relevant to bank rescues and other situations where the Bank is party to a contract.

As a result of financial difficulties, the plaintiff company, which owned a large holding of shares in British Petroleum Co. Ltd ("B.P.") had to obtain outside support. For reasons of national interest, the Bank requested that the company should not obtain foreign support until it had discovered what help the Bank itself could offer. In the meantime, the Bank provided temporary credit, secured by a charge over the holding of B.P. shares. One consequence of the charge was that the company lost the power of disposing as it thought fit the B.P. equity holding, over which the Bank acquired full power of sale. The rescue package suggested by the Bank involved, inter alia, the sale of the B.P. shares to the Bank at the price quoted currently at the Stock Exchange and the division between the company and the Bank of any subsequent profit upon the resale of the holding. After a period of negotiations, the Bank indicated that, on the insistence of the government, it was no longer prepared to agree to the profit-sharing scheme and, furthermore, that it would only pay for the shares a price which was considerably inferior to the one that had been reached in the meantime in the market. The final agreement was on the government's terms and provided also for the creation of a stand-by credit facility as well as for the transfer of other assets of the company to the government.

As the price of the B.P. shares continued to rise, the company brought an action, seeking to set aside the sale of its holding as unconscionable, inequitable and unreasonable; as in breach of the Bank's duty of fair dealing; and as at an undervalue. In the Chancery Division, Walton J. held that there was no authority for a principle of general application that a court of equity would give relief against a transaction in circumstances in which a party had taken unfair advantage of its superior bargaining strength. Furthermore, nothing could be found in law to support the proposition that, due to its unique position in the world of banking, the Bank owed a duty to everybody to behave fairly. The Bank was governed only by the general rules of contract law. As a general proposition, the position was always that "Chancery mends no man's bargain", subject to certain isolated exceptions which are classified under the heading of "equitable fraud" and of which no evidence could be found in the particular case. More specifically, equity would interfere with an unconscionable

---


159 The facts of the case can be found in the preliminary judgement of the House of Lords; [1979] 3 All E.R. 700.
bargain. The present case, however, was not one of unconscionability: the plaintiff company had received independent advice; the Bank might have adopted a take-it-or-leave-it attitude, but this did not amount to putting pressure on the plaintiff; the only links between the parties were commercial, without an implicit trust relationship; the Bank did not exercise, as a matter of fact, direct or indirect control over the plaintiff; and, even though the plaintiff company was faced with ruin, this did not impair the personal ability of its directors to act dispassionately. If the Bank had not come to the rescue, the company would have been liquidated and its shareholders would have got absolutely nothing. Accordingly, the action was dismissed.\footnote{161}

In qualification to the above, the possibility must be considered that, insofar as they are of an essentially regulatory nature, the Bank's contractual activities will be open to potential judicial interventions on the basis of the same legal principles which apply to private bodies exercising de facto regulatory functions.

Notwithstanding the doctrine of freedom of contract, the courts can intervene, on grounds of public policy, in a limited number of private contractual ("domestic") relationships with essentially regulatory objectives, when this is necessary for the protection of certain vital interests of the parties and, especially, for the effective enjoyment of the "right" (or, more precisely, the liberty) to work. This may be the case if, in particular, a private licensing body possessing de facto monopoly powers over the admission to a profession, which it exercises by entering into contracts with applicants, unreasonably or unfairly refuses access to an applicant by declining to establish a contractual relationship with him. Despite the doctrine of privity, in order to protect the applicant's right to work, the courts can provide relief in the form of a declaration that the body's contractual policy is void as contrary to public policy or an injunction ordering the admission of the applicant and the grant of the licence.\footnote{162}

The circumstances that would justify judicial intervention, however, are narrow. At least as long as the applicant is not deprived of an existing position or of a legitimate expectation that he will succeed, the requirements of procedural fairness will impose on the licensing body merely an obligation to reach a honest and unbiased decision on the matter of admission. Substantively, a degree of protection will be provided by

\footnote{160}The English law gives relief to one who, without independent advice, enters into a contract upon terms which are very unfair or transfers property for a consideration which is grossly inadequate, when his bargaining power is grievously impaired by reason of his own needs or desires, or by his own ignorance or infirmity, coupled with undue influences or pressures brought to bear on him by or for the benefit of the other", \textit{Lloyds Bank Ltd v. Bundy} [1975] 1 Q.B. 326 (C.A.), p.339 per Lord Denning M.R.


the principle that this decision should not be taken in pursuance of a capricious policy. Accordingly, in cases where the contractual freedom of a de facto regulatory body clashes with the effective enjoyment of a potential counterparty's freedom to earn a livelihood, the courts will stand ready to review the substantive contractual policies of the body.

Furthermore, once a contractual relationship has been established between a de facto licensing body and an applicant, the exercise of regulatory and disciplinary functions by the body under the terms of their contract will be subject to a duty of fairness and reasonableness. This duty will arise either under the same principle of public policy that protects one's freedom to earn a livelihood or, possibly, from a broader duty of fairness owed by those responsible for making decisions relating to the administration of a "constitutive" or "relational" contract (i.e. a contract whose purpose is to establish an on-going governing structure for a long-term relationship between the parties by allocating decision-making responsibilities for the resolution of future disputes) and, more generally, by any party reserving unilateral discretionary powers under a contract. There is an evident affinity between this type of judicial intervention for the control of de facto regulatory bodies and the supervisory jurisdiction of the High Court, although this is only an exceptional jurisdiction, limited to the protection of vital interests, whose exact juridical nature remains uncertain.

\[\text{Mclnnes v. Onslow-Fane [1978] 1 W.L.R. 1520 (Ch.D.)}\]

\[\text{See, e.g., Weinberger v. Inglis [1919] A.C. 606 (H.L.), a case decided on the assumption that the Committee of the Stock Exchange, a voluntary association regulated by a deed of settlement, was under a duty not to act arbitrarily or capriciously with regard to the annual re-election of members. The duty of fairness and reasonableness may be construed as an implied term of the contract. Alternatively, it may be claimed that the rules of natural justice are applicable "to every tribunal or body of persons invested with authority to adjudicate upon matters involving civil consequences to individuals"; Wood v. Wood (1874) L.R. 9 Ex. 190 (C. of Ex.), p.196 per Kelly C.B.; statement approved in Ridge v. Baldwin [1964] A.C. 40 (H.L.), p.70 per Lord Reid. This would import in the area of discretionary powers reserved under the terms of a contract concepts and principles derived from the public law. See Daintith, "Regulation by contract...", loc.cit., n.148, p.55-59. In a recent case, Society of Lloyd's v. Clementson [1995] 1 C.M.L.R. (C.A.), where Lloyd's sought to recover monies paid out of its Central Fund from certain Names who had failed to discharge their liabilities. One of the defendants raised in his defence, inter alia, a claim that certain implicit terms should be read into the standard General Undertaking executed between himself and Lloyd's (whose purpose was to bind him as a Member of Lloyd's to the latter's self-regulatory rules), to the effect that Lloyd's should regulate and direct the business of insurance at Lloyd's in good faith, for the purposes set out in the Lloyd's Act 1911, s.4, and with reasonable care. The Court of Appeal rejected this argument, on the basis that the suggested terms were not strictly necessary to the efficacy of the contract; pp.699-700 per Sir Thomas Bingham M.R., pp.712-715 per Steyn L.J., and pp.715-716 per Hoffmann L.J. It could be the case, however, that the courts would be more willing to read implied terms in self-regulatory contracts which (unlike the Lloyd's system which operates on the basis of the Lloyd's Acts 1871-1982) are not underpinned by statute.}\]

\[\text{In Law v. National Greyhound Racing Club Ltd [1983] 1 W.L.R. 1302, the Court of Appeal, considering the issue of the appropriate type of procedure, held that the authority of the defendant}\]
The significance of these principles for the present discussion consists on the fact that they can affect the exercise by public authorities in the position of the Bank of \textit{de facto} regulatory powers under private contractual forms, even on the assumption that this is not amenable to judicial review in public law.\textsuperscript{166}

\textbf{(c) Competition law.} When exercising its power of the purse for a regulatory purpose, the Bank does not appear to be bound by the fundamental provisions of U.K. competition law that could conceivably impede other persons, including the trade associations of banks, from acting in similar manner.

Generally, agreements concluded by persons whose business consists in supplying services within the United Kingdom are subject to registration under the Restrictive Trade Practices Act 1976, if their effect is to restrain competition through the acceptance of restrictions on the pricing, the terms and form or manner of provision or the volume of supply or demand for such services or through the geographical or personal division of the relevant market.\textsuperscript{167} The High Court, on an application by the Director-General of Fair Trading, has jurisdiction to declare

\begin{thebibliography}{99}
\bibitem{1} company to act as a disciplinary body in the field of greyhound racing was derived wholly from contract and that, accordingly, the company was a domestic tribunal whose decisions were not public-law matters and, for this reason, not subject to judicial review. The corollary is that the judicial remedies in this context are available under the private law. However, in the light of the landmark decision in \textit{R. v. Panel on Take-overs and Mergers, ex p. Datafin plc.} [1987] 1 All.E.R. 564 (C.A.), according to which the supervisory jurisdiction of the High Court extends to the public functions of non-statutory ("domestic") bodies exercising \textit{de facto} powers of coercion, it appears that the decisions of private bodies which regulate entry to a profession or business can be within the realm of public law; see also \textit{R. v. Advertising Standards Authority Ltd, ex p. The Insurance Service plc.} [1990] C.O.D. 42 (D.C.). The classification may depend on the nature of regulated activity. E.g., regulatory bodies active in the field of sport will be considered "domestic" bodies, subject only to the requirements of private law (including those discussed above); see \textit{R. v. Disciplinary Committee of the Jockey Club, ex p. His Highness the Aga Khan} [1992] C.O.D. 51 (D.C.); \textit{The Times}, 9 Dec. 1992 (C.A.); and \textit{R. v. Football Association Ltd, ex p. Football League Ltd} [1992] C.O.D. 52 (Q.B.D.). On the other hand, a regulatory body active in the financial arena and operating through contractual forms will be subject to judicial supervision in public law; see \textit{Bank of Scotland, Petitioner} [1989] B.C.L.C. 700; \textit{R. v. F.I.M.B.R.A., ex p. Cochrane} [1991] B.C.L.C. 106; \textit{R. v. L.A.U.T.R.O., ex p. Ross} [1993] Q.B. 17; \textit{R. v. L.A.U.T.R.O., ex p. Kendall} [1994] C.O.D. 169.
\bibitem{2} On the question regarding what functions are sufficiently public or governmental to be subject to judicial review, see \textit{infra}, section 4.
\bibitem{3} Restrictive Trade Practices Act 1976, ss.1 and 11. However, restrictive agreements whose operation is important for the national economy can be exempted from registration by the Secretary of State for Trade; s.29. All types of services have been brought within the framework of restrictive-practices legislation by the Restrictive Trade Practices (Services) Order 1976, S.I. 1976/98 (as amended by the Transport Act 1985 and S.I. 1985/2044, 1986/2204 and 1989/1082) - although a limited number of restrictive agreements relating to the provision of services have been excluded from registration by virtue of art.3(1)(c) and the Sch. of the Order. The Order was made under s.111(2) of the Fair Trading Act 1973 but, following the repeal and replacement of the relevant provisions of that statute by the Restrictive Trade Practices Act 1976, is now in operation by virtue of Sch.4, para.1(1), of the latter. As a result, restrictive practices in this area can no longer be investigated under the anti-monopoly 1973 Act; Fair Trading Act 1973, ss.10(2) and 54(5) (as amended by the Restrictive Trade Practices Act 1976, s.44 and Schs.5-6).
\end{thebibliography}
whether or not the registered agreements contain restrictions on competition which are void as contrary to the public interest and to make orders for the purpose of impeding the parties to the agreements and their trade associations of giving effect to any void restrictions. The same rules apply to restrictive recommendations made by the trade associations of persons engaged in the supply of services to their members, as well as to agreements which, without imposing directly restrictions on competition, have an equivalent effect by conferring privileges or benefits only upon those parties who comply with restrictive conditions or by imposing obligations upon parties who do not. Failure to register a registrable agreement in violation of the 1976 Act renders the restrictions of competition contained in it automatically void and confers a cause of action to anybody harmed by their operation.

When the restraints on competition in the field of services are not imposed by a cartel of competitors, but are the de facto result of the activities of a single dominant party, the Competition Act 1980 applies. According to that Act, "a person engages in an anti-competitive practice if, in the course of a business, that person pursues a course of conduct which of itself or when taken together with a course of conduct pursued by persons associated with him, has or is intended to have or is likely to have the effect of restricting, distorting or preventing competition in connection with [...] the supply or securing of services in the United Kingdom or any part of it." The Director-General of Fair Trading has responsibility for the identification of anticompetitive practices of this type, whose effect upon the public interest can become the subject of investigation by the Monopolies and Mergers Commission.

All forms of financial regulation have either a direct or indirect constraining effect upon the types of competitive behaviour that are open to the actual and potential market participants. The corollary is that, depending on their sources and the form of their promulgation, the regulatory rules may amount to restrictive agreements or practices for the purposes of competition law. This will often be the case for rules having a private-law source and set out in contractual form. To the extent that they can be found to include restrictions on competition which operate against the public interest, these will be incompatible with the relevant competition provisions. Breaches could include, for instance, the enforcement by clubs of financial intermediaries exercising an effective control over access to a particular

---

169 S.16.
170 S.17.
171 S.35(1)-(2).
172 S.2(1). This definition is of general application, but the Secretary of State for Trade has the power to exclude from its ambit various categories of conduct, defined by reference to the size of the relevant business, the persons involved in the anticompetitive conduct or other "particular circumstances"; s.2(3)-(4). Certain exclusions have indeed been made under this power; Anti-Competitive Practices (Exclusions) Order 1980, S.I. 1980/979 (as amended by S.I. 1984/1919).
market of anticompetitive membership restrictions or conduct of business rules and standards of performance which cannot be objectively justified as essential from the standpoint of market organisation, as well as the discriminatory use of a self-regulatory structure for the generation of incidental benefits (e.g. the dissemination of inside information) which accrue exclusively to market incumbents. In this manner, the provisions of competition law can set very narrow limits to the ability of associations of financial intermediaries or of leading players in particular markets to engage in self-regulation.

As has been mentioned already, the chain of events leading to the collapse of the Stock Exchange's traditional self-regulatory arrangements was triggered precisely by a legal challenge under the provisions of competition legislation. To avoid unpredictable challenges that could upset the elaborate regulatory framework operating under its provisions, the F.S.A. exempts the rules and practices of the institutions of self-regulation in the securities field (i.e. the S.I.B. and the recognised S.R.O.s, investment exchanges and clearing houses) from the general provisions of competition law. On the other hand, to prevent situations where self-regulation results in practice to the restriction, distortion or prevention of competition beyond the measure that could be justifiable on grounds of investor protection (but not of other economic purposes, e.g. the standardisation or rationalisation of the relevant markets), the F.S.A. provides for an alternative mechanism of competition control. In particular, it imposes the obligation on the Treasury to abstain from delegating its regulatory responsibilities to a "designated agency" (e.g. to the S.I.B.) and from issuing, or allowing the designated agency to issue, an order for the recognition of an S.R.O., investment exchange or clearing house if it is not satisfied that the rules and practices of the body concerned are not intended or likely to have a significant anti-competitive effect, greater than what is necessary for the protection of investors.

---

173 See Butterworths Competition Law (P. Freeman and R. Whish, gen eds.), Div. IX, ch.4: A. Sutton and M. Brealey, "Financial Services and Competition Policy" (Issue 8, July 1993), paras.[1245]-[1268].
174 Supra, section 1(a).
175 F.S.A., ss.124-126 (as amended by the Companies Act 1989, s.206 and Sch.23, Pt.I, para.17).
176 Ss.119-23 (as amended by the Companies Act 1989, ss.153, 206, 212, Sch.20, para.26, Sch.23, Pt.I, para.14-16, Sch.24). See also Butterworths Competition Law, op.cit., n.173, paras.[1204]-[1268].
177 The responsibility for the operation of the F.S.A. belonged originally to the Secretary of State for Trade, but in 1992 it was transferred to the Treasury; Transfer of Functions (Financial Services) Order 1992, S.I. 1992/1315.
178 Ss.119-121. The Treasury can reach a decision on the matter only after the Director-General of Fair Trading has made a report on the possible anti-competitive effects of the rules, although it is not bound by the report; ss.122-123. The Director-General of Fair Trading has a continuing responsibility to monitor the rule-books of the self-regulatory institutions and advice the Treasury; s.122(6). His activities under the F.S.A. are summarised in his Annual Report.
The special competition rules of the F.S.A. apply only to the securities industry. In contrast, self-regulatory agreements between banks and the guidelines issued by the banking associations are subject to the general principles of competition law. Nonetheless, a special régime applies to agreements having a regulatory purpose to which the Bank is a party. Thus, any "agreement to which the Bank or the Treasury or both are parties and which relates exclusively to the exercise of control by the Bank of England or the Treasury or one of them, as the case may be, over financial institutions or over the monetary system generally, or to the conduct of markets in money, in public sector debt instruments or in foreign currencies" is exempted from the anti-cartel provisions of the Restrictive Trade Practices Act 1976.\textsuperscript{179} De facto behaviour which would otherwise amount to an anti-competitive practice for the purposes of the Competition Act 1980 is also permitted if it is "required or envisaged" by such an agreement.\textsuperscript{180}

By virtue of these exemptions, the Bank may initiate a broad number of agreements for the regulation of the banking system and for the organisation of the sterling, foreign-exchange and gilt-edged markets. Agreements whose purpose is not exclusively regulatory will not be covered. This may exclude transactions of a commercial nature, but the range of permissible agreements is not confined only to issues of prudential and monetary control. Thus, agreements regulating a broad variety of matters, including the conduct of business in the wholesale banking markets, the operation of clearing systems, the standardisation and rationalisation of particular markets, the rescue of ailing banking institutions, etc., will be valid despite their restrictive effects. The exemptions refer to agreements for the control of financial institutions generally, a term which does not cover only banks. It would appear from the context that the purpose of the exemptions is limited to agreements concerning institutions of a banking or monetary character, but this wording may suggest that agreements concerning other City institutions, active in the securities or insurance fields, are also exempt. The Bank can make use of the exemptions either by initiating itself agreements with the institutions concerned or by lending its name to restrictive self-regulatory arrangements put in place by the trade associations of these institutions. Significantly, there is no provision for a mechanism of external review for the prevention of anti-competitive restrictions which are unjustifiable or disproportionate, as in the case of the rule-books of self-regulatory bodies in the securities area.

The broader conduct of the Bank is not covered by the exemptions. In this regard, the Bank may not be completely protected from the provisions of

\textsuperscript{179} Restrictive Trade Practices (Services) Order 1976, S.I. 1976/98, art.3(1)(c) and Sch., para.6.
\textsuperscript{180} Anti-Competitive Practices (Exclusions) Order 1980, S.I. 1980/979 (as amended by S.I. 1984/1919), art.2(1) and Sch.1, para.6
competition law. In particular, the Competition Act 1980 enables the Secretary of State for Trade to refer corporate public bodies such as the Bank\textsuperscript{181} to the Monopolies and Mergers Commission for the investigation of the efficiency of their operations and the possible abuse of monopoly situations.\textsuperscript{182} It also empowers the Secretary to take action for the implementation of the Commission's recommendations.\textsuperscript{183} Nonetheless, from a practical point of view, it seems unlikely that the Bank could become the subject of a monopoly investigation.

The potential anti-competitive effects of the Bank's \textit{de facto} regulatory activities may be treated differently in domestic and Community law. The Treaty of Rome contains strict provisions for the protection of competition within the Common Market. Under these provisions, agreements between undertakings whose object or effect is the prevention, restriction or distortion of competition are prohibited,\textsuperscript{184} although certain restrictive agreements, decisions of trade associations and concerted practices which contribute to the improvement of technical or economic efficiency may be given exemption following their notification to the Commission, provided that the restrictions that they impose are indispensable for this purpose and are not such as to completely eliminate competition in the relevant market.\textsuperscript{185} A similar prohibition applies to the abuse of a dominant position by undertakings, whether acting alone or in combination, if the trade between Member States is affected.\textsuperscript{186}

The Treaty's provisions on competition are applicable to the banking industry on the same basis as to other sectors.\textsuperscript{187} Numerous agreements between banks and guidelines issued by banking associations have been investigated by the Commission with a view to establishing whether they violate Community law or not. In general, agreements establishing uniform charges for services provided to bank clients have been considered to be prohibited agreements. Nonetheless, certain collective agreements imposing uniform charges or terms of operation in connection to the

\textsuperscript{181} The Secretary can refer "any body corporate - (i) which supplies goods or services by way of business, (ii) the affairs of which are managed by its members, and (iii) the members of which hold office as such by virtue of their appointment to that or another office by a Minister under any enactment"; s.11(3)(a).

\textsuperscript{182} S.11(1).

\textsuperscript{183} S.12.

\textsuperscript{184} Art.85(1)-(2).

\textsuperscript{185} Art.85(3).

\textsuperscript{186} Art.86.

interbank transfer of funds, collection of cheques or clearing arrangements have been either cleared as not having any appreciable effect on competition or exempted from the prohibition on anti-competitive agreements despite their restrictive effects, on the ground that, by avoiding the need for separate bilateral agreements with regard to the services in question between all the banks concerned, they contributed to the standardisation and rationalisation of the market and the more efficient production of banking services, without however eliminating competition altogether (since they allowed banks to determine whether to pass the relevant costs to their consumers or not).  

In view of the importance and volume of the U.K. money and gilt-edged markets, the de facto regulatory activities carried on by the Bank by means of relying on its dominant position in these markets are not merely of domestic significance, but arguably affect the trade in banking services between the Member States. Accordingly, the question arises whether these activities can be regarded as potentially in breach of Treaty obligations.

Since the Bank engages in commercial transactions in the wholesale markets, and even in retail banking activities, it can be regarded as an "undertaking" and as such must comply with the Treaty competition rules. The fact that it is a publicly owned (as distinct from private) undertaking does not automatically bring it outside the scope of these rules. Admittedly, as an undertaking "entrusted with the operation of services of general economic interest", the Bank may be subject to these rules only to the extent that their application "does not obstruct the performance, in law or in fact, of the particular tasks assigned to [it]". Any restrictions imposed on competition, however, must be strictly necessary for the attainment of this purpose.

Moreover, while Article 2(4) of the Investment Services Directive purports to confirm the right of the governments and central banks of the Member States to freely choose their counterparties when entering into contracts "in the pursuit of [their] monetary, exchange-rate, public debt and reserves management policies", this right must be exercised "on the basis of objective, non-discriminatory criteria", as is

---


189 Art.90(1).

190 Art.90(2).

explicitly recognised in the 25th recital of the Directive's Preamble. In addition, it is clear that, in potential cases of conflict, the Treaty's provisions on competition prevail over the Article in question.

The regulatory nature of the Bank's *de facto* activities should not make a difference to the applicability of the competition rules. It is true that the Treaty's competition rules do not apply to legislative or regulatory measures emanating from the Member States, but this should not cover decisions taken by the Bank in its private capacity as an undertaking which engages in market activities.

In general, "private" regulatory arrangements which result in restrictions on competition (e.g. by making affiliation to certain professional organisations a condition of entry to a particular market) are incompatible with Community law, notwithstanding the tacit support that they may receive from the monetary authorities. In the Sarabex case, the London branch of a foreign money-broker was precluded from trading in the main currencies in the London foreign-exchange market as a result of certain self-regulatory arrangements agreed between the British Bankers Association ("B.B.A.") and the Foreign Exchange and Currency Deposit Brokers Association ("F.E.C.D.B.A.") under the auspices and at the request of the Bank. Under these arrangements, British banks were prohibited from employing the services of non-F.E.C.D.B.A. members, while the later charged fixed commission rates which were considerably higher than those prevailing in Frankfurt, Paris or Zürich. In addition, applications for membership the F.E.C.D.B.A. required the sponsorship of at least six banks. However, the banks could never gain sufficient experience of an applicant upon which to base their sponsorship, because they were prevented from using his services before he became a member. This created an effective barrier to entry. The money-broker complained to the Commission, which brought the matter to the attention of the Bank. The latter, acting on behalf of the Treasury, which was the appropriate authority, responded by introduced a new system, under which broking houses wishing to be admitted to the foreign-exchange markets had to be formally "recognised" by the Bank and subject to its control. In case of refusal of recognition, a right of appeal to the Chairman of the Appeals

---

192 See Case C-2/91 Meng [1993] E.C.R. I-5751 (E.C.J.); Case C-245/91 Ohra Schadeverzekeringen N.V. [1993] E.C.R. I-5851 (E.C.J.). However, the provisions of Arts.85-86 in conjunction with Art.5 preclude the Member States from adopting measures, even of a legislative nature, which encourage or reinforce anticompetitive agreements or from depriving their own legislation of its official character by delegating to private undertakings responsibility for taking decisions affecting the organisation of the market; Case 267/86, P. van Eycke v. ASPA N.V. [1988] E.C.R. 4769 (E.C.J.). Thus, the delegation by the Bank to the U.K. banking associations of responsibility for the making of restrictive conduct-of-business rules or the provision of assistance in the enforcement of such rules, would constitute a breach of Community obligations. On the limits on the power of Member States to take measures that restrict competition between banks, see Dassesse, Isaacs and Penn, *op.cit.*, n.187, pp.313-315.

Committee of the City Panel on Take-overs and Mergers was given. Although membership of the F.E.C.D.B.A. remained a requirement, it was subjected to objective criteria. The structure of commission rates was also liberalised. In the Commission's opinion, the case should underline the principle that "there [should be] no confusion between marker regulation by the authorities and regulation by the market participants themselves, whether by way of an agreement or through an association. In the latter case, any action taken by enterprises to restrict competition which may affect interstate trade would come within the scope of the competition rules of the E.E.C. Treaty".  

In this respect, the "private" decisions of the Bank should be treated in the same manner as the decisions of large banks or banking associations occupying de facto or de jure a dominant position in any segment of the financial sector. Therefore, unless the Bank can point to a particular rule of U.K. law which sanctions expressly or by implication any restrictive or distortive effect, its de facto regulatory activities should not be exempted from the prohibitions on anticompetitive forms of behaviour.

Significantly, one way in which an undertaking can abuse a dominant position is by "making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts". Conceivably, the insistence by the Bank on the observance of requirements of a regulatory nature as a necessary condition for the establishment of contractual links with specific counterparties could be included here, since such requirements are not necessarily linked to the trading purpose of the wholesale transactions. In similar fashion, a claim could be made that the preferential treatment by the Bank of its wholesale-market counterparties, e.g. by means of the provision of liquidity support and the favourable treatment of their liabilities, amounts to a prohibited agreement or practice which has the effect of distorting competition. In short, it is at least arguable that, insofar as the relevant arrangements cannot be justified under the Treaty as being inherently linked to the pursuance by the U.K. of its monetary-policy objectives, they could amount to prohibited restrictive agreements for the purposes of the Community competition law. If this were the case, the fact that the relevant restrictions might be objectively justified on grounds of prudential necessity,
technical standardisation or economic justification would not protect them, unless they were notified to the Commission and received a specific exemption.¹⁹⁸

For these reasons, in principle Community law may present, with regard to the exercise by the Bank of its de facto regulatory functions, a legal barrier which is absent in domestic law. It is difficult to say, however, whether this is a significant practical prospect or merely a theoretical possibility.

Community law may have a more immediate role to play in the context of bank rescue operations. The banking sector is not exempted from the restrictions on state aids to industry of Article 92 of the Treaty of Rome. This can set strict limits on the Bank's ability to provide outright support to failed banks, by taking over their bad assets or indemnifying them for losses.

The announcement on 17 March 1995 by the French government of its decision to bail out one of world's largest banks, the state-controlled Crédit Lyonnais, caused the Commission to address directly the issue of bank rescues for the first time. Following strong complaints by the bank's two largest private-sector competitors, Société Générale and Banque Nationale de Paris, who claimed that the planned rescue would gravely damage competition, the Commission launched an inquiry into the affair - possibly Europe's biggest state aid case ever.

In its final decision on the matter, the Commission concluded that the provision by the state of financial support to banks facing financial difficulties for the purpose of helping them to restore their solvency may indeed amount to state aid within the meaning of Article 92.¹⁹⁹ When the banking sector participates to a financially significant degree in a bank rescue on a non-obligatory basis, it may be assumed that no state aid is involved. If, on the other hand, the state provides all or most of the support, the Commission must evaluate the intervention, so as to establish whether it constitutes a prohibited aid to industry. The Commission must apply the "principle of the private investor in a market economy", i.e. it must assess whether a comparable private investor, acting under the normal conditions of a market economy, would have undertaken a similar operation.

In the event of a systemic crisis, affecting the total banking system and attributable to reasons outside the control of banking institutions, the state could justifiably provide support to the banking sector as a whole, but only insofar as this is necessary to restore the normal operation of the market. In principle, the difficulties of individual banks, especially when they are attributable to internal reasons, should not raise similar issues of systemic safety. Nonetheless, in certain cases the failure of a single large bank may put in jeopardy the survival of other

¹⁹⁸ Art.85(3).
¹⁹⁹ Décision de la Commission du 26 juillet 1995 portant approbation conditionnée de l'aide accordée par la France à la banque Crédit Lyonnais, pp.6-14.
banks, which are financially exposed or linked to the first bank. In this situation, state support may be justified, provided that: (i) it can restore the bank's financial soundness in reasonable time; (ii) it is proportional to the costs and benefits of the restructuring and does not go beyond what is strictly necessary; (iii) it causes the least possible distortions to competition and it places a significant part of the costs to the bank itself; and (iv) it is accompanied by countervailing measures, aimed at compensating to any extent possible for the anticompetitive consequences.

In the case of Crédit Lyonnais, the rescue contained important elements of state aid, with a potential cost to the state of FFr 45 billion. An aid of such magnitude could have significant anticompetitive effects for the banking sector. Moreover, the bank's difficulties were the result of its own aggressive and ill-thought commercial policies. Nonetheless, the Commission exercised its discretion to exempt the rescue from the prohibition of Article 92(1). As the price for its consent, the Commission imposed strict conditions, setting limits to the bank's future ability to expand its activities or its branch network. In particular, Crédit Lyonnais is required to reduce to a substantial degree its commercial presence in Europe and elsewhere, to contribute to the costs of the rescue once its financial health is restored, to keep strictly separate from the "bad bank" set up to take over its worst assets, and to be privatised within five years. However, much of the detailed conditions remain confidential, and there are some doubts regarding the real stringency of the conditions. More ominously, the decision effectively recognises the "too big to fail" doctrine as part of European competition policy, thus entrenching an important source of moral hazard.200

4. Reviewability of de facto regulatory activities in public law

By relying on its private legal capacity and the forms of private law, the Bank manages to underpin its regulatory authority in areas which Parliament has left unregulated. At the same time, it remains free from the procedural restraints which it must observe when it carries on formal public functions and which aim at the protection of the parties concerned. This seems unjustifiable.

The traditional doctrine which accepts that, "[l]ike public figures, at least in theory, public bodies are entitled to have a private life",201 which includes their activities with regard to their property and contracts and as to which public law should remain silent, misrepresents the nature of these bodies and of their legitimate

objectives. Of course, there is no doubt as to the constitutional capacity of governmental entities to pursue informally their policies by means of their *dominium*. On the other hand, it should always be remembered that these entities do not have an independent life, will or purpose. Their resources belong to the public, while their policy objectives are either those mandated by the political process or those of the individuals who manage them. Insofar as the "private" activities of public bodies relate to the implementation of legislative policies, they can only be legitimately undertaken for the purposes authorised by Parliament. In other cases, the employment by public authorities of their private resources for the furtherance of policies which do not relate to a legislative framework raises serious concerns, because it opens the way for the "privatisation" of public action and its subjection to the non-transparent agendas of the executive decision-makers. This danger is much stronger in connection to the Bank, a public body run by bureaucrats lacking political legitimation, than to departments of state, in charge of which are politically accountable ministers.

A different objection to the unfettered freedom of action of governmental authorities in a "private" capacity relates to the protection of the subject. Legally, any person subject to a public body's moral or financial leverage is free to resist the pressure and refuse to conform with that body's policy. In practice, however, in many cases the public body's position will be dominant and the force of its *dominium*, overwhelming. Much will depend on the concrete context, but the informality and lack of transparency that characterise the power of the purse can open the way to abuses in the implementation of policy, especially in terms of the uneven and discriminatory treatment of those to which a particular policy is directed.

The subjection of the activities of public bodies to judicial review cannot compensate fully for the lack of formal procedural or substantive guarantees. Nonetheless, it can ensure in all cases that certain minimum standards of good administration are respected. By insisting on the fairness and reasonableness of the manner in which public bodies carry out their functions, judicial review enforces a conception of "due process" and provides an opportunity for the protection of interests that might otherwise fail to be heard and considered. In addition, by

---


203 In this sense, it can be fairly claimed that "under our constitution, the need for legislative approval of policy has been not only an expression of the rule of law but also, and no less importantly, a reflection of our concepts of parliamentary democracy"; Daintith, "The functions of law...", *loc.cit.*, n.124, p.78.

204 See Daintith, "The executive power...", *loc.cit.*, n.139, pp.209-213.
scrutinising the purposes that animate public action, it increases the overall coherence of public decision-making.

When de facto powers are concerned, the "private" legal forms employed for their exercise create primarily difficulties in terms of reviewability, although they can also affect the grounds for review. The classification of certain governmental capacities as "private" can preclude judicial review. In recent years the readiness of the courts to assert their supervisory jurisdiction with regard to the exercise of non-statutory powers has increased dramatically,\textsuperscript{205} but the point where all the decision-making of public authorities, including their contractual and property-related decisions, would be automatically subject to review has not yet been reached.\textsuperscript{206} The development of the law in this field is piecemeal, and in certain respects inconsistent, justifying to a large extent Dawn Oliver's view that there is an "absence of workable concepts and of a framework of theory about the nature of power, whether public or private, upon which to build the supervisory jurisdictions of the courts".\textsuperscript{207} The expansion of jurisdiction has been accompanied by judicial insistence on two central but ill-defined ideas: (i) that the existence of a "public element" is an essential factor that attracts the supervisory jurisdiction; and (ii) that authority derived solely from contract, \textit{i.e.} from the agreement of the parties, is not amenable to judicial review.\textsuperscript{208} However, these concepts cannot always provide clear criteria for distinguishing

205 In a landmark case, \textit{R. v. Criminal Injuries Compensation Board, ex p. Lain} [1967] 2 Q.B. 864 (C.A.), it was held that the Board, which operated a scheme of \textit{ex gratia} payments promulgated under "prerogative" powers (in the wide sense of the word), came under the supervisory jurisdiction of the High Court as being a body of a public (as opposed to purely private or domestic) character, which had the power to determine matters affecting subjects and was under the duty to act judicially. The formal source of the body's power, \textit{i.e.} the fact that it was not set up by statute but under the prerogative, was no bar to jurisdiction; see pp.881-882 \textit{per} Lord Parker C.J. and p.884 \textit{per} Diplock L.J. On the other hand, "[p]rivate or domestic tribunals have always been outside the scope of [review] since their authority is derived solely from contract, that is, from the agreement of the parties concerned"; p.882. This view was substantially adopted by the House of Lords in \textit{Council of Civil Service Unions v. Minister for the Civil Service} [1985] 1 A.C. 374. The effect of these decisions has been to expand reviewability to the exercise of the Crown's "prerogative" in a wide sense, which covers the non-statutory functions of public bodies with the exception of contractual ones. It is not easy to explain why, while other capacities (\textit{e.g.} that to make gratuities) which belong to the Crown as to any private person are classified judicially as prerogative and their exercise is reviewable, but the power to enter into contracts is generally excluded. On the judicial understanding of prerogative, see C. Lewis, \textit{Judicial Remedies in Public Law} (1992), pp.13-15.

206 See the systematic analysis of the issue by Lewis, \textit{ibid.}, ch.2; also, D. Oliver, "Is the \textit{ultra vires} rule the basis of judicial review?" [1987] \textit{P.L.} 543; S. Arrowsmith, "Judicial review and the contractual powers of public authorities" (1990) 106 \textit{L.Q.R.} 277; Harris, \textit{loc.cit.}, n.138. The discussion of the public/private distinction in this context concerns the reviewability of the actions of public authorities \textit{per se}, rather than the question regarding the appropriate form of proceedings for each type of case.

207 Oliver, \textit{ibid.}, p.568.

between reviewable decisions in the public domain, on the one hand, and non-reviewable decisions of "domestic tribunals", on the other. In the case of the Bank, this means that it is not self-evident whether its de facto regulatory activities are reviewable or not. A number of factors may play a role in the classification.

Accordingly, the "public element" which is necessary for reviewability is not present merely by reason of the Bank's public status as an administrative body or of its form of incorporation. Instead, the nature of the particular functions carried out is far more important in this connection.

On the other hand, the existence of a public element is not excluded merely because a function is exercised in a contractual form. In certain cases, the authority of the Bank may not be derived solely from contract, since its ultimate basis may be found in a specific statutory provision. For instance, its ability to attach regulatory conditions to certain contractual relationships may be attributable to its functions in connection under section 43 of the F.S.A. If so, the relationships may not be purely "domestic". However, the presence of a statutory basis will not necessarily inject by itself a public element sufficiently strong to attract the supervisory jurisdiction of the courts. In this sense, the requirement of a public element may not only serve to expand but also to exclude reviewability. In practice, it is often an unpredictable matter of judicial policy whether, in the circumstances of each particular case, weight will be given to the statutory basis of a public body's power or to its allegedly

---

209 See R. v. Royal Life Saving Society, ex p. Heather Rose Mary Howe [1990] C.O.D. 440 (C.A.), where it was held that reliance on the respondent society's incorporation by Royal Charter carried very little weight.

210 This distinguishes the scope of judicial review from that of the tort of misfeasance in public office. While an additional "public element" must exist before the actions of persons holding a public office can be amenable to review, even the purely "private" contractual activities of public authorities, if carried out maliciously, would constitute misfeasance; Jones v. Swansea City Council [1990] 1 W.L.R. 54 (C.A.). With regard to misfeasance, "[i]t is not the nature or origin of the power which matters. Whatever its nature or origin, the power may be exercised only for the public good. It is the office on which everything depends"; p.85 per Nourse L.J. It is conceivable that the same rationale could be transplanted to the question of reviewability with beneficial results.

211 For instance, those public bodies which have been created by statute are confined only to those powers which are authorised expressly or impliedly by their parent Act; Bromley London Borough Council v. Greater London Council [1983] 1 A.C. 768 (H.L.), pp.813-814 per Lord Wilberforce; Hazell v. Hammersmith and Fulham London Borough Council [1991] 1 All E.R. 545 (H.L.). Since such bodies can do nothing without authorisation, it should follow that all their activities (including their contractual ones) may be reviewed by the courts as a matter of public law on grounds of vires. It is clear from the case-law, however, that even they may act in a private capacity in certain matters which do not involve a "public element" (e.g. in employing or dismissing staff), in which case their activities may not be reviewable. See, e.g., R. v. East Berkshire Health Authority, ex p. Walsh [1985] 1 Q.B. 152 (C.A.); cf. Roy v. Kensington and Chelsea and Westminster Family Practitioner Committee [1992] 1 A.C. 624 (H.L.). See also Lewis, op.cit., n.205, pp.9-13; and Woolf, loc.cit., n.201, pp.222-224, where the example of "the local authority [that] cuts down [a] hedge without permission" is provided, p.223.
"private" nature. To the extent that particular functions of the Bank are not
corroined or underpinned by statute, the crucial distinction between decisions of a
public and those of a private character may similarly depend more on pragmatic
considerations than on established principle.

Some attempts towards the clarification of the issue can be found in the case-
law. In particular, in Massingberd-Mundy, the Divisional Court thought that the
question whether the decisions of a particular body were in the public domain, and
thus subject to judicial review, could not be answered on the basis of a single test. In
many cases the source of the relevant power in statute law or the prerogative would
be sufficient, but in others the nature of the body's functions would be decisive.
Accordingly, the exercise of monopolistic powers in fields of general public interest
or where many persons earned a livelihood could amount to the public element
necessary to attract the supervisory jurisdiction of the High Court. This would
bring within the scope of public law virtually any body exercising a de facto power
over entry to a profession or business, including the Bank insofar as its selection of
counterparties is concerned.

---

(Q.B.D.), it was held that, notwithstanding the Board's statutory powers and duties which it
exercised in its capacity as a public body, its decision to close a colliery was an executive act
undertaken in a "managerial" capacity and, as such, not in the field of public law. However, in a
(D.C.), the court declined to follow National Union of Mineworkers on the basis that it "had
probably been wrongly decided" and went on to quash the decisions of the Secretary and by
British Coal to close several collieries.

213 It must be noted that what is lacking, is not merely a coherent concept of the public element, but
even an explicit theory of what constitutes a "decision". The rationalisation of the concepts
of public law through the entrenchment of workable definitions of what is a "public relationship",
on the one hand, and what is a "decision", "determination" or "act of administration", on the
other, are necessary for certainty in the law.


215 The ambiguity of these criteria is testified by the fact that their particular application to the
Jockey Club in Massingberd-Mundy has been substantially rejected by the Court of Appeal in R.
v. Disciplinary Committee of the Jockey Club, ex p. His Highness the Aga Khan, The Times, 9
Dec. 1992 (C.A.), where it was decided that the Jockey Club is a domestic body, whose functions
are "in no sense governmental"; see also R. v. Football Association Ltd, ex p. Football League
possibility that parties aggrieved by the decisions of the Jockey Club but having no contract on
which to rely might be allowed, in the absence of alternative remedies, to seek judicial review.
However, the relevant part of the judgement must be approached with caution as inconsistent
with the finding that the Jockey Club does not, in any event, carry out public functions, because,
if reviewability depends to the existence of a public element, the availability of a remedy in
contract cannot be a relevant criterion. See R. Gordon and C. Barlow, "Falling at the last fence"
(1993) 143 N.L.J. 158, p.159. Furthermore, the Master of the Rolls appeared to include in his
class of non-contractual (and potentially reviewable) cases those concerning the precontractual
behaviour of a domestic monopolistic or regulatory body, e.g. cases in which applicants had been
refused a contractual relationship with the body. However, a private action could be available in

379
A more restrictive test has been adopted in other cases, most notably in the decision of the Court of Appeal in *Aga Khan*. From these cases, it appears that the exercise by a body of virtually monopolistic powers or the making of decisions which are important to many members of the public will not be enough, because the public character of a decision must be determined by its intrinsically governmental nature and not by the seriousness of its practical consequences. On this interpretation, the effect of *Datafin* has been to extend reviewability to bodies which, although not constituted by an exercise of governmental power, have been woven into the fabric of public regulation. A sign (i) that a body is underpinned directly or indirectly by the organs of the state, (ii) that there is potential governmental interest in its activities, or (iii) that, if it did not exist, the state would intervene to create another body with similar functions, could be decisive in indicating that its functions are in the public field. The self-regulatory organisations which operate in the area of financial services are a case in point. Although the links binding them to their members are contractual, they perform administrative functions as an integral part of the regulatory régime set up by the F.S.A., for which reason their decisions are amenable to judicial review. The *de facto* regulatory functions of the Bank do not form part of a structure recognised by statute. Nonetheless, they could be fairly regarded as "governmental functions" in the particular sense described here, since they belong to a broader matrix of financial regulation which, failing other ways of implementation, the state would probably pursue on a statutory basis. Accordingly, if this approach to the question of the public character of particular functions is valid, their pursuance under contractual forms should not preclude reviewability.

Even if the Bank's decisions in this area are, in principle, sufficiently "public" to be reviewable, from a practical standpoint the residual problem is that the grounds

---


for review may be strictly circumscribed. The effectiveness of any challenge to the Bank's informal extrastatutory decisions will be curtailed by the lack of a clear statutory standard of legality. As B.V. Harris rightly observes, in all cases of review of informal governmental actions,

"[t]he absence of statutory authorisation will affect the courts' use of grounds such as improper purpose, the failure to take into account relevant considerations, the taking into account of irrelevant considerations, and Wednesbury unreasonableness. Even the procedure required in order to satisfy procedural propriety, or the principles of fairness, will be more difficult to ascertain because of the absence of the statutory authorisation."219

The problems in this case are similar in nature to those arising from broad and ill-defined, if not altogether meaningless, statutory standards, but more acute.220

In the case of the Bank, the review of extrastatutory activities can conceivably be confined to clear cases of abuse of power or of breach of the rules of natural justice only.221 For instance, the Bank could be prevented from "blackballing" certain institutions and excluding them from its contractual relationships for reasons of vindictiveness, from discriminating against them on the basis of the origin or attitudes of its owners, etc.222 Beyond these matters, the Bank could be left free to set and apply its preferred regulatory goals and standards.223 This, however, would once more raise important constitutional concerns regarding the legitimacy of leaving to the Bank, an unaccountable bureaucratic body, the responsibility of being the sole arbiter of the objectives to be pursued by means of its de facto powers.

221 It must be remembered that, when the potential effective enjoyment of the right to earn a livelihood is threatened, as may sometimes prove to be the case with "blackballing", the courts might be ready to intervene on these grounds even in private law; see Nagle v. Feilden [1966] 2 Q.B. 633 (C.A.); and supra, section 3(b).
Chapter 5

The Question of Liability for Regulatory Decisions

As indicated in the previous chapters, mainly because of the absence of precise and transparent regulatory standards and the retention by the Bank of wide discretion regarding the concrete application of its general regulatory policies to the circumstances of individual institutions, the existing mechanisms of administrative review provide only limited opportunities for the redress of grievances arising from the regulatory activities of the Bank of England. This raises the question whether compensatory remedies could provide a more appropriate and effective form of redress.

This chapter explores the possibility of holding the Bank liable for damages attributable to its failure to perform successfully its regulatory functions. Two main types of potential claims can be identified: on the one hand, those by regulated persons alleging that their financial position, reputation or ability to engage in professional activities in the financial sector have been negatively affected by acts or omissions of the Bank relating to them; and on the other, those by depositors or other creditors of insolvent banks alleging that their losses would have been prevented if the Bank had exercised timely and effectively its supervisory responsibilities or powers of intervention. It will be shown that, both in common law and under the Banking Act, the possibility of recovery on these grounds is restricted.

Under English law, compensation is not available for hardship resulting from legally authorised actions of the administrative authorities, nor is there a special system of liability for public bodies. In principle, the liability of public authorities is governed by the ordinary rules of private law that also apply to the affairs of private citizens. The authorities are liable on this basis for torts such as trespass to the

\[1\] The idea that public authorities should be subject to the ordinary law of the land as administered by the ordinary courts of justice, and not to a special régime of liability for public authorities only, has been elevated by its proponents to the status of a "constitutional principle". Behind it lies the belief that the development of a special system would entail in practice unduly expansive immunities and exemptions for the authorities and limited protection for the subject. See A.V. Dicey, Introduction to the Study of the Law of the Constitution (8th ed., 1915), ch. 4. The
person, negligent interference with property, trespass to goods or personal injury both directly, for example in their capacity as occupiers or employers, and also vicariously for the actions of their servants and agents, who legally bear the primary responsibility for any torts committed by them but who in practice do not actually contribute to the compensation of successful plaintiffs. However, the application of the private law is subject to many qualifications when the exercise of specifically administrative powers is involved. Certain special liability rules apply most commonly, or even exclusively, to the administrative activities of public authorities (e.g. the defence of statutory immunity in nuisance, the tort of misfeasance in public office, or the rule against fettering of discretion by contract). The distinction between public and private matters can also have significant procedural implications. Finally, there is special governmental liability for breaches of European Community law. All these special considerations play an important role in determining the practical scope of governmental liability.

Concerning the Bank's regulatory functions, the Banking Act constrains the operation of the law of torts by providing a statutory immunity from liability in damages, which does not however exclude entirely the possibility of claims, especially for intentional torts (section 1). Nonetheless, it would be a mistake to assume that the statutory immunity is the only barrier to recovery in the event of regulatory failure. In fact, even without an express immunity, considerations of legal principle unrelated to the specific statutory framework and affecting a broad spectrum of regulatory activities would probably lead to similar results. As will be explained in greater detail in the following pages, in its present state the common law is very reluctant to impose liability for the non-intentional negative effects of regulatory actions (section 2). For this reason, in the context of the Bank's regulatory activities the potential remedial value of the law of torts is confined mainly to cases of intentional wrongdoing by its officials, where damages may be recoverable under the heading of misfeasance in public office or for a range of other intentional torts (section 3). In comparison, a more liberal régime of governmental liability prevails in Community law. Thus, breaches by the national authorities of the procedural immunity of the Crown by the Crown Proceedings Act 1947, s.2(2), removed the most important limitation on the operation of this principle. The domestic situation, however, must be contrasted with that of governmental liability for breaches of E.C. law.

2 Powers belonging to their imperium; see supra, ch.4, section 3(a).
rights that the citizens derive under Community law can give rise to liability, conceivably even in situations where the breaches were not the result of the authorities' fault. Since the field of banking regulation is becoming increasingly harmonised, it is possible that in the future the decisions and omissions of the Bank will frequently have to be considered from the perspective of this heading of strict liability (section 4).

In relation to discussions regarding the Bank's civil liability, it must be remembered that, insofar as depositors are concerned, a degree of protection is provided by the Deposit Protections Scheme. Under this statutory scheme, depositors are partially compensated for losses incurred as a result of an authorised institution's collapse. To the extent that these losses could be attributed not only to the conduct of that institution's business, but also to supervisory inadequacies, the Deposit Protection Scheme could be regarded as an alternative system of non-fault, insurance-like compensation for regulatory failures, whose effect should be taken into account when proposals are made for the expansion of the Bank's liability to depositors (section 5).

From a prescriptive point of view, it is doubtful whether a relaxation of the rules of liability to facilitate private actions for regulatory failures would be warranted, especially since such a development would not necessarily result in more effective public control over the direction of regulatory policy. On the contrary, a good case could be made on policy grounds for the total exclusion of tort actions from the range of remedies for wrongful regulatory action, with the exception of direct personal liability of officials who have committed an oppressive intentional tort (section 6).

1. Statutory immunity from liability

As will be seen in the following sections, the common law erects very significant barriers to actions in tort relating to the exercise of discretionary public powers - barriers which have become almost insurmountable in recent years. Nevertheless, impressed by the need to protect the Bank from actions which could inundate and paralyse the regulatory process and might even result in very considerable expenditure of public funds, Parliament has not left the issue of liability for the defective performance of regulatory functions open for judicial determination. Where the original Banking Act of 1979 did not contain special rules of regulatory liability,
the legislative overhaul of 1987 bestowed on the Bank a wide immunity from liability.\(^5\) Thus, section 1(4) of the Banking Act 1987 provides that

"[n]either the Bank nor any person who is a member of its Court of Directors or who is, or is acting as, an officer or servant of the Bank shall be liable in damages for anything done or omitted in the discharge or purported discharge of the functions of the Bank under this Act unless it is shown that the act or omission was in bad faith".

However, regulatory activities which are outside the Banking Act are not covered by the immunity.\(^6\)

The new provision must not be seen in isolation, as similar protection is conferred on almost identical terms upon other financial regulators under the Financial Services Act 1986 ("F.S.A.").\(^7\) This indicates a broader pattern in recent economic regulation, which arises from the firm legislative judgement that, in this context, the emergence of liability in damages would be detrimental to the effective exercise of the regulatory functions. The main explanation for the statutory immunity is that regulators must be able to approach their supervisory functions uninhibited from the threat of liability and to show independence and confidence in carrying them out.\(^8\) In addition to the untoward effects of the threat of liability on the psychological outlook of regulators, however, other considerations are also relevant in this context, relating in particular to the diversion of the regulatory resources to meet the burdens of litigation and to the potentially explosive effect of recovery by successful claimants on the costs of running the regulatory system.

The immunity does not apply to cases of bad faith. The ordinary meaning of the term suggests deliberate wrongdoing or dishonesty. An alternative reading could be

\(^5\) Ss. 1(4). The immunity also extends to acts or omissions of the members of the Board of Banking Supervision; s.2(7).

\(^6\) The main issue in this regard will concern the reviewability of the Bank’s decisions as to the exercise of its contractual powers, rather than issues of liability. See supra, ch.4.

\(^7\) S.187. The practical effect of the regulatory immunity is much more important in the case of the Self-Regulatory Organisations ("S.R.O.s") of the F.S.A., because the potential grounds of liability are different in their case. Thus, without the statutory immunity, these S.R.O.s would be potentially liable under the relational contracts that bind them to their members. This could be a significant source of liability, especially if an implicit contractual obligation to administer fairly their long-term relationship with these members were imposed on the S.R.O.s. On the other hand, the potential threat of causes of action in contract is not an issue under the Banking Act, because the Bank is not bound by contract to the regulated deposit-takers and its decisions could give rise only to tortious liability. This difference seems to have gone unnoticed during the enactment of the provision relating to the Bank’s immunity.

\(^8\) See A. Arora, "Banking Act 1987" (1988) 9 Co.Law. 8 (pt.1), p.8; and, on the identical rationale of F.S.A., s.187, H. McLean, "Negligent regulatory authorities and the duty of care" (1988) 8 O.J.L.S. 442, p.450. During the Banking Act's passage through the House of Lords, Lord Beaverbrook noted that the immunity was granted with the purpose "that the supervisors can act positively in the interests of depositors without being unduly constrained by threat of legal action"; H.L. vol.485, col.1220.
derived from the field of administrative law, where "bad faith" is used occasionally to describe an exercise of power on the basis of considerations, however benevolent or innocent, which do not reflect the true purposes for which the power was given. The use of the term in this manner would lead to the conclusion that, while the persons benefiting from the immunity will be protected from liability "for any act or omission committed or arising in the discharge of their duties", no protection will be available "where [they] have acted outside their powers or in bad faith". This interpretation of the statutory immunity cannot be correct. *Intra vires* decisions can never give rise to liability, because the proper exercise of functions delegated by statute cannot be wrongful. Accordingly, an immunity confined to actions that are within the Bank's powers, in the manner suggested above, would be redundant. Moreover, the immunity explicitly covers the "purported", as much as actual, discharge of statutory functions. For this reason, there can be no doubt that the term "bad faith" in the Banking Act is used in a stricter sense, to connote either (a) a specific intention to injure for improper reasons or (b) the adoption of an injurious regulatory decision in the knowledge that it is beyond the Bank's statutory powers, thus excluding from the immunity any actions or omissions of the Bank's officials that constitute misfeasance in public office or some other intentional tort.

From a practical standpoint, a major limitation of the immunity is that it only covers the directors and staff of the Bank, but not its appointed agents. This may have considerable implications. Such agents of the Bank as may be used, for instance, for the carrying out of inspections or investigations are excluded from the immunity, while the servants of the Bank acting in very similar circumstances are not. Furthermore, the wording of section 1(4) suggests that, although these agents can be held liable, the Bank will not bear vicarious liability for their actions. This inconsistency of treatment is difficult to explain. Assuming that it is not the result of drafting error, its possible explanation could be that the Bank's agents are likely to be professional persons who should not enjoy special protection in carrying out their professionals functions.

---

9 Arora, *ibid.* (emphasis added).

10 See *Melton Medes Ltd. v. Securities & Investments Board* [1995] 3 All E.R. 880 (Ch.D.), pp.889-890. On the Bank's liability for misfeasance and other intentional torts, see *infra*, section 3. The second category of bad faith also includes the situation where regulatory action is taken under the pretext of a legitimate purpose, but the true and dominant purpose of the action is *ultra vires*, see *Westminster Corp. v. London and North Western Railway* [1905] A.C. 426 (H.L.).

11 The wording of the section ("Neither the Bank nor any person [...] shall be liable") distinguishes the (presumably vicarious) liability of the Bank from that of its officers and servants - and, consequently, also from that of its agents.

12 During the Act's passage, an attempt to amend this discrepancy was resisted on grounds of technical consistency (the immunity granted to regulators under the F.S.A. being expressed in similar terms), as well as for fear of extending immunity beyond what was strictly necessary to ensure its exact purpose; H.L. vol.485, cols.1219-1220.
It must be noted, in particular, that the immunity does not absolve the auditors of authorised institutions from the professional duties owed to their clients. Thus, they may be liable for the negligent performance of the supervisory functions which they perform under section 39 of the Act as their clients' agents but at the Bank's request, as well as of those that they perform as the Bank's agents, especially in the event of their appointment to conduct investigations under section 41. This creates an apparent inconsistency in the reformed supervisory system, which places particular emphasis on co-operation between the Bank and the auditors of authorised institutions. Nonetheless, the absence of immunity may have very little practical effect. Section 47(1) of the Act states that no duty owed by an auditor of an authorised institution or reporting accountant shall be regarded as contravened by reason of his bona fide communications of any information or opinion to the Bank, whether made in response to the Bank's request or not. Although this section does not apply to investigators appointed directly by the Bank under section 41, it is doubtful whether the auditor of an institution owes a professional duty of care to his client when acting in the capacity of investigator. If he does owe such a duty, however, section 47(1) could provide him with a measure of protection.

2. Liability for negligent regulatory decisions: 
the question of the duty of care

While the statutory immunity provides an explicit barrier to recovery by persons aggrieved by instances of inadequate and inappropriate performance of the Bank's regulatory functions under the Banking Act, it seems clear that, even without it, the scope of recovery would be very limited in view of the position in common law. The development of the law of negligence, in particular, suggests that the making of discretionary regulatory decisions is unlikely to give rise to liability in damages. The issue is of considerable theoretical importance because it points to inherent limits in the potential development of liability as a mechanism of legal accountability.

---

14 See the White Paper "Banking Supervision" (Cmnd. 9695, Dec.1985), ch. 8.
for economic regulators such as the Bank, even though for most practical purposes the discussion could be confined to the statutory immunity.\textsuperscript{16}

In principle, public authorities are subject to the ordinary law of negligence.\textsuperscript{17} Nonetheless, any attempt to hold them liable for their regulatory decisions would meet serious difficulties, especially when exercise of discretionary powers is involved.

In traditional analysis, the tort of negligence is committed when the breach of a duty of care owed by the defendant to the plaintiff becomes the source of damage to the latter.\textsuperscript{18} This abstract formulation, however, conceals the considerable ambiguity and uncertainty of the law.\textsuperscript{19} A fundamental difficulty concerns the identification of specific factual situations in which a duty will be owed. Lacking a general principle of liability, the common law has been willing to recognise a duty of reasonable care only in relation to particular classes of factual relationships, in which case sufficient "proximity" between the parties is said to exist.\textsuperscript{20}

Attempts have been made in the past to expand the tort under a homogeneous, broad principle of liability, the so-called "neighbour" principle, which recognises that a duty of care exists \textit{prima facie} in every situation where the plaintiff is so closely affected by the alleged tortfeasor's acts or omissions that the latter should reasonably foresee that his carelessness might cause damage to the former, even though this duty could be negatived or restricted, depending on the circumstances, by special policy considerations.\textsuperscript{21} These attempts, however, have been fiercely resisted, and

\textsuperscript{16} Since the immunity only applies to acts and omissions imputable to the discharge of the Bank's functions under the Banking Act, the position in common law could be of practical importance insofar as the Bank takes regulatory decisions in relation to matters which are not governed by that statute, for instance as lender of last resort or as regulator of the wholesale markets. However, in this context the contractual aspects of its decisions will often be more important, as explained in the previous chapter.

\textsuperscript{17} \textit{Mersey Docks Trustees v. Gibbs} (1866) L.R. 1 H.L. 93 (H.L.); \textit{Geddis v. Proprietors of Bann Reservoir} (1878) L.R. 3 App.Cas. 430 (H.L. (I.)).

\textsuperscript{18} *In strict legal analysis, negligence means more than heedless or careless conduct, whether in omission or commission: it properly connotes the complex concept of duty, breach, and damage thereby suffered by the person to whom the duty was owing"; \textit{Lochgeily Iron & Coal Co. v. M'Mullan} [1934] A.C. 1 (H.L. (Sc.)), p.25 per Lord Wright.

\textsuperscript{19} \textit{Clerk and Lindsell}, op.cit., n.15, pp.606-611; Smith, op.cit., n.15, ch.1.

\textsuperscript{20} The "proximity" of the parties is said to be an element that can give rise to a duty of care in a specific situation. In truth, however, proximity cannot provide an independent criterion for the imposition of liability, because it is an "elusive element" that "persistently defies definition"; \textit{Murphy v. Brentwood District Council} [1991] 1 A.C. 398 (H.L.), p.487 per Lord Oliver. Essentially, the word is applied to particular types of factual relationships only after the judicial conclusion that the law will superimpose a duty of care upon them has been reached.

\textsuperscript{21} \textit{M'Alister (Donohue) v. Stevenson} [1932] A.C. 562 (H.L. (Sc.)), p.580 per Lord Atkin; \textit{Dutton v. Bognor Regis Urban District Council} [1972] 1 Q.B. 373 (C.A.); and \textit{Anns v. Merton L.B.C.} [1978] A.C. 728 (H.L.), pp.751-752 per Lord Wilberforce. \textit{Dutton} and \textit{Anns} have been overruled,
eventually rejected, by the mainstream of the case-law. The reason has been a justifiable fear that the proposed formulae would prove incapable of discriminating adequately between different situations of loss to the plaintiff and would, therefore, result in unduly wide liability. For this reason, the law continues to recognise new duty-situations, not by applying a general formula to the concrete factual circumstances of new cases, but by precedent and close analogy. In this climate, "[w]hether, as a matter of abstract law, there is liability in any given situation depends on recognition by law of the kind of damage, the manner of its infliction, and the categories of plaintiff and defendant. By 'recognition' is meant that an action will lie; it represents the form and limits of the protection given to the interest of the plaintiff".

The paradigmatic situation where the law will recognise liability is that where the careless conduct of the defendant becomes the cause of physical injury to the plaintiff's person or property. Two situations represent a drastic departure from this model. First, in many cases the plaintiff's loss is not physical, but consists only in a diminution in value of his assets. This situation can be described as one of "pure economic loss". Second, frequently the actions of the defendant are not the immediate cause of the damage to the plaintiff, which is instead caused by an independent source of risk (either the behaviour of a third party or an inanimate causal factor). In this case, the potential responsibility of the defendant consists merely in his failure, as a result of his omissions or inadequate acts of intervention, to prevent the materialisation of that risk to the plaintiff's detriment. The imposition of liability in this situation implies that the defendant, even though he has not been himself the source of fresh damage to the plaintiff, was nevertheless under a responsibility to come to the latter's rescue. Difficult questions of policy and law arise as to the appropriate circumstances in which a duty of care should be owed in such cases.


23 Clerk and Lindsell, op.cit., n.15, p.22. B.S. Markesinis and S. Deakin, "The random element of their Lordships' infallible judgment: an economic and comparative analysis of the tort of negligence from Anns to Murphy" (1992) 55 M.L.R. 619, p.642, observe that the law is in a state of uncertainty, enhanced by reliance on the ill-defined notions of "justness", "fairness" and "reasonableness" which must guide judges in deciding whether a duty of care exists. These notions conceal the true policy considerations that influence the judiciary, and which should be made explicit.

24 Smith, op.cit., n.15, ch.2, observes rightly that in cases of physical injury a general principle of liability based on foreseeability of harm can indeed be seen in operation, although this principle cannot be extended to other types of cases.

25 "A failure to remember that the nature of the plaintiff's interest is a relevant factor has been responsible for some confusion, as we shall see when we consider liability for economic loss"; Salmond and Heuston, op.cit., n.15, p.203.
The restrictive approach of the common law to recovery in both situations defines the limits of the law of negligence as an effective remedy for the Bank's regulatory failures, because most actions against the Bank will belong to one or both of them. Evidently, the type of damage that could be suffered by either its regulatees or the depositing public as a result of inappropriate regulatory actions will be typically of the purely economic kind. On the other hand, the manner of the infliction of the harm will vary, depending on the potential plaintiffs. Thus, the Bank's regulatory actions may be a direct cause of harm for the regulatees at which they are directed. The situation will be different, however, in the context of bank failures, when the aggrieved persons will be members of the public having suffered loss as an immediate consequence of the insolvency or fraudulent conduct of a deposit-taker to whom they had entrusted their money and who has defaulted under his contractual obligation relating to the repayment of deposits. In this case, the inadequate performance of the Bank's supervisory functions will be a cause of that loss only in the derivative and indirect sense that the Bank had failed to detect the problem early enough and to take every appropriate measure to prevent its occurrence.

(a) Pure economic loss. While the infliction of physical damage to person and property is almost invariably actionable, the law has been extremely reluctant to grant a remedy for the careless invasion of purely financial interests. The restrictions on recovery for pure economic loss play a significant role in limiting governmental liability.

The view is frequently expressed that the purpose of recovery for other cases of economic damage arising in connection to the plaintiff's personal injury or damage to his property is the same as for cases of pure economic loss, namely, to safeguard the plaintiff's economic position, rather than a particular physical state of things. If so, the effort to draw a sharp distinction between the two types of cases is "evidently arbitrary from the point of view of principle".26 and the law would be better served, if "paradoxical" distinctions27 were put aside and a general principle of liability for all foreseeable harm, including pure economic loss, were adopted in principle, to be curtailed only for cogent reasons of policy.28 Nonetheless, the mainstream of the common law has strongly resisted the expansion of recovery for economic loss.

This attitude can be explained in several ways,29 but probably the most influential factor is the fear that the acceptance in principle of recovery for pure economic loss

26 Buckley, op.cit., n.15, p.102.
would open the floodgates of litigation, resulting in "liability in an indeterminate amount for an indeterminate time to an indeterminate class". The "floodgates" argument points to policy considerations which, applied primarily to the question regarding the extent of recovery, could have important implications. However, it cannot by itself provide full justification for the a priori exclusion of actionability in this area, because frequently the economic loss will be no more extensive than recoverable physical damage or loss arising from breach of contract.

A more fundamental argument emphasises the distinction between tort and contract. It does so, not out of a merely ritualistic adherence to formal legal distinctions, but in the belief that the general law of negligence should be confined to the protection of the person and of established property rights, but should not attempt to regulate the distribution of purely economic risks, which in a market economy should be a matter for voluntary allocation by means of contract. Within the sphere of self-responsibility for economic decisions, each person is in principle free to conduct his affairs with a view to his perceived benefit and at his own peril. Without a specific contractual allocation of risk, losses lie where they fall and even the intentional infliction of financial damage is generally accepted. Exceptionally, the law may make specific contrary provisions in appropriate circumstances, such as where the need to protect the interests of certain vulnerable parties appears

30 Ultramares Corp. v. Touche, Niven & Co. (1931) 174 N.E. 441 (C.A., N.Y.), p.444 per Cardozo J. See also Cattle v. Stockton Waterworks Co. (1875) L.R. 10 Q.B. 453, p.457, where Blackburn J. used the example of liability for the flooding of a mine: if liability for economic loss were accepted, "the defendant would be liable, not only to an action by the owner of the drowned mine, and by each of his workmen as had their tools or clothes destroyed, but also to an action by every workman and person employed in the mine, who in consequence of its stoppage made less wages than he would otherwise have done".

31 Thus, the "floodgates" argument mixes issues of extension of the tort of negligence, foreseeability of risk and remoteness of damage, which should better be kept separated; Smith, op.cit., n.15, pp.54-55.

32 The problem would not arise if, as in civil-law systems, the limits of liability were demarcated by a developed doctrine of rights, some of which would operate in rem, but others only in personam, so that their invasion by persons who are under no obligation to respect them would not be actionable. See ibid., p.84-89; G. Samuel, "Governmental liability in tort and the public and private law division" (1988) 8 L.S. 277.

33 An intentional act which is calculated to cause damage to the plaintiff's business is not actionable per se. As Hoffmann J. has pointed out in Associated Newspapers Group plc. v. Insert Media Ltd. [1988] 1 W.L.R. 509 (Ch.D.), p.511, in the common law this principle can be traced back to at least as early as 1410, when in the Schoolmasters of Gloucester Hankforth J. said: "If I have a mill and my neighbour builds another mill, by which the profit of my mill is diminished, I have no action against him and yet there is damage to me." Thus, generally the intentional and harmful interference with the trade or business of another is permitted, unless it is carried out by unlawful means. The exception is the anomalous category of conspiracy established in Quinn v. Leathem [1901] A.C. 495 (H.L.), to the effect that if the predominant purpose of the conspirators is to damage another person by use of lawful means (as distinguished, e.g., from the purpose of promoting their own benefit), the tort of conspiracy may be committed. See H. Cohen, "Conspiracy, intentional harm and economic loss" (1991) 6 J.I.B.L. 478.
expedient. An example would be the recognition of liability in tort for breach of professional duty, which can be justified by the drastic informational asymmetries in the client/professional relationship. However, a broader turn in the direction of recovery for pure economic loss would not only upset legal certainty, but also transform the law's basic character. For this reason, the attempt to impose on builders of defective houses liability for the financial loss of home-buyers, despite the fact that the builders' only contractual relationship was with the houses' original owners, has been repudiated by the House of Lords as "involving the introduction of something in the nature of a transmissible warranty of quality". If, as many claim, a reallocation of risk, under which the negligent builders or even the local authorities which have failed to exercise effective planning control over them could be held liable, is desirable in this field, this should be achieved by special legislative initiative directed to the particular issue of concern, rather than by shifting the boundaries of the ordinary principles of liability.

Despite its generally negative approach to liability for pure economic loss, in a limited number of circumstances the common law allows recovery. Most notably, a duty to take reasonable care in providing information may exist under the Hedley Byrne principle where a "special relationship" is established between the parties. Such a relationship can exist even if there are not contractual links between the advisor and the advisee. After long uncertainty as to the theoretical basis and proper

---


35 This "need not indirectly to subvert the inherent characteristics of a market economy by imposing liability in negligence" is recognised by Buckley, op.cit., n.15, p.6 - an author nonetheless favourable to the introduction of a general principle of liability for the foreseeable infliction of harm. See, however, infra, section 5, on the partial reallocation of risk by means of non-fault compensation schemes. Generally, the argument from self-reliance assumes that the proper role of private law is to protect certain entrenched private rights, which guarantee a sphere of private autonomy and whose allocation, however arbitrary, is not in question. A different conclusion could be reached under other normative assumptions. Thus, according to one version of normative economic analysis of law, precedence must be given to aggregate wealth maximisation over the entrenchment of spheres of self-reliance and, in consequence, the imposition of liability for the avoidance of risk on the "least-cost avoider" is desirable, even if it means that a positive obligation to play the "good Samaritan" must be imposed on the latter. See Markesinis and Deakin, "The random element...", loc.cit., n.23, pp.622-632.


38 Contra: N. Brown, "Murphy: out of the frying pan and in to the fire" (1990) 6 Prof. Neg. 150; and A. Olowofoyeku, "Murphy, Anns and pure economic loss" (1990) 6 Prof. Neg. 158.

ambit of this type of liability, the House of Lords set a restrictive test of liability for negligent misstatements in *Caparo Industries plc. v. Dickman,* according to which recovery will be possible only if it can be shown both (a) that the advisor knew (i) that his statement would be communicated to the recipient relying on it, either as an individual or as a member of an identifiable class, (ii) that it was required in connection to a particular transaction or transaction of a particular kind and (iii) that the recipient was very likely to rely on the statement for the purpose of deciding whether to enter into that transaction, and (b) that the recipient acted upon the information to his detriment. Potentially, a public authority which negligently makes a statement or gives advice could be found liable under this principle, but in practice the current judicial approach does not favour claims for negligent advice given to individual citizens.* Judicial responses to claims of liability for general announcements and statements addressed to the public at large can be expected to be even more restrictive.

Liability for negligent misstatements is undoubtedly the most important heading of recovery for pure economic loss, but not the only one. In a number of more or less anomalous situations, the law allows recovery for economic loss resulting directly from the careless actions of the defendant. For instance, the intended beneficiary of a will can recover if he is deprived of his legacy due to the professional negligence of the solicitor who was instructed by the testator to draw up the will;
an employee, if his former employer has given negligently a negative reference to a new employer; and the holder of a land charge, if the local land registry has negligently failed to include his charge in a certificate issued to a third party, insofar as by statute this failure frees the land from the obligation and defeats his right to the security. Such cases cannot properly be classified as cases of negligent misstatement, because the loss to the plaintiff is not caused through his reliance on the content of the defendant's statements, but occurs as a factual consequence of the defendant's behaviour.

The idiosyncratic factual circumstances of the decided cases hinder a clear, bright-line statement of the limits of actionability for pure economic loss. Some of the cases - for example, those recognising the employer's liability for negligent references - can be explained as arising under the *Hedley Byrne* principle, because they involve both assumption of responsibility by the defendant and reliance by the plaintiff on the exercise by the former of due care and skill. On the other hand, in

---


46 The cases under discussion must be distinguished from certain three-party situations, where the immediate recipient communicates a statement to a further recipient, who then acts on the advice; see *Yianni v. Edwin Evans & Sons* [1982] Q.B. 438 (Q.B.D.); *Smith v. Eric S. Bush* [1990] 1 A.C. 831 (H.L.). The latter fall now clearly within the ambit of the rule in *Caparo Industries plc. v. Dickman* [1990] 1 All E.R. 568 (H.L.). J.A. Hayes, "After Murphy: building on the consumer protection principle" (1992) 12 O.J.L.S. 112, pp.123-124, has expressed the view that the extension of builders' liability for defective buildings could be achieved in common law by analogical application of the principles expounded in *Smith v. Bush*, i.e. by asking whether the reliance of the purchaser on the quality of the construction is "reasonable", despite the absence of a contractual relationship. Even if this view is correct, however, similar "reliance" arguments could not be used easily against public authorities.

47 *Spring v. Guardian Assurance plc.* [1994] 3 All E.R. 129, p.143 per Lord Goff. However, Lords Slynn, Lowry and Woolf held that the duty of care in *Spring* arose by analogical extension of established principles of liability, because there was sufficient proximity between the parties and foreseeability of harm and it was "fair, just and reasonable" to impose the duty of care. The notions of voluntary assumption of responsibility by the employer and of reliance by the employee did not play a part in their reasoning. Indeed, the case's specific factual context renders an analysis based on voluntary assumption of responsibility, as that reflected in Lord Goff's speech, problematic, because the defendant insurance company was a member of the Life Assurance and Unit Trust Regulatory Organisation ("L.A.U.T.R.O."), whose Code of Conduct required it to
certain cases one or both of these elements are absent. For instance, the lawyer who undertakes the drafting of a will assumes thereby responsibility, but the potential beneficiary, who will often be unaware even of the will's existence, cannot be said to place any reliance on him. In the case of the negligent registrar, there is neither voluntary assumption of responsibility by the registrar nor reliance by the holder of the land pledge, who may be confident that his right cannot be defeated. In such cases, liability rests probably on a combination of the defendant's special professional role or position of control, which creates a broader - even though less exact - public expectation that his functions will be performed with the appropriate skill and care, with the plaintiff's inability to take any protective steps. However, the cases create liability only in exceptional and narrow circumstances and cannot be easily brought under a general formula that would allow the easy identification of new factual circumstances warranting similar treatment.

(b) A duty to rescue? The question of liability for negligent regulatory decisions may often depend on the possibility of holding a defendant liable for his failure to confer a positive benefit to the plaintiff or to prevent the infliction of damage to him, including, in particular, damage arising from actions of third parties (whether the latter are themselves liable for these actions or not).

In private relations, the rule is that there can be no liability without fresh damage caused directly by the defendant. The law refuses in most cases to impose a positive obligation to exercise reasonable care with a view to rescue another person from independently inflicted harm, because this is deemed to be a disproportionate restriction of freedom and contrary to the basic notion of individual responsibility. Exceptionally, an independently caused result will be attributed in law to the defendant's negligent omission to prevent it under exceptional circumstances, involving a special relationship between the defendant and the immediate source of


48 See supra, n.43.

49 The distinction between acts and omissions is not always easy to draw, especially when complex behavioural situations are involved. In many cases, it may not turn as much to the difference between physical action and inaction, but to the legal evaluation of causal factors as to what constitutes a "positive influence on the chain of causation"; M.J. Bowman and S.H. Bailey, "Negligence in the realms of public law - a positive obligation to rescue?" [1984] P.L. 277, pp.282-285. In this sense, the imposition of a duty to rescue implicitly interpolates in the chain of causation of the plaintiff's damage the absence of appropriate precautionary interference by the defendant as an extraordinary, negative link, which would otherwise be an irrelevant and extraneous factor from the standpoint of causation.
the loss. This relationship will generally consist in the plaintiff's reliance upon the
defendants forthcoming intervention or the control exercised by the defendant over
the source of the risk, although the cases cannot be easily united into a single
criterion of liability or classified in systematic manner.

With regard to governmental functions, however, the situation may be different.
The argument that the imposition of liability is inappropriate because it involves an
undue restriction of liberty is clearly inapplicable in this context. The public law
imposes on many occasions on public authorities a responsibility to take appropriate
action for the purpose of protecting the citizens from particular risks or conferring
positive benefits upon them. This raises the question whether a failure to perform
properly this responsibility is, not only reviewable, but also actionable at the instance
of the disappointed beneficiaries.

Generally, the fact that a public authority is delegated by statute the task of
taking action to safeguard the position of individual citizens does not confer on the
latter a private right to be rescued. In Kent v. East Suffolk Rivers Catchment
Board, the defendant authority, in pursuance of its statutory duties, undertook the
work of repairing a breach in a protecting river bank, but was initially unsuccessful in
carrying out the work. The plaintiffs, who were the owners of adjoining land,
brought an action against the authority, seeking recovery of the damage inflicted by
flooding on that land. The House of Lord held that the authority was not liable for
the plaintiffs' loss, because it had no statutory duty to act to improve their position.
In the opinion of Lord Romer:

"Where a statutory authority is entrusted with a mere power, it cannot be
made liable for any damage sustained by a member of the public by reason of
failure to exercise that power. If, in the exercise of their discretion, they
embark upon an execution of that power, the only duty they owe to any
member of the public is not thereby to add to the damage which he would
have suffered had they done nothing." 

The East Suffolk decision has been criticised on the basis that the granting of
discretion to a statutory authority does not necessarily imply that liability in
negligence will not lie if the authority decides to exercise its power, but does so
carelessly. On this view, the discretionary planning or policy stage must be

50 See, e.g., Smith v. Leurs (1945) 70 C.L.R. 256 (H.C. of A.); P. Perl (Exporters) v. Camden
A.C. 241 (H.L.(Sc.)).
51 For attempts of classification, see Bowman and Bailey, loc.cit., n.49, pp.280-282; and Smith,
op.cit., n.15, p.34.
52 S. Todd, "The negligence liability of public authorities: divergence in the common law" (1986)
distinguished from the operational stage of the authority's action, so that, once a
decision to intervene has been reached in favour of the plaintiff, he may be entitled to
its careful implementation.\textsuperscript{55} This, however, overlooks the problem of causation: if
the authority is free to abstain altogether from assisting the plaintiff, it cannot
logically be held liable for doing so, but providing less than full assistance.\textsuperscript{56}

Liability can only exist, if the duty of care covers the discretionary decision itself.
In principle, even if a statute does not go so far as to confer absolute private rights
on the intended beneficiaries, its protective effect may give them a remedy for the
negligent failure of an authority to exercise its discretionary functions in appropriate
manner to their benefit. This possibility cannot be excluded by the \textit{East Suffolk}
decision. In the rare cases where a private duty of care will be superimposed in this
manner on the exercise of particular statutory functions, its scope may be limited by
the statute's protective policy. This means that the statutory duty of care would be
owed only to the relevant provisions' intended beneficiaries and only in respect of the
intended types of loss.\textsuperscript{57}

Nonetheless, as the \textit{East Suffolk} case shows clearly, in most cases the public
authorities, like private individuals, will not owe a duty of care unless their activities
cause fresh damage to the plaintiff.\textsuperscript{58} Exceptionally, an authority having close and

On the policy/operational distinction, see infra, subsection (c). A similar argument could succeed
only where an authority's quasi-adjudicatory decision gives rise by statute to a fully-blown private
right. This could be the case, for instance, with regard to the conferment of welfare rights
following an administrative determination that the statutory conditions giving rise to these rights
are satisfied in the applicant's case.

\textsuperscript{56} Viscount Simon L.C. and Lord Thankerton decided against liability on this basis, following the

\textsuperscript{57} If the object of granting the relevant administrative powers is to protect particular interests, the
negligent infliction of damage to interests of a different type will not give be actionable, even if it
is foreseeable; \textit{Peabody Donation Fund Governors v. Sir Lindsay Parkinson & Co.} [1985] A.C.
Lord Oliver. For criticism of this approach, see Todd, \textit{loc.cit.}, n.52, pp.396-397; also, K.M.
Stanton, \textit{Breach of Statutory Duty in Tort} (1986), pp.29-30. Certain cases cast doubts about the
conclusiveness of the statutory goal as a limiting factor of the authorities' duties of care. \textit{E.g.}, in
circumstances where the Secretary of State for Trade had imposed restrictions on a company with
regard to the acquisition of another company, it was thought that, even though the Secretary's
statutory power to impose the restrictions was exercisable in the public interest, this was not
necessarily incompatible with the assumption of a private duty to release the company from the
restrictions when they were no longer needed. Nonetheless, it would be impossible to maintain
that the interests of a company bound by restrictions are within the protective purpose of the
Secretary's statutory power to impose them.

\textsuperscript{58} See Bowman and Bailey, \textit{loc.cit.}, n.49; Arrowsmith, \textit{op.cit.}, n.4, pp.179-185. The trend of the
case-law is very restrictive, especially following the overruling of \textit{Anns} [1978] A.C. 728 (where
liability for the negligent inspection of a defective building by a local authority exercising
planning control was accepted, even though the local authority's negligence was not a source of
fresh damage) by \textit{Murphy} [1991] 1 A.C. 398; see \textit{supra}, text and n.21. On the post-\textit{Murphy}
thorough control over the situation of certain third parties (as, for example, a prison authority over imprisoned persons) and having put certain members of the public at a special risk through its policy decisions regarding the manner of exercising its control, may have thereby assumed a special duty to take care that the former are prevented from causing harm to the latter.\(^5\) However, it will not be enough that an authority is able to prevent the infliction of harm by third parties, if it does not exercise a detailed control over the activities.\(^6\) In particular, as the discussion of the cases concerning banking will illustrate, the mere fact that an authority has licensed a private party to undertake a particular type of activity does not make it responsible for the ensuing abuses of the licensee, however careless its original licensing decision or its subsequent failure to withdraw the license.

Cases of liability for the careless exercise of control must be distinguished from the those where an authority falsely represents that it is in control of a certain activity and a private person relies on this representation to his detriment. The application of the rules relating to negligent misstatements would be appropriate in this situation.\(^6\)

(c) Public-policy immunity from liability. The limitations to actionability discussed above affect the liability of public authorities in the same manner as that of private persons, even though their practical significance may be greater in the context of the exercise of regulatory functions. On the other hand, even in circumstances where an authority might be liable in accordance to the general principles of the law of negligence to the victims of its inappropriate and negligent conduct, considerations of public policy may give rise to a special immunity. Much will depend on the specific statutory and administrative context, but generally the courts will be reluctant to reach the conclusion that decisions regarding discretionary policy choices constitute actionable negligence.\(^5\)

return to the approach enunciated in East Suffolk, see Markesinis and Deaking, Tort Law, op.cit., n.4, pp.336-341.


See Arrowsmith, op.cit., n.4, pp.169-176. As Arrowsmith observes, pp.173-174, talking of "immunity" for policy decisions could suggest that there can never be liability for policy decisions involving the deployment of administrative resources, even if the effect of these decisions is to inflict damage on a particular party or permit damage to be inflicted for the purpose of achieving a benefit for others. The case-law, however, does not support the view that immunity will always be available in these circumstances. A crucial factor will be whether the situation has a private law parallel, i.e. whether a private person in similar position would owe a duty of care to those affected by his actions. For instance, in their capacity as occupiers of land the public authorities cannot adopt a policy of creating nuisance with a view to cutting down their costs. For this reason, S.H. Bailey and M.J. Bowman, "The policy/operational dichotomy - a cuckoo in the nest" (1986) 45 C.L.J. 430, and Harlow, op.cit., n.4, pp.56-57, think that the notion of "public-policy
The public-policy immunity for discretionary decisions must be distinguished from the defence of statutory authorisation. An act specifically authorised by statute can never be tortious, even though the same act would be unlawful and actionable in the absence of the authorisation. On this basis, public authorities and statutory undertakers have a defence of statutory authorisation against torts of strict liability, e.g. nuisance or trespass, insofar as the prima facie wrongful consequences of their actions are inevitable for the furtherance of the statutory purpose. On the other hand, the negligent performance of statutory functions can never be authorised by the parent statute. Accordingly, provided that the existence of a duty of care owed by those exercising statutory functions to those affected thereby can be established in principle, the defence of statutory authorisation will not be available against claims in negligence for breach of that duty.

The recognition of private rights of action in the context of discretionary decisions of policy, however, can have the perverse effect of shifting the focus of the decision-making process from considerations of public interest towards common-law duties of care owed to private parties. For this reason, the scope of the private duties potentially owed by an authority acting under statute must be circumscribed to the extent necessary for the unimpeded exercise of its discretionary powers in the interest of the general public.

The problem was originally addressed by the House of Lords in *Dorset Yacht* where it was held that the Home Office was vicariously liable in respect of damage to property caused by young offenders who had escaped from an "open borstal" as a result of the negligence of the prison officers responsible for their supervision. The liability arose only because the officers had no discretion in relation to the matter, and had simply failed to carry out their instructions. On the other hand, there was recognition in the speeches that the Home Office could not be held liable for the

---

63 Cooper v. Wandsworth Board of Works (1863) 14 C.B.(N.S.) 180 (C.P.); Hammersmith and City Railway Co. v. Brand (1869) L.R. 4 H.L. 171 (H.L.). The test of inevitability in this context is whether the avoidance of the harmful consequences could be achieved by the exercise on the defendant's part of due care and skill. "The onus of proving that the result is inevitable is on those who wish to escape liability for nuisance, but the criterion of inevitability is not what is theoretically possible but what is possible according to the state of scientific knowledge at the time, having also in view a certain common-sense appreciation, which cannot be rigidly defined, of practical feasibility in view of situation and of expense"; *Manchester Corp. v. Farnworth* [1930] A.C. 171 (H.L.), p.183 per Lord Dunedin.

64 Mersey Docks Trustees v. Gibbs (1866) L.R. 1 H.L. 93 (H.L.); and Geddis v. Proprietors of Bann Reservoir (1878) 3 App.Cas. 430 (H.L.), p.455 per Lord Blackburn.


consequences of adopting a policy of "open borstals".67 As Lord Diplock explained, in the area of discretionary policy decisions, the courts lack the criteria by which they could assess where the balance lies between different private and public interests. "It is, I apprehend, for practical reasons of this kind that over the past century the public law concept of ultra vires has replaced the civil law concept of negligence as the test of the legality, and consequently of the actionability, of acts or omissions of government departments or public authorities done in the exercise of a discretion conferred upon them by Parliament. According to this concept Parliament has entrusted to the department or authority charged with the administration of the statute the exclusive right to determine the particular means within the limits laid down by the statute by which its purpose can best be fulfilled. It is not the function of the court, for which it would be ill-suited, to substitute its own view of the appropriate means for that of the department or authority by granting a remedy by way of a civil action at law to a private citizen adversely affected by the way in which the discretion has been exercised. Its function is confined in the first instance to deciding whether the act or omission complained of fell within the statutory limits imposed upon the department's or authority's decision. Only if it did not would the court have jurisdiction to determine whether or not the act or omission, not being justified by the statute, constituted an actionable infringement of the plaintiff's rights in civil law."68

Accordingly, when the adoption of policy decisions can affect many different interests, it is within the discretion of governmental authorities to balance these interests as they think fit. The courts will not question the reasonableness of the authorities' choices or reach their own view on the balance of costs and benefits, since the efficiency of official policy is a matter of political accountability and cannot be investigated by means of an action for damages.69 They will only insist that, if a particular policy entails exceptional additional risks for particular persons, as in the case of the "open borstals", due care is taken in its implementation.70

67 Ibid., p.1031 per Lord Reid and p.1069 per Lord Diplock.
68 Ibid., p.1067-1068.
70 Dorset Yacht [1970] A.C. 1004, pp.1070-1071 per Lord Diplock. Thus, in Hill [1989] A.C. 53, pp.59-62 per Lord Keith, a negative answer was given to the question, whether the members of the police force owe a duty of care to citizens who may suffer injury as a result of the manner in which they exercise their functions of controlling and keeping down the incidence of crime. Police officers could be liable to persons injured as a direct result of their acts or omissions. They could also be guilty of a criminal offence if they wilfully failed to perform a duty that they have a duty to perform; see R. v. Dytham [1979] Q.B. 722 (C.A.). However, they have a wide discretion regarding the manner of discharging their duty to enforce the criminal law, the deployment of resources, the following of particular lines of inquiry and the decision to prosecute. If their decisions are unreasonable, they can be reviewed, but this is not a situation where the existence of a common-law duty of care towards members of the general public can be readily inferred.
In this connection, a distinction between policy and operational decisions is sometimes drawn in the effort to illustrate the limits of actionability.71 However, as Lord Keith has observed judicially, this distinction "does not provide a touchstone of liability, but rather is expressive of the need to exclude altogether those cases in which the decision under attack is of such a kind that a question whether it has been made negligently is unsuitable for judicial resolution, of which notable examples are discretionary decisions on the allocation of scarce resources or the distribution of risks".72

The emphasis on the justiciability of the particular discretionary judgements implies that the public-policy immunity may not be available in all decisional environments. This creates an element of unpredictability. Generally, however, the courts will resist efforts to impose upon regulatory agencies operating under a complex set of statutory powers and duties and charged with the exercise of wide responsibilities in the general public interest common-law duties of care for the benefit of particular private persons, because they lack the criteria for deciding whether a particular regulatory failure constitutes negligence for which a private action should lie. In the words of Lord Keith, "it would be strange that a common law duty of care should be superimposed on such a statutory framework".73 Moreover, even in largely operational and, therefore, justiciable situations, the courts will refuse on grounds of public policy to impose liability if, in view of the particular decisional environment, this is likely to inhibit the discharge by office-holders of their public responsibilities by diverting their scarce resources or putting them in constant fear of actions.74

71 In Anns [1978] A.C. 728, p.751, Lord Wilberforce expressed the view that "[i]t can safely be said that the more 'operational' a power or duty may be, the easier it is to superimpose on it a common law duty of care". However, following the overruling of Anns by Murphy [1991] 1 A.C. 398, it is clear that even in strictly operational matters there will be no liability for the failure of an authority to confer a benefit to a plaintiff by implementing carefully or correctly those of its own policy decisions which happen to favour the latter, see supra, subsection (b).


74 Hill [1989] A.C. 53, pp.63-64 per Lord Keith; X (Minors) v. Bedfordshire County Council, The Times, 24 Nov. 1993 (Q.B.D.); Alexandrov v. Oxford [1993] 4 All E.R. 328 (C.A.); and, especially, Osman v. Ferguson [1993] 4 All E.R. 344 (C.A.), where the decisions of police officers in relation to the apprehension of criminals were found to be covered by total immunity from liability, even if the factual circumstances are such that the officers are aware that the plaintiff is personally exposed to an exceptional risk from a criminal which they are able to avert, in which case the close degree of proximity between the parties which is necessary for the recognition of a duty of care arguably exists. See also J. Steele and D.S. Cowan, "The negligent pursuit of public duty - a police immunity?" [1994] P.L. 4. Cf., however, Lonrho plc. v. Tebbit [1991] 4 All E.R. 973 (Ch.D.); [1992] 4 All E.R. 280 (C.A.). In this case, it was thought that the Secretary of State for Trade could be liable for his negligent failure to release a company from restrictions with regard to the take-over of another company, because "the timing of the release did not involve the allocation of resources or the distribution of risks", nor were there any other obvious considerations of public policy militating against liability; [1991] 4 All E.R. 973, p.980 per Sir Nicolas Browne-Wilkinson V.-C.
Finally, as the above-mentioned remarks of Lord Diplock indicate, even in situations where the operation of private duties of care is not precluded altogether by considerations of public-policy, it will be a necessary condition for liability that the defendant authority's actions were *ultra vires*, because its discretion with regard to the plaintiff's case was exhausted. Leaving aside questions regarding the appropriate type of procedure, this could place a potentially heavy burden on the plaintiff, additional to that of establishing his cause of action in principle.75

**(d) Banking supervision and the duty of care.** The Bank's faulty decisions relating to the authorisation and supervision of banking institutions can have a direct detrimental effect on the persons immediately concerned by them, *i.e.* either the institutions themselves or their managers and controllers. On the other hand, its failure to supervise effectively these institutions can have an indirect but clearly foreseeable negative effect on their clients. Other categories of persons could also be affected indirectly by the Bank's regulatory decisions, including banks' employees, their business associates and contractual counterparties or their competitors, but the loss in these cases will probably be less foreseeable and more remote. The question then arises whether the Bank is under a duty in common law to exercise its regulatory functions with all the care necessary for avoiding the infliction of loss to the institutions concerned or their clients. In view of the generally restrictive approach of the law to issues of regulatory liability, discussed above, it is not surprising that the courts have consistently given a negative answer to this question.

The leading case is *Yuen Kun Yeu v. Attorney-General of Hong Kong*,76 a case with "far-reaching implications as regards the potential liability in negligence of a wide variety of regulatory agencies".77 In this case, the plaintiffs, who were residents of Hong Kong, sought to recover damages that they had sustained as depositors by reason of the failure of a deposit-taking institution. They alleged that their loss should be attributed to the negligence of the Commissioner of Deposit-taking Companies (who had broad powers in respect to the registration of deposit-taking institutions) in discharging his functions in respect to the supervision of that institution. In particular, they alleged that the Commissioner knew, or ought to have known, of the irregularities in the conduct of the company's business, and that he had

---

75 In one Canadian case concerning the liability of banking regulators, *Baird v. The Queen* (1983) 148 D.L.R. (3d) 1 (F.C.A., Can.), p.17, Le Dain J., even though he was willing to contemplate the existence in principle of a duty of care owed by the supervisors, hinted at this difficulty by expressing his doubt whether the plaintiffs could succeed, when they had not even alleged invalidity of the relevant discretionary decisions.


failed to exercise his powers under the Deposit-taking Companies Ordinance (Laws of Hong Kong, cap. 328), so as to ensure that the company complied with the obligations and restrictions imposed upon it. The case came before the Privy Council on further appeal from the direction of the High Court of Hong Kong that the plaintiffs' statement of claim be struck out as disclosing no reasonable cause of action.

In the formulation of Lord Keith, who delivered the court's unanimous judgement, the question of principle was whether the Commissioner, in the discharge of his supervisory powers, owed to potential depositors a duty "to exercise reasonable care to see that such members of the public did not suffer loss through the affairs of [deposit-taking] companies being carried on by their managers in fraudulent or improvident fashion." The answer given in the judgement was that he did not.

Lord Keith admitted that it was reasonably foreseeable to the Commissioner that a deficient operation of the system of registration might put potential depositors at risk of losing their money, but was unwilling to deduce a duty of care from mere foreseeability: the primary question was whether such a close and direct relation existed in the circumstances between the Commissioner and potential depositors as to place him under a duty of care towards them. Specifically, the court was faced with two alternative grounds of liability in negligence (and an additional one for breach of statutory duty).

In the first place, it was argued (on the assumption that pure economic loss was not a barrier to recovery) that, although the conduct of the deposit-taking company was the immediate cause of the plaintiffs' loss, the relationship between the Commissioner and the company was so close that it imposed on the former a duty to prevent the latter from causing financial loss, in analogy to established cases of liability for third-party actions. In Lord Keith's opinion, that argument failed, because the regulator did not have a power of day-to-day control of the company's activities, but only a remedial discretionary power to stop it from carrying on business. In any event, no special relationship existed between the Commissioner, who had to act in the broader public interest, and potential depositors. The latter's interest would be a relevant factor, but surely not the only, or even the primary, one. In considering deregistration of a company, the purpose of protecting potential

78 Ibid.
79 Ibid., p.194.
80 See Smith v. Leurs (1945) 70 C.L.R. 256 (H.C. of A.); and Home Office v. Dorset Yacht Co. Ltd. [1970] A.C. 1004 (H.L.); and supra, subsection (b).
depositors should be balanced to that of existing ones, who might be gravely harmed by it. Accordingly, no duty was owed.

The second allegation of liability in Yuen was based on the reliance placed by the plaintiffs upon the registration in deciding to deposit their money with a registered company. In effect, this would amount to treating the registration as a negligent misstatement on the Commissioner's part. Lord Keith found the argument disingenuous, since liability for negligent misstatements was based on the voluntary assumption of responsibility. It was, indeed, argued that the effect of the Ordinance was to place an analogous responsibility upon the Commissioner, even though there was clearly no voluntary assumption of responsibility by him. However, the interpretation of the Ordinance led to the conclusion that a duty of supervision in the public interest was created thereby, but no special responsibility towards individual members of the public. The Ordinance was designed to give added protection to the public, but it could not reasonably be regarded as having instituted "such a far-reaching and stringent system of supervision as to warrant an assumption that all deposit-taking companies were sound and fully creditworthy".

In this connection, it must be noted that, following the B.C.C.I. debacle, the Bank has decided to include a "health warning" in its lists of authorised institutions, in order to misspell any lingering misconceptions about its supervisory role and renounce liability. The warning is phrased in the following terms: "The inclusion of an institution does not mean that the Bank of England in any way guarantees its obligations."

Finally, in Yuen considerations of public policy would have probably provided immunity for the Commissioner's discretionary decisions, even if a relationship of proximity sufficient for the establishment of a duty of care had been shown on either of the suggested grounds to exist between him and the plaintiffs. The Commissioner would be less likely to exercise sound judgement if he were to work in the constant fear of claims against him. This could lead to distortions in his judgements.

82 Ibid., pp.19-195.
84 It must be doubted whether this is true in all cases. See Caparo [1990] 1 All E.R. 568; also, H. Evans, "The application of Caparo v. Dickman" (1990) 6 Prof:Neg. 76, p.77. Nonetheless, the very restrictive Caparo test of liability for negligent misstatements does not appear, in any event, to allow recovery in the circumstances of Yuen.
Nonetheless, since the court had decided that in any event proximity did not exist, it preferred not to rest its decision upon the public-policy argument.  

In Yuen a very similar Canadian case, Baird v. The Queen, was distinguished on two grounds: (a) that the decision was not decisive because, being on a motion to strike out the statement of claim, it left the issues of principle to be dealt with after trial on the merits; and (b) that the relevant legislation was different in important respects. Delivering the leading judgement in Baird, Le Dain J. had confined himself in expressing the view that the test for a striking-out order, namely that it was "plain and obvious and beyond doubt" that the plaintiffs did not have a cause of action, had not been satisfied in respect to a number of issues, refraining however from making a positive declaration that a cause of action was indeed available on the alleged facts. In particular, Le Dain J. thought that, as the scheme of financial supervision under consideration was created (at least in part) for the protection of investors, the possibility that a duty was owed to them could not be excluded in advance, but would depend on what was, or should be, known by the supervisory authorities. Although he recognised the force of the "floodgates" argument against liability, he thought that the plaintiffs might be considered to belong to a limited class to which a duty could be owed. Nonetheless, the judge admitted his serious doubt as to whether the plaintiffs could overcome a defence based on public policy, since the alleged negligence concerned what were mainly discretionary decisions of policy and there was no allegation of malice or bad faith, or even of mere invalidity. By countenancing, however cautiously, the possibility of liability, this decision cannot be easily reconciled with the views expressed by Lord Keith in Yuen. Nonetheless, in view of subsequent developments in the law of negligence, it appears certain that today the English courts would dismiss Baird, if only because of its assumption that pure economic loss is recoverable on the basis of mere foreseeability. Indeed, in Canada itself at least one decision has followed Yuen by holding that the Alberta Securities Commission did not owe a duty of care to the lenders of a mortgage company which was under its supervision. Significantly, Baird was not even referred to in the judgement.

92 Ibid., pp.13-17.
While the claimants in *Yuen* where members of the investing public, other claims may centre on the duties of banking regulators towards the regulated firms and their owners. *Johnson Matthey p.l.c. v. Arthur Young*,\(^95\) a case concerning the Bank's position under the Banking Act 1979, belongs to the latter category. The case arose out of the financial collapse of Johnson Matthey Bankers Ltd. ("J.M.B.") as a result of the careless and imprudent manner in which this institution conducted its business. Both J.M.B. and its parent company, Johnson Matthey p.l.c. ("P.L.C."), brought actions against their auditors, Arthur Young, alleging that the latter had breached the professional duties owed to them. The Bank was joined to the proceedings by means of third party notices, on the ground that, if the auditors were under liability to the companies, the Bank was liable to make a contribution\(^96\) to them, because it owed to J.M.B. and P.L.C. a duty to supervise the U.K. banking system with reasonable skill and care, which it had breached, not so much by its decisions in areas of discretionary judgement, but simply by the careless executions of those investigations and checks which it had considered itself appropriate for the exercise of its supervisory functions.

On an application by the Bank for the striking-out of the third-party notices, Saville J., allowing the application, held that there was nothing fair or reasonable in holding the Bank responsible for the common commercial prudence and care that J.M.B. owed to itself. The plaintiffs had claimed that the Bank had for a very long time exercised power and authority over the U.K. banking system, in particular by assuming responsibility for the supervision of banks active in the jurisdiction, in the interest both of depositors and of individual bank stability. They had further claimed that, insofar as J.M.B. was concerned, a close relationship existed between that institution and the Bank, since there was a clear history of visits by Bank officials to J.M.B. and discussions of its banking business, of collection of information by the Bank from J.M.B. concerning the latter's operations and of reliance by J.M.B. on the Bank's advice and of compliance with that advice. Nonetheless, principles of common sense were offended by the allegation that such a relationship might result in a legal obligation being owed by the Bank to take reasonable care so as to prevent financial loss accruing to J.M.B. from its own imprudence and carelessness. J.M.B. was a self-responsible commercial enterprise, bearing the just financial deserts of its activities, not a mental patient in need of protection from himself.\(^97\)

---


\(^96\) Civil Liability (Contribution) Act 1978, s.1.

Regarding a claim that a duty was owed to P.L.C. as a depositor in J.M.B., Saville J., rather than relying on the broader principle of Yuen, preferred to focus on the interpretation of the specific statutory provisions. Although one of the principal purposes of the Banking Act 1979 was to protect depositors, this Act (in contrast to the repealed Protection of Depositors Act 1963) excluded from its definition of deposit sums paid to a company by its parent or sister companies. Whatever the position with regard to depositors generally, it could not be argued that the Bank owed a duty in respect to matters which did not even fall within its statutory remit. Accordingly, persons which were not depositors (in the statutory sense) could not recover. An argument based on the exercise of customary, extra-statutory supervisory powers by the Bank would also fail. In deciding whether a duty existed in common law, every relevant circumstance should be taken into consideration, including, in particular, the impact of the 1979 Act. However, the exclusion of parent companies from this statute's definition of depositors was doubtless due to their enhanced capacity to take the measures necessary for protecting themselves by investigating, monitoring and controlling the activities of their subsidiaries. The same reason rendered unsustainable the suggestion that the Bank should nevertheless owe a common-law duty of care to these persons.

While the Johnson Matthey decision stands for the proposition that regulators do not have any obligation to rescue their regulatees from their own errors of judgement or commercial misconduct, it should be noted that in certain situations the regulatees' financial and other loss can be the direct result of negligent regulatory decisions, e.g. those relating to authorisation or the conduct of investigations. In such cases, the regulators exercise complete and unilateral control over the affairs of the persons affected by their decisions and this could provide a ground for liability. The existence of a duty of care might be denied in these circumstances on any of the following grounds: (a) that the public-policy immunity precludes liability for decisions of this type; (b) that, since the object of the relevant statutory powers is to protect the interests of the public and not of the regulated persons, no duty can be owed to the latter; and (c) that the regulators are covered by a specific statutory immunity. The first two grounds are not certain always to succeed. Indeed, on the (debatable) assumption that the desirability of governmental liability should be accepted in principle, the a priori exclusion from its ambit of cases where the

---

98 Banking Act 1979, s. 1(5)(d).
100 See supra, subsection (c).
102 See infra, section 6.
negligence of the regulatory authorities becomes a source of damage for those subject to their direct control would be unjustifiable.  

From this standpoint, Johnson Matthey must be compared to the more recent judgement of the Court of Appeal in Lonrho p.l.c. v. Tebbit.  In this case, the Secretary of State for Trade had failed to release the plaintiff company from an undertaking given to him not to proceed with a take-over bid as soon as he received a report from the Monopolies and Mergers Commission that the take-over would not operate against the public interest. By the time that the Secretary finally gave his assent, the target company had already been taken over by a competitor. The plaintiff company brought an action in negligence against the Secretary, claiming that the latter had breached a private-law duty of care through his failure to waive the undertaking promptly, causing economic loss to the plaintiff. The Court of Appeal recognised that the plaintiff would face formidable obstacles both in law and on the facts in its effort to establish the existence of a private-law duty, or the breach of it, but refused to strike out the claim. Admittedly, there was no precedent for holding a minister liable in damages, particularly for economic loss, as a result of his exercise in good faith of public-law powers. In a striking-out application, however, it would be inappropriate to decide a point of law arising in a new and developing field of law; the test was only one of arguability. The imposition of restrictions on a company in the public interest was not necessarily incompatible with the assumption of a private-law duty to release that company when the restrictions are no longer needed. Thus, the plaintiff could not be said to be without a reasonable cause of action, although, even if private duty did exist, its nature (i.e. whether it was an absolute duty or only a duty of care) would have to be carefully defined.  

The significance of this decision is that it countenances the possibility of liability for the conduct of regulatory functions, provided that the regulator exercises direct and close control over the plaintiff's affairs and that his discretion with regard to the issue in question is effectively removed under the circumstances, leaving the plaintiff's interest as the only relevant factor.

103 Cf., however, Jones v. Department of Employment [1989] 1 Q.B. 1, where the Court of Appeal, relying in part on dicta from Yuen, held that a social-security adjudication officer owed no duty to a benefit claimant to take care in reaching a decision to disallow his claim.


106 "In this country the law has never allowed that a private individual should recover damages against the Crown for an injury caused to him by an ultra vires order made in good faith."; Bourgoin S.A. v. Ministry of Agriculture, Fisheries and Food [1985] 3 All E.R. 585 (C.A.), p.633 per Nourse L.J.


108 As Browne-Wilkinson V.-C. observed in his first-instance judgement in Lonrho plc. v. Tebbit [1991] 4 All E.R. 973, as a result of the report the Secretary came under a duty to reconsider the
It is at least conceivable that these conditions could be satisfied in certain cases where the Bank exercises immediate control over matters affecting the interests of its regulatees, e.g., in the course of an investigation. It is in connection with them, that the effect of the Bank's statutory immunity under section 1(4) of the Banking Act 1987 becomes felt.\textsuperscript{109}

Significantly, certain events relating to the conduct of investigations, particularly the exercise of the power of entry and the seizure of documents, are governed by the law of trespass, rather than that of negligence. Accordingly, if its statutory immunity did not provide protection with regard to its investigatory actions, the Bank would undoubtedly be under a common-law duty of care to the persons concerned and would bear the burden of proving their legality in defence of an action for damages.\textsuperscript{110}

If the narrow ground on which \textit{Johnson Matthey} was decided, with the emphasis on the difference under the Banking Act 1979 between connected persons having placed money with an institution and depositors \textit{stricto sensu}, had left open the possibility that, depending on the immediate statutory context, the banking regulator might owe a duty of care to depositors, the decision of the Privy Council in \textit{Davis v. Radcliffe}\textsuperscript{111} dispelled any remaining doubts about the broader applicability of \textit{Yuen}.

In \textit{Davis}, a case from the Isle of Man, the plaintiffs brought an action against the persons responsible for the regulation of the Manx banking system, claiming damages for losses inflicted by the collapse of a licensed institution.\textsuperscript{112} Lord Goff,

\begin{flushright}
\textsuperscript{109} See supra, section 2.
\textsuperscript{110} In an action for trespass, the regulator would have to disclose the grounds of his belief that investigatory action was desirable, and the reasonableness of his belief would be then a matter of fact to be tried on the evidence. "[S]ince the act of handling a man's goods without his permission is \textit{prima facie} tortious, at the trial of a civil action for trespass to goods based on the seizure and removal of things by an officer [...] in purported exercise of his powers [...] the onus would be on the officer to satisfy the court that there did in fact exist reasonable grounds that were known to him for believing that the documents he removed might be required as evidence [...] not that they \textit{would be} so required"; \textit{R. v. Inland Revenue Commissioners, ex p. Rossminster Ltd.} [1980] 1 All E.R. 80 (H.L.), p.93 per Lord Diplock; also p.85 per Lord Wilberforce and pp.89-90 per Viscount Dilhorne. See also \textit{Reynolds v. Commissioner of Police of the Metropolis} [1985] Q.B. 881 (C.A.).
\textsuperscript{112} For a brief account of the factual circumstances, see D.C. Doyle, "Isle of Man: two recent judgements regarding the Savings and Investment Bank Limited (now in liquidation)" (1990) 5 B.J.I.B.&F.L. 271. That the Manx authorities had shown gross incompetence, if not outright recklessness, in their supervision of the failed institution, issuing in effect a "license to defraud", has now been established officially by the publication of the Chadwick Report, "The Savings and Investment Bank Ltd.: Investigation under s.5 of the Companies Act 1974" (Isle of Man Treasury, 22 Sep. 1992). In response to the Chadwick Report, the Manx government announced
\end{flushright}
delivering the unanimous judgement, thought that the case was for all practical
reasons indistinguishable from *Yuen*.\(^{113}\) The functions of the regulators were
"typical functions of modern government, to be exercised in the general
public interest. These functions are [...] of the broadest kind [...] In
circumstances such as these, competing considerations have to be carefully
weighed and balanced in the public interest [...] The making of decisions such
as these is a characteristic of modern regulatory agencies; and the very nature
of the task, with its emphasis on the broader public interest, is one which
militates strongly against the imposition of a duty of care [...] upon such an
agency in favour of any particular section of the public".\(^{114}\)

A further consideration was that there was insufficient control over the management
of banking institutions to warrant the imposition of liability for their negligence.\(^{115}\)

An important common theme in *Yuen* and *Davis* was the use of the "floodgates"
argument, which was explicitly adopted, not simply as a background consideration,
but as a directly effective legal premise against liability. In *Yuen*, Lord Keith
observed that the plaintiffs were
"simply a few among the many inhabitants of Hong Kong who might choose
to deposit their money with that or any other deposit-taking company. The
class to whom the commissioner's duty is alleged to have been owed must
include all such inhabitants".\(^{116}\)

Does it necessarily follow that in such circumstances there can exist no special
relationship? Considering the ambivalence of any attempt to distinguish in terms of
abstract legal description limited or identifiable classes of potential plaintiffs from the
public as a whole,\(^{117}\) it would seem preferable that the question of proximity should
turn on the nature of each relationship, and not on speculation regarding the number
of would-be plaintiffs, unassociated to the actual proceedings. However, the
argument highlights one of the most common underlying fears in relation to recovery
for pure economic loss and, more importantly, to governmental liability.

---

\(^{113}\) In a comparison of the statutory environments of Hong Kong and the Isle of Man, the essential
common feature was the regulators' power to discontinue registration, while differences in their
more detailed powers did not add up to much: "who has it in his power to suspend registration,
has in practice the ability to induce change without going so far as to exercise either of those

\(^{114}\) Ibid., pp.826-827.

\(^{115}\) Ibid., p.827.

that a "consideration militating against the existence of the alleged duty of care in the present
case is that it is said to be owed to an unlimited class of persons".

Overall, the case-law shows that regulators in the position of the Bank will not owe common-law duties of care, whether to the investing public or to its regulatees, with regard to loss arising from market activities. It is immaterial that the loss might have been prevented if the regulators' supervisory and remedial powers had been exercised properly. Even if regulatory liability for damages were not specifically excluded by virtue of a statutory immunity, regulators could be potentially liable only for events over which they have direct control. As for liability to parties only indirectly concerned, such as competitors or employees affected by the inadequate or inappropriate supervision of an institution, the lack of "proximity" seems to exclude the possibility of a duty-situation.118

It must be noted that, even if the law imposed private duties of care on regulators, the other elements of the tort of negligence would have to be established before a claim could succeed. The burden to prove negligence and causation would be left on the plaintiff. The reported cases, having been decided on preliminary points of law, do not shed light on this point. Nonetheless, most of them leave the impression that the plaintiffs approached the question of breach as if "the affair spoke for itself".119 The viability of this approach in a trial on the merits would be doubtful. Similarly, the question of contributory negligence of the plaintiffs might also have been raised.120

(e) Breach of statutory duty. The breach of a statutory duty121 will only give rise to liability in tort if an inference of legislative intent that the duty gives rise to corresponding private rights and that its breach is actionable at the instance of the right-holders can be drawn.122 The inference is supposed to be facilitated by the application of certain presumptions.123 Thus, generally, liability will only exist in respect of the particular type of harmful situation that the statutory duty purported to prevent.124 On the other hand, there will be no liability, if the duty is intended for the benefit of the public in general, rather than for that of particular persons or a

121 See Stanton, op.cit., n.57; R.A. Buckley, "Liability in tort for breach of statutory duty" (1984) 100 L.Q.R. 204; Salmond and Heuston, op.cit., n.15, ch.10; Clerk and Lindsell, op.cit., n.15, ch.14; Winfield and Jolowicz, op.cit., n.15, ch.7; Markesinis and Deakin, Tort Law, op.cit., n.4, pp.307-325, 342-343; Charlesworth and Percy, op.cit., n.15, ch.11; Arrowsmith, op.cit., n.4, ch.7.
class of persons, or if the relevant statute provides a specific and adequate remedy for its enforcement. However, these presumptions can be unreliable as tests of liability.

As a matter of practical reality, the courts may prove willing to uphold an action in damages for breach of statutory duty in the area of industrial safety or, more broadly, personal injury, but will be reluctant to do so elsewhere. In particular, liability will be less likely in cases involving public functions. The courts will refrain from interpreting statutes so as to impose upon public authorities constructive statutory duties, where the functions in question are essentially discretionary. Furthermore, even if breaches of public duties are found to be actionable, they will rarely attract strict (non-fault) liability. Thus, where a public authority owes a duty to achieve a certain end but the means are left to its discretion, principles of strict liability will not apply. Since the courts will tend to determine the question regarding an authority's duties of care in negligence by considering the protective purpose of the relevant statutory provisions, this restriction of liability for breach of statutory duty to situations involving a degree of fault brings the two conceptually distinct torts very close together.

In relation to regulatory activities in the field of banking, in particular, insofar as the plaintiff does not allege breach of specific statutory obligations, but merely seeks to supplement a claim in negligence with an alternative plea of breach of a general statutory duty of care supposedly owed by the relevant authority by virtue of the functions entrusted to it by Parliament, the courts will refuse to accept his argument. On the other hand, in Guernsey (States) v. Firth, the courts of Guernsey held that the breach of a specific statutory duty was actionable. Section 13 of the Protection of Depositors (Bailiwick of Guernsey) Ordinance 1971 required Guernsey's banking regulator, the States Advisory and Finance Committee, to

---


127 See Stanton, op.cit., n.57, pp.52-55.

128 See ibid., pp.73-77; and Clerk and Lindsell, op.cit., n.15, pp.769-771.


132 1981, Guernsey Court of Appeal, No.10 (Civil) (unreported). The case was distinguished in Yuen Kun Yeu v. Attorney-General of Hong Kong [1988] A.C. 175 (P.C.), p.197, as being concerned "with the construction of an enactment imposing a specific statutory duty", not with the existence of a common-law duty of care.
publish from time to time a list of all registered deposit-takers. The Committee, which had not renewed the registration of a particular company for 1977, did not publish a list of registered persons in either 1977 or 1978. In the meantime, the company pursued illegally its deposit-taking activities. It eventually went into liquidation in December 1978, causing loss to the plaintiff, who had deposited money with it. The Guernsey Court of Appeal decided that section 13 had placed a duty on the Committee to publish lists of registered persons as often as might be necessary to keep the public reasonably informed and that any depositor who might suffer loss due to breach of the duty had a right of action. Apparently, the fact that the duty was intended for the benefit of the public in general, rather than that of a particular narrower class, was not considered to be a barrier to liability in that case.

The provisions of the Banking Act 1987 impose on any person who receives regulatory information relating to the private affairs of another person a duty to keep that information confidential. The duty, which is mainly directed to the Bank's officials and personnel, is enforceable with criminal sanctions. Exceptionally, the disclosure of information by the Bank is permitted under various "gateways" for various regulatory purposes specified in the Act.

There can be little doubt that the duty of regulatory secrecy is mainly intended to protect the interests of the Bank's informants and of those persons whose business falls within the ambit of the Bank's supervisory control or to whom the regulatory information relates, although it may also have the purpose of facilitating the collection of supervisory information. Since the obligation is imposed for the benefit of a clearly defined class of individuals, the question arises, whether it is in principle enforceable by members of that class by way of an action for damages.

The answer appears to be negative. In a recent decision concerning the effect of a duty of regulatory confidentiality imposed in almost identical terms on the Securities and Investments Board ("S.I.B.") under the F.S.A., Lightman J. has come...
to the conclusion that the disclosure of restricted information in contravention of that duty cannot give rise to a cause of action in tort.\textsuperscript{136} The purpose of the statutory duty is, indeed, to protect the interests of informants and persons to whom the information relates. Nonetheless, it should be observed that the F.S.A. has put in place an elaborate scheme of duties, providing in each case a specific mechanism for their enforcement. Against this background, the fact that the statute sets out as the specific and only sanction for breach of the duty of regulatory confidentiality that of criminal prosecution, precludes the inference of any additional remedy in private law. Moreover, the S.I.B. regulates investment business in the public interest, and in particular in the interest of investors. Its duty of confidentiality must be seen in this context. Its role is "to control in the public interest the use and dissemination of information acquired rather than to subject the S.I.B. in this respect to private law actions."\textsuperscript{137} On the other hand, the special interest of informants and persons to whom the information relates is safeguarded by the fact that they can seek to enforce this public duty by way of judicial review.

3. Misfeasance in public office and other intentional torts

Since the statutory immunity from liability does not cover cases where a regulatory act or omission is vitiated by bad faith, the Bank and its officers, servants or agents may be held liable in damages for committing the tort of misfeasance in public office if they abuse deliberately their regulatory authority. This mainly economic tort provides a special basis of governmental liability.\textsuperscript{138}

Today, there can be no doubt that mere invalidity is not enough to establish liability for misfeasance and that the mental element of "malice" or "bad faith" is indispensable for the commission of the tort.\textsuperscript{139} While it is clear that requiring malice in the strict, colloquial use of the word, \textit{i.e.} in the sense of active spite, hatred or ill-will towards the plaintiff, would restrict unduly the scope of liability, the precise

\textsuperscript{136} \textit{Melton Medes Ltd. v. Securities & Investments Board} [1995] 3 All E.R. 880 (Ch.D.), pp.887-889.

\textsuperscript{137} \textit{Ibid.}, p.889.


\textsuperscript{139} This was first established in certain early decisions; \textit{Cullen v. Morris} (1819) 2 Stark. 577 (C.P.); \textit{Tozer v Child} (1857) 7 El.&Bl. 377 (Ex.Ch.). In modern law, it was reaffirmed in \textit{Dunlop v. Woollahra Municipal Council} [1981] 1 All E.R. 1202 (P.C.).
nature of the necessary mental element raises certain difficulties. In this regard, two categories of cases should be distinguished: those in which an otherwise plausible exercise of public power is vitiated specifically by reason of malice in the subjective, moral sense, *i.e.* cases characterised by the improper ulterior motive of the official decision-maker ("malice in fact")\(^{140}\); and those in which the official deliberately or intentionally oversteps the objective limits of his powers, irrespectively of whether he has a legitimate and reasonable subjective motive for doing so or not, *i.e.* cases characterised by intentional or deliberate illegality ("malice in law").\(^{141}\) Apparently, malice in the narrow, moral sense was originally an essential element of the tort.\(^{142}\) The modern case-law, however, has dispensed with malice in fact as a test of liability in cases of the second category,\(^{143}\) recognising knowledge on the part of an official of the excess of jurisdiction as an independent ground of liability.\(^{144}\) Accordingly, the tort of misfeasance is committed either (a) where a public official acts with "malice towards the plaintiff", *i.e.* with the specific purpose of inflicting harm on the latter, or (b) where he acts in a certain manner in the knowledge that thereby he exceeds his powers and that his act will injure the plaintiff.\(^{145}\) A question could arise regarding situations where the official knows that he exceeds his powers, but not that this is likely to cause damage to the plaintiff. Is "malice" in the modified subjective sense of deliberate intention to injure the plaintiff, or at least recklessness in this regard, still a necessary element of the tort? Or is the simple fact that the official was aware of the invalidity of his actions (or even merely acting with reckless disregard as to whether his actions where within the limits of his power) sufficient to satisfy the mental element of the tort, with damage to the plaintiff being a pure question of causation in fact?\(^{146}\) Judicial dicta of the greatest weight appear to adopt the latter view, but the former also finds clear support in certain recent decisions.\(^{147}\)

---

\(^{140}\) See, *e.g.*, *David v. Abdul Cader* [1963] 1 W.L.R. 834 (P.C.).


\(^{143}\) In the Canadian case *Roncarelli v. Duplessis* (1959) 16 D.L.R. (2d) 689 (S.C., Can.), p.706, Rand J. defined malice as "simply acting for a reason and a purpose knowingly foreign to the administration".


\(^{146}\) Wade and Forsyth, *Administrative Law, op.cit.*, n.4, p.794, refer to *Bourgoine* [1985] 3 All E.R. 585, to establish the point that the remedy would lie if the official had abused his powers, "well knowing" that his action was in breach of the law "and would injure the plaintiff's business", noting that both the judge of first instance and the Court of Appeal had cited a previous edition of their book. In the next page, however, they maintain that *ultra vires* action will found an action
Recovery for misfeasance in public office may be possible in certain situations, even though a remedy by way of judicial review or administrative appeal is not available to the plaintiff, e.g. because the matter is time-barred.\footnote{148} Moreover, liability probably exists even for decisions taken by public officials in the exercise of powers conferred by contract and having no public element.\footnote{149} In this case, a specific intention to injure the plaintiff will be a necessary ingredient of the tort.

Being based on a mental element of malice or bad faith, misfeasance will usually be committed by individual public officials. In the case of decisions reached by collective bodies, such as the Board of Banking Supervision,\footnote{150} it will be necessary to show that a majority of the members present at the time had supported the relevant decision with a guilty mind.\footnote{151}

A particular difficulty in the case of the Bank of England's regulatory decisions is that it is not clear who are the persons whose guilty mind can establish liability for misfeasance. The Banking Act 1987 delegates regulatory responsibilities to the Bank as a whole, but the effective decision-making power rests at various stages with the

\footnote{147} In Dunlop [1981] 1 All E.R. 1202, p.1210, Lord Diplock emphasised that the crucial criterion "in the absence of malice" was whether a void resolution had passed with knowledge of its invalidity. Also, in Calveley v. Chief Constable of Merseyside [1989] 1 All E.R. 1025 (H.L.), pp.1031-1032, the possibility was envisaged that misfeasance might be established simply by showing that a public official had done "without reasonable cause" an act in the exercise or purported exercise of some power. See also the Scottish case Micosta S.A. v. Shetland Islands Council [1986] S.L.T. 193 (O.H.), p.198. On the other hand, in Bourgoin [1985] 3 All E.R. 585, both the judge of first instance, p.602, and the Court of Appeal, p.624, insisted on knowledge of the consequences for the plaintiff as an additional element to the deliberate excess of powers.

More recently, Rattee J. has affirmed that an intention to injure is an essential ingredient of the tort; Bennett v. Commissioner of Police of the Metropolis [1995] 2 All E.R. 1 (Ch.D.). The few brief paragraphs in Bennett by which the plaintiff's allegation of misfeasance is rejected would appear to contradict much of what has been said above. However, the contradiction may be only apparent: the decision does not discuss the relationship between the two categories of the tort, and it is possible that Rattee J. considered that, in the context of the facts pleaded in the specific case, liability might only arise under the first category; if so, his requirement of an intention to injure would not necessarily apply to the second.


\footnote{149} Jones v. Swansea City Council [1990] 3 All E.R. 737 (H.L.). Evidently, misfeasance in the sense of deliberate invalidity may be committed only in relation to acts which are governed by public law, but not in the context of the "private" activities of public authorities. See S. Arrowsmith, "Judicial review and the contractual powers of public authorities" (1990) 106 L.Q.R. 277; and supra, ch.4, sections 3-4.

\footnote{150} On the legal status and reviewability of advice given to the Bank by the Board of Banking Supervision, and in particular by its independent members, see supra, ch.2, n.341.

\footnote{151} Jones v. Swansea City Council [1990] 3 All E.R. 737.
Governor, the executive director responsible for banking supervision, and the review committee of the Supervision and Surveillance area of the Financial Stability wing (formerly, of the Banking Supervision Division). For this reason, it should be recognised that it would be a sufficient condition for liability if the particular person or persons who took the particular decision as a matter of fact acted with a guilty mind.

With this caveat, the Bank and its officers will be liable for misfeasance on the same basis as all other persons occupying a public office. In fact, an action is currently pending against the Bank on this basis in connection with the failure of B.C.C.I., the allegation being that the Bank, by continuing to permit B.C.C.I. to trade long after becoming aware of serious irregularities in its operations, had wilfully or recklessly failed to discharge properly its regulatory duties.152

In addition, in the event that the prosecution of an offence under the Banking Act by the Bank and its officers is activated by improper motives, they may be liable for committing the tort of malicious prosecution. This non-economic tort is distinct from misfeasance, because the element of malice is not sufficient by itself to make a prosecution tortious, but proof that the prosecution lacked a reasonable and probable cause is also needed.153

Misfeasance in public office and malicious prosecution are not the only intentional torts that may apply to the exercise of regulatory functions. Potentially, other economic torts may also provide a basis of liability in certain cases. The tort of intimidation may be of relevance where the threat of taking ultra vires regulatory action (as distinct from its actual exercise) is used to coerce the Bank's regulatees to conform to its wishes by behaving in a way involving loss to themselves (e.g., by abstaining from entering into transactions of a particular description or by participating in the costly rescue of another institution) or to a third party (e.g., by

---

152 The action, which is effectively directed by the failed bank's liquidators, seeks to recover damages from the Bank for the benefit of B.C.C.I.'s English liquidation. Formally, the action is brought under the names of 6,019 depositors who have equitably assigned their individual claims to B.C.C.I. On the use of the assignors' names and the need to join the assignee as true claimant, see Three Rivers District Council v. Governor and Company of the Bank of England, The Times, 6 Dec. 1994 (C.A.); see also M. Leeming, "B.C.C.I.: The real party in interest?" (1995) 111 L.Q.R. 549. In addition to their claim in misfeasance under domestic law, the plaintiffs also pursue the Bank on the alternative ground that it is liable under Community law for breach of directly effective provisions of the First Banking Directive. On liability for breaches of Community law, see infra, section 4.

153 If misfeasance could be alleged as an alternative cause of action in this context, it would be a sufficient condition of liability that the prosecution was motivated by an improper purpose. Proof that it was also unreasonable would be unnecessary. Accordingly, in this area malice cannot give by itself rise to liability for misfeasance and proof of all the elements of malicious prosecution is essential; McDonagh v. Commissioner of Police of the Metropolis, The Times, 28 Dec. 1989 (Q.B.D.).
"blackballing" that third party and abstaining from any contractual relationship with it). In this case, knowledge of the invalidity of the threatened action and of its potential detrimental consequences for the plaintiff is enough and it is not necessary that the main purpose of the intimidation be to inflict injury to the plaintiff. It has been suggested that the tort can be also committed if the threat of taking what would otherwise be lawful action is vitiated by the malicious ulterior motive to injure either the person receiving the threat or a third party. In private relationships, threatening to do acts which are not wrongful in themselves is generally lawful, even if there is a purpose of intimidation or coercion and however malicious the intention behind the threat. In contrast, in the context of public functions malice or bad faith is sufficient to taint an otherwise lawful course of action and make it invalid. Accordingly, bad faith could render the threatened action an ipso facto unlawful means, opening the way to actionability. Nonetheless, bad faith in the limited sense of awareness on the part of the threatening officials that the action would probably be ultra vires, cannot by itself establish liability, because in the tort of intimidation knowledge of the likely injury to the plaintiff is of essence to the cause of action.

Inducement to breach of contract is another heading of liability, which could be of relevance in situations involving the application by the Bank of informal pressure on a regulated institution, e.g., for the purpose of removing an undesirable manager or director from his employment. An action was commenced against the Bank on this ground by Lord Spens, a merchant banker accused of fraud in connection with the Guinness insider-dealing affair, who lost his job as a result of pressure exercised by the Bank on his employer. The Bank had acted in pursuance of its general responsibility under the Banking Act 1979 to ensure the prudent management of banks. Following his acquittal of the charges made against him, Lord Spens sued over the loss of his job, claiming aggravated damages from the Governor of the Bank for inducement to breach of contract and damages from his former employer bank for breach of contract.

---

155 Allen v. Flood [1898] A.C. 1 (H.L.); Rookes v. Barnard [1964] A.C. 1129 (H.L.), pp.1168-1169 per Lord Reid. Cf., however, Universe Tankships Inc. v. International Transport Workers' Federation; The Universe Standard [1983] 1 A.C. 366 (H.L.), where restitution was accepted with respect to money which had been extracted under duress, by exercising pressure on the plaintiff of a kind "which the law does not regard as legitimate", p.384 per Lord Diplock. Exceptionally, intimidation by means of threat of lawful action is tortious when the intimidation is the act, not of a single person, but two or more acting in combination. In this case, the idiosyncratic tort of conspiracy to injure with lawful means may be committed; Quinn v. Leathem [1901] A.C. 495 (H.L.).
This claim raises important questions regarding the availability of damages in similar circumstances following the enactment of the Banking Act 1987. In common law, the tort is committed whenever the defendant knowingly persuades a party bound to the plaintiff by contract to break this contract, resulting in loss to the plaintiff. In the statutory context, however, mere intention of interference with the plaintiff's contract may not be enough because, insofar as the Bank or its officers act in the bona fide belief that the interference with the plaintiff's contract is appropriate as part of the discharge of the statutory regulatory functions, they are protected by the immunity of section 1(4). For this reason, an additional mental element may be necessary, i.e. knowledge that there is no reasonable statutory ground for the interference or a predominant purpose of inflicting injury to the plaintiff. If this can be proven, the tort will have been committed. However, an argument could be made that it is always procedurally improper and outside the Bank's jurisdiction to act in the described manner, since this would remove the protections which the Act guarantees to the individuals concerned, including the requirement of notification and the right of appeal. If this is correct, knowledge on the part of the Bank's officials of the invalidity of their actions could be imputed without need of further proof, bringing them outside the scope of the statutory immunity.\footnote{157}

It must be noted that in cases of oppressiveness or arbitrariness, the Bank's liability for intentional wrongdoing may extend to exemplary damages.\footnote{158} However, the wisdom of introducing in the law of torts a punitive element and giving to the

\footnote{157}{See McBride, \textit{loc.cit.}, n.138, pp.328-331.}

\footnote{158}{The availability of exemplary damages is confined only to three traditional categories of cases: those concerning "oppressive, arbitrary or unconstitutional actions by servants of the government"; those for which exemplary damages are expressly authorised by statute; and those involving conduct by the defendant which is premeditated to confer a profit which may well exceed any compensation payable; \textit{Rookes v. Barnard} [1964] A.C. 1129 (H.L.), p.1226 \textit{per} Lord Devlin. Only the first of these categories, \textit{i.e.} oppressive behaviour by officials, is relevant here. The category is to be widely construed and "would embrace all persons purporting to exercise powers of government [...] conferred upon them by statute or at common law"; \textit{Cassell & Co. Ltd. v. Broome} [1972] A.C. 1027 (H.L.), p.1130. Following Lord Diplock's remarks in \textit{Cassell}, p.1131, the Court of Appeal has held recently that the effect of \textit{Rookes v. Barnard} was to create a "cause-of-action" test, which froze not only the categories of cases, but also the torts for which exemplary damages are available, so that awards of exemplary damages can only be made for torts in respect of which an award had been made prior to 1964; \textit{A.B. v. South West Water Services Ltd.} [1993] 1 All E.R. 609 (C.A.). Thus, \textit{Bradford Metropolitan City Council v. Arora} [1991] 3 All E.R. 545 (C.A.), awarding exemplary damages for race discrimination, was treated by the majority of the Court of Appeal as \textit{per incuriam}. See also \textit{Deane v. Ealing London Borough Council} [1993] I.C.R. 329 (E.A.T.). This approach would allow exemplary damages for torts such as misfeasance in public office, trespass to land and goods, assault, defamation, false imprisonment, breach of copyright, and private nuisance; but it would exclude them for torts such as negligence, breach of statutory duty, deceit, malicious prosecution, conversion, or public nuisance. See A. Burrows, "The scope of exemplary damages" (1993) 109 \textit{L.Q.R.} 358; and G.S. Pipe, "Exemplary damages after Camelford" (1994) 57 \textit{M.L.R.} 91.}
plaintiff an unearned windfall must be seriously doubted, particularly if the practical effect is to increase a public authority's vicarious liability for the wrongdoings of its officers and agents, thereby imposing on it - and, ultimately, on the public - an unnecessary additional financial burden.159

4. Liability for breaches of Community law

The potential impact of Community law on the civil liability of regulatory authorities can no longer be ignored.160 Article 5 of the Treaty of Rome requires the Member States of the European Community to take all appropriate measures to ensure the fulfilment of their obligations arising out of the Treaty or the secondary Community legislation. The jurisprudence of the European Court of Justice has interpreted this requirement to include the responsibility of the Member States' national courts to guarantee "that legal protection which citizens derive from the direct effect of the provisions of Community law".161 The European Court of Justice continues to offer formal recognition to the principle that the determination of the relevant remedies and procedural rules is a matter of national law and that Community law does not require for its enforcement the creation at the national level of new remedies per se. However, in its endeavour to ensure the protection of Community rights even through remedies that are essentially unavailable in comparable domestic circumstances, the Court has circumvented in practice this limitation by considering the domestically available remedies in extremely broad terms. Accordingly, provided that the relevant general type of remedy, for example damages or interim relief, is available in domestic law, the courts of a Member State which is in breach of its obligations under Community law are required to provide relief to the parties harmed by such breach, disregarding any special protections that

159 See A.S. Burrows, Remedies for Torts and Breach of Contract (1987), pp.247-250. Contra: Pipe, ibid. In cases of misfeasance in public office, whether an authority will be in fact vicariously liable for the acts of its agents will depend on whether the latter are engaged in a misguided and unauthorised method of performing their authorised duties or in activities which are totally unconnected with those duties; Racz v. Home Office [1994] 1 All E.R. 97 (H.L.).

160 See Arrowsmith, Civil Liability..., op.cit., n.4, pp.34-42, 251-261.

161 Case 33/76, Rewe-Zentralfinan z eG. v. Landwirtschaftskammer für das Saarland [1976] E.C.R. 1989 (E.C.J.), p.1997. Case 106/77, Amministrazione delle Finanze dello Stato v. Simmenthal [1978] E.C.R. 629 (E.C.J.), establishes that the competent national courts must give full effect to the provisions of Community law, if necessary by refusing to give recognition to any conflicting rules of domestic law without waiting for such rules to be set aside by legislative or other constitutional means, and that any national provisions or practices which would have the effect of withholding from the national courts the power to do everything necessary to ensure the full enforceability and effect of Community law at the moment of its application are themselves incompatible with Community law.
the domestic law may provide for the benefit of the state and other public authorities which are an emanation of the state. This means, in particular, that a breach of Community law can give rise to governmental liability in damages even if the state cannot be held liable in damages for comparable breaches of domestic law.

Actions for breach of Community law must be brought against the offending Member State in its national courts. It is for the domestic legal system to specify the competent courts and to determine the procedural conditions governing such actions. For example, the domestic law may impose reasonable time limits for recovery. The operation of the domestic rules, however, is heavily qualified by the minimum requirements upon which the European Court of Justice insists. First, the conditions applying to actions for breach of Community law must not be less favourable than those applying to similar actions relating to internal matters ("principle of non-discrimination"). Second, the relief provided by the national court must be direct and effective, and the procedural conditions and time-limits must not make the vindication of the rights which the national courts are obliged to protect practically impossible or excessively difficult ("principle of effective protection"). It is also necessary in this respect, that the relief must "have a real deterrent effect". To achieve the result of effective protection, the national courts may have to disapply restrictive domestic rules.

The liability of national authorities could arise in a number of situations. Firstly, liability could arise in cases of breach by a Member State of regulations or of "directly effective" measures in directives, i.e. of measures which are sufficiently precise and unconditional to confer enforceable rights directly on individuals (including rights against the central state and other public authorities) even if the Member State has failed to enact legislation for their national implementation. Secondly, liability could arise when a Member State fails to implement a non-directly-effective provision in a directive, or when the domestic measure which purports to implement it contravenes itself the provisions of Community law. Finally, liability could arise as a result of actions taken by a Member State on behalf of the Community (for instance, in the course of the administration of the Common Agricultural Policy) which are defective, either because the original Community

---


measures upon which they were based are themselves invalid or because the national authorities have misinterpreted and wrongly applied these Community measures.  

The significant *Francovich* case\(^\text{167}\) applies the principle of effective protection of Community rights to situations of the second type, by establishing the conditions under which the Member States must pay compensation for the damage suffered by individuals as a result of their failure to implement the provisions of a directive within the prescribed time limits, in accordance with Article 189(3) of the Treaty of Rome. In certain cases, the provisions of Community law may require the protection of individual rights whose content can be determined with sufficient precision from such provisions but which are not directly applicable, for example because they involve obligations between private parties which cannot be created immediately by means of a directive\(^\text{168}\) or because the identity of the person liable to guarantee the relevant rights cannot be identified from the wording of the directive. Although in such cases the provisions depend for their full effectiveness on the Member States' measures of implementation and cannot provide a direct basis for the vindication of individual rights, a Member State which fails to safeguard the relevant rights will be liable to compensate the individuals who suffer damage as a consequence of this failure. While the conditions of liability depend on the nature of the breach of Community law which gives rise to the damage, at least in the case of non-implementation of a directive (as distinct from defective implementation) governmental liability can arise on the following conditions: (a) that the Community provisions entail the creation of individual rights; (b) that the content of such rights is identifiable with sufficient precision from the provisions in question; and (c) that a causal link exists between the failure to implement the directive and the damage suffered by the plaintiff.  

It has been maintained that the right of compensation under *Francovich* arises only when the Community provision in question cannot otherwise be relied upon before the national courts by the individuals to which it intends to confer rights. This would exclude by definition all directly effective measures. However, the restriction of the *Francovich* principle to a purely residual role cannot be easily reconciled with the insistence of the European Court of Justice on the effective protection of Community rights. Where financial damage has been sustained by an individual as a result of an infringement of Community law, *e.g.* the incorrect implementation of a directive or the application of an incompatible rule of national law, the fact that the individual may be able to seek the annulment of the offending national measure may

\(^{166}\) In the last case, the Community may also be liable. Arrowsmith, *Civil Liability..., op.cit.*, n.4, pp.34-35, 257-261.  

422
not always be sufficient to ensure real and effective protection and, accordingly, should not preclude *a priori* protection in respect to the financial damage.\(^{169}\) Thus, individual citizens may derive rights from Community provisions enacted in the public interest, the infringement of which entitles them concurrently to public remedies and private compensation.

*Francovich* would appear to rely on principles of strict liability, similar to those applying under English law in certain cases of breach of statutory duty, but it is still unclear whether mere infringement of Community law, however minor or innocent, is sufficient in all cases to establish liability on the part of the Member States or whether a more demanding test should be applied.\(^ {170}\) In a recent opinion, Advocate General Guiseppe Tesauro suggests that, while the liability of a Member State for breaches of its Community obligations cannot depend on fault as a subjective component of the unlawful conduct imputed to it, but rather only on objective factors, liability should only arise where a breach was serious and manifest. In the Advocate General's view, the decisive factors for the purpose of setting limits to the liability of the Member States are the discretion which these may enjoy and the degree of precision of the obligation imposed under the provision in question, and ultimately the possibility of identifying with a sufficient degree of precision the content of the right asserted by an individual in a particular situation.\(^ {171}\) A manifest and serious breach can be considered to exist when: (a) obligations whose content is clear and precise in every respect have not been complied with; (b) the case-law of the European Court of Justice has provided sufficient clarification of doubtful legal

---


\(^{170}\) Arguably, liability should not be imposed under *Francovich* for minor or innocent infringements of Community law. This view is supported by the argument that the liability of Member States should not arise on wider grounds than that of the Community itself. With respect to legislative measures of economic policy, the Community institutions are only liable for damages under Art.215(2) of the Treaty of Rome when (a) there has been a sufficiently serious breach of a superior rule of law for the protection of the individual and (b) the institution concerned has manifestly and gravely disregarded the limits on its powers; Case 5/71, *Zäckerfabrik Schopenstedt v. Council* [1971] E.C.R. 975 (E.C.J.), p.984. In addition, practical considerations suggest that the Member States should not be liable for innocent mistakes in interpreting and implementing Community measures. Liability under these circumstances would have grave financial consequences for the Member States, even though no degree of caution could ensure conclusively that they do not make such mistakes. See P.P. Craig, "*Francovich*, remedies and the scope of damages liability" (1993) 109 L.Q.R. 595, in particular pp.604-619; and also R. Caranta, "Governmental liability after *Francovich*" (1993) 52 C.L.J. 272.

\(^ {171}\) *Brasserie du Pécheur S.A.*, opinion of Advocate General G. Tesauro, 28 Nov. 1995, paras.74-90.
situations which are identical or similar to that at issue; or (c) the national authorities' interpretation of the relevant Community provisions is manifestly wrong.\textsuperscript{172}

Although the award in an action for damages for breach of Community law must be assessed through the application of the domestic law, the Member States cannot set limits to the measure of the damages, but must provide full compensation, including interest.\textsuperscript{173}

As the harmonisation of banking regulation at the Community level progresses and the relevant legislative measures become more specific and comprehensive, it is conceivable that in certain circumstances the rules adopted will entail the entrenchment and legal protection of individual rights. For instance, the adoption of a uniform minimum level of protection that must be provided by every national deposit-guarantee scheme involves precisely rules which are likely to be held to be directly enforceable and able to create governmental liability on a strict basis. In cases of this nature, the vindication of the protected individual rights could involve actions for damages against the responsible national banking regulator. Regulatory liability on such grounds may become a significant issue in the future. Nonetheless, in many cases it will be difficult to establish that the Community provisions intended the creation of individual rights.\textsuperscript{174}

It would appear that not only a Member State's central government, but any public authority to which a breach of Community law is attributable could be held liable for that breach. This could be the case where a public authority failed to act in accordance with a directly effective provision of Community law or, possibly, by being the designated authority for the national implementation of a particular measure of Community law which has not been correctly transposed.\textsuperscript{175} Liability of

\textsuperscript{172} \textit{Ibid.}, para.84.

\textsuperscript{173} \textit{Case C-271/91, Marshall v. Southampton and South West Hampshire Area Health Authority (No.2) [1993] E.C.R I-4367 (E.C.J.).}

\textsuperscript{174} For instance, in one English case it was thought that, while Council Directive 79/279/EEC of 5.3.79 expressly recognised that the conditions imposed by the competent authorities of the Member States with regard to the admission of a company's securities for listing in an exchange should aim to protect the interests of investors, its primary purpose was to coordinate listing practices across the Community with a view to establishing a common market in securities and not in any direct way to provide additional protection for investors, \textit{i.e.} by conferring upon shareholders a right of recourse to the courts; \textit{R. v. International Stock Exchange of the U.K. and the Republic of Ireland Ltd., ex p. Else (1982) Ltd. [1993] 1 All E.R. 420 (C.A.).}

\textsuperscript{175} Every public body has a duty to apply "directly effective" Community provisions, despite the fact that these have not been implemented or have been incorrectly implemented at the national level or are incompatible with other national legislative provisions, and could be liable for a breach of such provisions attributable to it. See \textit{Brasserie du Pêcheur S.A.}, opinion of Advocate General G. Tesauro, 28 Nov. 1995, paras.34-35, 42, 48 and 51. On the other hand, where a binding Community measure in a directive is devoid of direct effect because the authority responsible for applying the measure can be chosen freely by the Member State, as in \textit{Francovich}, only the central government of that Member State should be liable for the failure to implement, for it is up to it to make the choices necessary for implementation.
the Bank of England could be established on this basis. Evidently, its statutory
immunity will be unable to offer any protection to the Bank in an action for breach of
Community law. On the other hand, it is not certain that every actionable
violation of the regulatory provisions of Community law will be attributable to the
Bank. For this reason, whether the Crown or the Bank will be liable will depend on
the facts and legal environment of each case.

5. Compensation under the Deposit Protection Scheme

A normative argument could be made that the Bank, as the de facto controller of
bank quality, should be held civilly liable to depositors if it negligently failed to
prevent bank failures. A recognition of quasi-professional liability to depositors on
these lines could find its social justification on the proposition that, either because of
their subjective vulnerability and lack of sophistication or because of informational
asymmetries which impede them from making informed decisions themselves, the
latter must rely on the regulatory authorities' assessment of bank safety and
soundness. Nonetheless, even on the assumption that depositors are indeed unable to
fend for themselves, liability in tort would not necessarily be a suitable means for
protecting them against the negative consequences of bank failures. Statutory
compensation on a non-fault, insurance-like basis could be more appropriate, since it
would ensure the desired measure of protection in all cases, without need for
establishing negligence on the part of the regulators.

Since the mid-1970s, various compensation schemes have been set up under
statute for the purpose of providing limited protection to investors against losses
suffered through the collapse of financial intermediaries to which they have entrusted
their assets. In the field of banking, this role is performed by the Deposit
Protection Scheme, which has been in operation since February 1982.

In contrast to U.S.-style deposit insurance, involving essentially full protection
for deposits of any size, the Deposit Protection Scheme provides only partial

---

176 See supra, text and n.162.
177 The trend can be traced back to the Policyholders Protection Act 1975; see also Building
Societies Act 1986, ss.24-30; and F.S.A., s.54.
178 Established under the Banking Act 1979, Pt.II, and currently regulated by the Banking Act
1987, Pt.II (ss.50-66), as amended by the Credit Institutions (Protection of Depositors)
Regulations 1995, S.I. 1995/1442, Pt.III (regs.25-35). On the Scheme, see Penn, op.cit., n.13,
ch. 9; and also I. Morison, P. Tillett and J. Welch, Banking Act 1979 (1979), ch. 4. Even before
1979, the banking industry had in certain occasions improvised ad hoc schemes to safeguard the
interests of the depositors of failed institutions.
coverage. Thus, before the implementation of the Deposit-Guarantee Directive\(^\text{179}\) on 1 July 1995, compensation under the Scheme was limited to 75% only of "protected deposits" as defined, *i.e.* of the first £20,000 of an authorised institution's total liability to each claimant in respect to sterling deposits made with the institution's U.K. branches.\(^\text{180}\) This has now been raised to 90% of an equal amount of deposits denominated in any E.E.A. currency or in ECU with branches in any Member State. The Scheme's purpose is to mitigate the effects of bank failure, especially insofar as depositors of relatively modest financial means are concerned. This makes it politically possible for the Bank to refuse to bail out ailing deposit-taking institutions, in particular if these are small or new. At the same time, by declining to offer complete protection, the Scheme seeks to minimise the moral hazard associated with deposit insurance, *i.e.* the incentive for insured depositors to place their funds with those banks which offer the best nominal return even if these are unsafe, since the repayment of their deposits is guaranteed by the state.

The Deposit Protection Scheme is operated by the Deposit Protection Board, a body corporate whose competence is limited to the administration of the Deposit Protection Fund.\(^\text{181}\) The Deposit Protection Board consists of three *ex officio* members, all of which represent the Bank, *i.e.* the Governor of the Bank (who is also the Board's chairman), the Deputy Governor and the Chief Cashier, and a number of ordinary members, of which three must be directors, controllers or managers of authorised institutions and the remainder must be officers or employees of the Bank.\(^\text{182}\) Thus, although the Deposit Protection Board is constituted as an independent body, in practice it is closely linked to the Bank, which always controls a majority of its members.

The Deposit Protection Scheme is financed on a compulsory basis by the banking industry, and not out of public funds. In this sense, it amounts to an earmarked tax on the industry. An implication of this form of financing, however, is that the safe and sound institutions are forced to share the cost of bailing out the depositors of their more profligate competitors. For this reason, the basis on which contributions are assessed becomes very important, especially to the extent that the larger - and apparently more reliable - banks are made to bear a greater share of the burden in


\(^{180}\) Including accrued interest, but excluding inter-bank deposits, deposits made by persons connected to the institution, secured deposits and deposits with an original maturity of more than five years; see original text of ss.58(1) and 60.

\(^{181}\) Banking Act 1987, s.50, as amended by S.I. 1995/1442, reg.25, and Sch.4.

\(^{182}\) Currently, the Board has a total of seven members. Sch.4 to the Act contains the constitution of the Board.
absolute terms. Even if the Scheme were not in existence, in appropriate cases the banking industry would probably be ready to organise *ad hoc* assistance schemes for the benefit of depositors of failed institutions, in order to avoid adverse publicity and a loss of confidence in its collective ability to honour its commitments. Under the present arrangements, however, banks have no discretion to withhold support. For this reason, the enactment of the Deposit Protection Scheme as part of the Banking Act 1979 was the subject of considerable controversy.

In May 1994, the Deposit-Guarantee Directive, aiming at the harmonisation of the minimum protection offered by the national deposit-insurance schemes of the Member States, was adopted at Community level. The Directive requires that all credit institutions must be members of the deposit-guarantee scheme of their home State. As a minimum, the national schemes of the Member States must guarantee to each depositor the repayment of the first ECU 20,000 of his aggregate deposits with the participating banks' branches in any Member State. Although Member States have a discretion to limit the guarantee to a specified percentage of qualifying deposits, this percentage cannot be less than 90% of aggregate deposits until the amount that a depositor is entitled to recover reaches ECU 20,000. The decisions regarding the form and sources of funding of the national schemes are left to the discretion of the Member States. However, to avoid the long delays that would result if the judicial declaration of insolvency were made a prerequisite of recovery by depositors, the Directive specifically provides that, if a judicial ruling having the

---

183 Note, however, that new entry is penalised because very small institutions are subject to a minimum initial contribution to the Deposit Protection Fund. In addition, there is a maximum limit on initial and further contributions, which has been specifically designed to benefit the largest deposit-takers, i.e. the "Big Four" clearing banks, because its effect is to keep their contributions at a lower level, as a percentage of their deposit base, than would be the case for smaller banks. However, the limit does not apply to special contributions, which may be called if the permanent Fund is not sufficient for the repayment of the protected deposits of failed banks. On contributions, see *infra* text and n. 196.

184 For an interesting example of an *ad hoc* rescue scheme organised by the building-societies industry, see *Halifax Building Society v. Registry of Friendly Societies* [1978] 3 All E.R. 403 (Ch.D.).

185 E.P.M. Gardener, "Supervision in the United Kingdom", in E.P.M. Gardener (ed.), *U.K. Banking Supervision: Evolution, Practice and Issues* (1986), p.78. Medium-to-large banks were particularly hostile to the Scheme, raising objections both of principle and of a more technical character. On the other hand, the "Big Four" clearing banks had less reason to complain because of the inclusion of an upper limit on initial contributions to the Deposit Protection Fund.

186 The Directive replaces the Commission Recommendation 87/63/EEC of 22.12.86 concerning the introduction of deposit-guarantee schemes in the Community, which was based on the host-country principle, according to which the European branches of credit institutions should be covered by the deposit-guarantee scheme of their host Member State.

187 Art.3(1).

188 Arts.7-8. Member States which before the adoption of the Directive provided a lower level of protection are allowed to limit the guarantee under their national schemes to an amount not less than ECU 15,000 until the end of 1999.
effect of suspending the repayment of deposits has not been made earlier, an administrative determination by the competent authorities that a bank is unable to reimburse its deposits is sufficient to activate the national deposit-guarantee schemes; the competent authorities are required to make such a determination as soon as possible and in any event within 21 days "after having becoming satisfied that a credit institution has failed to repay deposits which are due and payable". The national schemes must be in a position to make payments to rightful claimants within three months from the relevant judicial ruling or determination of the competent authorities.

The Directive extends the home-State principle in this area of deposit insurance as a means of placing some responsibility for the costs of bank failure with the State which exercises supervisory control in accordance with the Second Banking Directive. This could dissuade Member States whose banks conduct a major part of their business abroad, such as Luxembourg, from tolerating the operation of weak banks from their jurisdiction or neglecting to exercise adequate prudential supervision, while shifting the costs of failure to other Member States.

As deposits with a bank's branches in other Member States are now covered by its home-State deposit guarantee scheme and subject to its terms, national discretion regarding the scope and level of coverage can lead to unequal conditions of competition, insofar as the deposit liabilities of banks coming from different Member States but operating in the same geographical market are, as a result, subject to different degrees of protection. In order to ensure competitive equality, the Directive prohibits the "exportation" of superior home-State guarantees by providing that, at least until the end of 1999, neither the level nor the scope of cover provided under the home-State scheme may exceed the cover offered by the corresponding scheme of the host Member State. Conversely, in situations where the host State's deposit guarantee arrangements are more generous than those of the home State, branches of European credit institutions are given the right to "top up" the protection offered

189 Art.1(3).
190 Art.10(1).
191 Usually, the responsibility for the provision of support to the foreign establishments of international banking groups is assumed by their parent institutions and, through them, by their home-country banking authorities. However, when support is not forthcoming from the home country, the host country may feel the need to take last-resort action itself. The host country may also bear the burden of compensating the domestic depositors of the foreign establishments out of its own deposit-insurance scheme. In this manner, the home countries reap the benefits of international banking in terms of highly qualified employment and tax revenues but meet only a small part of the costs of bank failure. With the introduction of the home-country principle, however, even if a Member State is unwilling or unable to provide informal assistance to its banking institutions, it will be at least obliged to formally guarantee part of their Community-wide deposit-taking. See D. Schoenmaker, "Internationalisation of banking supervision and deposit insurance" (1993) 8 J.I.B.L. 106.
by their home-State scheme by participating voluntarily in the host State's scheme, thus ensuring that, overall, their deposits enjoy an equal degree of protection with those of institutions incorporated in the host State. This is a compromise solution which, by imposing on the host country an obligation to provide partial insurance without exercising supervisory control, weakens the disciplinary role of the home-country principle and leaves room for conflicts between the resolution policies of the two applicable schemes.

A number of changes to the Deposit Protection Scheme were necessary to bring it in line with the Directive. These were made by the Credit Institutions (Protection of Depositors) Regulations 1995, which came into effect on 1 July 1995. The most significant modifications effected by the Regulations were the following: (a) the level of compensation under the Scheme, which was originally 75% of qualifying deposits, was increased to 90%; (b) the coverage of the Scheme, which previously covered only sterling deposits with the U.K. branches of authorised institutions, was widened to encompass (i) non-sterling deposits denominated in any E.E.A. currency or in ECU and (ii) deposits with all branches of U.K.-incorporated institutions in any Member State; (c) the U.K. branches of institutions from other Member States, which must now be covered by their home-State schemes, were excluded from the Deposit Protection Scheme - although branches of banks from those Member States with less generous deposit guarantee schemes, were given the option to participate in the Scheme in order to obtain "top up" cover for their U.K. deposits; and (d) new provisions were made to ensure that payments under the Scheme are activated by the mere inability of a bank to honour its repayment obligations, without need for judicial declaration of insolvency. The maximum amount of protected deposits for each depositor remains at £20,000 (provided that this is greater than the sterling equivalent of ECU 22,222).

192 Art.4.
193 The Deposit Guarantee Directive was adopted despite Germany's strong objections concerning three main aspects of the new arrangements, namely: the obligation on all credit institutions to belong to a guarantee scheme and the corresponding obligation on the guarantee scheme to cover all authorised credit institutions (Germany favoured optional national schemes, that would be allowed to turn down unsuitable applicants for membership); the obligation on German schemes to accept as members branches of European banking institutions wanting to top up the coverage of their home State's scheme; and the cap on the exportation of the home State's guarantee for branches of German banks established in Member States with lower levels of protection. Following the adoption of the Directive, Germany has raised a legal challenge to the Directive, pleading that the legal basis of the Directive in Art.57(2) of the Treaty of Rome does not justify the topping-up and capping provisions, which are moreover contrary to the principle of freedom to provide services and also to the principle of subsidiarity. The case is still pending before the E.C.J. See M. Andenas, "Directive on deposit guarantee schemes challenged" (1995) 16 Co.Law. 18.
194 S.I. 1995/1442.
More specifically, under the amended statutory provisions, payments must be made out of the Deposit Protection Fund to any depositors who, as a result of an authorised institution's failure, are unable to recover their deposits. The Fund is financed by obligatory contributions, levied by the Deposit Protection Board from all authorised institutions in proportion to each institution's "deposit base" (i.e., the average over a period of time of total deposits in any E.E.A. currency or in ECU held with its offices in the U.K. or any other E.E.A. State, with the exception of secured deposits, deposits which qualify as own funds for capital adequacy purposes, interbank deposits and deposits by insurance undertakings, and deposits in respect to which a certificate of deposit has been issued). 195

Authorised institutions are liable for three types of contributions to the Deposit Protection Fund. "Initial contributions" are levied upon the authorisation of each institution. If the newly-authorised institution already has a deposit base, the initial contribution is calculated as a percentage of its deposit base at a level determined by the Deposit Protection Board with a view to put the institution on a basis of equality to its competitors, but always subject to an absolute minimum of £10,000 and a maximum of £300,000; in the more typical case of an institution without a pre-existing deposit base, the initial contribution is equal to the statutory minimum of £10,000. "Further contributions", subject to the maximum limit of £300,000, may be raised (a) for the purpose of restoring the value of the Fund to its targeted permanent level of between £5 million and £6 million, if at the end of a financial year this has fallen below £3 million, and (b) for the purpose of increasing the size of the Fund above that level, following a decision of the Treasury to this effect. "Special contributions" may be raised with the approval of the Treasury, if during a financial year it appears that payments to claimants are likely to exhaust the Fund. If at the end of any year the Fund exceeds its targeted permanent level, the special contributions must be repaid on a pro rata basis. However, no further or special contribution may be levied from an institution, if as a result the aggregate amount of all contributions made by it would exceed 0.3% of its deposit base. 196

The U.K. branches of European banks whose home State provides less generous protection have the option of participating to the Scheme in order to provide "top up" cover to their depositors, bringing their total protection to the same level of

195 S.52, as amended by S.I. 1995/1442, reg.27.
196 S.53, as amended by S.I. 1995/1442, reg.28, and ss.54-56. Further to its power to levy contributions, the Deposit Protection Board has the power to borrow at any time up to a total of £125 million; s.64(1) and Deposit Protection Board (Increase of Borrowing Limit) Order 1991, S.I. 1991/1684. The Treasury, after consultation with the Deposit Protection Board, has a power to alter by order the amounts specified in the statutory provisions.
cover as that offered to the depositors of U.K.-incorporated institutions. In reverse, the participation by a U.K. institution in the scheme of a host Member State is also possible when this is necessary for "topping up" the protection of its depositors in that Member State. Branches of third-country institutions must participate in the Scheme, unless, on an application by them, the Deposit Protection Board determines that their home-country deposit protection scheme provides at least equivalent protection to their U.K. depositors.

The Deposit Protection Scheme is activated when an authorised institution, or former authorised institution, becomes insolvent. For the purposes of the Scheme, an institution becomes insolvent following either (a) a determination of the Board that, for reasons directly relating to its financial circumstances, it is unable to repay deposits which are due and payable and has no current prospect of being able to do so, or (b) following a judicial ruling directly relating to its financial circumstances and having the effect of suspending the ability of depositors to make claims against it, but in either case only if deposits due and payable have as a matter of fact not been repaid. The Board must make a determination within 21 days of its being satisfied that the institution must be declared insolvent. The administrative declaration of insolvency by the Board avoids delays in the activation of the Scheme such as could occur prior to the implementation of the Deposit-Guarantee Directive, when the critical time of an authorised institution's insolvency was determined by the making of a winding-up order against it.

---

197 Provisions regarding the eligibility of such branches for participation in the Scheme, the procedures for participation, withdrawal or exclusion from the Scheme, and the co-operation between the Deposit Protection Board and the home-State authorities having responsibility for the home-State deposit-guarantee scheme are made by S.I. 1995/1442, Pt.II, ch.1 (regs.3-12). The calculation of a participating branch's deposit base for purposes of determining its contributions to the Fund must follow a formula set out in the Banking Act 1987, s.52(4B), inserted by S.I. 1995/1442, reg.27.

198 Provisions for this purpose are made by S.I. 1995/1442, Pt.II, ch.2 (regs.13-18).

199 Provisions regarding the eligibility of such branches for non-participation in the Scheme and the procedures to be followed for ensuring non-participation are made by S.I. 1995/1442, Pt.II, ch.3 (regs.19-24).

200 S.59, as substituted by S.I. 1995/1442, reg.31. The insolvency of a participating European institution cannot be determined by the Board, and must be declared by the supervisory authorities of its home State or by a judicial ruling; sub-s.(2).

201 See the original text of s.59. A requirement for the judicial declaration of insolvency could lead to very considerable delays. For instance, the hearing of the Bank's petition for the winding-up of B.C.C.I. S.A. was adjourned on three occasions. In addition to the potential hardship to depositors, the requirement of judicial declaration of insolvency was originally thought to have another unintended effect, by allowing the assignee of a deposit to be treated as the original depositor for the purpose of claiming compensation, even though the assignement was made after the presentation of the petition for the deposit-taking institution's winding-up. The ex post division of a single deposit between different assignees could, on this interpretation, result in the multiplication of the amount of the Deposit Protection Fund's liability. This view, which was endorsed by the court of first instance and the Court of Appeal in Deposit Protection Board v. Dalia [1994] 1 All E.R. 539 (C.A.); rev'd., [1994] 2 All E.R. 577 (H.L.), led to the adoption of
Payments to the rightful claimants must be made out of the Fund as soon as practicable after the determination of insolvency, but in any event the Board must secure that, except in exceptional circumstances, it is in a position to make payments within a period of three months following the insolvency. In other words, compensation under the Scheme cannot wait the completion of the institution's liquidation. This complicates the administration of the Scheme. In order to receive compensation, proof of the insolvent institution's liability to the claimant must be lodged with the liquidator or administrator, otherwise information and documents supporting the claim must be made available by the claimant to the Bank. A claim must be made in such form and within such period, and must be supported by such evidence, as the Board directs.

Compensation under the Scheme is limited to 90% of "protected deposits" as defined, i.e. of the first £20,000 of the institution's total liability to each claimant in respect to deposits (including accrued interest) made while the institution was authorised, but excluding, in particular: (a) secured deposits; (b) deposits which qualify as own funds for capital adequacy purposes; (c) deposits made in the course of a money-laundering transaction; (d) interbank deposits and deposits by insurance undertakings, except where these were made by the depositing institution as a trustee for a client; (e) deposits made with a former authorised institution after it had ceased to be authorised, unless the depositor did not know and could not be expected to know that the institution was no longer authorised. If immediately before the institution became insolvent the sterling equivalent of ECU 22,222 was greater than £20,000, this equivalent must be substituted for the amount of £20,000 for the determination of protected deposits. The Deposit Protection Board is under a legal obligation to compensate rightful claimants, although it may decline to make any payment to a person who bears responsibility for, or has profited from, an institution's failure.

---

202 S.58(1)-(2), as substituted, and (2B), as inserted by S.I. 1995/1442, reg.30(1).
203 S.60(3), as substituted by S.I. 1995/1442, reg.32(1).
204 S.58(2B), inserted by S.I. 1995/1442, reg.30(1).
205 S.60(1) and (6), as substituted by S.I. 1995/1442, reg.32(1) and (3). The limit may be altered by order of the Treasury, subject to affirmative resolution of both Houses of Parliament; s.60(5), as amended by S.I. 1995/1442, reg.32(2). Special rules apply to trust deposits, joint accounts, etc.; s.61, as amended by S.I. 1995/1442, reg.33.
206 S.58(5), as amended by S.I. 1995/1442, reg.30(3).
To the extent that the claimants receive compensation out of the Deposit Protection Fund, the liability of the failed institution towards them is discharged. Instead, the Deposit Protection Board acquires a direct statutory claim of its own against the institution, which has a priority over the remainder of the claimants' original deposit claim in the distribution of the institution's liquidated assets. For this reason, the Deposit Protection Board enjoys creditor's rights in the insolvency proceedings and may be represented in the creditors' committee. Any money received by the Deposit Protection Board from the liquidation is put aside, to be used at the end of the financial year for the repayment of special and further contributions. If the amounts available are not thereby exhausted, the balance is credited to the Fund.

The availability of deposit protection under the Deposit Protection Scheme lessens the political pressure for bailing out insolvent banks and, at the same time, makes arguments for the imposition of civil liability on the Bank less influential. Indeed, the operation of the Scheme has coincided with a curtailment of the implicit governmental "safety-nets" for banking institutions facing financial difficulties. The Bank's growing reluctance to offer support to smaller or less important institutions for the purpose of keeping them afloat and ensuring full protection for their depositors has contributed to a sharp increase in the incidence of bank insolvencies in recent years, with B.C.C.I. being the most spectacular case of this type. Furthermore, the Government has consistently resisted calls for the making of ex gratia compensatory payments to depositors who have suffered loss upon such insolvencies, disclaiming any responsibility and indicating that the role of the state in this context is confined to ensuring that the regulatory system incorporates the

---

207 S.62, as amended by S.I. 1995/1442, reg.34.
208 S.58(8)-(9), as amended by S.I. 1995/1442, reg.30(6). Because it acquires priority in the distribution by virtue of the statutory subrogation, the Deposit Protection Board has a bona fide interest in promoting the early distribution of liquidated assets even if this can prevent the liquidators from achieving the absolute maximum return to creditors generally. This puts it in a slightly different position from the other creditors in the liquidation and may lead it to oppose them in the creditors' committee; see Re Bank of Credit and Commerce International S.A., 17 Jul. 1991, C.A., reported in LEXIS.
209 S.63.
210 Nonetheless, during a two-year period starting in summer 1991, the Bank provided support to several smaller institutions, which used to rely on wholesale deposits but had been unable to renew their funding because of the combined effect of the recession, a liquidity squeeze triggered by a number of small-bank failures in the previous year and the withdrawal of local-authority deposits from smaller institutions in response to the failure of B.C.C.I. The purpose of the Bank's intervention was to prevent systemic contagion. The Bank made provisions of some £115m. in respect of indemnities given to the lenders to the institutions covered by the support operations. See Bank of England, "Report and Accounts for the Year Ended 28 February 1993" (13 May 1993), pp.6-7, 10.
lessons from these events. Accordingly, in a number of occasions the depositors of failed institutions had to rely on the Deposit Protection Scheme for compensation. A different question is whether the Scheme has in fact provided compensation to all the potential claimants. For instance, nearly three years after the formal closure of B.C.C.I. in July 1991, payments under the Scheme had been made to some 15,000 depositors at an approximate total cost of £75 million; nonetheless, over half of the eligible depositors of that bank had apparently failed to make a claim.

6. Regulation and compensation: policy considerations

It is often suggested that all citizens who have suffered damage as a result of wrongful administrative action should have a cause of action in tort. This would be particularly appropriate in view of "the great extension of governmental functions and the increasing need for them to be exercised with the responsibility that good administration demands".

Two main reasons are invoked in support of the expansion of governmental liability. First, liability can provide protection to the citizen against undue or arbitrary damage suffered as a result of inappropriate administrative action even in circumstances where the notional restoration of legality by way of judicial review or administrative appeal cannot reverse the real loss caused by the transgression. On this view, it is proper that the authorities provide compensation for their improper exercise of their regulatory functions even if this is not the immediate cause of the loss, but is only indirectly connected to it through a failure to achieve an adequate level of protection, because their ample resources allow them to assume the citizen's loss and prevent an "unjust" result at the individual level. Second, the fear of liability may motivate public officials to pay all necessary care in the observance of their duties. In this sense, the imposition of liability is said to serve an "educational"

---

211 A single exception was made in the case of the Western Isles local authority, which lost a considerable amount of community-charge-payers' money in the collapse of B.C.C.I. and to which the Scottish Office reallocated additional governmental grant funds; see The Guardian, 4 Aug. 1994, p.24. The reallocation was made at the expense of the Shetland local authority, which as a result suffered a considerable squeeze on its resources. The difficulties faced by the latter authority serve as an example of the manner in which compensatory payments distort the application of public funds; see infra, section 6.

212 See K. Mullan, "B.C.C.I.: the latest developments" (1994) 15 Bus.L.Rev. 119, p.120.


and disciplinary purpose, by bringing home to the authority the need to be careful and law-abiding.\textsuperscript{215}

Despite these arguments, a strong case can be made for the opposite view, which rejects the extension of liability to the exercise of discretionary public functions, especially to the extent the damage to the plaintiffs has not been inflicted directly by the authorities in the form of detrimental compulsory measures.\textsuperscript{216} Applied specifically to the Bank, the general counter-arguments support the view that its immunity from liability is justified and should be preserved.

Insofar as claims by disappointed depositors are concerned, the introduction of liability for the failure of the Bank to guarantee an adequate level of protection to the intended beneficiaries of a regulatory policy would undermine the fundamental normative principle of self-responsibility which is implicit in the enjoyment of economic freedom. As Tony Weir had rightly observed, "if by leaving your house you assume the risk of accidental injury to your body, you should, I think, by entering the market-place, and especially the stock-market-place, be held to take the risk of financial loss due to the negligence of third parties, \textit{i.e.} non-contractors".\textsuperscript{217} This should apply to depositors as much as to other economic decision-makers. Depositors should not be allowed to pass the risk of their investment activities to the authorities as last-resort defendants. An additional reason for shielding the Bank from claims by depositors concerns the need to maintain symmetry between regulatory gains and losses. From the depositors' standpoint, the Bank's functions regarding the supervision of deposit-taking institutions amount to the provision of a free monitoring service. For this reason, when the disappointed depositors of an insolvent institution try to recover from the Bank, they essentially claim damages for the loss of a benefit which, if the Bank had performed its functions properly, they would have obtained free of charge. Recovery in this situation would transform the unearned benefit into a fully-fledged right.\textsuperscript{218} To the extent that a measure of protection is, nonetheless, deemed necessary as a matter of "social justice", there is no reason why this should be achieved through the extension - and distortion - of liability in tort. The provision of statutory or \textit{ex gratia} compensation on a non-fault basis is more appropriate, if the ultimate aim is to guarantee the protection of certain

\textsuperscript{215} The law of torts "is sometimes the last resort of the citizen who wishes to bring a serious grievance to the attention of the public. The great advantage is that the levers of the civil action are operated by the citizen himself and are not in the benevolent control of an official such as the Attorney-General, the Ombudsman or the D.P.P."; Harlow, \textit{op.cit.}, n.4, p.160.
\textsuperscript{216} See the forceful arguments of T. Weir, "Governmental liability" [1989] \textit{P.L.} 40; and Markesinis and Deakin, \textit{Tort Law, op.cit.}, n.4, pp.327-329.
\textsuperscript{217} \textit{Ibid.}, p.56.
\textsuperscript{218} See Markesinis and Deakin, "The random element...", \textit{loc.cit.}, n.23, p.631.
By legislating for the Deposit Protection Scheme, Parliament has made unambiguously clear its intention to provide a special degree of protection for depositors and has provided a specific means to this end. Furthermore, the costs from the operation of the Scheme are passed on to the regulated industry, and ultimately to the users of its services, including the depositors as a class. To this extent, the Scheme includes an element of co-insurance, although it must be noted that the distribution of costs within the banking industry is indiscriminate and generally unjust. In comparison, under a system of liability for regulatory failures, the costs of compensation would be borne by the Bank and, ultimately, by the taxpayers.

More generally, the imposition of liability for discretionary regulatory decisions could distort the Bank's decision-making process by concentrating the attention of its officials on the potential consequences of their decisions for potential claimants, leading to a defensive frame of mind. It could also open the way to incidental judicial interference with the general direction of regulatory policy as a by-product of the adjudication of individual cases. As a result, significant distortions in regulatory policy could occur, with an undue emphasis being placed on the private interests of particular parties. At the same time, the expansion of liability would force the Bank to employ scarce resources for the purpose of defending actions for damages and paying compensation to successful plaintiffs. This would involve considerable expense of public funds, and could ultimately place a heavy burden on the taxpayers' shoulders.

Finally, it is not certain that liability would have the desired disciplinary effect on the behaviour of the Bank's officials. The impact of liability on official conduct depends to a great extent on whether the officials are held directly and personally liable for their actions or not, and is weakened considerably in practice by the vicarious liability of public authorities for the faults of those acting on their behalf. From a disciplinary standpoint, even the need of retaining the Bank's vicarious liability for the intentional wrongdoing of its officials may be questioned, since criminal liability for misbehaviour in public office can provide an appropriate remedy in this situation.

Parliament has bestowed on the Bank a wide immunity from civil liability. Although in theory a more flexible position might be appropriate, in particular in the event of negligent interference with the goods and property of the regulatees or of harm to their reputation, the legislative choice is generally justifiable by the practical

219 See Harlow, op.cit., n.4.
need to prevent the superimposition of considerations of liability to the discretionary performance of the Bank's regulatory responsibilities. At the end of the day, this choice amounts to a recognition of the fact that the law of torts is a very crude instrument for the control of regulatory authorities.
Chapter 6

The Bank of England and Public Accountability

In Chapters 2 to 4 an attempt has been made to chart the legal fetters on the Bank of England's regulatory activities. It has been shown, however, that with regard to certain issues of strategic importance, including the determination of solvency ratios and other financial requirements for individual authorised institutions, the vetting of controllers, managers and directors of such institutions or the extra-statutory provision of support to ailing banking institutions, the Bank retains a very wide discretion. With regard to these matters, an increased emphasis on more formal and transparent rules could ensure greater consistency, predictability and fairness in the making of individual regulatory decisions and provide the basis for more effective judicial protection of those affected by the Bank's regulatory decisions against potential arbitrariness and abuse of power.

Nonetheless, it would be wrong to examine the regulatory powers of the Bank exclusively from the standpoint of the protection of the subject. Whatever the quality of the Bank's individual decisions, it is always necessary to ensure effective public control over the general direction of its regulatory policy. The exercise of public control does not pass from the same institutional channels as the protection of the aggrieved individual. While the interests of the latter can be protected effectively through appropriate mechanisms of judicial and administrative review, adjudication cannot ensure the congruence of an administrative body's policy choices to the broader public interest. In the case of regulatory authorities, in particular, review proceedings can ensure the fairness of their decisions regarding individual

\[1\] D. Oliver, "Law, politics and public accountability: the search for a new equilibrium" [1994] P.L. 238, pp.246-252, believes that the courts can provide a suitable forum for the representation of interests that would not otherwise have effective representation in the administrative process and that they can develop substantive standards of review. Whether this is correct or not, however, the important fact is that the adversarial nature of review proceedings necessitates an exclusive emphasis on the interests of the applicant and does not provide a legitimate substitute for the determination of the broader public interest, which is essentially a matter for the political process.
regulatees, but the threat of litigation can reinforce their tendency to accommodate the interests of the regulated industry as a whole.

Public control over the activities of the administration is only possible if these activities are characterised by openness and transparency and are subject to formal mechanisms of accountability, requiring the official decision-makers to justify their decisions against more or less authoritative standards of public behaviour and opening the way for corrective interventions in the event of administrative failure. Accountability can be political, insofar as it is concerned with the congruence of administrative decision-making to the public interest as determined through the political process, but also managerial. In the latter case its focus is the operational quality, *i.e.* the effectiveness, efficiency and financial regularity, of the administrative activities.

In the case of the Bank, the search for appropriate mechanisms of accountability and public control is subject to certain difficulties frequently encountered in relation to "expert" non-departmental regulatory agencies. The traditional mechanism of political accountability, *i.e.* the responsibility of government ministers to Parliament for the activities of their departments, does not work well in this context, because the supposedly responsible ministers have limited powers of intervention and control over the agencies' operations. A more fundamental tension arises from the fact that every increase in political accountability reduces the relative institutional and functional independence of these agencies, whose institutional design aims precisely at shielding them from external interference and politicisation and presupposes a high degree of deference to their expertise and professionalism. In these circumstances, the absence of a clear and precise legislative mandate can create intractable difficulties insofar as the exercise of meaningful public control over these agencies is concerned (section 1).

Over the years, a relatively high degree of openness and transparency with regard to the Bank's activities as a monetary authority and a more precise definition of its relationship with the Treasury have been achieved by means of gradual institutional changes (section 2). However, the situation is less satisfactory in connection to its regulatory activities. The Bank is by-and-large free of political control in this area and - excepting the occasional scrutiny of its activities by investigating parliamentary Select Committees - its accountability is confined mainly to the making of public pronouncements about the general way in which it purports to exercise its statutory powers under the Banking Act (section 3). On the other hand, its specific actions with regard to the identification and disposition of individual problem cases are covered by a thick veil of secrecy, which is underpinned by a statutory prohibition on the disclosure of regulatory information (section 4).
1. Non-departmental regulatory agencies and public accountability

The lines of accountability in public administration can be discontinuous and fractured. In the existing constitutional system, accountability to Parliament is the cornerstone of public control. For a non-departmental public body in the position of the Bank, however, a number of practical difficulties impede effective accountability on this basis.

Parliament performs many roles in the life of an "expert" non-departmental regulatory agency: it creates it by statute; appropriates funds for its financing; legitimises its operation by approving its mandate; exercises control over policy by setting legal standards to direct agency activities; and, finally, scrutinises its performance. The first four functions concern essentially the planning or law-making stage of public action and are performed mainly in the course of Parliament's legislative activities - although debates on motions, questions to ministers or the work of parliamentary committees may also contribute in legitimising or directing agency activities. In contrast, in scrutinising performance, Parliament becomes a mechanism of accountability over the executive stage. This last function is of particular importance in the case of the Bank, whose legal capacity is not confined by fetters so strict as those imposed upon statutory authorities and which is self-financing.

In parliamentary government, retrospective accountability for the activities of departments of central government is achieved mainly through the well-established (even though not always effective) link of ministerial responsibility, supplemented by other techniques, such as investigations by departmentally-related parliamentary Select Committees and audit controls. These traditional parliamentary lines of accountability are supplemented by other techniques, such as investigations by departmentally-related parliamentary Select Committees and audit controls. These traditional parliamentary lines of accountability are supplemented by other techniques, such as investigations by departmentally-related parliamentary Select Committees and audit controls. These traditional parliamentary lines of accountability are supplemented by other techniques, such as investigations by departmentally-related parliamentary Select Committees and audit controls. These traditional parliamentary lines of accountability are supplemented by other techniques, such as investigations by departmentally-related parliamentary Select Committees and audit controls. These traditional parliamentary lines of accountability are supplemented by other techniques, such as investigations by departmentally-related parliamentary Select Committees and audit controls. These traditional parliamentary lines of accountability are supplemented by other techniques, such as investigations by departmentally-related parliamentary Select Committees and audit controls. These traditional parliamentary lines of accountability are supplemented by other techniques, such as investigations by departmentally-related parliamentary Select Committees and audit controls.
accountability cannot easily accommodate the activities of non-departmental regulatory agencies. The more independent an agency, the less meaningful ministerial responsibility to Parliament becomes, as ministers cannot be held accountable for the actions of those whom they neither can, nor are supposed to, control. Despite this, there are various channels beyond ministerial responsibility through which the House of Commons can increase the accountability of regulatory agencies. These include special debates, investigations by Select Committees, statutory requirements imposing on non-departmental bodies a duty to report to Parliament, financial scrutiny of those public bodies which receive public funds by the Public Accounts Committee and the office of the Comptroller and Auditor-General, the occasional "technical" oversight of delegated rule-making, as well as more indirect forms of control, such as scrutiny of their proceedings by Parliament's "watchdog", the Council of Tribunals. Not all of these, however, are available with regard to each non-departmental public body. For instance, as the Bank does not receive public funds, financial controls are not applicable in its case. Taken together, however, these special procedures provide opportunities for agency contact with Parliament. Nonetheless, these forms of accountability have not yet reached the point of a fully developed system of parliamentary control over non-departmental specialist agencies.

Limitations in public control and accountability are inherent in the original decision to give such bodies a high degree of institutional autonomy. Two main

succeed. Unable to exert an independent influence on governmental policy, Parliament can nevertheless play an important role in ensuring its efficient implementation. In recent years, investigations by departmentally-related back-bench Select Committees have had a generally beneficial impact on operational accountability with regard to departmental activities by increasing visibility and understanding of the administrative process and by bringing matters of concern to public - and even ministerial - attention. On the origins and work of departmental Select Committees, see G. Drewry, "Select Committees and back-bench power", in Jowell and Oliver, above, and idem (ed.), The New Select Committees: A Study of the 1979 Reforms (2nd ed., 1989). Select Committees act normally in a collegiate spirit, avoiding factional confrontations and contentious matters of policy, with the aim of assisting in the successful technical implementation of public policy, which is in the interest of the executive as much as of Parliament (even though it may be detrimental to the "private" interest of ministers and their departmental officials, whose effective leeway is reduced under the constraints of increased visibility). To this extent, they bypass the anachronistic view of parliamentary accountability as a field of institutional conflict between the legislature and the executive.

5 For a systematic examination of the points of contact between Parliament and administrative agencies under the similar institutional setting of Canadian parliamentarism, see Slatter, op.cit., n.3, ch.4.

6 See, e.g., Joint Committee on Statutory Instruments, Twenty-Seventh Report, H.C. (1979-80) 146-xxxix / H.L. 250, where the purport of Reg.14(2) of the Banking Act 1979 (Appeals) Regulations 1980, S.I. 1980/353, was found to require elucidation. The substantive scrutiny of delegated legislation by parliamentary committee would be a more important step towards effective accountability.

7 On the historical emergence of regulatory agencies in Britain, see R. Baldwin, C. McCrudden, et al., Regulation and Public Law (1987), ch.2. While administrative developments in the 19th
purposes can explain the delegation of governmental functions to quasi-independent agencies. First, agencies are used as a vehicle for administrative professionalism in areas which are deemed to require specialist skills and expertise. Second, agencies are used to insulate the political process from regulatory decisions in situations involving potentially high political costs, and occasionally to open regulation to participation by various sectional interests.

The institutional arrangements relied upon to achieve these aims raise a number of specific difficulties which reduce the effectiveness of agency accountability to Parliament. The discussion of these difficulties, however, should take into account the basic difference between two alternative types of institutional arrangements. Thus, the following observations concern the delegation of significant policy-making power to "expert" regulatory agencies under imprecise mandates, but not necessarily the devolution of specific and measurable administrative functions to executive agencies. If carried out properly, the delegation of specific functions to separate executive bodies may actually increase accountability by ensuring transparency in decision-making, by replacing nominal ministerial responsibility for the activities of departmental administrators by genuine, direct accountability of these bodies to the ministers responsible for strategic policy-making as well as to Parliament, and by decentralising financial and budgetary controls. The delegation of policy-making competence to regulatory agencies without specific statutory mandates and measurable targets, on the other hand, entails complex problems of public accountability and control.

The institutional arrangements relied upon to achieve these aims raise a number of specific difficulties which reduce the effectiveness of agency accountability to Parliament. The discussion of these difficulties, however, should take into account the basic difference between two alternative types of institutional arrangements. Thus, the following observations concern the delegation of significant policy-making power to "expert" regulatory agencies under imprecise mandates, but not necessarily the devolution of specific and measurable administrative functions to executive agencies. If carried out properly, the delegation of specific functions to separate executive bodies may actually increase accountability by ensuring transparency in decision-making, by replacing nominal ministerial responsibility for the activities of departmental administrators by genuine, direct accountability of these bodies to the ministers responsible for strategic policy-making as well as to Parliament, and by decentralising financial and budgetary controls. The delegation of policy-making competence to regulatory agencies without specific statutory mandates and measurable targets, on the other hand, entails complex problems of public accountability and control.

century were characterised by the decline of government by boards and commissions and the concentration of functions in ministerial departments accountable to Parliament, this century has witnessed the gradual rise of quasi-independent administrative processes, such as operational boards, public inquiries and nationalised industries and, more recently, that of regulatory agencies.

8 See D. Howell, "Public accountability: trends and parliamentary implications", in B.L.R. Smith and D.C. Hague (eds.), The Dilemma of Accountability in Modern Government: Independence versus Control (1971); Oliver, "Law, politics...", loc.cit., n.1, pp.242-243. Institutional reform along these lines has been undertaken recently under the "Next Steps" program for the overhaul of the Civil Service through the separation within central government of strategic policy-making from the delivery of services. Under this program, the latter function is devolved to specialist executive agencies, headed by chief executives who are personally responsible for their efficient management, while policy-making remains at the hands of ministers; White Paper The Financing and Accountability of Next Steps Agencies" (Cm. 914, 1989). It must be noted that ministerial responsibility continues to provide the main channel of accountability of the executive agencies to Parliament. See G. Drewry, "Next Steps: the pace falters" [1990] P.L. 322. However, it is possible that the direct contacts with Select Committees and agency officials will increase considerably in the future. Moreover, there are recommendations for the publication of written answers by agency chief executives to parliamentary questions in Hansard, Select Committee on Procedure, "Parliamentary Questions", H.C. (1990-91) 178. This would create a new mechanism of direct accountability, which could expand to the scrutiny of other non-departmental bodies, such as the Bank.
The first problem concerns the lack of clarity in an agency's legislative mandate.\textsuperscript{9} With clear legislative standards, against which agency performance could be measured, accountability as well as legitimacy would be easily achievable. Nonetheless, lack of clarity in statutory standards cannot be avoided in many cases. In certain situations where the expansion of governmental regulatory activities into new fields is hindered by the paucity of information necessary for planning the public intervention, vesting agencies with a loose regulatory mandate permits the gradual exploration of the regulated field. In this sense, regulation by a quasi-independent authority, combining rule-making and adjudicative functions, can conceal learning processes and the incremental development of policy as experience builds. Frequently, however, obscure statutory standards are the result of narrower political calculations. The delegation of contentious issues of public policy to unaccountable agencies allows politicians to appear to take action with regard to these issues while avoiding responsibility for the substantive decisions. Although in such cases Parliament formally exercises its legislative competence over the subject-matter of the delegation, in essence it abdicates political control over, and responsibility for, the substantive choices of regulatory policy.\textsuperscript{10}

A second problem, associated with the previous one, concerns the limited use of delegated rule-making by regulatory agencies. Given that Parliament lacks both the capacity and the inclination to improve statutory mandates, the extension of administrative rule-making could contribute in confining and structuring agency discretion and increasing the transparency of the policies followed in practice.\textsuperscript{11} In particular, the explicit delegation of rule-making functions to agencies in terms making the promulgation of rules a prerequisite of individual regulatory determinations, would provide a partial substitute for the missing specific and intelligible enacted standards. Unlike the often non-transparent incremental unfolding of policy in the course of resolving concrete cases, delegated rule-making would offer a point of reference for the open discussion and potential correction of administrative policy and thus acts as a constraint on the relevant agency. In the meantime, regulatees and the broader public would know where they stand. Nonetheless, agencies are not likely to take the initiative for elaborating hard rules,


\textsuperscript{10} Although it relies for its legitimation on a widespread distrust of "politics", this type of "insulation" of the substantive policy decisions from the political process raises basic questions of constitutional allocation of power. "[A]n elected government ought not to be able to avoid responsibility for governing effectively"; L.N. Cutler and D.R. Johnson, "Regulation and the political process" (1975) 84 \textit{Yale L.J.} 1395, p.1400.

since this reduces their effective freedom of action. From their standpoint, flexible, open-ended policies are preferable because they facilitate coordination and control while allowing for derogation whenever this is deemed advantageous. Conversely, the elaboration of hard rules by administrators is legally hindered by the perverse effect of the doctrine against fettering discretion. This doctrine assumes that discretion must be exercised by the delegated decision-makers personally and that the outcome of individual cases must not be predetermined by the application of hard rules. This is justified on the questionable ground that, if it had been within the legislative intention to allow the elaboration of hard rules in a particular area, Parliament would have enacted them itself or would have specified its intention by delegating to the relevant administrative decision-makers a clear power for making secondary legislation. Yet, by allowing the promulgation of provisional policies, but not of hard rules, the doctrine indirectly impedes accountability and public control. Non-binding policies may be useful in structuring discretion but, by leaving open the possibility that they will be overridden at the point of their application, they cause normative indeterminacy and confusion regarding the exact legal position. This hinders, not only the judicial review of regulatory decisions, but also public debate and legislative review of the agency's policy-making. In contrast, agency rule-making, ideally coupled with an institutionalised mechanism for the parliamentary review and sanction of administrative rules, would bring back to the legislature the responsibility of controlling the production of rules, even ex post facto.¹²

A third problem involves the widespread resort to hybrid institutional structures of responsibility. In particular, ministers usually retain ill-defined default powers which give them the opportunity to intervene in the work of the quasi-independent agencies. This is one way of avoiding formal responsibility while retaining a large measure of effective control, but it entails a blurring of the lines of accountability. The concurrent administrative competence of ministers and agencies reduces transparency and hides the real allocation of decision-making power, especially as ministerial interventions tend to remain informal. This creates scope for potential abuses of power, as well as for conflicts to arise between the departments of the central state and the quasi-independent agencies. It also destroys the supposed integrity of the agency model, with its claims to expertise, professionalism and depoliticisation. On the assumption that independent agencies are a defensible exception to the hierarchical departmental organisation of governmental activities, there is a need to establish direct lines of accountability to Parliament, rather than to ministers. Supervision over policy could be undertaken by Parliament in public.

Direct interventions and secret political control by the executive should be eliminated.13

The fourth, and most profound, problem concerns the tension between public accountability and control, on the one hand, and the claims of administrators to expertise and professionalism, on the other. If the context of agency action is one that justifies deference to expert opinion, then in principle demands for public accountability become redundant. Only their peers can appropriately judge the performance of experts. Nevertheless, the claims of administrators to technocratic expertise cannot be taken always at face value. It is a matter of debate whether the subject-matter of the regulatory activities of an agency is characterised inherently by real difficulties of assessment or whether the protestations of complexity and technicality conceal an attempt for the mystification of its functions. The precision and clarity of legal standards for action is relevant in this context too. Accountability involves intractable problems when an agency is entrusted with an array of heterogeneous purposes, when its operations take a complex and non-transparent form or when the outcomes of its activities are uncertain and success or failure cannot be measured against intelligible standards. These parameters depend crucially on organisational design. By allocating specific and discrete tasks to the agencies, prescribing clear standards of performance and limiting the range of relevant outcomes in order to increase calculability, the Parliament could achieve an optimal combination of operational autonomy for the professional bureaucracies of the agencies and of opportunities for the public assessment of their efficiency and effectiveness at the same time.14 Unfortunately, this rarely happens in practice.

For the reasons mentioned above, the institutional design of quasi-independent regulatory agencies may present serious deficiencies in terms of legitimacy and accountability. It is true that agencies look only partially for their legitimacy to their legislative mandate and their subjection to procedures of parliamentary and ministerial control. The legitimation of their autonomous development outside the usual patterns of political control over departmental bureaucracies cannot be merely formal, but must also rely on popular perceptions regarding matters such as the fairness and representativeness of their procedures, their expertise or professionalism and the successful performance of their functions.15 Despite this, legitimacy on these grounds is never beyond question.

---

13 See L. Vandervort, Political Control of Independent Administrative Agencies (1979); and Law Reform Commission of Canada, ibid., ch.2.
14 See Day and Klein, op.cit., n.2, ch.3; and supra, n.8.
It is claimed sometimes that the difficulties concerning the legitimacy and accountability of agencies - in short, their constitutionality - can be overcome through their direct "responsibility to the community" for the quality of their performance and their procedural fairness. This, however, seems more than doubtful. Emphasis on fair and participatory procedures may conceal the corporatist tendencies implicit in sectionally-controlled decision-making processes without guaranteeing outcomes which are acceptable by the broader public. More importantly, legitimation on the basis of public satisfaction with agency performance is always precarious. An agency cannot be fully successful over time. Relative success will necessarily be followed by occasional spectacular failures, and the agency's assessment will vary accordingly. Furthermore, the perceptions of different sections of the public about an agency's performance will often diverge, making its legitimation on substantive grounds precarious. For these reasons, direct pseudo-responsibility to the public, without formal guarantees and sanctions, cannot provide an adequate substitute to proper lines of accountability and public control.16 These, however, are rarely in place.

2. Openness and accountability in the operations of the Bank of England

In the particular case of the Bank, questions of openness and accountability have traditionally focused for the most part on its primary role as a monetary authority. As an important pillar of the machinery of economic policy, the Bank acts as both the independent adviser and the operational arm of government in monetary affairs. In performing these roles, the Bank works in close co-operation with the Treasury in shaping and executing monetary policy, but there is no clear division of functional responsibility between them. That the ultimate authority in monetary affairs rests with the Treasury has been settled since the early decades of this century, long before the Bank's nationalisation in 1946. In recent decades, the Treasury has generally exercised closer control over the details of interest-rate changes, as a consequence of the increasing significance of monetary policy in government thinking and its integration into overall economic policy. Accordingly, over the years the Bank has had to work in close co-ordination with the Treasury's ministers and officials. This has not lead, however, to the elimination of its relative operational autonomy. Furthermore, its close relationship with the financial markets ensured its

16 On the tendency of administrators to adopt this "community" view of accountability, see Day and Klein, op.cit., n.2, pp.227-239.
continuing influence as an adviser, so that the Bank is invariably consulted before the Chancellor of the Exchequer takes any decision on interest rates. 17

Lack of clarity regarding the precise monetary responsibilities of the two bodies - with an emphasis on "co-operation", rather than Treasury "control" - and the existence of only limited (and essentially redundant) formal ministerial powers of direction, 18 has been mutually advantageous. The arrangements have provided considerable scope for the Bank to pursue its distinct institutional interests. Even if the Treasury has the ultimate responsibility in matters of monetary policy, the prevailing functional opaqueness allows the Bank to retain the prestige and power of an effective policy-maker and protect its institutional status. It also provides to the Bank an opportunity to ensure a high degree of autonomy in operational and administrative matters. Conversely, the sharing of jurisdiction over monetary affairs - a highly contested and precarious field of governmental activity - provides a political safety-net to the Treasury, insofar as the Bank may stand to share the blame if things go seriously wrong. The complex lines of responsibility can also conceal the precise locus of policy formation and implementation, and thus deflect criticisms. In this sense, more than what is lost in control is gained in political hedging and insulation. These arrangements have, therefore, the result of reducing the public accountability of both bodies, to their mutual advantage.

In combination with the blurring of functional responsibilities, the institutional separateness of the Bank also contributes to the creation of a non-transparent decisional environment. As a non-departmental body, the Bank is only indirectly answerable to Parliament. Ministerial responsibility for its activities lies with the Chancellor of the Exchequer and the junior Treasury ministers, who nonetheless lack direct powers of control and can, accordingly, decline to assume responsibility for controversial specific decisions, if not for matters of general policy. This breaks an essential link in the chain of accountability. As will be discussed below, this


18 A formal power of direction is vested on the Treasury under s.4(1) of the Bank of England Act 1946, but the Treasury relies instead on its direct contacts with the Governors and senior officials of the Bank to control its monetary activities; see supra, ch.1, section 1(a). The Bank's directors have retained a considerable degree of personal independence, as their appointment by the Prime Minister is for a fixed term, and the government has no power of dismissal; Bank of England Act 1946, Sch.2. On discretionary appointments to the membership of public bodies by the Prime Minister and other ministers and the lack of openness regarding the appointment process, see generally A. Doig, "Public bodies and ministerial patronage" (1978) 31 Parliamentary Affairs 86.
discontinuity is particularly important with regard to banking supervision, for which
the Treasury does not share any powers, although its impact is also felt to some
extent in the context of monetary affairs.

Despite these limitations, in the decades since nationalisation slow but
considerable progress has been made, especially in operational matters, in the
direction of increasing the Bank's public accountability, through greater openness
and more scrutiny by parliamentary committees. Originally, in addition to the lack
of clarity regarding the division of monetary responsibilities, the Bank was protected
from external criticism by a thick veil of operational secrecy, which proved resistant
even to the Treasury's "curiosity" - although in one occasion its decision-making
process became the subject of an ad hoc public inquiry, following an allegation
(which was not substantiated by the inquiry) that information concerning the
imminent raising of the Bank Rate had been improperly disclosed to private parties
by a member of its Court of Directors. It did not publish accounts, nor did it
provide information on matters of internal administration and financial management.

This situation was criticised in the report of the Radcliffe Committee, which not
only noted that the "meagreness of [the Bank's annual report] has become a
byword", but also rejected at both the descriptive and the prescriptive level the
attempt of the Bank to draw a casuistic distinction between certain statutory
activities - e.g. those relating to exchange control - in which it acted as the
government's "agent" and those internal "affairs of the Bank" - in particular, the
fixing of the Bank Rate and the management of the money market and the public
debt - in which it enjoyed full and independent responsibility and should be its own
judge. Instead, the Committee emphasised the necessary interdependence of
monetary action and general economic policy for which the ultimate decision-making
power belonged constitutionally to the government. Even so, it was accepted that
the Bank should continue to enjoy the benefit of operational independence in its role
as a highly skilled specialist body in the service of the government. Nevertheless, the
Committee thought that "there should be a clear public understanding of the
purposes which a central bank exists to serve" in its roles as "adviser" and "highly
skilled executant" of government policy and a clarification of the division of
responsibilities between the Bank and the Treasury as the two monetary authorities.

33 Parliamentary Affairs 67.
20 "Report of the Tribunal appointed to Inquire into Allegations of Improper Disclosure of
Information relating to the Raising of the Bank Rate" (Cmnd. 350, Jan.1958).
21 Radcliffe Committee, "Committee on the Working of the Monetary System: Report" (Cmnd.
22 Ibid., paras.763-765.
In particular, the fact that the initiative for changes in monetary policy belongs to the Treasury should be made explicit.\textsuperscript{23}

Although these recommendations of the Radcliffe Committee were not adopted by the government, the Bank itself took a step to greater openness by launching the \textit{Bank of England Quarterly Bulletin}, whose first issue appeared in December 1960. Over the years the \textit{Bulletin} has become an indispensable source of information, bringing to the public eye valuable detailed descriptions of the internal organisational patterns of the Bank and of the technical aspects of its monetary operations and other activities. However, greater openness was not followed by increased formal accountability. Especially, the financial details of the administration of the Bank remained hidden from public view. Following the coming of the Labour party into power in 1964, however, calls for greater political control of the Bank were intensified.

A turning point was the inclusion of the Bank in the mandate of the Select Committee on Nationalised Industries. Although the Select Committee was first established in 1956, doubts had been expressed whether the Bank was within its Order of Reference. Following a general review of its mandate,\textsuperscript{24} the Select Committee was finally specifically authorised in 1968 to examine the activities of the Bank, but excluding those concerning monetary and financial policy-making, exchange operations and controls and private banking. With most politically sensitive areas arguably beyond its reach, the Select Committee concentrated its attention to the organisation of the Bank and the technical aspects of its work. It is possible that this compromise may have been conditioned by the departmental aims of the Treasury. Parliamentary scrutiny over the "administrative" domain of the Bank could weaken the Bank's institutional resistance to Treasury control, without affecting the convenient confusion which existed about the lines of responsibility in monetary policy.

In May 1970, the Select Committee produced the first - and more important - of its two reports on the Bank.\textsuperscript{25} The report, which was generally hostile to the Bank, pointed to its complete lack of managerial accountability: the Bank published no proper accounts\textsuperscript{26}; only a nominal amount was charged for the services provided in

\textsuperscript{23} \textit{Ibid.}, paras.766-771. Similar conclusions were reached by the other major post-war reports on the functioning of the financial system; Wilson Committee, "Committee to Review the Functioning of Financial Institutions: Report" (Cmnd. 7937, Jun. 1980), ch.25, in particular paras.1276-1278.

\textsuperscript{24} Select Committee on Nationalised Industries, Special Report: "The Committee's Order of Reference", H.C. (1967-68) 298, paras.36-63.


\textsuperscript{26} \textit{Ibid.}, paras.243, 262-263. The accounts should ideally include true figures for assets (including reserves and fixed assets) and liabilities, income and expenditure, and profit and loss; para.262.
its capacity as the government's agent; profits were treated as its own private affairs; no details were given of operational costs; its capital investments were not subject to review; and there was no external review of the efficiency of its operations. The Bank defended its culture of secrecy by reference to arguments based on the need for confidentiality in financial matters and for central-bank independence. Rejecting the Bank's arguments, the Select Committee thought that "any institution which is protected by secrecy and shielded from scrutiny is in danger of becoming unselfcritical and complacent". There was need for public accountability, and control by the Bank's own Court of Directors was no substitute for that. Drawing an important distinction between political and managerial accountability, the Select Committee accepted that with regard to matters relating to monetary policy, the Bank "acts very much as an arm of Government", and should be accountable "primarily through the Treasury or to the same extent as the Treasury." As for internal administration, the model of pure political accountability could not work. "The Treasury are not in a position, nor do they want [...], to be responsible in great detail for the way in which the Bank manages its own affairs", and accountability should take the form of publishing accounts and coming under the continuing scrutiny of parliamentary investigating committees.

Following the publication of the Select Committee's report, a number of steps were taken to implement its recommendations. Starting with the financial year ending 28 February 1971, some meaningful information about the financial situation of the Bank has been provided through accounts attached to the Bank's annual report. Although the Bank is still not legally required to publish audited accounts under the Companies Acts, it follows the accounting requirements for commercial banks as far as this is compatible with its activities as central bank. One important area where even today the accounts exceptionally fail to give a full picture of the Bank's activities is that of support operations. While the financial effects are included in the accounts for the year in which they occur, the provision of crisis support to banking institutions with a view to preventing their impending failure is usually not

---

27 Ibid., ch.XIV.
28 Ibid., paras.187-193.
29 Ibid., paras.194-197.
30 The Committee did not accept that greater openness would result to a loss of autonomy for the Bank. There was no reason to believe that the degree of central-bank independence was in inverse proportion to information; ibid., para.258. In any case, "[i]n fact in important respects the Bank is less independent than other nationalised industries"; para.259.
31 Ibid., para.267.
32 Ibid., paras.269-270.
33 Ibid., para.271.
34 Ibid., para.275.
identified explicitly, for the reason that its disclosure could potentially disturb confidence in the financial system by raising concerns about systemic fragility. In this case, the operations are disclosed in the annual report only when market conditions have improved and the need for secrecy has ceased.\textsuperscript{36} By this time, however, it will usually be very late for the public review of the Bank's approach. Interestingly, the Select Committee had specifically noted in its report that, as far as "doing good by stealth" in salvaging ailing institutions was concerned, "[t]o the extent that that kind of help might be more effective if less well advertised, so would it be less acceptable in our form of democracy".\textsuperscript{37}

The Bank's position as banker to the government was also financially regularised, with full costs being charged for the services provided. The profits of the Banking Department have since been surrendered to the government, while the Bank's capital expenditure has come under Treasury oversight.\textsuperscript{38} Significantly, though, the Select Committee's recommendation that the Treasury's power of direction should be formally used to make the precise relationship between the Bank and the government clearer,\textsuperscript{39} was ignored, as had been the similar recommendations of the Radcliffe Committee a decade earlier.

On the other hand, increased accounting regularity and openness with regard to organisational matters were not accompanied by full political, or even managerial, accountability. The major monetary and banking policies of the 1970s, in particular Competition and Credit Control and the "Lifeboat" for the institutions facing insolvency as a result of the secondary banking crisis, were embarked upon by the monetary authorities without consulting the Parliament. Nor were the reports of the Select Committee on Nationalised Industries on the Bank debated in the full House. In fact, the second report of the Committee, which was produced in 1976, provided a very favourable assessment of the Bank and its work.\textsuperscript{40} The matters it addressed went beyond the purely operational, to cover for the first time banking supervision

\textsuperscript{36} Bank of England, "Report and Accounts for the Year Ended 28 February 1994" (12 May 1994), p.10; "The pursuit of financial stability" (1994) 34 B.E.Q.B. 60, p.65. Accordingly, attention was drawn to provisions made in the financial year ending 29 Feb. 1992 against the Bank's losses from its support operations with regard to a number of smaller banks only in the Bank's annual report for the following financial year. It must be noted that even when the existence of the support operations is revealed, the details are frequently kept confidential, because disclosure could weaken the recipient banks even though they may have overcome their problems in the meantime.

\textsuperscript{37} Loc.cit., n.25, para.253.


\textsuperscript{39} Loc.cit., n.25, para.204.

and regulation and other substantive aspects of the Bank's work; but the Committee did not discuss the aims (as distinct from the instruments of implementation) of monetary policy. As to accountability, the Committee unquestioningly accepted the Treasury's view that the provision of the Bank of England Act 1946 solved satisfactorily the problem of Bank/Treasury relationships, and that there was no need for direct accountability to Parliament of the Bank for monetary affairs, as this should continue to rest with the Treasury. Despite its restricted terms of reference, the Committee thought fit to express its broader support for the Bank and to reject "emotive and uninformed" criticisms of its performance. Other observers were less impressed. As B. Griffiths noted at that time:

"In view of the fact that the years which the Report is reviewing were those of the money supply explosion, the fringe bank collapse, the bankruptcy of a number of banks, the dramatic fall in the pound and foreign exchange reserves, and large swings in interest rates, one cannot help feeling that the report has tackled certain questions superficially." In fact, the Committee lacked the expertise to scrutinise monetary affairs, and its judgements were based on evidence submitted by the Bank, its political masters in the Treasury, and various financial institutions "all of whom depend on the patronage of the Bank, are supervised and regulated by it and who use the Bank as a spokesman within government to further their own interests".

The Select Committee of Nationalised Industries was dissolved in 1979 as a result of parliamentary reforms which introduced a comprehensive system of departmentally-related Select Committees. Under the new system, the Bank was brought within the jurisdiction of the Treasury and Civil Service Committee. During the 1980s, the Committee, whose members often try to conduct its main investigatory functions in a non-partisan spirit, provided a forum for informed public discussion of economic-policy affairs, even though its comprehensive report on the general principles of monetary policy did not attract the attention it deserved. Even so, the Committee did not prove more successful than the full House in bringing to light the precise workings of monetary policy-making, or in identifying

41 Ibid., paras.53-69, 166-200.
42 Ibid., paras.198-199.
43 Ibid., paras.201-202, 207.
44 "The Bank under scrutiny" (Feb. 1977) 127:612 The Banker 111 (emphasis in the original).
46 On this Committee, see A. Robinson, "The Treasury and Civil Service Committee 1979-83", in Drewry, The New Select Committees..., op. cit., n.4.
48 Robinson, loc.cit., n.46, p.281.
the precise responsibilities of the Bank and the Treasury in this politically sensitive area.

By the early 1990s, one could point at the country's unimpressive monetary record to support the argument that secrecy breeds complacency and failure. This strengthened the demand for full accountability of the monetary authorities. Eventually, major improvements in monetary accountability were adopted as a consequence of the poor handling of monetary operations in September 1992, which led to sterling's devaluation and exit from the E.R.M., less than two years after its entry. The events created a sense of urgency in this regard. With a view to restoring confidence and adding credibility to the government's commitment to sound money, the Chancellor of the Exchequer, Norman Lamont, announced that the Bank would provide in future a regular quarterly report on the progress being made towards the government's inflation objectives, which would be published in the Quarterly Bulletin. Outside commentators would make their own assessment, and the Bank would be publicly accountable for the quality of its analysis. The first Inflation Report was published in February 1993. The Report measures developments against an explicit fixed goal of price stability, initially expressed in an immediate target of between 1 and 4 percent for retail-price inflation, with the aim of bringing inflation in the lower half of the band before the next general election. An important additional step in the direction of transparency in monetary affairs was taken in April 1994, when the new Chancellor of the Exchequer, Kenneth Clarke, decided to publish details of his latest monthly meetings with the Governor of the Bank and announced his intention to release the minutes of future meetings within about six weeks after they have taken place.

These innovations have not affected the basic constitutional position. Treasury retains overall responsibility for formulating economic policy and for fixing the level of interest rates, while the Bank remains subordinate to the Treasury, its specific responsibility being to manage the announcement of changes in these rates. Nevertheless, the developments of the last two years mark an entrenchment of price stability as a policy goal. While the effect of the Inflation Report is to make for the first time possible a precise assessment of the performance of the monetary

---

51 "Inflation Report" (1993) 33 B.E.Q.B. 3. Interventions in the preparation of the reports are unlikely, because since autumn 1993 the Treasury does not see them before they are printed; Treasury and Civil Service Committee, "The Role of the Bank of England", loc.cit., n.17, para.20.
authorities on the basis of official data, the publication of the minutes of the meetings between the Chancellor of the Exchequer and the Governor of the Bank reduces the opaqueness of the internal networks of policy-making and establishes the relative input of the Treasury and the Bank in actual monetary decisions. Visibility acts as a powerful incentive for both authorities to follow a consistent monetary policy and effectively constrains their ability to trade-off price stability for other policy objectives, such as facilitating government financing or keeping the politically sensitive mortgage rates low, which the Treasury in particular may find convenient to pursue in the short term. It also acts as an incentive for the Bank - which is particularly responsive to the opinion of the financial community - to prefer the active pursuance of monetary objectives acceptable to the market over the maintenance of frictionless relations with the Treasury. There has also been a shift in the real institutional balance, with the Bank, with its pre-eminent role in day-to-day operations and its new obligation to make public its views, becoming more assertive.\(^\text{54}\) In this manner, although the exact distribution of policy-making power remains unclear, the combination of openness and measurability of performance against a relatively entrenched public standard has a strong practical impact on the behaviour of the monetary authorities.

Taken to its logical conclusion, the new approach also suggests the desirability of institutional reform, with the Bank being given a clear statutory mandate to try to achieve price stability, supported by a high degree of operational independence. In such a system, the government would only be able to overrule the central bank in a formal and open way.\(^\text{55}\) In this case, independence is less justifiable on the basis of mere deference to the expertness and professionalism of the Bank's officials as on grounds of the need to assess performance against an objective and publicly available \textit{ex ante} standard - in other words, as a means of increasing managerial accountability for the performance of a "neutral" task and guaranteeing an appropriate incentive structure for the conduct of monetary policy.\(^\text{56}\)


\(^{56}\) See supra, text and n.14. For general observations on the manner in which the delegation of specific responsibilities to distinct executive bodies can actually increase accountability, see supra, text and n.8. On the tensions between the concept of an independent central bank, controlled principally by means of measuring its performance against an unambiguous legal mandate, and the traditional constitutional channels of \textit{ex post facto} accountability to Parliament and the courts, see T. Daintith, "Between domestic democracy and an alien rule of law? Some thoughts on the 'independence' of the Bank of England" [1995] P.L. 118.
The proposals for reform have been officially endorsed by the Treasury and Civil Service Committee in a report published in December 1993.\(^\text{57}\) The Committee concluded that, given wide acceptance of the necessity to maintain price stability, the weight of opinion favours devolving responsibility for monetary policy to the Bank under an anti-inflationary statutory mandate as the best method of entrenching this objective.\(^\text{58}\) In particular, "[t]he transfer of authority from the Treasury to the Bank would provide a clearer focus for Parliamentary accountability".\(^\text{59}\) A first attempt to implement the Committee's recommendations was made when a private-member's bill was brought before the House of Commons in January 1994.\(^\text{60}\) The bill's objectives were

"to remove the general power of the Treasury, to give directions to the Governor of the Bank; to establish price stability as the primary objective of the Bank and to provide for policy targets for the carrying out of this objective".

However, the bill failed to pass its first hurdle when time run out in its second-reading debate.\(^\text{61}\) In the debate, the governmental response to the proposal was mixed: the aim of price stability was fully endorsed, but on the issue of central-bank independence the government's position was said to be "agnostic", and proponents of independence were warned that no institutional arrangement could be a "panacea" guaranteeing price stability. Furthermore, it was maintained that an independent central bank with full monetary powers should be perceived by the public to be legitimate, which is not currently the case. Accordingly, wholesale institutional change in the proposed direction was not envisaged "in the foreseeable future", and only gradual improvements on the existing institutional balance could be expected.\(^\text{62}\)

---


\(^{58}\) Ibid., paras.64-65, 73, 76-77. In the scheme proposed by the Committee, the government's role would consist in setting in co-operation with the Bank publicly-stated intermediate monetary targets, which could be subject to debate in Parliament; however, the government would retain the power to override, with parliamentary approval, the objective of price stability "temporarily and in exceptional circumstances"; paras.78, 82.

\(^{59}\) Ibid., para.79.

\(^{60}\) Bank of England (Amendment) Bill, presented by N. Budgen.

\(^{61}\) H.C. (6th. Series) Vol.236, col.520. During the debate, M. Spicer, cols.554-555, noted that operational autonomy of an administrative agency such as the Bank within policy parameters set by a minister such as the Chancellor actually muddles accountability, because both the agency and the minister can decline responsibility for specific decisions by attributing them, respectively, to the external policy constraints or to the autonomous operational decisions. The logical corollary of this argument would be that operational autonomy is desirable only under a specific and publicly announced policy standard. However, precisely such an explicit policy standard underpinned the particular Bill under discussion. As D. Abbott, col.559, strongly emphasised, the argument for central-bank independence relied totally on the endorsement of the aim of low inflation above every other consideration, independence being a means of institutionalising this aim; without it, the argument for independence would lose its raison-d'être.

\(^{62}\) The then Financial Secretary to the Treasury, S. Dorrell, ibid., cols.571-578.
Overall, these developments define a continuing trend towards greater transparency with regard to monetary performance which has given the Bank a stronger incentive - linked to considerations regarding its institutional status and power - to work towards the objective of price stability. More generally, the point has now been reached, where the Bank itself recognises the need to give account to Parliament and to explain its actions in its annual reports, in its evidence to parliamentary committees and in its more informal contacts with M.P.s. The Bank also accepts the need to disclose to the wider public information regarding its operations. Under new guidelines prompt and full response to all inquiries by members of the public is required, and arrangements for monitoring compliance with the guidelines have been established.

From a managerial standpoint, the Bank remains largely unaccountable for its more detailed operations, and its performance is not yet judged against specific and measurable targets and standards. However, there are certain encouraging signs of improvement in this direction as well. New arrangements were put in place in 1994 by the Chancellor of the Exchequer with regard to the Bank's operations as the government's adviser and agent in matters of public funding, which satisfy to a considerable extent the requirements of managerial accountability by providing for a specific mandate and the periodic assessment of operational performance. Under the new system, the Treasury must set an "annual remit" for the Bank's sales of gilt-edged securities, which is published before the beginning of each financial year and regulates the size, pace and methods of such sales. Specific guidelines must also be given for the detailed operation of the remit. While in the past individual decisions on public funding were taken after discussion between the Treasury and the Bank, a clearer division of responsibility must now be followed, and the proposals of the Bank as the government's adviser and agent in the gilt market must normally be approved by the Treasury. Furthermore, the Bank must make monthly reports on the performance of its remit and participate in regular review meetings with the Treasury and the Department for National Savings.

In view of the clear improvements described above, Lord Lawson's view that, considering its influence, the Bank has "virtually no accountability at all", appears to exaggerate the actual situation. It is true, nonetheless, that much has still to be achieved. The internal decision-making processes of the Bank are still opaque, and most of its contacts with the Treasury are surrounded by secrecy. Even its annual

---

64 "Annual remit for the Bank's operations in the gilt market" (1994) 34 B.E.Q.B. 112.
reports have never been debated in Parliament. Possibly the most important limitations in the Bank's accountability, however, involve the area of banking regulation.

3. Accountability and prudential regulation

At the time of enactment of the Banking Act 1979, it was envisaged that parliamentary control over, and accountability for, the Bank's general direction of regulatory activities would be achieved at a number of levels: the statutory standards set out in the Act would provide guidance to the Bank; the Bank would lay before Parliament its own interpretation of the licensing criteria for banking institutions, as well as an annual report on the exercise of regulatory responsibilities; and Treasury ministers would bear the ministerial responsibility for regulatory activities. Nevertheless, the handling of individual cases was recognised to be a quasi-judicial matter which should be for the Bank only, and in respect of which the Treasury would have no responsibility.\(^\text{66}\)

This early notion of regulatory accountability failed to take into account that the practical result of political non-interference to the "adjudicatory" aspect of individual determinations was to make political accountability as to general regulatory policy and operations redundant, because the Bank's regulatory policy is flexible and open-ended, and only takes a specific and definite form when a decision is taken with regard to an individual institution. In this sense, the lack of unambiguous and publicly available regulatory standards inhibits the political control of regulatory policy. On the other hand, the Bank's own insistence on regulatory secrecy, on the ground of the protection of market confidence, also precludes that openness which, together with the giving of reasons, serves as the main safeguard in judicial decision-making. As will be shown below, later events have clearly shown the severe limitations of existing lines of accountability - limitations which are to a great extent the direct result of the overlap of the policy-making and "adjudicatory" stages of banking regulation.

\(^{66}\) White Paper "The Licensing and Supervision of Deposit-Taking Institutions" (Cmnd. 6584, Aug. 1976), para. 19; and Select Committee on Nationalised Industries, Seventh Report: "The Bank of England", Seventh Report: "The Bank of England", loc.cit., n.40, para.194. However, under the appeals system of the 1979 Act, the Treasury could come under scrutiny for the handling of an individual case if there was an appeal to the Chancellor against a decision of the Bank concerning authorisation - but even then, accountability would probably be appropriate only after a decision on the appeal had been reached, because the handling of appeals would be a quasi-judicial function.
In particular, indirect political accountability to Parliament through Treasury ministers has proven unsatisfactory, given that the latter are powerless to intervene in the supervisory process. The Bank will generally keep the Treasury informed about its regulatory activities, but as a matter of practice the Treasury will decline to reveal to Parliament the content of its contacts with the Bank. For the Bank, the purpose of briefing the Treasury of its activities is not to provide a "blow-by-blow account" of its actions but "to keep them informed if there is likely to be a difficult or substantial or controversial issue". In any event, the initiative for the briefings belongs to the Bank, whose legal independence is far greater in the regulatory than in the monetary area. This creates the clear danger of political responsibility without real control, which can prove acutely embarrassing to the Treasury in cases of perceived regulatory failure, for which it must suffer criticism in Parliament and before the public.

The policy of successive Chancellors has been to recognise that they had been kept informed about the specific actions of the Bank relating to banking supervision and last-resort lending, but to decline responsibility for them. In 1976, in reply to a written parliamentary question regarding loans made by the Bank the previous year to avert the collapse of Slater Walker Securities, the then Chancellor of the Exchequer, Dennis Healey, explained his position:

"I was aware of the general approach adopted by the Bank of England to the problems of the Slater Walker Group and accepted the Governor's assessment that the Bank's actions offered the best prospect of securing the interests of outside depositers [...] with the least potential call on public funds. [...] My specific approval of the standby loan facility and guarantee was neither sought nor required." The same attitude was in evidence a decade later. Following the collapse and rescue of Johnson Matthey Bankers in December 1984, both the then Chancellor of the Exchequer, Nigel Lawson, and the Economic Secretary to the Treasury, Ian

---

67 Subject to the Act's confidentiality requirements, which allow disclosures to the Treasury only where this is necessary for reasons of prudential control; s.84(5), as replaced by the Banking Coordination (Second Council Directive) Regulations 1992, S.I. 1992/3218, reg.39(2). Although the section refers generally to disclosures "in the public interest", the inclusion of a reference to Art.12(7) of the First Banking Directive, as amended, has the effect of confining the exception only to disclosures which are specifically necessary for reasons of prudential control.


Stewart, responding to criticisms over the handling of the affair in the House of Commons, expressed the view that the decision to rescue Johnson Matthey was a decision of the Governor of the Bank, not of the Treasury, but added their qualified personal support to the Governor, stating that the decision was, in any case, correct and within the Governor's discretion.

If this is a good example of the limitations of ministerial responsibility as a conduit of accountability with regard to the Bank's regulatory activities, it is also an illustration of the nuances in the Bank's underlying relationship with the Treasury. While the Bank has a clear statutory responsibility with regard to the authorisation and supervision of banking institutions, it has no specific mandate for launching rescue operations. Accordingly, opposition politicians sought to embarrass the government by pointing to the "scandal" of spending large sums of money to support problem banks while allowing insolvent manufacturing industries to go down. If institutions were to stand or fall according to their performance, this should apply to banks as to other companies. With good reason, the opposition rejected as totally artificial the argument that this was not a matter for political accountability, because the money spent by the Bank in rescue operations is not a charge on public funds, but comes out of the Bank's own funds. There was also persistent questioning about the exact size of the contingent liability assumed by the Bank in the form of an indemnity to cover Johnson Matthey's liabilities, as well as the Chancellor's possible involvement in authorising the expenditure. In one of his statements, the Chancellor, while insisting that his approval of the indemnity was "neither sought nor required", indicated that he had been notified in advance of the expenditure. By making this statement, however, the Chancellor inadvertently provided misleading information to Parliament, because he failed to mention a direct loan made to Johnson Matthey, which went beyond the indemnity under discussion and of which he was himself unaware at the time of the exchange in the House. As a result of this incident, the Bank's relations with the Treasury were significantly damaged, and some months later, the Chancellor took the unprecedented step of expressing directly his criticism of the Bank's handling of the affair, with regard both to the quality of their supervision of Johnson Matthey and especially to the failure to inform him of the rescue loan. This amounted to a public rebuke of the Bank, even though the

75 See, e.g., H.C. (6th. Ser.) Vol.70, cols.21-22.
76 Ibid., cols.27-28; and Vol.81, col.455.
Chancellor formally expressed his "fullest confidence in the Governor of the Bank of England".  

Following this affair, a new accommodation has been arrived at. The Bank will now always consult the Treasury prior to committing financial resources to a rescue operation, even though its involvement in the markets allow it a degree of freedom in dealing with problem situations. There has also been a more consistent approach to keeping the Treasury informed of impending problems. This would be necessary, e.g., whenever a regulatory issue could have wider economic or political repercussions, especially in situations where the failure or closure of an institution can have implications for the financial system as a whole, or where a regulatory decision is likely to provoke parliamentary questions. Nevertheless, although the new arrangements increase the preparedness of the Treasury to face inconvenient questions, it does not improve the situation regarding accountability for the Bank's regulatory decisions which, with the possible exception of rescue operations, remain ultimately within its exclusive legal competence and for which the Treasury ministers decline responsibility to Parliament.

An equal lack of comprehensive accountability characterises the reporting requirements to which the Bank is subject. In addition to its statutory obligation to publish a statement of the principles in accordance with which it intends to interpret the statutory criteria for the authorisation of deposit-taking institutions and to exercise its discretion in granting, revoking or restricting authorisation, the Bank has a duty to submit to the Chancellor of the Exchequer and publish in appropriate manner an annual report on its supervisory activities, copies of which the Chancellor of the Exchequer must lay before Parliament. In this report, it must specify any material change in the regulatory principles and include a list of all authorised institutions.

The duty of making reports contributes to a certain extent in structuring the Bank's discretion, because it improves transparency in so far as the general policies

79 Ibid., col.456.
80 See Bingham Report, "Inquiry into the Supervision of the Bank of Credit and Commerce International", H.C. (1991-2) 198, para.2.487. But when the reason for the communication to the Treasury is political rather than prudential, e.g. when it concerns potential diplomatic or foreign relations problems, or Parliamentary questioning, this established practice may conflict with the Bank's duty of confidentiality, as it has been redefined under the impact of the Second Banking Directive; see supra, n.67, and infra, section 4. It is interesting to note that, in the particular case of B.C.C.I., even though the Treasury did not express dissatisfaction with the flow of information, in the opinion of Lord Justice Bingham, the Bank had in fact communicated a misleading picture of the situation, even though it had no intention to mislead the Treasury; paras.2.511-2.515.
81 Banking Act 1987, s.16.
82 Ibid., s.1(3).
83 Ibid., ss.16(2) and 17(1), respectively.
underlying its regulatory decisions are explained in its pages. As a means of increasing accountability to Parliament for these decisions, however, it has serious limitations. The figures published in the annual reports show that the Bank actually refuses authorisation only to a small proportion of applicants. They also show that the powers of revocation and restriction are rarely used (affecting yearly only about one percent of the institutions authorised by the Bank). The situation is similar in respect of the exercise of certain other powers provided under the Banking Act 1987, such as the investigation of possible irregularities, the making of petitions for the winding-up of insolvent institutions and the prosecution of illicit deposit-takers. However, to evaluate the Bank's performance by reference only to the formal exercise of its statutory powers is, at the very least, misleading. Despite their crucial significance for the practical operation of the regulatory system, the informal aspects of the Bank's activities are excluded from the statistical picture provided in the reports. In particular, the Bank does not give any indication of its activities relating to the informal preliminary vetting of institutions intending to apply for authorisation, of its objections to individual controllers or managers, of its decisions on the solvency and liquidity ratios for authorised institutions or of the exercise of informal pressures instead of formal remedial action. Nor is the effective fine-tuning of market practice by means of guidance by the Bank given consideration in the reports. An indication of how the exercise (or non-exercise) of the Bank's powers relates to the merits of concrete cases is also missing. In this respect, the important considerations are substantive, not statistical - and on these, the annual reports are silent.

Investigations by Select Committees, and in particular the Treasury and Civil Service Committee, provide the only direct, and possibly the only effective, channel for parliamentary scrutiny of the Bank's regulatory activities. Following the spectacular and much publicised collapse of B.C.C.I. on 5 July 1991, the Treasury Committee reviewed supervisory performance with regard to the failed bank, producing three different reports. In its main report on the affair, the Treasury Committee was critical of the Bank's general handling of the matter, and recommended a stricter supervisory approach. Yet, despite its past record of non-

---

86 Ibid., paras.61-89.
partisanship, the Treasury Committee did not manage on this occasion to reach a unanimous verdict, and was divided along party lines, with opposition members insisting on the inclusion in the report of scathing charges of incompetence against the Bank. Lack of unanimity was one of the reasons that the Treasury Committee's work on B.C.C.I. was overshadowed by the ad hoc independent inquiry undertaken at the same time by Lord Justice Bingham. Another was the greater publicity attracted by the Bingham inquiry - a possible indication that the public gives greater credibility to the reports produced by independent inquiries rather than to the findings of elected politicians. The generally aggressive attitude displayed by the Treasury Committee towards the Bank and its officials was probably a third factor which reduced the impact of its reports.

It was in immediate response to the publication of the Bingham Report, not the Treasury Committee's reports, that the government and the Bank announced their plans for improvements in the regulatory system on 22 October 1992. However, the particularities of the B.C.C.I. affair should not conceal the fact that investigations by Select Committees remain a major channel of accountability in the area of banking regulation. The evidence collected by the Select Committees

87 Ibid., pp.xxxiv-xlii.
88 Significantly, the Treasury Committee itself used the publication of Lord Justice Bingham's report as an opportunity to vindicate its views and to launch a belated attack on the Bank; Second Report: "Banking Supervision and B.C.C.I.: The Implications of the Bingham Report", H.C. (1992-93) 250. This could only serve to reinforce the impression that the Treasury Committee had become involved in a dispute with the Bank and was biased. Furthermore, the Treasury Committee demanded the ex gratia compensation of the victims of B.C.C.I. on grounds of "maladministration" on the part of the Bank; paras.32-39. This demand was unambiguously rejected by the Treasury, because it might create a precedent which would soften market discipline and create moral hazard. In addition, the Treasury pointed to the issue of causation: the losses were suffered by the frauds committed by the B.C.C.I. directors, not by the acts or omissions of the authorities; nor could it be shown that, had the Bank acted differently, depositors would not have suffered losses. In any event, Parliament had expressed its verdict on compensation by granting the Bank statutory immunity in the 1987 Act and by establishing the Deposit Protection Scheme. See App.5 to the same Report, Memorandum Submitted by H.M. Treasury, "Compensation for B.C.C.I. depositors".
89 Loc.cit., n.80.
contains unique disclosures regarding the Bank's internal processes and working assumptions and an opportunity to subject them to the test of external questioning.

4. Regulatory confidentiality as an impediment to accountability

At least insofar as the Bank's regulatory operations are concerned, the lack of proper lines of accountability is exacerbated by the secrecy surrounding its decisions. Even when it resorts to formal remedial action, the Bank rarely gives notice to the public. The Bank maintains that, if a regulatory intervention were disclosed before the exhaustion of all legal avenues for its reversal, the outcome of the case could be prejudiced. Moreover, even after the completion of every process, the Bank's inability to disclose the factual basis upon which it acted, due to the statutory prohibition on the disclosure of confidential regulatory information, whose aim is to encourage the communication of sensitive information to the supervisors, would ostensibly render any public statement incomplete and might even be contrary to natural justice. The most plausible reason, however, for keeping regulatory action secret is that confidence in the institution concerned could collapse if the restrictive measures taken against it became known, potentially leading to its disorderly termination. In the Bank's view, "[i]t is difficult to think of circumstances where the Bank would be able to judge that the interests of depositors were served by potentially destabilising publicity regarding an authorised institution or its controllers." In the past, the Bank was willing to provide information and opinions regarding the creditworthiness and standing of individual bankers. Apparently, there was no fear that this could jeopardise the stability of the institutions concerned, much less of the banking system as a whole. Today, the only piece of information that the Bank makes available about banking institutions is whether they are authorised under the Banking Act. Otherwise, unless an institution discloses itself any action taken against it, the public has no means of becoming informed. The Bank's view is that the public disclosure of regulatory action is not necessary, since shareholders can be trusted to care for themselves, potential depositors are not in danger once remedial action has already been undertaken, while existing ones may be informed by the

91 Banking Act 1987, s.82(1); and s.86, as replaced by the Banking Coordination (Second Council Directive) Regulations 1992, S.I. 1992/3218, reg.41. See supra, ch.2, section 3(b).
93 Ibid., p.272.
94 Banking Act 1987, s.17.
institution itself on the Bank's requirement if this is appropriate under the circumstances.95

Regulatory secrecy, however, inhibits openness and accountability, as well as market transparency and discipline. The public disclosure of adverse regulatory findings of fact could serve in itself as an alternative regulatory sanction and could contribute in disinfecting the marketplace, since, under the pressure of the adverse publicity, bad banks could be priced out of business.96

At any rate, treating certain matters as confidential creates intractable difficulties with regard to the Bank's public accountability. In particular, confidentiality often clashes with the need of providing information to Parliament, especially in front of Select Committees. Select Committees have the power to order the attendance of persons and the production of papers and records.97 Their orders can be enforced by Parliament through contempt procedures, and communications with them are covered by parliamentary privilege.

In practice, Parliament has proved somewhat reluctant to make formal orders to compel civil servants to answer questions and provide documents and has generally deferred to the underlying decisions of ministers on whether disclosure of particular matters would be in the public interest or not.98 Although generally the scrutiny of the Bank's activities by Select Committees does not raise directly issues of deference to the ministerial view of the public interest, in those cases where the Bank acts as the government's adviser the situation can be different.

During its investigation into the collapse of the tin market in 1985, the Trade and Industry Select Committee attempted unsuccessfully to acquire information from the Bank regarding its role in the events. The Bank acknowledged that it had warned the government of the impending crisis, but declined to provide certain papers to the

95 See Trade and Industry Committee, "Company Investigations: House of Fraser. Minutes of Evidence, Tuesday 19 February 1991", H.C. (1990-91) 239-i, qq. 1066, 1082-1087. Similarly, the Bank does not think that the public necessarily needs to know the identity of controllers of financial institutions: "They know into whose hands they are putting their money in the sense that they are putting their money with an institution authorised by the Bank of England"; q. 1210. However, the value of this "guarantee of quality" is doubtful, since the Bank has absolutely no legal responsibility for losses that may be suffered by those members of the public which rely upon it; see supra, ch. 5, sections 1 and 2(d). The extraordinary view that the public should rely on the Bank's best judgement is unlikely to be openly reiterated after the B.C.C.I. affair, as a result of which an explicit "health warning" has been added to the list of authorised institutions, to the effect that "[t]he inclusion of an institution does not mean that the Bank of England in any way guarantees its obligations"; "Banking Act 1987: Annual Report under the Banking Act for 1993-94", p.43.


98 See K.P. Poole, "The powers of Select Committees of the House of Commons to send for persons, papers and records" (1979) 32 Parliamentary Affairs 268.
Committee, citing the sensitivity of its position and asking the Committee to accept that its advice to ministers is confidential. In this manner, the Bank asked, in effect, to be treated as if it were part of the Civil Service. The Committee criticised the Bank on other grounds, namely for its failure to give to the London Metal Exchange and to the banks engaged in lending to the tin market an unambiguous warning that a crisis was impending since, despite their expectations to the contrary, the intention of the government was not to provide additional assistance to that market. However, it accepted that its power to send for persons, papers and records could not be used to force the production of the internal papers of a government department headed by a minister answerable to Parliament and that the restriction also applied to papers circulating between departments and their professional advisers. In the Committee's view, this enabled the government to control which papers the Bank was able to return against its Order in so far as they were passed to it in its unique capacity as an adviser to the government.

In other cases, difficulties arise because it is unclear whether Select Committees can compel the production of information on matters which are still under administrative consideration or whether they should instead confine themselves only to the ex post scrutiny of decisions. The appropriateness of contemporaneous scrutiny is an important consideration in relation to the Bank's regulatory activities. Because the Bank's mode of regulatory decision-making does not involve a formally distinct policy-making stage, separate from the resolution of individual cases, scrutiny in this context will often revolve around specific cases which have attracted the public eye. However, individual regulatory decisions, being of a "quasi-judicial" nature in the sense of applying statutory criteria to a specific factual situation, are not an appropriate target for parliamentary interventions. Under these circumstances, it is doubtful whether Select Committees should compel disclosure.

From a legal standpoint, the Witnesses (Public Inquiries) Protection Act 1892 protects, through civil and criminal sanctions, persons from reprisals taken against them for having given evidence to a public inquiry. But it has to be doubted whether this protection extends to preclude criminal prosecutions or civil reprisals against public employees for breach of an express statutory duty not to disclose.

---


100 Ibid., para.13.

101 See Poole, loc.cit., n.98.

102 Ss.2 and 4. "Inquiry" is defined as "any inquiry held under the authority of any Royal Commission or by any committee of either House of Parliament, or pursuant to any statutory authority, [...] but shall not include any inquiry by any court of Justice"; s.1. Protection is given under the 1892 Act, notwithstanding any further privilege of communication, parliamentary or statutory; s.7.
Furthermore, it is not certain that parliamentary privilege can in this case override the duty of confidentiality with regard to regulatory information owed by the Bank under the Banking Act 1987.

In certain cases, the Bank has clearly taken the view that it cannot. In February 1991, giving evidence to the Trade and Industry Committee in relation to its investigation into the affairs of the House of Fraser business group, the then Governor of the Bank, Robin Leigh-Pemberton, referring to the confidentiality provisions of the Act and noting that Parliament is not included in the statutory exceptions, expressly refused to disclose to the Committee information acquired by the Bank in a supervisory capacity which related to the group's banking subsidiary, despite the fact that the Committee's Chairman had stated at the outset that anything disclosed during the examination would be covered by parliamentary privilege. A similar approach was apparent in the context of the Barings collapse. Following a request of additional information by the Treasury and Civil Service Committee, last October the current Governor, Eddie George, in a letter informed the Committee that he was unable to provide the relevant information. In the Governor's words, "[t]he essence of the problem is that to disclose documents obtained in the course of supervision [...] would breach the confidentiality provisions of Part V of the Banking Act 1987." On the other hand, in the aftermath of the B.C.C.I. affair the Bank was willing to put aside its objections to disclosure and to provide information about the circumstances leading to the collapse both to the Treasury and Civil Service Committee and to the ad hoc inquiry conducted by Lord Justice Bingham. The Bank's attitude of co-operation with these inquiries cannot easily be reconciled with its outright refusal to disclose in other cases. Rather than reflecting a consistent legal interpretation of the statutory position, it may be better be seen as a shift of position necessitated by considerations of expediency and, in particular, by the Bank's weakened political position following a bank failure of major proportions. The affairs of B.C.C.I., even though more dramatic than those of the House of Fraser or Barings, could not be readily classified under the rubric of "public knowledge", so as to escape the requirement of regulatory confidentiality. Nor were the persons to which the relevant information was divulged covered by the statutory "gateways" of permissible disclosure.


105 Although the duty of confidentiality was occasionally employed in this case as well to shield the Bank from the need of answering a sensitive question; see, e.g., Treasury and Civil Service Committee, "Banking Supervision and B.C.C.I.: International and National Regulation", loc.cit., n.85, Minutes of Evidence, 23 July 1991, p.117, q.107.
Eventually, the duty of regulatory confidentiality will inevitably raise barriers to the demand for public accountability, and it may be a matter of balancing the external pressures whether the one or the other will prevail in a particular case. Yet, it seems that the B.C.C.I. episode has weakened to some extent the emphasis on confidentiality.

The decision in *Price Waterhouse v. B.C.C.I. Holdings (Luxembourg) S.A.*

must be considered in this context. In that case, the plaintiffs, being the accountants of B.C.C.I. and having received notices requiring the production of documents under section 39 of the Banking Act 1987, as well as a request to disclose confidential information to the extra-statutory inquiry conducted by Lord Justice Bingham, sought declarations from the court as to their professional duties of confidentiality. It was held that the documents requested in respect to the statutory investigation were not covered by legal privilege. But it was indicated that, even if they were, section 39 would override a claim of the privilege. It was also held that, by analogy to investigations under section 39, confidential information may be produced to the *ad hoc* extra-statutory inquiry (provided that dissemination of the information would be no wider than that permitted under the statutory provision), because the public interest in seeing that an inquiry into the performance of the Bank's supervisory functions receives all necessary information was at least as great as that which underpinned the Bank's own statutory powers of investigation into the affairs of authorised institutions.

It will be noted that the *Price Waterhouse* decision concerned the private duty of confidentiality owed by professional accountants to their clients, but not the Bank's duty, which exists in public law and is enforceable with criminal sanctions. If, however, it can be taken to imply that, in giving evidence to the Bingham inquiry, the Bank properly proceeded on the same legal basis of analogy from section 39, a number of difficult questions, which cannot be answered on the basis of the decision itself, arise as to the exact limits of this type of extra-statutory disclosure in the

---

107 As other controversial reports which may contain information that could be regarded as defamatory or suggest criminal activity by an individual, the Bingham Report was published by use of a "motion for an unopposed return", the effect of which is to ensure that a report is "returned" to the H.C. and in consequence its publication is protected by absolute legal privilege against an action in defamation; Parliamentary Papers Act 1840, ss.1-2. Although this is nominally a parliamentary request of information, the actual decision to use it is in fact taken by a minister. In fact, the paper is not presented to the House before it orders its publication, and although some limited comment may be possible on the day of publication, even that will not be possible if the content of the report becomes subject to the House's own *sub judice* rule before publication. See P.M. Leopold, "The publication of controversial parliamentary papers" (1993) 56 M.L.R. 690.
public interest, in particular whether they cover parliamentary or other public
inquiries and in what circumstances. If, on the other hand, only private-law duties of
confidentiality can be qualified in this manner (so that the Bank's earlier
interpretation of its responsibilities regarding disclosures to parliamentary and public
inquiries is right in law), the logical conclusion would be that, by co-operating with
the inquiries on the supervision of B.C.C.I., the Bank violated its statutory duty. In
the face of the competing claims of accountability and confidentiality, the halfway
house that was constructed for the special purposes of the Bingham inquiry displays
a measure of pragmatic disregard for the strictures of the statutory confidentiality
provisions.

In conclusion, despite the indisputable willingness of the Bank to publicise and
explain its regulatory policies by various means (including speeches of its Governors
and directors, articles in the Quarterly Bulletin and appearances before
parliamentary committees), the regulatory system remains opaque to a considerable
extent. This is a consequence of both the non-conclusive nature of the Bank's
general policies and the strict policy of regulatory secrecy which precludes
disclosures relating to the Bank's actions with regard to particular institutions.
Regulatory openness and accountability cannot be achieved unless the Bank is
required to disclose and justify the manner in which its policies are translated into
concrete individualised decision-making. However, the existence of a statutory duty
of regulatory confidentiality, also entrenched in E.C. law, sets a strict limit on the
ability of the regulatory system to evolve in the direction of greater transparency.
Conclusion

In this thesis, the functions of the Bank of England in the area of banking regulation and supervision have been examined critically for the purpose of determining the extent to which the current regulatory system allows, and at times even requires, the exercise of discretionary judgement (as distinct from the application of formal rules) by the regulators and of evaluating the opportunities offered to those affected by the Bank's decisions for challenging these decisions by legal means.

Since the early 1970s, the Bank's traditional regulatory practices, based on the voluntary acceptance of its authority by City institutions and the employment of the Bank's de facto market power as an instrument of structural control over the operation of the banking markets, have been gradually replaced by more formal regulatory requirements. A number of factors contributed to this shift, including: (i) the failure of post-War macroeconomic policies; (ii) the break-down of cartel arrangements; (iii) the subversion of barriers to entry in the banking sector by innovative fringe institutions; (iv) the secondary banking crisis of the early 1970s; (v) the growing significance of considerations relating to the international competitiveness of British banking; (vi) the increasing interest shown by "outsiders" (politicians and the public) in the internal workings of the City, largely as a result of perceptions of regulatory crisis and financial scandal; and (vii) the efforts for the harmonisation of banking regulatory standards at the European and international levels.

Close examination of the development of the regulatory system following the enactment of the Banking Act 1979 illuminates the subtle interplay between increased formalisation and transparency, resulting in the imposition of constraints on the Bank's regulatory discretion, on the one hand, and the retention by the Bank of almost unchecked discretion regarding a number of strategic issues affecting the conduct of banking institutions, on the other.

Even a limited degree of formalisation results in important dynamics by providing a basis for raising legal challenges to the regulatory decisions and increasing the
openness of the decision-making process. The constraining effects on the exercise of regulatory discretion are considerable. The drafting of the Banking Acts 1979 and 1987 was intended to secure a firm statutory basis for the Bank's regulatory functions while preserving, to the fullest extent possible, the very wide discretion enjoyed by the Bank under the prior non-statutory system. Nonetheless, the exercise of regulatory functions against a statutory background has resulted in considerable reduction of the Bank's effective freedom of decision-making. This trend has been reinforced by the rapidly growing significance of binding provisions of E.C. law in this area and the parallel, and equally spectacular, expansion of English administrative law. In particular, the Bank's practice of issuing quasi-formal policy pronouncements (especially insofar as financial requirements for banking institutions are concerned) has contributed to an extensive legal structuring of many aspects of the regulatory system.

The reversal of these trends, with a return to totally informal practices of "moral suasion", does not seem possible. None of the conditions which permitted the exercise of informal regulatory control prior to the 1970s, namely, the concentrated and cohesive nature of the City, the existence of cartel arrangements and restrictions on competition setting strict limits on the ability of non-complying institutions to operate, and the Bank's provision of countervailing privileges to the institutions which submitted to its authority, are in existence anymore. The ensuing erosion of the voluntary acceptance of its regulatory authority makes it necessary for the Bank

---

1 The Bank's former Governor, Robin Leigh-Pemberton, has graphically summarised the emerging situation as follows: "I have to be very careful about calling people in and, as it were, reading the rules to them because our power is both statutory and traditional and those who are not minded to accept the traditional exercise of authority by the Governor [...] nowadays are in a stronger position than they were in the old days, simply because the Bank's power of banking supervision is now statutory. Whereas in the old days it was not possible for a banking chairman to turn round and say, 'Look, I am sorry, under the Act you have no power to do this, I am not responding', that is the case now and, therefore, I have had to think very carefully whether the person in question or the situation in question is one where the exercise of this calling in of people and reading the Riot Act to them, as it were, is appropriate or not. It is a different world." At the same time, however, the Governor insisted that he had not lost his proverbial "eyebrows": "There have been cases where people have come into my room and have gone out for good."; Treasury and Civil Service Committee, Second Report: "Banking Supervision and B.C.C.I.: The Implications of the Bingham Report", H.C. (1992-93) 250. Examination of witnesses, Leigh-Pemberton, q.44. Brian Quinn, the Bank's executive director with immediate responsibility for matters of prudential supervision, has also acknowledged that "using the Bank's traditional methods of moral suasion could in some circumstances be represented as amounting to unfair or unjust behaviour on the Bank's part [...]. The corollary of a legal framework with considerable powers is a set of safeguards to protect the interests of those to whom these powers apply. The use of statutory powers allows the institutions and individuals concerned access to formal remedies. Paradoxically, then, these institutions and individuals may consider it preferable for the Bank to employ its legal powers rather than to rely on the informal methods it has traditionally used."; B. Quinn, "The influence of the Banking Acts (1979 and 1987) on the Bank of England's traditional style of banking supervision", in J.J. Norton (ed.), Bank Regulation and Supervision in the 1990s (1991), p.5.
to increasingly rely on its statutory powers. Despite the survival of antilegalistic and antiformalistic attitudes within the Bank's walls, this need entrenches the legalisation of banking regulation and brings to the forefront the related issues of transparency, legal control and accountability. Moreover, the European and international harmonisation of banking regulation reinforces the trend towards greater transparency and formality.

These developments notwithstanding, it remains the case that under the Banking Act 1987 the Bank retains a wide zone of autonomy and enjoys very broad, and practically unreviewable, discretion with regard to a number of issues of fundamental importance for the conduct of banking institutions.

Insofar as the interpretation of the minimum criteria for authorisation of deposit-taking institutions in Schedule 3 of the Banking Act 1987 is concerned, the most significant points of residual discretion involve the setting of exact financial ratios for individual banking institutions and the vetting of bank controllers, directors and managers. At least of equal importance is the discretion enjoyed by the Bank in determining the appropriate course of action to be followed once a problem or irregularity has been detected - i.e. whether to withdraw authorisation from institutions which fail to meet the minimum criteria, to seek their formal termination by initiating insolvency proceedings or to pursue their restructuring. The extrastatutory power of the Bank to launch support operations for the benefit of ailing institutions must also be mentioned in this context. Moreover, the activities of the Bank in relation to the regulation of wholesale markets by the Bank under section 43 of the Financial Services Act 1986 are subject to practically no statutory constraints, while the Bank is also able to impose de facto its will on its actual or potential counterparties under its private contractual power.

In all these areas, the Bank yields enormous power over individual banks, and it is not inconceivable that this power could be employed in an abusive, discriminatory or arbitrary manner. At the same time, the legal recognition of the Bank's wide margin of discretion sets strict limits to the review of its decisions.

While the future development of banking regulation is likely to involve even greater reliance on quasi-formal policies and a further increase in the significance of formal regulatory requirements at the European level, the Bank's transformation into a regulatory agency in which the functions of policy-making and enforcement are clearly separated is far from complete. For the accomplishment of this transformation, two things would be necessary: (a) the formal recognition of the binding character of the Bank's regulatory pronouncements, both against its

---

2 See, e.g., Quinn's remarks, ibid., p.6, to the effect that "moral suasion" should continue to play an important role, because formal regulation may not be always able to produce the same kind of stability that decisive "informal" action had ensured in the past.
regulatees and itself when acting in the capacity of enforcer; and (b) a concerted attempt towards the promulgation of a comprehensive set of substantive regulatory rules and standards.

The formalisation of the regulatory process in this manner, including the entrenchment of specific and transparent enforceable standards, is particularly desirable. Overall, the current system involves a combination of draconian legal powers with negotiated enforcement. The Bank's residual discretion has the effect of ensuring that, regardless of their substantively merit, criticisms of its decisions can rarely give rise to effective legal challenges. This reduces legal accountability, and potentially encourages regulatory complacency and arbitrariness. On the other hand, there is precious little evidence that residual discretion is strictly necessary for the management of the supervisory system. The development of consistent frameworks for the measurement of the financial viability of banking institutions underscores that the most important aims of prudential regulation can be achieved through the application and enforcement of binding rules, which would provide externally verifiable points of comparison and criteria of performance.

The solution to the problem of administrative discretion has often been sought in the subjection of every instance of effective exercise of public power to substantive review and to the judicial development of standards of good administration. Nonetheless, without entrenched and legally binding substantive standards, it is doubtful whether a more active judicial or appellate approach to the review the Bank's regulatory decisions would be possible, or even desirable. Purely judicial solutions would in and of themselves raise questions of legitimacy, in particular with regard to the exercise of public control over the direction of regulatory policy.

The dominant constitutional tradition does not recognise an independent role for the judiciary in issues of policy, but instead limits the function of judges to ensuring that the will of the legislature is effective implemented according to its terms, especially through the interpretation and application of primary rules of law. On the other hand, the dramatic expansion of administrative law in recent years is to a considerable extent the result of the growing willingness of courts to control abuses of power, to redress individual grievances and to promote the values of good administration, even in situations where such values are not reflected in statutory provisions. The proponents of judicial activism would like to see the courts taking even bolder steps in this direction. However, the endorsement of ostensibly

---


4 On the two approaches to judicial review and the role of judges in the administrative state, see the discussion between R. Cotterrell, "Judicial review and legal theory", The Hon. Mr. Justice
unobjectionable values of good administration as standards for legally evaluating the substance of administrative decisions may conceal a substitution of judicial discretion for that of the primary decision-makers and an attempt to enforce the subjective value-judgements of judges. This would be tantamount to a usurpation of discretionary policy-making functions by unelected and politically unaccountable judges. Moreover, it is by no means certain that, in engaging in substantive review of administrative decisions, courts would always strike a correct balance between the protection of the interests of applicants and the need for effective administration. Courts may be unable to understand the realities of administrative practice, and their interventions may hinder the performance of public functions by forcing administrative decision-makers to adopt a defensive mind-set and divert resources from the main tasks of administration. For these reasons, judicial intervention in regulatory decision-making can only be truly legitimate when it consists of the application of pre-existing rules which provide clear criteria for adjudication.

These arguments apply with equal force to the review of the Bank's regulatory decisions by either the Banking Appeal Tribunal or the courts. It is significant that, in practice, courts are generally reluctant to review the decisions of financial regulators, with the exception of cases concerning the application of precise pre-existing rules or the procedural fairness of an individual determination. Judicial deference in the regulatory field is premised on reliance in the expertise and professionalism of regulators and on a marked reluctance to upset certainty in the fast-moving financial markets. As more cases are litigated and judges gain experience with regard to questions of financial regulation, their attitudes may change, thus leading to the adoption of a more intrusive approach. However, the current "hands-off" approach may be appropriate as long as the decision-making environment is not subject to precise rules.

As the active involvement of Parliament in banking regulation in the form of comprehensive primary legislation not only appears unlikely, but would also be in all likelihood unnecessarily burdensome, the best hope for the achievement of formalisation and government by rules in this area lies in the crystallisation of the principles which guide regulatory decision-making in precise and enforceable regulatory rules. In this manner, the Bank's regulatory policies would be transformed into rules that bind the Bank as much as its regulatees, thus restraining the exercise of its power in connection to individual determinations. The complete formalisation of the Bank's policies and the drawing of a clear distinction between its functions as

---


5 See Cranston, ibid.
rule-maker and enforcer would promote legal certainty, minimise the potential threat of discriminatory or oppressive regulatory behaviour, provide the necessary substantive standards for the review of individual decisions, and increase the legitimacy of the Bank's decision-making processes.

Of course, the argument for comprehensive formalisation of the regulatory régime is abstracted to a significant extent from the concrete realities of regulatory practice. It should be emphasised that the professionalism and high ethical standards of the Bank's officials are not in question. Accordingly, formalisation should not be viewed as a means for combating perceived abuses of the regulatory powers, but as a way of increasing the legal integrity of the regulatory process and avoiding even the appearance of arbitrary or discriminatory decision-making. An apparent difficulty in this context is that formalisation would tend to impede the undertaking of remedial action in situations where the Bank cannot provide conclusive evidence of breach of its regulatory rules. Indeed, the excessive judicialisation of regulatory process could completely undermine its effectiveness. As Lord Alexander of Weedon, the former chairman of the City Panel on Take-overs and Mergers, has observed:

"[t]he principal function of the regulatory bodies is essentially the protection of investors, and the provision of a framework in which there is investor confidence in the integrity of the markets. Their powers clearly affect the rights of individuals to earn their living - but in a real sense their overriding duty is towards investors."6

A clear sense of priorities is particularly significant, since in most cases it may be extremely difficult to obtain direct and totally incontrovertible evidence of malpractice or irregularity, of the kind required, e.g., for the prosecution of criminal offences.

On the other hand, the negative consequences of the formalisation of substantive regulatory standards in terms of enforcement should not be exaggerated. Even under the present system, the requirements of administrative law place the burden of establishing a reasonable basis for suspicions on the Bank before its remedial powers become exercisable. The need to strike a balance between the statutory purposes and the interests of those whose professional and financial lives depend on the regulatory decisions is a fundamental imperative guiding the exercise of regulatory functions in the public interest, and this is expressly recognised by the Bank itself.7

---

7 See, e.g., Treasury and Civil Service Committee, First Special Report, "Banking Supervision and B.C.C.I.: The Response of the Bank of England to the Second and Fourth Reports from the Committee in Session 1991-92", H.C. (1992-93) 178, Response of the Bank to the Fourth Report, para.5: "If the Bank lacks evidence or if a proposed course of action is unreasonable on the basis of the evidence which it has, the Bank's decision could indeed be overturned by an appeal tribunal or by judicial review. Public bodies, such as the Bank, charged with administering a statute must be able to justify their actions before either removing someone's livelihood or closing down an institution, where depositors and other creditors and shareholders may as a result suffer

474
There is no reason why the threshold for enforcement under a system of fully-determinative rules should not be as pragmatic as it currently is. Indeed, the Banking Appeal Tribunal and the courts can be expected to respect the freedom of regulators to take appropriate action without being required to support such action with unduly technical or otherwise inaccessible evidence. Although the regulators cannot be permitted to act solely on the basis of their instincts or impressions, they could be permitted to resort to their professional judgement in applying the substantive criteria, but not to vary such criteria for the purposes of an individual case. In this sense, the formalisation of substantive rules would primarily serve to secure greater specificity of the operational criteria of regulatory compliance and enforcement, as well as greater transparency and common understandings between the Bank and its regulatees.

It might be claimed that the formal recognition of a rule-making power to the Bank would be of questionable legitimacy, because the substantive content of the regulatory rules would not reflect any particular legislative mandate and the procedures for the adoption of these rules would not be representative. Nonetheless, the promulgation by the Bank of sub-delegated rules, in addition to promoting legal certainty, would also contribute to the greater transparency of regulatory policy - the concrete translation of which in individual rulings is currently opaque and inaccessible to outsiders -, and would even increase the probability of corrective interventions by Parliament and the courts in appropriate cases.

An indirect benefit of rule-based decision-making would be to distance the Bank as regulator from the unavoidable instances of bank failure. Currently, the price that the Bank is forced to pay for retaining extensive discretion regarding the prudential conduct of individual institutions is that, while the successes of the regulatory system are unpublicised (and probably unquantifiable), public opinion tends to attribute responsibility to the Bank for every major bank failure. Recognising the ultimate futility of efforts to totally eliminate the phenomenon of bank failures and in an attempt to minimise public expectations in this regard, in recent years the Bank has insisted that regulators cannot (and should not) be expected to ensure total bank safety, since this would be inconsistent with the operation of a competitive and efficient banking market, and that the occurrence of difficulties in the banking sector is frequently the result of factors beyond the regulators' control (such as macroeconomic instability) and should not be automatically interpreted as a failure of

losses. The requirements of administrative law - for example of fairness, reasonableness and of proportionality - distinguish public authorities from private sector counterparties who can freely terminate a business relationship if they so wish, whereas the Bank must have justifiable reasons for its actions.

475
Notwithstanding such "protestations of innocence", however, the Bank faces a very considerable political predicament: whenever there exists a question of taking remedial action, its discretionary decisions are bound to be criticised as unduly timid if it fails to close down the suspect institution, or both unduly harsh and belated if it does close it down (as in the case of B.C.C.I.). In particular, the perceptions of insufficiently rigorous supervision that naturally follow every bank failure lead to renewed criticisms of the Bank. As the institutional prestige and influence of the Bank does not primarily depend on its regulatory powers, but on its monetary functions, one solution to this political predicament would be for the Bank to focus exclusively on the latter and encourage the legislative delegation of its supervisory responsibilities to a separate agency. However, this would reduce considerably the day-to-day influence the Bank has over the operation of commercial banking institutions, and no agency is favourably inclined to a contraction of its jurisdiction. In the past, the Bank has been successful in deflecting criticisms following major banking crises (such as the secondary banking crisis, the Johnson Matthey Bankers failure, or the B.C.C.I. affair) by re-interpreting these crises as evidence of gaps in its legal mandate, and has managed to secure considerable extensions of its statutory powers on this basis. Given the comprehensive range of powers that the Bank currently exercises, however, and the increasingly critical attitudes of politicians and the public, this may no longer be a viable tactic. In contrast, the adoption of an arm's-length approach to its regulatory functions, based primarily on the application and enforcement of formal regulatory rules, and even the increasing judicialisation of the regulatory process, could dispel the impression that the Bank maintains cosy and non-confrontational relationships with its regulatees.

Notwithstanding the aforementioned benefits, it should be made clear that formal regulatory rule-making would not be a panacea. The most difficult (and possibly the most important) problem that needs to be tackled, i.e. the limits set to the transparency and effective public accountability of the Bank's regulatory work by the strict observance of regulatory secrecy, would not be automatically solved simply as a result of the complete formalisation of the regulatory process.

The regulatory duty of confidentiality and, more generally, the policy of non-disclosure of supervisory information concerning the financial situation of regulated institutions, not only impede public control over the operation of the regulatory system, but also deprive the market of valuable information, which is available only to regulators but which could be used, if publicly disseminated, for the private

---


assessment of bank viability, thus enforcing market discipline. It is significant that, rather than pursuing the comprehensive public disclosure of all relevant information, prevailing policies have led to the emergence of a secondary system of bank accounting, involving frequent and detailed supervisory returns and supplementary bank audits by reporting accountants, which operates only for the benefit of regulators. A reconsideration of the present legal framework in the direction of encouraging more meaningful public disclosures could prove particularly beneficial, not least because it would place the responsibility for responding to adverse new information at the hands of the market participants themselves, and so minimise the risk of regulatory mistakes or complacency in connection to the taking of remedial action. Such a dramatic shift in the use of supervisory information, however, would require action at the European level.
OFFICIAL PUBLICATIONS

Command Documents:
Cd. 9052, Colwyn Committee, "Report of the Treasury Committee on Bank Amalgamations" (May 1918).
Cmd. 3897, Macmillan Committee, "Committee on Finance and Industry: Report" (June 1931).
Cmd. 218, Franks Committee, "Report of the Committee on Administrative Tribunals and Enquiries" (Jul. 1957).
Cmd. 3292, National Board for Prices and Incomes, "Report No.34: Bank Charges" (May 1967).


Cm. 622, The Review Committee on Banking Services Law (Jack Committee), "Banking Services: Law and Practice" (1989).


**Hansard:**


**Parliamentary Papers:**

Joint Committee on Statutory Instruments:


Select Committee on Procedure:


Select Committee on Nationalised Industries:


Trade and Industry Committee:

Treasury and Civil Service Committee:
H.C. (1979-80) 720: "Memoranda on Monetary Policy".


Monopolies Commission:

Council on Tribunals:

Bingham Report:

Board of Banking Supervision:


Bingham Report:

Board of Banking Supervision:

480
BANK OF ENGLAND SOURCES

Articles in B.E.Q.B.:
"The management of money day by day" (1963) 3 B.E.Q.B. 15.
"Credit restraint in 1967/68" (1967) 7 B.E.Q.B. 164.
"Control of bank lending: the Cash Deposits scheme" (1968) 8 B.E.Q.B. 166.
"Credit restriction" (1969) 9 B.E.Q.B. 145.
"Competition and credit control" (1971) 11 B.E.Q.B. 189.
"Key issues in monetary and credit policy" (1971) 11 B.E.Q.B. 195.
"Extract from a speech by the Governor" (1971) 11 B.E.Q.B. 224.
"Reserve ratios and Special Deposits" (Sept. 1971), supplement to 11 B.E.Q.B.
"Reserve ratios: further definitions" (1971) 11 B.E.Q.B. 482.
"Bank lending" (1972) 12 B.E.Q.B. 327.
"Banking mergers and participations" (1972) 12 B.E.Q.B. 452.
"Credit notice" (1973) 13 B.E.Q.B. 445.
Blunden, G., "The supervision of the U.K. banking system" (1975) 15 B.E.Q.B. 188.
"The capital and liquidity adequacy of banks" (1975) 15 B.E.Q.B. 240.
"Reflections on the conduct of monetary policy" (1978) 18 B.E.Q.B. 31.
"Regulation in the City and the Bank of England's rôle" (1978) 18 B.E.Q.B. 379.
Foot, M.D.K.W., Goodhart, C.A.E., and Hotson, A.C., "Monetary base control" (1979) 19 B.E.Q.B. 149.
"International conference of banking supervisors" (1979) 19 B.E.Q.B. 298.
"The measurement of capital" (1980) 20 B.E.Q.B. 324.
"British economic policy over the last decade" (1983) 23 B.E.Q.B. 194.
"Recent banking difficulties" (1993) 33 B.E.Q.B. 103.
"Annual remit for the Bank's operations in the gilt market" (1994) 34 B.E.Q.B. 112.
"CREST - the first phase completed" (1994) 34 B.E.Q.B. 130.
"Credit and economic policy" (1994) 34 B.E.Q.B. 169.
"Recent developments in supervisory practice" (1994) 34 B.E.Q.B. 365.


Speech of the Governor of the Bank, E. George, published under the title "Protect the banking system but not individual banks", The Times, 27 Oct. 1995, p.29.

Bank of England Reports:
"Reports and Accounts" for the years 1978-79 to 1994-95.

Policy and Practice Notices Issued by the Banking Supervision Division, now Supervision and Surveillance (Banking Supervisory Policy Division), Currently (May 1995) in Force:


Untitled notice on connected lending; accounts; large exposures; fraudulent invitations; floating charges (BSD/1983/1, Apr.1983).
"Foreign Currency Options" (Apr. 1984).
"Statistical Notice to Monetary Sector Institutions", released in conjunction with previous paper (Apr. 1985).
"Large Exposures in Relation to Mergers and Acquisitions" (BSD/1986/1, Feb.1986).
"Subordinated Loan Capital Issued by Recognised Banks and Licensed Deposit-Takers" (BSD/1986/2, Mar. 1986).
"Large Underwriting Exposures" (BSD/1987/1.1, Feb.1988).
"Advertising for Deposits" (BSD/1988/1, Apr. 1988).
"Loan Transfers and Securitisation" (BSD/1989/1, Feb. 1989).
Letter to authorised institutions on "Money Laundering" (10 Nov. 1989).


**Application Forms:**

Form 1: "Banking Act 1987: Application for Authority to Accept Deposits in the Course of Carrying On a Deposit-Taking Business".

Form 2: "Banking Act 1987: Questionnaire for Institutional Controllers".

Form 3: "Banking Act 1987: Personal questionnaire for individuals who are, or are proposing to become, directors, controllers or managers".

Form RO: "Banking Act 1987: Notice of a Proposal to Establish a Representative Office in the United Kingdom".  

485
Papers Issued by the Banking Supervision Division, Not in Force:


Letter to U.K.-incorporated authorised institutions with exposures to countries experiencing debt servicing and repayment difficulties on "Country Debt Provisioning" ("the Matrix") (5 Aug. 1987).
"Large Exposures Undertaken by Institutions Authorised Under the Banking Act 1987" (BSD/1987/1, Sep. 1987).
"Guidance Note on Accounting and Other Records and Internal Control Systems and Reporting Accountants' Reports Thereon" (BSD/1987/2, Sep. 1987).
Letter to U.K.-incorporated authorised institutions with exposures to countries experiencing debt servicing and repayment difficulties on "Country Debt Provisioning" (26 Jan. 1990).


Consultative document, "Loan Transfers and Securitisation" (Dec. 1987).
Prudential Return Forms:
(In addition to the following forms, which are used either partially or exclusively for supervisory purposes, the Bank's Monetary and Financial Statistics Division collects additional returns that are used for the compilation of monetary statistics, the national accounts and international banking statistics and for the analysis of domestic lending)

Form BS: "Balance Sheet" (completed monthly; a number of small institutions file a modified quarterly version, Form QBS).

Form BSD1: "Capital Adequacy Return" (completed quarterly on an unconsolidated / solo consolidated basis, and half-yearly on a consolidated basis).

Form LE: "Analysis of Large Exposures" (unless otherwise agreed with the Bank, completed quarterly on an unconsolidated basis, and half yearly on a consolidated basis, by U.K.-incorporated banks only).

Form S3: "Foreign Currency Exposure" (completed monthly).

Form Q6: "Maturity Analysis of Liabilities and Assets in Sterling" (completed quarterly; a number of small institutions file a modified quarterly version, Form QMA).

Form S5: "Maturity Analysis of Liabilities and Assets in Currencies Other Than Sterling" (completed quarterly).

Form C1: Country exposure report of worldwide offices of U.K.-incorporated banks (completed half-yearly).

U.K. branches of foreign institutions are required to submit Form B7 on profits, exposures, etc., and Form B1 on country exposures (both completed half-yearly).

The following supervisory returns are collected from specialist money-market institutions:

Form CD(DM): Discount houses' transactions in sterling CDs (completed monthly).

Form MM: Bill turnover in the money market (completed monthly).

Form M1: Market-makers' holdings of subordinated-loan capital issued by banks (completed quarterly).

Interview:

Wholesale Markets Supervision Division Papers:


Market notice (4 Jan. 1993), replacing ch.1, para.17, of the "Grey Paper".

"The London Code of Conduct: For Principals and Broking Firms in the Wholesale Markets" (July 1995).

Codes of Conduct:


OTHER PAPERS

U.K. Papers:


Foreign Official Papers:

Basle Committee on Banking Regulations and Supervisory Practices (now the Basle Committee on Banking Supervision) Papers:
"Report to the Governors on the Supervision of Banks' Foreign Establishments" (the "Concordat") (Sep. 1975).
"Principles for the Supervision of Banks' Foreign Establishments" (the "revised Concordat", replacement to the 1975 paper) (May 1983).
"International Convergence of Capital Measurement and Capital Standards" (the "Basle Accord") (July 1988).
"The Ensuring of Adequate Information Flows between Banking Supervisory Authorities" (supplement to the Concordat) (Apr. 1990).
"Amendment to the Capital Accord of July 1988 (July 1994).
"Risk Management Guidelines for Derivatives" (July 1994).


International Organisation of Securities Commissions ("I.O.S.C.O.") Papers:
BOOKS, ARTICLES, PAMPHLETS, RESEARCH PAPERS


Bagehot, W., Lombard Street: A Description of the Money Market (London: H.S. King, 1873).


Batiffol, H., "Le déclin du droit: examen critique" (1963) 8 Archives de Philosophie du Droit 43.


Beatson, J., "The courts and the regulators" (1987) 3 Prof. Neg. 121.
Benston, G.J., "Are large banks more efficient?" (1968) 118 The Banker 605.
Birkinshaw, P., "Departments of State, citizens and the internal resolution of grievances" (1985) 4 C.J.Q. 15.
Blanden, M., "How the Bank's liquidity controls will bite" (Jul. 1980) 130:653 The Banker 25.


Brown, N., "Murphy: out of the frying pan and in to the fire" (1990) 6 Prof. Neg. 150.


Burdeau, G., "Le déclin de la loi" (1963) 8 Archives de Philosophie du Droit 35.


Cothren, R., "Asymmetric information and optimal bank reserves" (1987) 19 *J.M.C.B.* 68.


Cutler, L.N., and Johnson, D.R., "Regulation and the political process" (1975) 84 Yale L.J. 1395.
Daintith, T., "The functions of law in the field of short-term economic policy" (1976) 92 L.Q.R. 64.
Daintith, T., "Regulation by contract: the new prerogative" (1979) 32 C.L.P. 41.
Dale, R., How Safe Is the Banking System? (Glencorse: David Hume Institute, 1986).


Doig, A., "Public bodies and ministerial patronage" (1978) 31 *Parliamentary Affairs* 86.


Ebeling, J.-W., "The proposed second banking coordination directive" (1990) 15 *E.L.Rev.* 60.


Emery, C., "The *vires* defense - 'ultra vires' as a defense to criminal and civil proceedings" (1992) 51 *C.L.J.* 308.


Evans, H., "The application of Caparo v. Dickman" (1990) 6 Prof.Neg. 76.


Fama, E.F., and Jensen, M.C., "Agency problems and residual claims" (1983) 26 J. Law & Econ. 327.


Feeney, P.W., The Supervision of Banks' Off-Balance Sheet Activities (Bangor: Institute of European Finance, University College of North Wales, 1988).


Friedman, G.H.L., "Malice in the law of torts" (1958) 21 M.L.R. 484.


Fuller, L.L., "The forms and limits of adjudication" (1978) 92 Harv.L.R. 353.


Gardener, E.P.M., Theory and Practice in Banking Supervision: Some Reflections (Bangor: Institute of European Finance, University College of North Wales, 1986).
Ghandi, P.R., "Exemplary damages in the English law of tort" (1990) 10 L.S. 182.
Gordon, R., and Barlow, C., "Falling at the last fence" (1993) 143 N.L.J. 158.


Harris, B., "Criminal sanctions under E.C. law" (1990) 140 N.L.J. 1324.


Holmes, O.W., "The path of the law" (1897) 10 Harv.L.R. 457.


Issing, O., Central Bank Independence and Monetary Stability (London: Institute of Economic Affairs, 1993)

Jack, A., "Bank challenged over regulatory powers", Financial Times, 9 Sep. 1993, 8


Jackson, J., "The right of silence: judicial responses to parliamentary encroachment" (1994) 57 M.L.R. 270.


Kane, E.J., "Good intentions and unintended evil: the case against selective credit allocation" (1977) 9 J.M.C.B. 55.
Kennedy, D., "Form and substance in private law adjudication" (1976) 89 Harv.L.R. 1685.
Kennedy, D., "Legal formality" (1973) 2 J. Legal Stud. 351.


Kinsella, R., Internal Controls in Banking (Chichester and New York: John Wiley & Sons, 1995).


Leopold, P.M., "The publication of controversial parliamentary papers" (1993) 56 M.L.R. 690.


Llewellyn, K.N., "The normative, the legal, and the law-jobs: the problem of juristic method" (1940) 49 Yale L.J. 1355.
Lomnicka, E., "The selling of regulation to the City - a confidence trick?" (1988) 3 J.I.B.L. 93.
McBride, J., "Damages as a remedy for unlawful administrative action" (1979) 38 C.L.J. 323.


Megrah, M., "Banks and moneylenders" (1967) 30 *M.L.R.* 86.

Meltzer, A.H., "Major issues in the regulation on financial institutions" (1967) 75 *J.Pol.Econ.* 482.


Moore, T.G., "The purpose of licensing" (1961) 4 *J. Law & Econ.* 93.


Morris, S., Financial Services: Regulating Investment See 89).


Oliver, D., "Is the ultra vires rule the basis of judicial review?" [1987] P.L. 543.


Olowofoyeku, A., "Murphy, Anns and pure economic loss" (1990) 6 Prof.Neg. 158.


Peltzman, S., "Toward a more general theory of regulation" (1976) 19 *J. Law & Econ.* 211.


Pipe, G.S., "Exemplary damages after Camelford" (1994) 57 *M.L.R.* 91.


Poole, K.P., "The powers of Select Committees of the House of Commons to send for persons, papers and records" (1979) 32 *Parliamentary Affairs* 268.


Reich, C.A., "The new property" (1964) 73 Yale L.J. 733.


Samuel, G., "Governmental liability in tort and the public and private law division" (1988) 8 *L.S. 277.*


Schoenmaker, D., "Internationalisation of banking supervision and deposit insurance" (1993) 8 *J.I.B.L.* 106.


Schweitzer, P.R., "The definition of banking markets" (1973) 90 *Banking L.J.* 745.


Shaffer, S., "Regulation and risk preferences" (1983-84) 32 Journal of Industrial Economics 349.

Shapiro, D.L., "The choice of rulemaking or adjudication in the development of administrative policy" (1965) 78 Harv.L.R. 921.


Slatter, F.F., Parliament and Administrative Agencies (Ottawa: Minister of Supply and Services, Canada, 1982).


Tussing, A.D., "The case for bank failure" (1967) 10 J. Law & Econ. 129.


Wardman, K., "Directors, their duty to exercise care and skill: do the provisions of the Company Directors Disqualification Act 1986 provide a basis for the establishment of a more objective standard?" (1994) 15 *Bus.L.Rev.* 71.


Welch, J., "Meaning of 'deposit' and 'deposit-taking business' under Banking Act 1979 - whether contract unlawful and monies paid recoverable" (1986) 1 *J.I.B.L.* 54


Williams, G., "Control by licensing" (1967) 20 *C.L.P.* 81.


"Banks under supervision" (1975) 125 *The Banker* 1149.

"The nationalization scare" (1976) 126 *The Banker* 333.