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Report to the Honorable
Charles E. Schumer
House of Representatives

December 1994

BANK REGULATORY STRUCTURE

The United Kingdom





United States
General Accounting Office
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General Government Division

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December 29, 1994

The Honorable Charles E. Schumer
House of Representatives

Dear Mr. Schumer:

Proposals to consolidate United States bank regulatory agencies have raised questions about how other countries structure and carry out their various bank regulation and central bank activities. You asked us to provide you with information about the structure and operations of regulatory activities in the Federal Republic of Germany, United Kingdom, Canada, and France. This report presents the information you requested for the United Kingdom. It describes the U.K. bank regulatory structure, how that structure functions, and how banks are examined.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies of this report to members of the House Committee on Banking, Housing and Urban Affairs; other congressional committees; and other interested parties. We will also make copies available to others on request.

The report was prepared under the direction of Mark J. Gillen, Assistant Director, Financial Institutions and Markets Issues. If you have any questions, please call me on (202) 512-8676. Other major contributors are listed in appendix IV.

Sincerely yours,

A handwritten signature in cursive script that reads "James L. Bothwell".

James L. Bothwell
Director, Financial Institutions
and Markets Issues

Executive Summary

Purpose

Proposals to consolidate U.S. banking regulatory agencies have raised questions about how other countries structure and carry out their various bank regulation and supervision and central bank activities. Representative Charles E. Schumer asked GAO to provide information about the structure and operations of such activities in the Federal Republic of Germany,¹ the United Kingdom (U.K.), Canada, and France. This report presents the information requested for the United Kingdom, which provides an example of a bank regulatory structure dominated by its central bank. Our objectives were to describe (1) the U.K. bank regulatory and supervisory structure and its key participants; (2) how that structure functions, particularly with respect to bank authorization, regulation, and supervision; and (3) how banks are examined. This report provides requested information about the U.K. bank regulatory structure, but does not include a GAO evaluation of that structure.

Background

The banking structure in the United Kingdom is relatively concentrated and, as a result of London's position as a major financial center, includes many foreign banks. As of February 28, 1994, 8 of the 518 banks in the United Kingdom held approximately 50 percent of the country's £1.2 trillion (\$1.9 trillion)² banking assets. More than half of the total banks, 286, were incorporated outside the United Kingdom, including 129 banks from member countries of the European Economic Area. Any bank in the United Kingdom may in effect conduct a universal banking business, including securities and insurance activities.

Bank regulation and supervision was first recognized in statute as a government function in the United Kingdom in the Banking Act of 1979 (1979 Act) in which supervisory and regulatory responsibilities, including the authorization of banks, were vested in the Bank of England (the Bank), the U.K. central bank. Nevertheless, the Bank—a private institution until it was nationalized under the Bank of England Act of 1946—had acted as informal bank supervisor long before then. The Bank's influence resulted primarily from its market power and respect from other market participants and was dependent on mutual trust and cooperation.

Bank supervision has gradually become more formal in nature, both as a result of changes in financial markets and as a consequence of three banking crises that prompted changes in law and supervision. For

¹For information on the German bank regulatory and supervisory structure, see Bank Regulatory Structure: The Federal Republic of Germany (GAO/GGD-94-134BR, May 9, 1994).

²We used the November 10, 1994, exchange rate of \$1.60.

example, the 1979 Act was passed (1) largely in response to the failure of several smaller banks in the United Kingdom, which exposed weaknesses in bank supervision, and (2) in order to implement the 1977 European Community First Banking Directive—a first step in the creation of a single European financial market. In addition to establishing an explicit bank regulatory and supervisory structure, the 1979 Act created a deposit protection system.

The Banking Act of 1987 (1987 Act) expanded the formal responsibilities of the Bank. It was passed largely because of the failure of a major participant in London's gold bullion market. The 1987 Act gave bank external auditors a legal responsibility to provide information to the Bank when requested to do so. This was seen as the most efficient way of introducing the necessary checks on bank systems and controls while drawing on an existing pool of expertise. In addition, the 1987 Act established a Board of Banking Supervision within the Bank. The Board's purpose was to advise the Bank on its supervisory and regulatory duties under the 1987 Act.

In 1991, the failure of the Bank of Credit and Commerce International led to changes in the 1987 Act and to the organization of bank supervision in the Bank that was intended to strengthen bank supervision. These changes notwithstanding, the Bank has retained most of its discretion in taking supervisory action.

The Bank is formally governed by its 16-member Court of Directors, but it is managed by the Governor of the Bank, his Deputy, and four executive directors responsible for monetary and financial stability. The Bank is subordinate to Her Majesty's Treasury (the Treasury) and accountable to Parliament, but is accorded a high degree of independence with respect to bank regulation and supervision. It has a bank supervisory staff of 249, including 57 support staff. (See app. I.)

Results in Brief

Since the passage of the 1979 Act, the Bank has been formally recognized in statute as the primary regulator and sole supervisor of authorized banks in the United Kingdom. Its primary purpose in bank supervision is to protect the interests of depositors. Its responsibilities include authorizing banks to take deposits; developing and issuing bank regulations; taking both formal and informal enforcement actions against banks—including the restriction and revocation of a bank's authorization; and taking action when bank liquidity or solvency problems arise.

The Bank also has the authority to examine and request information from banks and to require accounting firms to produce reports—including annual reports on bank records and controls. The Bank, however, does not conduct full-scope, on-site examinations of authorized banks, nor does any other entity. Instead, on-site information of banks comes from limited bank reviews carried out by an 11-member Bank review team and annual and special reports required of banks' reporting accountants.

The Board of Banking Supervision is an independent committee that advises the Bank on its actions. The Board is generally viewed as a valuable component of banking supervision. Its involvement with the Bank's Surveillance and Supervision area, which carries out bank supervisory activities, has recently been strengthened.

In addition to its role in bank regulatory and supervisory matters, the Bank has responsibilities in other bank-related activities, such as liquidity provision, crisis management, payments settlement, international negotiations, and lender of last resort. Furthermore, the Bank's Governor heads the Deposit Protection Board, and the Bank provides staff to the deposit protection system, although the Deposit Protection Fund is privately funded through levies on authorized banks with no direct financial backing from the Bank or U.K. taxpayers.

Figure 1: Responsibility for Bank Regulatory and Related Functions in the United Kingdom

Key participants	Developing laws	Developing regulations	Issuing regulations	Licensing/chartering banks	Bank information reporting and analysis	Bank supervisory oversight	Bank examinations	Developing enforcement actions	Enforcement authority	Failure resolution	Liquidity provider	Crisis management	Payment/clearance system	International forum representative	Deposit insurance	Lender of last resort
Public																
The Treasury	•	•	•											•		
Bank of England	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•
Deposit Protection Board															•	
Private																
Reporting accountants and external auditors						•										
Association for Payment Clearing Services (APACS)												•				

Source: GAO analysis.

Principal Findings

The Bank Has Sole Responsibility Over Bank Authorization and Supervision

The 1987 Act gives the Bank sole authority to authorize banks to take deposits, but stipulates that banks first meet six minimum criteria. These criteria are related to capital; liquidity and other measures of prudent conduct; and the number, integrity, and ability of bank managers.

The Bank is also solely responsible for taking enforcement actions against banks “to ensure compliance with . . . standards and to protect depositors and potential depositors.” Many of the supervisory actions taken by the Bank are informal. In such cases, the Bank will “recommend” that certain actions be taken by a bank to remedy identified problems. Formal actions—such as revoking a bank’s authorization, taking action against a bank in order to remove bank managers or directors, or imposing conditions on a bank—are taken relatively infrequently. According to the Bank, informal action is normally the first choice because it is easier to put into effect and provides more flexibility to ensure that corrective action is taken by the bank. Furthermore, informal recommendations are effective

because of the well recognized and broad discretionary authority the Bank has to use its formal enforcement powers.

The Bank Has Primary Responsibility Over Regulation

The Bank has primary responsibility for implementing the 1987 Act, to clarify provisions in law, and to provide guidance on the Bank's interpretations of requirements in the act. It has done so by issuing (1) its Statements of Principles, supervisory notices, and guidance notes, which have the force of law; (2) recommendations on certain issues, with which banks are expected to make every effort to comply; and (3) interpretive letters on its policies in response to questions from individual banks. The Treasury, headed by the Chancellor of the Exchequer, on the other hand, is solely responsible for developing legislation, although it does receive advice from the bank. The 1987 Act also provides that the Treasury may issue regulations in some instances.

The Bank Relies on Many Sources of Information to Carry Out Its Supervisory Responsibilities

To carry out its supervisory responsibilities, the Bank relies on several sources of information including banks, financial markets, and chartered accountants. The sources of information upon which bank supervisors place primary reliance are the numerous reports banks are required to submit to the Bank, over 3,000 formal meetings in a recent 1-year period, and other informal contacts with the banks.

In addition, Bank supervisors are provided with on-site information collected by Bank review teams and chartered accountants. This information, together with that collected directly from banks, is intended to give supervisors a complete picture of the banks for supervisory purposes.

The Bank's own review teams are small, and their reports tend to be qualitative, focusing on quality of management, since visits are short and much of the teams' information is derived from interviews. U.K. chartered accountants, therefore, perform a meaningful part of the on-site information gathering function through (1) annual bank systems and records reviews, (2) special reviews under the 1987 Act, and (3) financial audits mandated under corporate law. These reviews and audits are conducted under guidelines issued by the Bank and standards issued by the industry's standard-setting body. Chartered accountants were assigned their Banking Act responsibilities not only because they had expertise in banking, but also because the Bank preferred its traditional, nonintrusive approach to supervision, which it believes has served it well. With the

exception of certain special reviews, the reviews and audits are done by accounting firms of the banks' choice and at the banks' expense. However, a bank's appointment of an accountant to conduct reviews under the Banking Act may be disapproved by the Bank. Chartered accountants are subject to unlimited liability whether performing reviews under banking or corporate audits law.

The Bank Has Several Other Bank-Related Responsibilities

The Bank also has several other bank-related responsibilities.

- The Governor of the Bank heads the Deposit Protection Board, which administers the deposit protection system and controls the Fund that pays out claims. Three other members of the Board are Bank officials, while three are representatives of member banks. The Bank, however, has no responsibility for funding the Deposit Protection Fund whose resources are provided by the banking industry.
- The Bank provides day-to-day liquidity to the banking system and acts as lender of last resort.
- The Bank plays the lead role in crisis management involving financial institutions, both as a result of its role as lead regulator of banks and as a major participant in financial markets.
- The Bank is the settlement institution for members of the payment systems and is a member of several organizations that operate payment systems. It does not, however, own or operate any of these systems.
- The Bank represents the United Kingdom in several international organizations, most notably the Bank of International Settlements, and the Basle Committee of Banking Supervisors.

Recommendations

This report contains no recommendations.

Agency Comments

Senior officials from the Bank of England, the Building Societies Commission, the British Bankers Association, and several accounting firms reviewed and commented on a draft of this report. These comments were generally technical in nature and were incorporated where appropriate.

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Abbreviations

APACS	Association for Payment Clearing Service
APB	Auditing Practices Board
BCCI	Bank of Credit and Commerce International
DTI	Department of Trade and Industry
ECU	European Currency Unit
EEA	European Economic Area
EFTA	European Free Trade Area
EU	European Union
JMB	Johnson Matthey Bankers
SIB	Securities and Investments Board
SIU	special investigations unit
SRO	self-regulatory organization

Introduction

The history of bank regulation and supervision in the United Kingdom (U.K.) reflects the relatively concentrated nature of the banking industry as well as British reliance on common law.¹ The conduct of bank regulation and supervision in the United Kingdom has evolved significantly since the Bank of England (the Bank), was given statutory responsibility for bank regulation and supervision in 1979. This evolution has largely been in response to a series of banking crises that reflected the changing nature and increasing complexity of banking in the United Kingdom.

Overview of U.K. Banking Industry

As of February 28, 1994, there were 518 banks operating in the United Kingdom with total assets of approximately \$1.2 trillion (see table 1.1).² Approximately half of these assets—\$593 billion—were held by eight of the larger British banks.³

Table 1.1: The United Kingdom Authorized^a Bank Population (1987-1994)

End-February	1987	1988	1989	1990	1991	1992	1993	1994
U.K.- incorporated	334	313	295	289	275	263	253	232
Incorporated outside the U.K.	254	254	256	259	255	255	255	286
Total	588	567	551	548	530	518	508	518

^aA financial institution that has been approved to conduct banking activities by its home country bank supervisor.

Source: The Bank of England, Banking Act report for 1993/94.

More than half of the banks in the United Kingdom, 286, were incorporated outside the United Kingdom. Of those banks, 129 were European-authorized institutions⁴—banks licensed in the European Union

¹The term “regulation” in this report is used to mean the enactment of rules by which U.K. banks must abide. The Bank has noted that it regards its responsibilities as primarily supervisory, not regulatory, since U.K.-authorized institutions’ powers are not restrictive—as long as they meet the Bank’s minimum criteria. In the context of this report, nevertheless, such minimum criteria as well as supervisory notices and guidance notes issued by the Bank, which have the force of law, are considered regulations. (See ch. 2 for further discussion of the Bank’s supervisory and regulatory responsibilities.)

²On October 14, 1994, the British pound was worth \$1.59.

³The banks that make up the eight larger U.K. banks as defined by the Bank, are Barclays, Lloyds, Midland, National Westminster—the four clearing banks—and the Bank of Scotland, The Royal Bank of Scotland, Standard Chartered, and the TSB Bank. In fact, they are not the eight largest banks in the United Kingdom since technically that number would include a former building society now converted to a bank.

⁴Ninety-seven of these were authorized to take deposits in the United Kingdom.

(EU)⁵ or European Free Trade Area (EFTA) member nations who have chosen to participate in the European Economic Area (EEA).⁶

Any authorized bank in the United Kingdom—including subsidiaries of foreign-owned banks—may conduct securities and insurance activities, as long as the latter are carried out in bank subsidiaries.⁷ This, in effect, permits banks to conduct a universal banking business. In principle, insurance and securities firms may also own banks—as may commercial firms—provided that they are considered to be “fit and proper” owners by the bank’s supervisor. In practice, however, such ownership arrangements are not widespread.

Another major class of deposit-taking financial institutions in the United Kingdom is building societies. They are mutual deposit-taking institutions owned by the depositors of the institutions, which lend predominantly for house purchases. Only 25 percent of their assets may be in commercial or unsecured lending. As of March 31, 1993, there were 87 building societies authorized to take deposits of which the top 10 held 90 percent of the industry’s assets. Building societies are supervised by the Building Societies Commission, rather than by the Bank (see app. III for additional details).

History of Bank Regulation and Supervision in the United Kingdom

Bank regulation and supervision was first recognized in statute as a government function in the Banking Act of 1979 (1979 Act) in which supervisory and regulatory responsibilities were vested in the Bank of England, the U.K. central bank. Banks in the United Kingdom are regulated and supervised almost exclusively to ensure the safety and soundness of individual banks and of the system as a whole. For example, U.K. banking

⁵Members of the EU are: Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, and the United Kingdom.

⁶The EEA came into being on January 1, 1994, and extends the EU single-market concept, covering the free movement of goods, services, capital, and people, as well as other rules to the EEA. The EEA includes the 12 EU member states and the 5 EFTA states participating in the EEA: Austria, Finland, Iceland, Norway, and Sweden.

A bank incorporated in any EEA country is free to branch elsewhere in the EEA, subject to satisfying its home supervisor that it is qualified to do so. This authority was provided under the EU’s Second Banking Coordination Directive and is often referred to as the banking “passport.” The host supervisor has no power to veto branches from EEA member banks.

⁷Branches of banks chartered in countries that are members of the EU may not conduct insurance activities in the United Kingdom until an EU directive on insurance activities is agreed to.

laws do not address issues such as fair lending practices or community reinvestment requirements.⁸

Until that time, no government agency had either formal powers to grant or refuse authorization to conduct banking business in the United Kingdom or any statutory supervisory role. Nonetheless, the longstanding position of the Bank as arguably the most influential financial institution in the United Kingdom⁹ resulted in its assuming an informal supervisory role as early as the mid-nineteenth century.

As a result of its primary role in the financial markets, the Bank was concerned about the creditworthiness of its counterparties—a relatively concentrated number of larger banks with whom it did business. It was also concerned about the prevention of market disruption, which could result from the failure of a market participant. Because of these concerns, the Bank assumed some informal supervisory responsibilities for these banks that involved (1) undertaking surveillance;¹⁰ (2) advising banks to take certain steps to resolve perceived problems; and (3) providing short-term financial support when needed. These actions on the part of the Bank were informal and nonstatutory and were based solely on the Bank's influence in the markets and the willingness of other banks to accept this supervision to further their business interests.

The Bank of England Act of 1946, which nationalized the Bank by giving ownership of the Bank to Her Majesty's Treasury (the Treasury), did not clarify or significantly bolster the Bank's informal supervisory role. It gave the Bank the power to "request information," "make recommendations" to bankers, or "issue directions" to bankers with the Treasury's consent, but of these none was considered to be a supervisory power, and the Bank never made use of its authority to issue directions. However, the act did not prohibit the Bank from continuing in its informal supervisory role, thus implicitly acknowledging the Bank's status as the principal supervisory force. This informality of bank regulation is consistent with British reliance on common law and a common understanding of government authority and its limits.

⁸The banking industry has addressed some of these issues in a voluntary Code of Banking Practices, which first came into force in March 1992.

⁹The Bank was established in 1694 as a privately owned bank. By 1844, it was the sole issuer of bank notes in England, the manager of the government debt, and the central participant in the market for discounting bills.

¹⁰For example, the Bank's Discount Office required financial information from other banks.

Thus, the Bank was able to continue exercising strong influence over the group of discount houses¹¹ and accepting houses¹² with which it did business. Its informal supervision was based on cooperation and trust and carried out via requests rather than directives. The Bank's influence resulted from its role as the arm of the government in the city (i.e. London financial center), its power in the market, and respect from other market participants, and it was dependent on mutual trust and cooperation. However, it was harder for the Bank to achieve this trust and cooperation with newer and foreign-owned banks that were established in the 1960s and 1970s.

The 1946 Act clearly establishes the subordination of the Bank to the Chancellor of the Exchequer who heads the Treasury, as well as the Bank's accountability to Parliament through the Treasury. For example, under the act, the Chancellor has the power to issue directions to the Bank after consultation with the Governor of the Bank, a provision that was designed to ensure that, in the event of disagreement, the government would have the final say. However, the Chancellor has never used this power, since policy has been actively coordinated between the Treasury and the Bank—the Chancellor and the Governor of the Bank meet at least twice a month, according to Bank officials—and the Bank has openly acknowledged the Treasury's policymaking preeminence.

The Treasury has no formal role under the Banking Act in banking supervision, although it would expect to be consulted on any major regulatory or supervisory decision, particularly when there are political, economic, or legislative implications or public expenditure consequences. Furthermore, although the Treasury generally defers to the Bank in such matters, it is not required to do so, and a future change in Treasury policy toward the Bank under a different government cannot be ruled out.

The bank regulatory and supervisory role of the Bank was not codified until the so-called “secondary banking crisis” of 1973 through 1974¹³ exposed weaknesses in the supervisory system. The crisis revealed that many smaller banks—called secondary banks—were outside even the

¹¹Discount houses are counterparties of the Bank in its operations in the pound sterling money market.

¹²The original purpose of accepting houses was the financing of trade, and they provided a large proportion of the acceptance facilities available in the U.K. banking system. Now accepting houses also specialize in corporate finance activities, stockbroking, investment management, term lending, and syndications.

¹³During the secondary bank crisis, several secondary banks in Britain developed serious financial difficulties that were feared to pose a threat to the financial system as a whole. The Bank organized a rescue of these banks to stave off systemic problems.

informal surveillance of the Bank. The 1979 Act that evolved from this crisis, as well as the requirement to implement the First Banking Directive passed by the European Economic Community (now the European Union) in 1977, recognized the need for a more formal framework for the supervision of all banks. The 1979 Act (1) codified the Bank's existing informal supervisory relationships,¹⁴ (2) brought all banks under the Bank's supervision, (3) required banks and deposit-taking institutions to meet certain criteria, (4) enacted a deposit protection system, and (5) was explicitly designed to provide a degree of protection for bank depositors.

Another banking crisis occurred in 1984, when Johnson Matthey Bankers (JMB) was rescued by the Bank and a group of other banks.¹⁵ According to a 1992 report to Parliament,¹⁶ bank management had suffered lapses that had not been recognized or addressed by Bank supervisors: controls and systems had been inadequate, the monitoring of credit had been defective, insufficient attention had been given to concentrations of risk, proper security measures had not been taken, and provisions for bad and doubtful debts had not been assessed with appropriate care. Concerns about the role inadequate bank supervision had played in this crisis led to a review of the system of bank supervision, which resulted in the passage of the Banking Act of 1987 (1987 Act).

The deregulation of financial markets in the United Kingdom in October 1986, commonly known as the "Big Bang," was another financial market milestone in the United Kingdom, as was the relaxation or abolition of exchange controls, mortgage lending guidance, and consumer credit controls. The Big Bang eliminated fixed commissions on stock and bond purchases; removed the separation among the underwriting, sales, and trading functions; and allowed foreign firms to buy U.K. securities firms. The heightened competition that followed resulted in a focus on capturing market share. Although securities firms were primarily affected,

¹⁴The 1979 Act made a distinction between banks, which the Bank was empowered to recognize, and other deposit-taking institutions, which the Bank was empowered to license. The major functional difference between the two was that the Bank could only recognize a bank if it was satisfied that the bank provided or would provide either a wide range of banking services—such as checking accounts, foreign exchange, commercial loans—or a highly specialized banking service. A licensed deposit-taking institution did not have to meet this requirement.

¹⁵JMB was one of the five London gold price fixers. When its failure became imminent as a result of large loans that were in default, the Bank feared for London's position as the leading international gold bullion market and more widely for the confidence in the U.K. banking system. Therefore, the Bank stepped in to provide support for JMB.

¹⁶The 1992 report was entitled Return to an Address of the Honorable the House of Commons, dated 22 October 1992, for the Inquiry into the Supervision of The Bank of Credit and Commerce International. Chairman: The Right Honorable Lord Justice Bingham. This report is commonly referred to as the Bingham Report.

banks were also involved in the competitive shakeout that followed the Big Bang.

The 1987 Act confirmed the role of the Bank as supervisor, expanded its formal responsibilities, and eliminated the distinction between banks and nonbank deposit-taking institutions. Among other things, the act (1) revised the minimum criteria for authorizing a bank; (2) established an advisory board, the Board of Banking Supervision, to advise the Bank on its actions; (3) amended the grounds on which the Bank might or was required to revoke authorization; (4) gave the Bank the power to restrict an authorization and set up an appeals process; (5) required banks to report their large exposures to the Bank; and (6) enhanced the Bank's authority to obtain information from a bank. These supervisory responsibilities are discussed in greater detail in chapter 3.

In addition, the act gave bank accountants and auditors¹⁷ a legal responsibility to provide information to the Bank when requested to do so. In conjunction, the act relaxed the ordinary duty of confidentiality owed by an auditor or accountant to its client in certain circumstances.

Further, the fraud uncovered in the Bank of Credit and Commerce International (BCCI) and its closure in 1991, led to additional concerns about bank supervision in the United Kingdom and questions about the Bank's continuing role in bank supervision. To date, major changes in the structure of bank supervision have not been made as a result of these concerns; however, changes have been made in the legislation and organization of bank supervision in the Bank. These changes were intended to improve the information available to the Bank, encourage a more proactive philosophy on the part of the Bank, and strengthen bank supervision in general. These changes included (1) establishing new Special Investigations and Legal units; (2) strengthening the involvement of the Board of Banking Supervision; (3) more intensely training supervisors in issues of fraud; (4) improving communication within the Bank, and between the Bank, the Treasury, and other government departments; and (5) requiring bank accountants and auditors to report material breaches of the authorization criteria by the banks they audit to the Bank.

¹⁷In this report, the term "reporting accountant" or "accountant" is used when describing accounting professionals conducting work under the 1987 Act. The term "external auditor" or "auditor" is used when describing accounting professionals conducting audit work under corporate law. As described in greater detail in chapter 3, the reporting accountant and external auditor for a particular bank are often the same accounting firm.

Overlaying these events has been the development of a unified financial services market in the EU, which has also affected U.K. bank regulation and supervision. Central to the liberalization of financial services under the Single Market Program is the concept of a “single passport.” Once a financial firm is established and licensed in one member state, its home country, that firm can use a single passport to offer financial services in any other member state, or host country. Underlying the Single Market Program is an understanding that a minimum level of harmonization in regulation is necessary among the member countries to ensure the safety and soundness of the financial system. For instance, the EU Second Banking Directive requires all EU banks to have a minimum capital base and a minimum level of shareholder disclosure and limits equity participation in nonfinancial firms. Consequently, all EU member countries, including the United Kingdom, have had to change their banking laws and regulations as necessary to meet the minimum requirements imposed by EU financial services directives. To date, however, the structure of bank regulation in the United Kingdom has not been changed as a result of EU directives.¹⁸

Regulation of Banks’ Nonbank Activities

In the United Kingdom, securities activities are conducted either in bank subsidiaries or within the bank itself. When securities activities are conducted in subsidiaries, the securities regulator, the Securities and Investments Board (SIB), is responsible for regulating the securities subsidiary.¹⁹ Insurance activities are not permitted within a bank but are restricted to banks’ subsidiaries, and the insurance regulator, the Department of Trade and Industry (DTI), regulates these subsidiaries.²⁰

Regulators in the United Kingdom operate under the functional regulation approach. Thus, when a bank owns nonbank subsidiaries, the Bank remains the lead regulator and retains responsibility for monitoring the capital levels of the banking entity as a whole, even though the nonbank subsidiaries may be regulated by the SIB or DTI. Similarly, if the major or top level entity is a securities firm owning a bank, then SIB is the lead regulator of the entire entity while the Bank regulates the bank subsidiary.

¹⁸For additional information about the single market program, see *European Community: U.S. Financial Services’ Competitiveness Under the Single Market Program* (GAO/NSIAD-90-99, May 21, 1990).

¹⁹In turn, SIB recognizes self-regulatory organizations (SRO), which carry out the regulation for almost all securities firms. The Securities and Futures Authority is the SRO that regulates most securities firms.

²⁰While the Banking Act places no restrictions on what banks may do, insurance legislation requires that insurance be carried out in a separately incorporated company.

Overview of Participants in U.K. Bank Regulation, Supervision and Examination

While the Bank of England is the sole bank regulator and supervisor in the United Kingdom, it receives advice from the Board of Banking Supervision and information from bank accountants and auditors to help it conduct its supervisory work, as described further in chapters 2 and 3.

Bank of England

The Bank of England was nationalized under the 1946 Act, which provided for the transfer of ownership of the Bank's stock to the Treasury, headed by the Chancellor of the Exchequer. According to the Bank's annual report, "its core purposes are to maintain the value of the currency and the integrity of the financial system, and to promote the efficiency of financial markets."

The 1946 Act grants the Bank budgetary independence but requires it to submit an annual report on its Banking Act responsibilities to the Chancellor who then submits the report to Parliament. Approximately half of the Bank's annual profit—£120 million in 1993—is paid to the Treasury each year.

The Bank is formally governed by its Court of Directors, which consists of the Governor, Deputy Governor, and sixteen directors, of whom four are employed full time by the Bank and called executive directors. One of these executive directors is responsible for bank supervisory responsibilities within the Bank as well as payment, settlement, and clearing systems.²¹ The 12 nonexecutive directors are drawn from banking, industry, and other areas such as accounting firms. The Court meets weekly and serves primarily as a sounding board for the Governor. In practice, the Bank is managed by the Governor, with the assistance of the Deputy Governor and the four executive directors.

All members of the Court of Directors are appointed by the Crown, which in effect means they are appointed by the Prime Minister acting on the advice of the Chancellor of the Exchequer after consultation with the Governor of the Bank. All are appointed for renewable terms: 5 years in the case of the Governor and Deputy Governor, 4-year staggered terms for the directors. Directors of the Bank may be dismissed by the Crown, but such an event has never occurred.

²¹Two of these executive directors are responsible for monetary stability, while the fourth has responsibilities for the United Kingdom's financial infrastructure. See appendix I for additional information on the structure and monetary policy responsibilities of the Bank.

The Bank carries out the supervision of banks in its Supervision and Surveillance area formerly known as the Banking Supervision Division. Supervision and Surveillance falls under the responsibility of one of the executive directors on the Court of Directors, and is headed by the Deputy Director of the Bank. It consists of five divisions: (1) supervisory policy and statistical reporting, (2) U.K. retail and merchant banks, (3) medium and smaller U.K. banks and enforcement, (4) industrial world division, and (5) developing world division. The latter two divisions include surveillance staff with expertise on the institutional and economic backgrounds of groups of countries, in addition to banking supervisors, who are able to draw on this expertise.

As of the end of February 1994, the Bank had 3,905 full-time staff, of whom 249 were Banking Supervision Division staff, including 57 support staff. The Supervision and Surveillance staff are located in London, the head office of the Bank and the headquarters of most of the United Kingdom's largest banks.²²

Board of Banking Supervision

The Board of Banking Supervision was established under the 1987 Act to advise the Bank on its Banking Act responsibilities. Although officially established by the act, the Board had been operating since 1986. It is structurally separate from Supervision and Surveillance and advises the Bank's Court of Directors.

The Board's nine members include the Bank's Governor, Deputy Governor, and the executive director responsible for bank supervision, all in an ex-officio capacity.²³ The Board's six independent members from the banking, accounting, and legal professions are jointly appointed to 5-year terms by the Governor of the Bank and the Chancellor of the Exchequer. (See ch. 2 for additional information on the Board's role.)

Accounting Firms

As described further in chapter 3, reporting accountants and external auditors provide substantial supervisory information to the Bank of England. Although there are hundreds of external accounting firms in the United Kingdom, about 80 percent of bank audits, including those of the

²²While the Bank has nine branches and agencies located throughout the United Kingdom, these are not used for bank supervisory purposes, but primarily as currency distribution points and points of contact with local industry. They also include the Bank's Printing Works and its Registrar's Department.

²³By virtue or because of their offices.

largest banks in the United Kingdom, are conducted by the “big six” accounting firms, primarily because they have the necessary resources to do the required work.²⁴ Banks audited by smaller accounting firms tend to be the smaller banks in the United Kingdom.

Objectives, Scope, and Methodology

At the request of Congressman Charles E. Schumer, we examined various aspects of the U.K. bank regulatory system. Specifically, our objectives were to describe (1) the U.K. bank regulatory structure and its key participants, (2) how that structure functions, and (3) how banks are examined. We completed a similar study on the bank regulatory structure in the Federal Republic of Germany²⁵ and are currently undertaking studies of the systems in France and Canada.

To address these objectives we conducted our interviews with the Deputy Director, Supervision and Surveillance, and four other officials of the Bank and the Deposit Protection Board. They also provided us with various documents and statistics including copies of reports that banks submit to the Bank, annual Bank of England reports and accounts, and Banking Act reports; annual reports of the Deposit Protection Board; guidance notes on relevant issues, including the role of external auditors and reporting accountants; and statistics on the banking industry.

In addition to our interviews with the Bank, we met with several senior executives at U.K. banks; senior executives from accounting firms and individuals from the Auditing Practices Board, the auditing standards setting body in the United Kingdom, who provided us with bank-related auditing standards, auditing guidelines, and guidance notes. We also met with individuals from the British Bankers Association—the organization representing banks operating in the United Kingdom, including foreign banks—who provided us with copies of related reports and legislation; and with an official from the Building Societies Commission, the regulator of U.K. Building Societies.

Finally, we reviewed the 1987 Act, the law that relates most directly to bank regulation and supervision, and related documents including the Bank of England’s Statements of Principles. This review does not constitute a formal legal opinion on the requirements of the law, however.

²⁴These firms are known in the United States as Ernst & Young, Arthur Andersen & Company, Deloitte & Touche, KPMG Peat Marwick, Coopers & Lybrand, and Price Waterhouse.

²⁵Bank Regulatory Structure: The Federal Republic of Germany (GAO/GGD-94-134BR, May 9, 1994.)

Chapter 1
Introduction

We conducted our review from May 1994 through August 1994 in accordance with generally accepted government auditing standards. Senior supervisory officials of the Bank of England, the Building Societies Commission, the British Bankers Association, and several chartered accounting firms reviewed and commented on a draft of this report. These comments were generally technical in nature, and were incorporated where appropriate.

The Bank of England Authorizes, Regulates, and Supervises Banks

Since the passage of the 1979 Act, the Bank has been formally recognized in statute as the primary regulator and sole supervisor of authorized banks in the United Kingdom. The Bank's powers include the responsibility to authorize banks to take deposits, the power to issue banking regulations, the power to take enforcement actions against banks—such as restricting and revoking a bank's authorization—the right to request and receive information from banks and accounting firms, and the right to examine banks. The Board of Banking Supervision advises the Bank on its actions under the Banking Act. (See ch. 3 for more information on accounting and audit reports and bank reviews.)

Authorization and Minimum Criteria

The 1987 Act gives the Bank sole authority to authorize banks to conduct a deposit-taking business, but stipulates that banks must meet the following six minimum criteria as set out in Schedule 3 to the Act. These minimum criteria state that

- (1) directors, controllers, or managers of institutions be fit and proper to hold their particular positions (“fit and proper persons”);
- (2) at least two individuals effectively direct the business (“four-eyes” principle);
- (3) for U.K. incorporated institutions, there are as many nonexecutive directors as the circumstances and scale of operations of the business require (nonexecutive directors);
- (4) the business be conducted in a prudent manner, maintain capital of such nature and amount as are considered appropriate, maintain adequate liquidity and loan loss provisions, and have adequate accounting and other records (prudent conduct of business);
- (5) the business be carried on with integrity and professional skills appropriate to the scale and nature of its activities (integrity and skill); and
- (6) the business hold at time of granting of authorization minimum net assets of £1 million (minimum net assets).¹

In determining whether to authorize a bank, the Bank, according to written Bank policy, also considers “if it is likely to receive adequate flows

¹Bank of England, *Statements of Principles*, (May 1993), and *The Bank of England's Relationship With Auditors and Reporting Accountants*, (Mar. 1994).

of information from the institution and relevant connected parties in order to monitor the fulfillment of the criteria and to identify and assess any threats to the interests of depositors and potential depositors.” Furthermore, it “will take account of any factors which might inhibit effective supervision, including in particular whether the structure and geographical spread of the bank, the group to which it may belong, and other connected companies might hinder the provision of adequate and reliable flows of information to the supervisors.” Finally, the Bank will consider whether the bank’s companies share a common external auditor, which would simplify the Bank’s “ability to assess a banking institution’s exposure to risks elsewhere in the same group.” Since the failure of BCCI, the Bank has given the preference for a common auditor a higher profile, and banking institutions without a common auditor have become increasingly rare.

Bank Regulation

Under the 1987 Act, the Bank is also responsible for issuing regulations to implement the act, to clarify provisions in law, or to provide guidance on the Bank’s interpretation of requirements in the Banking Act. It may do this in a number of ways. First, the Bank is required under the 1987 Act to publish a statement of the principles in accordance with which it will (1) interpret the criteria for authorization and the grounds for revocation of a bank’s authorization established in the act and (2) exercise its power to grant, revoke, or restrict an authorization. The Bank’s Statements of Principles are legally binding on the banks it supervises. For example, the Statements of Principles discuss the Bank’s expectations on capital adequacy or liquidity which, therefore, must be adhered to by banks.

The Bank also issues “supervisory notices” and “guidance notes”—which also have the force of law—when, for example, amending its Statements of Principles or updating previous notices. In fiscal year 1994, the Bank issued five such notices on large exposures, on-balance-sheet netting and cash collateral, the Bank’s relationship with auditors and reporting accountants,² reporting accountants’ reports, and subordinated loan capital.

Supervisory guidance may also include the issuance of a “recommendation” on a certain issue by the Bank. There is an expectation on the part of the Bank and the banks it regulates that banks will make every effort to comply with Bank recommendations. These recommendations do not directly carry the force of law, although

²See chapter 3 for discussion of the responsibilities of auditors and reporting accountants.

noncompliance could in certain circumstances call into question whether a bank met the general criterion in the act requiring institutions to conduct their business in a prudent manner. This allows the Bank to be flexible in enforcing such recommendations: it can take account of special circumstances which may be discussed with individual institutions. For example, in April 1993 the Bank recommended that banks active in derivatives activities have at least two board members knowledgeable about derivatives, of whom one should be the Finance Director. This caused a problem for some banks whose finance directors were not expert in derivatives, even though at least two other Board members were. The Bank accepted that it was reasonable to make an exception for such cases.

Before issuing supervisory notes or making recommendations, the Bank will—as a practical matter rather than because it is required to do so—get advice from and consult with interested parties such as the British Bankers Association or the Auditing Practices Board. It is also likely to request comment from the Treasury. Finally, the Bank consults with the Board of Banking Supervision before issuing notices or recommendations.

The Bank will also issue interpretive letters on its policies in response to questions that it receives from individual banks. For example, banks might have questions about how the Bank would categorize a certain type of capital. This kind of interpretation is viewed as binding on the bank.

Although the Bank is very involved in the drafting of banking legislation and may be asked to testify before Parliament on bank-related issues, the Treasury has the primary responsibility for bank legislation. As a result, the Banking Act on several occasions gives the Treasury the authority to change certain definitions or requirements in the act and also provides that the Treasury may issue regulations in some instances.³

Enforcement Actions

The Bank is solely responsible for taking enforcement actions against banks “to ensure compliance with . . . standards and to protect depositors and potential depositors.” Nevertheless, the Bank is subordinate to the Treasury and would notify the Treasury of any significant action before taking it, and Bank officials said that the Bank would abstain from taking a specific action if the Treasury disapproved.

³For example, the act exempts a number of entities—such as the Bank, building societies, or the International Monetary Fund—from the restriction on deposit taking and allows the Treasury, after consultation with the Bank, to add entities to or remove them from the list. The Treasury may also make regulations with respect to the act’s subsection on acceptance of deposits and has the authority to make advertising rules.

Enforcement actions are either informal, in which banks are strongly encouraged to take an action, or formal, where actions by the affected bank are required. The Bank has a great deal of discretion to decide whether to take formal action or seek remedial action by some other informal means—through persuasion and encouragement, for instance. If, for example, “the Bank considers that adequate and speedy remedial steps are likely to be taken by an authorized institution,” then it “would generally be reluctant to revoke or restrict the authorization” and would be more likely to “recommend” that certain actions be taken by a bank. Indeed, in the Statements of Principles, the Bank further asserts that “where appropriate [the Bank] will seek remedial action by [informal means such as] persuasion and encouragement.” This language reflects the Bank’s preference for informal over formal enforcement actions.

Informal enforcement actions are normally the Bank’s first choice because they are easier to put into effect, and provide for flexibility to ensure that corrective actions are taken by the banks. Furthermore, banks fully understand that if they do not comply with informal actions and recommendations, then a strong formal action, which the Bank has clear discretion to choose, is sure to follow. Informal actions are, therefore, more effective than might otherwise be assumed since banks recognize the formal authority which underlies informal actions.

According to the Bank, such a system of supervision also works because bank managers understand that if they notify the Bank of a problem, Bank supervisors will help them find solutions and will not discipline a bank for a problem that is being resolved. As a result, many potential problems are brought to the attention of the Bank by the banks themselves. Smaller banks in particular may not have the expertise in-house to resolve certain problems and can turn to the Bank for advice.

Nevertheless, the banking statute provides the Bank with powers to take formal enforcement action against authorized institutions on a number of grounds, particularly if the criteria for a bank to receive approval to take deposits discussed above have been breached. Such formal action can include revoking a bank’s authorization; removing bank managers or directors; or imposing conditions on the bank such as limiting deposit taking to current depositors, restricting the bank’s scope of business, and prohibiting the bank from entering into certain transactions.

Despite its preference for taking informal action, the Bank, in its Statements of Principles, says that if it is necessary for the Bank to take

formal actions “in order to ensure compliance with the standards or to protect the interests of depositors and potential depositors [then] it will move to revoke or restrict authorization.” The Bank’s Statements of Principles acknowledges that the threshold for being authorized to take formal action under the Banking Act is relatively low. For example, the Bank can take formal enforcement actions to restrict or revoke a license “before the deterioration in the institution’s condition is such that there is a serious likelihood that depositors will suffer a loss.” It would, for example, revoke an institution’s license even if the institution had adequate capital and liquidity if “there was no reasonable prospect of speedy and comprehensive remedial action.”

Both formal and informal actions are subject to judicial review. In addition, formal enforcement actions are subject to review by the Banking Appeal Tribunal,⁴ as provided for in the Banking Act, and the Board of Banking Supervision is informed by Supervision and Surveillance of prospective formal actions that are being considered. Appeals before the Tribunal are rare, however, and all but one case—which was decided in favor of the Bank—have been withdrawn by the appealing bank before a full hearing could take place. This fact reflects the authority the Bank has over the banks it supervises and, according to the Bank, the potential for appeal does not affect its decisions to take formal action. Nevertheless, some banking industry representatives have speculated that the Bank postponed decisions to close BCCI because of the evidence that was deemed necessary to forestall the possibility of an appeal to the courts.

In the 11-year period from March 1, 1983 through February 28, 1994, the Bank used its powers to revoke bank authorizations 35 times⁵ and its power to restrict bank authorizations 47 times. In most cases, such action is taken when the minimum criteria for authorization are not being met.⁶

While the Bank has sole authority to withdraw a bank’s authorization, the U.K. courts must be petitioned to close a bank, and the courts officially

⁴The Tribunal is constituted on a case-by-case basis by three individuals: a chairman—who must have legal experience and is appointed by the Lord Chancellor of the Exchequer—and two other members who have accountancy and banking experience and are appointed by the Lord Chancellor.

⁵In most cases when the Bank has made a decision to withdraw a bank’s authorization, the bank has had sufficient capital to wind down its operations without losses to depositors.

⁶Beyond its enforcement authority, which gives the Bank discretion to revoke an authorization, there are two circumstances under the Banking Act in which the Bank must withdraw a bank’s authorization. First, if the home supervisory authority of an EU member bank that has branches in the United Kingdom withdraws its authorization of the bank. Second, when a bankruptcy order has been made against the institution in the United Kingdom.

decide whether an institution should be placed into administration, receivership, or liquidation under the Insolvency Act of 1986. Furthermore, in a majority of the cases where banks have experienced sufficient solvency problems to warrant their closing, the banks' directors or stockholders, not the Bank, have petitioned the courts for an order closing the bank because this allows them to play a role in determining who is appointed administrator of the bank. Nevertheless, the Bank remains the driving force in determining when and how a bank gets closed. For example, most often, when banks petition the courts, they do so only after it is clear from their discussion with bank supervisors that they have little other choice. Furthermore, if the Bank decides that a bank must be closed and that it should, for example, be placed in receivership, then the court's approval is merely a formality.

If a bank is suffering from liquidity problems, the Bank will encourage a bank to sell some of its assets, to get a line of credit from other financial institutions, or, as a last resort, provide liquidity itself. If these measures do not work, or if the bank is suffering from solvency problems, the Bank will first turn to the bank's largest shareholders to resolve the problem. If the shareholders do not have sufficient resources, then the courts would be petitioned to wind down the institution. Since 1987 there have been nine bank failures in the United Kingdom.

The Bank Relies on Several Sources of Information

To carry out its supervisory responsibilities the Bank relies on several sources of information including banks, accountants, auditors, and the financial markets. According to Bank officials, the sources of information upon which they primarily rely are reports submitted by, and meetings and other contacts with, the banks themselves.

Statistical information on banks is received in electronically-filed prudential reports, which are provided by the banks daily, weekly, monthly, quarterly, semi-annually, or annually—as is considered necessary by the Bank to fulfill its information needs. These include detail on the banks' assets and liabilities and highlight the main characteristics of a bank's business, such as its capital adequacy, liquidity, large exposures, maturity analyses, foreign currency exposures, industry exposure, dependence on connected business, and derivatives activities. Banks must also report to the Bank on such issues as management changes, proposed changes in ownership, and branch openings.

In addition, the Bank receives on-site information about banks from reports by the banks' reporting accountants and conducts its own reviews through small review teams and, more infrequently, by special investigation teams, as discussed in chapter 3.

The Bank also relies on information it receives from banks in formal bilateral meetings and also from informal meetings and telephone calls with them. It attaches considerable importance to regular interviews with senior management from each institution to discuss and elaborate on the information received in prudential reports. Through these interviews, the Bank attempts to assess the capabilities of bank management to control the business, achieve the institution's objectives, and satisfy itself that the criteria for authorization continue to be met.

In the 12 months between March 1, 1993, and February 28, 1994, the Bank held over 3,000 "routine" and "nonroutine" meetings with banks.⁷ Of these, over 1,000 were routine prudential or trilateral meetings to discuss the banks' performance, business, systems and controls, and compliance with requirements such as capital and liquidity minimums that have been agreed to between the Bank and individual banks.⁸ Most of these routine meetings were prudential interviews: 401 were interviews with banks incorporated in the United Kingdom, and 283 were with branches of foreign banks. An additional 357 routine meetings were trilateral meetings that included the banks and the banks' reporting accountants as participants (see discussion on auditors and reporting accountants in chapter 3 for further information).

The Bank also held nearly 2,000 nonroutine, but formal meetings with banks to discuss specific issues about which the Bank wanted more information. Topics at such meetings could include: individual supervisory concerns, changes in bank management, plans to expand into new areas, or suitability of controllers—managing directors, chief executives, or

⁷As noted earlier, there are approximately 500 banks in the United Kingdom, 232 incorporated in the United Kingdom and 286 incorporated outside the United Kingdom.

⁸The Bank adheres to minimum capital and liquidity requirements set out in EU directives that were modeled on the Basle Committee on Banking Supervision recommendations, which the Bank played a significant role in developing. However, these requirements are considered to be minimums and the Bank will discuss acceptable capital and liquidity levels individually with the banks it supervises. According to the Bank's Statements of Principles, "the Bank sets a trigger ratio for individual banks according to an overall assessment of the risks that they face and the quality of their risk management. A bank is required to meet its trigger ratio at all times. In order to lessen the risk that the trigger ratio might be breached, the Bank generally expects each institution to conduct its business so as to maintain a higher ratio (the target ratio)." See International Banking: Implementation of Risk-Based Capital Adequacy Standards (GAO/NSIAD-91-80) for additional information on risk-based capital standards.

stockholders owning 15 percent or more of the voting stock of a bank—to name only a few.

More informally, bank management will often meet with or telephone Bank staff to discuss future plans, potential problems, or other issues if they wish to obtain Bank opinions, informal approval, or advice.

In addition, the Bank has contracts with other participants in the financial markets that also provide it with more informal information about the banks it supervises. For example, the Bank might be told that participants in the foreign exchange market have limited their counterparty exposure to a particular bank because of concerns about the bank's operations. Or the Bank may hear that a senior manager at a particular bank has been borrowing heavily or speculating in the markets, which might raise concerns about his or her suitability to manage a bank. Although such information is often subjective, it may provide the basis for the Bank to follow up with the banks or their reporting accountants.

In all cases, Bank staff may follow up on information received with written or oral requests for further information, meetings with banks and/or their accountants, or visits to the banks by Bank review teams or special investigation teams.

The Board of Banking Supervision Advises the Bank

As noted in chapter 1, the Board of Banking Supervision was established in the 1987 Act as an independent committee advising the Bank's Court of Directors and consists of three ex-officio Bank members and six independent members. According to a paper issued by the Treasury at the time, the Board was intended to bring independent commercial banking experience to bear on banking supervisory decisions at the highest level. The independent members have a responsibility to advise the Board's ex-officio members on the Bank's actions taken under the authority of the act, either generally with respect to matters of policy or in relation to particular institutions.

Questions about individual institutions can range from new applications for authorization and proposals for changes of control to concerns on the part of the Bank about the suitability of controllers, possible threats to the interests of depositors, or formal enforcement actions that are being considered to resolve problems. For example, the Board met numerous times over the problems associated with BCCI and eventually endorsed the Bank's decision to close BCCI. In addition to institution-specific issues, the

Board will also address broader policy issues, and it reviews the staffing and training arrangements for Supervision and Surveillance.⁹

If the Bank decides not to accept the advice of the independent members of the Board, then the Banking Act requires the ex-officio members of the Board to give written notice of that fact to the Chancellor of the Exchequer. This has happened only once.¹⁰

The Board generally meets once a month, although during crises it meets more often. Minutes of the Board's meetings are provided to those of the Bank's directors who request them. The nonexecutive directors of the Bank (those who are not officials of the Bank) and the six non-Bank members of the Board of Banking Supervision also meet once a year to discuss issues of interest, including the Bank's annual report and accounts and the annual report required under the Banking Act.

In order to resolve some supervisory weaknesses that came to light after the BCCI failure, procedures for involving the Board of Banking Supervision in the Bank's Supervision and Surveillance area's work have been strengthened. For example, internal guidance on when to report matters to the Board has been tightened, and those cases about which the Board's advice is specifically sought are highlighted. In general, according to Bank officials, the Board's advice has been very helpful and effective over the years since its establishment.

Industry Satisfaction With the Bank as Bank Supervisor

While the failure of BCCI has opened a public debate on the role of the Bank as bank supervisor, in general the banks we interviewed, and the British Bankers Association, speaking for its membership, believe that the regulatory and supervisory system in the United Kingdom works fairly well. The Bank is perceived as a prudent, but not onerous regulator and a pragmatic supervisor. The banks appreciate that the Bank operates with discretion but that it also gets the job done. Although the failure of BCCI dealt a blow to the reputation of the Bank, banks we interviewed continue

⁹According to the Board's annual reports, policy questions that have come before the Board have included the implications for banks of changes in the markets in which they participate, questions of provisioning against sovereign risk, arrangements between the Bank and other U.K. financial institutions regulators with respect to their separate regulatory responsibilities, the ownership of U.K. banks, and implications for the banking system of Iraq's invasion of Kuwait.

¹⁰In this case, based on confidentiality requirements in the Banking Act of 1987, the Board in 1991 advised against the Governor's testifying before Parliament on the specifics of the BCCI case for fear of creating the precedent of speaking before Parliament about an individual case. The Governor made the decision not to take the advice of the Board and notified the Treasury as required under law.

to believe that the Bank is doing a better job than bank regulators in systems where supervisors are more intrusive.

Some representatives of the accounting firms we talked to were slightly more critical. For example, questions were raised about whether the Bank was firm enough with banks experiencing problems and whether concerns about the economy might be affecting bank supervision.¹¹ However, these representatives felt that the additional information being required by the Bank on bank records and systems would be useful to the Bank in understanding routine financial reports banks submitted to the Bank (see ch. 3 for additional discussion).

¹¹See appendix II for discussion of potential conflicts of interest between the Bank's role as monetary authority and bank supervisor.

The Bank Conducts Limited Bank Reviews and Uses Reporting Accountants and External Auditors to Obtain Additional On-Site Information

The U.K. supervisory approach does not depend on full-scope, on-site examinations of authorized banks.¹ Accounting firms carry out on-site work at banks in their formal roles as reporting accountants appointed under the Banking Act to produce reports on any relevant matter, as well as their role as external auditors appointed under the Companies Act. The Bank also has its own small staff (review teams) that carry out short visits to banks on an informal basis as specific needs arise. Bank supervisors are provided with the reports commissioned by them from reporting accountants and the results of the visits of the Bank's own review teams. These reports and the results of the review teams' visits, together with information collected directly from banks (as described in ch. 2), and trilateral meetings with the banks and accountants are intended to give supervisors a complete picture of the banks for supervisory purposes.

Bank Staff Conduct Limited On-Site Bank Reviews

The Bank has the authority under the 1987 Act to enter the premises of a bank to obtain information or documentation. While it does not use this power to conduct full-scope examinations, the power enables the Bank to carry out limited bank reviews on an informal basis, drawing from a small group of 11 review team members. The group currently includes four accountants from major accounting firms, three bankers from large banks who have all been assigned for two years to the Bank of England as well as four Bank staff, and former bankers who are on contract to the Bank.

The reviews are conducted in small "review" teams of two or three, with at least one accountant and one banker on each team. In addition, a Supervision and Surveillance career line supervisor usually accompanies the review team in order to obtain first-hand information about the banks for which he has responsibility. The teams assess the quality of banks' lending and the adequacy of their systems and controls. For example, they may check a bank's treasury operations, its electronic data processing systems, or its credit area. Visits by review teams can range from 2 to 3 days to several weeks and may cover locations throughout the country. Review team visits in smaller banks may cover the full range of a bank's activities, whereas in larger banks the teams may concentrate on a specific line of business.

Reports by review teams tend to be fairly qualitative since visits are short and much of the review team information is derived from interviews rather than documents. Nevertheless, a Bank official stated that such subjective

¹Full-scope examinations include examining bank asset quality, assessing banks' systems and internal controls, judging capital adequacy and reserves, and assessing compliance with laws and regulations.

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The Bank Conducts Limited Bank Reviews
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On-Site Information

reports often provide helpful information that gives a flavor of the bank's operations that cannot necessarily be derived from an accountant's report or bank audit. After its visit, the review team will hold a closing meeting with the bank's management to discuss initial conclusions. The review team will then draft a detailed report that will be provided to the bank's supervisor who will, in turn, discuss the report with the bank and provide a list of significant points to be resolved.

In principle, review teams are meant to visit all 518 banks in the United Kingdom, including foreign branches, although not on an annual basis. In practice, visits to the 129 European-authorized institutions tend to be rare and are largely confined to liquidity and money laundering since primary supervisory responsibility over these banks rests with the home supervisory authorities. Banks about which the Bank has no concerns are also not given high priority for review team visits. In the year ending February 28, 1994, the Bank carried out 112 review team visits and 11 additional "special" visits. Special review teams will focus on specific issues when the Bank suspects a problem.

The Bank also conducts reviews of banks' foreign exchange operations and assesses their compliance with Bank guidelines. In such reviews, Bank staff will review specifically the position limits that the Bank has set with individual institutions as well as other issues such as netting arrangements and general business strategies. These reviews are conducted by staff within Supervision and Surveillance—generally one senior manager assisted as necessary by detailed accountants and bankers, and/or experienced analysts from within the supervisory divisions. The Bank conducted 41 such visits in the year ending February 28, 1994.

Both review team visits and foreign exchange visits are conducted with the cooperation of the institution and do not explicitly involve the use of the Bank's statutory powers. In principle, this means that a bank could refuse entry to the Bank's teams, although such a case has never happened and is unlikely to happen given the Bank's arsenal of statutory powers to obtain information. If a bank were to refuse entry, the Bank would have to use its statutory powers to require the bank to cooperate, which, according to a Bank official, "would clearly be at odds with the spirit within which we normally conduct our supervision."

As a result of recommendations resulting from investigations into the BCCI failure, the Bank established a special investigations unit (SIU) with 11 staff

including support staff, made up of both experienced banking supervisors and specialist forensic accountants recruited from major international accounting firms. According to a Bank of England Banking Act Report, “the SIU now acts as the focal point for all cases where there are concerns about possible criminal activity involving institutions for which the Bank has supervisory responsibility.” The primary role of the SIU is to advise Bank supervisors on appropriate actions to take in pursuing suspicions and warnings of fraud and other criminal activity based on information provided by the supervisors. Special investigation teams will also investigate such cases when appropriate.

Reporting Accountants Contribute to Examination function

In the United Kingdom, reporting accountants perform a significant part of the examination function through annual and special reviews provided for in the 1987 Act. All banks in the United Kingdom, with the exception of European-authorized institutions,² are subject to two types of reviews under the act: (1) an annual records and controls review required by section 39 of the 1987 Act (records and controls audits), as requested by the Bank;³ and (2) special reviews of individual banks, under section 41 of the 1987 Act, that may be requested by the Bank if it perceives a need for additional information, for example, with respect to suspected fraud or unexpected losses (special reviews). While reporting accountants must comply with Bank requests for such reports, the Bank has no access to accounting firms’ work papers.

Accountants were assigned their responsibilities under the Banking Act of 1987 not only because it was seen as the most efficient way of introducing the necessary checks on systems and controls by drawing on an existing pool of expertise, but also because the Bank preferred its traditional approach of supervising banks “based on dialogue, prudential returns and trust”—which it believes has served it well—rather than more intrusive examination techniques.

In addition to reviews conducted under the Banking Act, external auditors conduct annual financial audits that are required of all U.K. corporations

²European-authorized institutions are those incorporated in the EU or in the EEA (but outside the United Kingdom) and are not required by the bank to have annual systems and control audits. The Bank, on a case-by-case basis, may periodically require such an audit, but it would generally be limited in scope to audits of prudential returns. European-authorized institutions are also generally not subject to special audits that may be requested by the Bank. On February 28, 1994, there were 129 European authorized institutions in the United Kingdom, 97 of which were allowed to take deposits.

³Under the law, the Bank is given the authority to request records and controls reviews. The Bank has used this authority to require such reports annually.

under corporate law. These audits may also be used by the Bank in the supervisory process.

The Bank Uses Annual Records and Controls Reports to Help Assess Records and Systems

The 1987 Act explicitly requires banks to maintain accounting and other records and internal control systems that enable a bank to prudently manage its business and to comply with legal requirements. To monitor compliance with this requirement, the Bank has been given the right under section 39 of the 1987 Act to require that banks hire accounting firms—called reporting accountants for the purposes of section 39 reporting—to conduct annual reviews of a bank’s records and systems of controls and to check the statistical and other prudential reports banks submit to the Bank. The records and systems and prudential return reviews are frequently separate assignments carried out under their own letters of instruction. Furthermore, a prudential return review will always result in a separate report being issued by the reporting accountant to the Bank.

The Bank uses information from the annual records and controls reports to assist it in judging the adequacy of a bank’s records and systems and whether the bank’s business is conducted in a prudent manner on a day-to-day basis. The Bank does not expect reporting accountants to make a judgment about prudent conduct, but it does want them to set out the risks that the institution runs by not correcting the weaknesses the accountants have identified. Records and controls reports do not, however, express an opinion on the bank’s financial statements.

Records and controls reviews are paid for by the bank being reviewed, and the reports are submitted to the bank for comment before the report and the bank’s comments are provided to the Bank. The scope of the report, however, is set by the Bank in annual discussions it holds with the banks and their reporting accountants and is formally communicated to reporting accountants in annual letters sent them by the banks.

The Bank’s policy is to require full-scope records and controls reviews on an annual basis for “small or vulnerable” banks.⁴ The Bank expects a full-scope review to include a consideration of the adequacy of the accounting and other records and internal control systems, including the internal audit function, throughout the institution. The reporting accountant is also expected to check the institution’s procedures with

⁴If a bank or branch has received positive records and controls audit reports for several years in a row, it may be permitted a year in which no report is required.

respect to preventing, detecting, and reporting suspicions of money laundering.⁵ Larger banks get rolling records and controls reviews since full-scope reviews would take too long and would be prohibitively expensive. A records and controls report of a larger bank might cover the bank's high-level controls in one year, then its treasury activities in another, and its credit activities in a third, for example.

The Bank Has Issued Guidance on Annual Records and Controls Reviews

The Bank does not have detailed requirements about the manner in which annual records and controls reviews should be conducted. Rather, it has issued 17 pages of guidance that emphasize the scope and nature of the financial information, which accounting and other records must be designed to capture, and the scope and nature of internal control systems.⁶ The guidance also includes three pages on the reporting accountants' reviews and reports.

The guidance requires that adequate records be maintained to facilitate the prudent day-to-day conduct of a bank's business, compliance with statutory reporting requirements, and provision of appropriate information for the bank's own statistical and prudential returns. Information provided to management for the day-to-day conduct of a bank's business should be sufficient to enable it to (1) monitor the quality of its assets and safeguard them; (2) identify, control, and manage risk exposures; (3) make timely and informed decisions; and (4) monitor the current performance of all aspects of the business.

With respect to internal controls, the Bank recognizes that internal control systems will vary from bank to bank, but controls should "provide reasonable assurances that a bank's revenues accrue to its benefit, all expenditure is properly authorized and disbursed, all assets are adequately safeguarded, all liabilities are recorded, all statutory requirements relating to the provision of accounts are complied with, and all prudential reporting conditions are adhered to." The Bank does not require, but strongly encourages, the establishment of an internal audit function and audit committees. As a result, most U.K. banks have established audit committees and internal control functions. The Bank recommends that the

⁵While the Bank's guidance in this area states that the procedures to be covered are those relating to "preventing, detecting, and reporting," an accounting firm with which we spoke brought to our attention that the Bank confirmed with them that the notice should refer to procedures for "prevention, deterrence, and reporting." The reason for this is that the U.K. legislation on money laundering requires banks (and others) to maintain systems for deterrence but not for detection (which would be overly onerous). This was confirmed by the Bank.

⁶"Guidance Note on Reporting Accountants' Reports on Accounting and Other Records and Internal Control Systems," (Mar. 1994).

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internal audit function should be responsible directly to the board's audit committee. In its notice, the Bank states that control functions that could be undertaken by an internal audit department may include: undertaking special investigations for management; reviewing accounting records and the control environment; reviewing appropriateness, scope, and efficiency of internal control systems; and reviewing implementation of management policies.

In its guidance on reporting accountants' reviews and reports, the Bank asserts its expectation that reporting accountants abide by the accounting industry's guidelines. The Bank also requires reporting accountants to give an overall assessment of the control environment for each business area that they have been asked to examine. As of year-end 1994, records and control reports by reporting accountants are also to include background information on the business areas in which systems were reviewed including the organizational structure, nature, and approximate volume of transactions, the key risks faced by the institution, and the key controls in operation.⁷

In conducting annual records and controls work, reporting accountants are "required to form an opinion on whether the institution's accounting and other records and internal control systems have been maintained by management in accordance with the Bank's interpretation of the requirements of the Act." In separate reviews, reporting accountants will check whether the material in certain prudential reports selected by the Bank has been properly extracted from the underlying accounting records. They are not required to check the accuracy of the underlying records, however. Over a period of years, the records and controls reports on each institution are to cover all relevant prudential reports.

Until this year, records and controls reports had been quite short. They consisted of a one-page letter to the directors of the bank with an appendix describing the exceptions to the Bank's criteria for adequate records and controls. Most reports have several pages of exceptions, while

⁷This information was requested by the Bank because the listings of exceptions provided by the reporting accountants were often cryptic and difficult to understand without some basic descriptive information about the bank's systems and controls.

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only a few will not have any exceptions. It is also relatively rare that a negative report will be issued.⁸

Guidelines on annual records and control reviews have also been adopted by the Auditing Practices Board (APB), an industry group similar to the American Institute of Certified Public Accountants in the United States, after close consultation with the Bank. The Bank expects that records and controls work will be conducted in accordance with its guidelines as well as those of the APB.

Special Reviews May Be
Requested If the Bank Has
Specific Concerns

Under section 41 of the 1987 Act, the Bank may also request that a reporting accountant conduct a special review if the Bank has specific concerns about a bank. In such cases, the Bank hires the accountant, pays the accountant, and sets the scope of the review. The Bank's authority to request information under section 41 is very broad, and reviews may cover the full operations of a bank or a specific area about which the Bank has concerns.

Special reviews are conducted on very short notice or even secretly—for example, during the course of a regular annual records and controls review—and reporting accountants report on their reviews directly to the Bank in bilateral meetings. The accountants do not first discuss the results of the special review with the bank. The Bank may use the bank's own accountant to conduct a special review if, for example, the Bank feels that it is easier to use an accountant already familiar with the bank, or it may choose another accountant if it wants a completely independent opinion. For the special review of BCCI, the Bank used Price Waterhouse, BCCI's annual auditor and accountant, without giving notice to BCCI that the review was being conducted.

Special reviews are not requested very frequently, averaging slightly more than four a year over the past 10 years, partially because of the high cost of such reviews to the Bank. Nevertheless, the Bank says that it does not let concerns about cost stand in the way of commissioning a special review.

⁸An annual records and controls audit opinion will read one of two ways. A positive report with exceptions will read: "in our opinion, having regard to the nature and scale of its business, during the year ended [] the accounting and other records and internal control systems examined by us were established and maintained in accordance with the requirements of the Guidance Note (with the exception of the matters set out in Appendix 3 attached to this report)." A negative report will read: "in our opinion, having regard to the nature and scale of its business, during the year ended [] the accounting and other records and internal control systems examined by us were not established and maintained in accordance with the requirements of the Guidance Note for the reasons set out in Appendix 3 attached to this report."

In order to avoid the cost of a special review, the Bank may send in its own special investigations teams for smaller banks, or it may request a bank to commission a special records and controls report about a specific area of concern. Such a report has the advantage of being paid for by the bank being reviewed, but the bank also is notified of the review and may have time to hide evidence of wrongdoing.

Banks Are Also Subject to Annual Audits Under Corporate Law

Corporate law in the United Kingdom, the Companies Act of 1985 (1985 Act), requires all companies incorporated in the United Kingdom to receive annual financial audits.⁹ The scope of such a statutory audit of a bank's financial statements is no different from that of any other company. External auditors are required to report whether, in their opinion, the annual financial statements give a true and fair view and have been properly prepared in accordance with the 1985 Act. Aspects of a bank's business typically examined would include: checking that the bank is complying with capital requirements; assessing asset quality, loan loss reserves, earnings, and management capability; and reviewing internal controls.¹⁰ In carrying out their audit work and in preparing their report on the financial statements, auditors comply with auditing standards prepared by the auditing profession. There are no financial audit requirements imposed by the Bank.

There is also no requirement that financial auditors hired under the 1985 Act's requirements provide the Bank with the management letter they send to the bank's directors describing the results of the audit. However, if a Bank supervisor requests a copy of the management letter, which can be quite detailed, then the bank will provide one after consulting with its auditor.

⁹At the end of February 1994, there were 232 banks incorporated in the United Kingdom that were required to receive annual audits. Branches of banks incorporated outside the United Kingdom are not required to receive audits, but many do, depending on the audit requirements in the bank's home country. The exact percentage of foreign branches that receive annual audits is not available, although some of the accountants we interviewed estimated that about 50 percent do. However, even when branches are audited, these audits are often not full financial audits.

¹⁰Management capability and internal controls are assessed as a basis for the production of reliable financial information and are not within the scope of the statutory audit opinion.

The Role of Reporting Accountants and External Auditors Continues to Evolve

The role of reporting accountants and external auditors and the content of the reviews they must conduct under the Banking Act has continued to evolve since 1987. For example, as of May 1, 1994, under a new provision recently added to the 1987 Act, reporting accountants and financial auditors must not only report the information requested under the 1987 Banking Act and the Companies Act but also have a statutory duty to report to the Bank any material breaches in the minimum authorization criteria that they discover during the normal course of their review and audit work (see ch. 2).¹¹ Such breaches must be reported without undue delay. Financial auditors must also report to the Bank if they have reason to believe that their audit opinion will be qualified, and reporting accountants have a similar duty to the Bank if they decide to issue an adverse report. In general, bank audits are qualified only rarely.

Reporting accountants and external auditors may use their own judgment with respect to whether such information should first be reported to their client. Furthermore, according to the accounting firms with whom we spoke, they will often try to persuade their clients to report to the Bank directly, instead of having the accounting firm report. When there is written evidence that a matter has been communicated to the Bank in full by bank management, and the accountant or auditor has adequate evidence from sources independent of the bank that the Bank is fully aware of all relevant information, then the accountant or auditor is not required to report that same information. There are, nevertheless, a number of situations—particularly those which cast doubt on the integrity or competence of directors and management—in which the auditor or accountant should report directly to the Bank, without discussing it with management. The exact legal responsibility for what the auditor or accountant should report and when he or she should report it remains subject to interpretation, however, since the requirement is still relatively recent and untested.

The Bank Holds Annual Trilateral Meetings With Reporting Accountants, Bank Auditors, and Banks

After the Bank receives the reporting accountant's records and controls report, it is to commission a trilateral meeting with the bank's reporting accountant—who, in most cases, is also the bank's financial auditor—and the bank.¹² Participants in the meeting will include the bank's Bank supervisor and the supervisor's assistant, representatives of the bank, and

¹¹The statutory duty to report to the regulator also applies to auditors of all other financial companies, such as securities firms, insurance companies, friendly societies, and building societies.

¹²If the reporting accountant is not the bank's financial auditor, a separate meeting is generally held with the financial auditor to discuss the annual financial audit.

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representatives of the accounting firm. On average, these meetings will last about 2 hours. At these meetings, the participants discuss the following five different agenda items:

- (1) The key accounting and auditing issues that came out of the annual financial audit, as required by the 1985 Companies Act.
- (2) The section 39 report on records and control systems. The supervisor will generally address each exception in the report, the reporting accountant will explain the exception, the bank comments, and then solutions to the problems are discussed and future actions to deal with the problems decided upon.
- (3) The reporting accountant's report on the bank's prudential returns to the Bank and any exceptions in that area, as required under section 39 of the Banking Act.
- (4) The scope for the following year's report.
- (5) Any other business. Under this agenda item, for example, the Bank would formally notify the accountant of any matters about the accountant's bank client that it felt were of concern and that the accountant should know about.

Trilateral meetings are generally not very contentious and in most cases the accountant and bank have agreed on the records and controls report before the meeting. Nevertheless, the accountant and bank sometimes agree to disagree and both present their cases to the Bank, according to both officials of the Bank and the accountants with whom we spoke.

There are generally no further communications between a reporting accountant and the Bank on a specific bank unless the accountant finds a serious problem with a bank during the course of his or her work or if, for example, the accountant simply wants to clarify a technical question. There is a strong feeling within the accounting profession, according to the accountants and the banks we interviewed, that all communications with the Bank should pass through the client bank. However, the Bank and accountants might meet on a variety of nonclient specific issues that are of common interest to both the accountant and the Bank, such as new APB auditing standards or Bank guidelines.

External Accounting Firms Are Subject to Unlimited Liability

The work of bank external accounting firms is subject to unlimited liability—several and joint—whether they are acting as reporting accountants or financial auditors. Furthermore, according to an accountant with whom we spoke, it is expected when a bank fails that its auditor will be sued, generally because the auditor has given an unqualified opinion that the bank’s accounts gave a true and fair view of the bank’s affairs that showed the bank was solvent and yet the bank failed in the following year. Nevertheless, lawsuits over bank audits have not been frequent in the United Kingdom since banks have not failed often; there have been nine bank failures involving the Deposit Protection System since 1987.¹³ However, lawsuits involving bank failures often involve large amounts of money. For example, at one extreme, Price Waterhouse, the auditor of BCCI, is being sued for \$8 billion over its audits of BCCI before its failure.

Lawsuits are generally brought by bank creditors.¹⁴ The Bank may also sue accounting firms for losses it suffers from a bank failure; for example, if it provided liquidity lending that was not repaid. However, the Bank has only sued an accounting firm once in its capacity as owner of JMB after it helped rescue the bank.¹⁵

Accounting firms are protected under section 47 of the 1987 Act from claims of breaching client confidentiality when they communicate information about a client to the Bank, if such a communication is made “in good faith.” Such protection is granted in cases where the Bank specifically requests information as well as in cases where the accountant or auditor approaches the Bank with information.

The Bank May Take Action Against Reporting Accountants

The Bank consciously decided not to require specific qualifications for reporting accountants/bank auditors nor to have a list of approved auditors because it did not want to make it too difficult for auditors to qualify to audit or review banks. Nevertheless, the Bank uses primarily the “big six” accounting firms (see p.19) when it commissions special reviews under section 41 and even though the Bank may not dictate who a bank’s statutory auditor should be, it has sometimes implied that banks switch

¹³While there have been many more revoked authorizations—approximately 35 since 1983—most of these have involved an orderly winding down of a bank’s business and are not considered to be failures.

¹⁴While bank stockholders may sue, they must sue individually since there is no class action suit in the United Kingdom. This restriction makes stockholder suits less likely.

¹⁵That lawsuit was settled out of court.

from smaller accounting firms to one of the big six without recommending a particular firm, according to a Bank official.

Furthermore, the Bank has the right to request that a bank change its reporting accountant or that the accounting firm's partner responsible for the bank be changed. Since a bank's reporting accountant and its financial auditor are almost always the same firm, the Bank, in effect, has some control over a bank's financial auditor. There have been cases where banks have changed accounting firms as a result of Bank dissatisfaction.

Even though formal disapprovals of reporting accountants/bank auditors are rare, the Bank is more frequently not fully satisfied with the work being done by section 39 reporting accountants and financial auditors. According to a Bank official, there have been a few cases where banks have had to make significant provisions to reserves shortly after an audit was completed, and questions were therefore raised about the quality of the audit work. In other cases, Bank review teams have visited a bank after it was audited and required additional provisions, which again raised questions about the bank's auditor.

When the Bank is dissatisfied with the work of a particular firm or of a firm's partner, it is likely to call the firm's senior bank partner to discuss the problem. Generally, this will be sufficient to address a problem or perceived problem. At the extreme, the Bank would request that a bank dismiss its auditor or accountant, as discussed above.

The Bank also recognizes that potential conflicts of interest between the accountant's responsibilities to his client and to the Bank may affect the quality of work. But senior regulators believe that the accountants are careful to guard their reputations and would, therefore, not allow the potential conflict to seriously affect their work.

The Bank Has Links With Deposit Protection Board and Has Other Bank-Related Responsibilities

The Bank's Governor chairs and the Bank provides staff to the independent Deposit Protection Board, which administers the deposit protection system. In addition to its role in bank regulatory and supervisory matters, the Bank has responsibilities in other bank-related activities such as liquidity provision, crisis management, payments clearance, international negotiations, and lender of last resort.

The Bank Heads Independent Deposit Protection Board

The U.K.'s deposit protection system was established under the provisions of the 1979 Act and revised in the 1987 Act and is mandatory for all banks in the United Kingdom. The deposit protection system covers 75 percent of pound sterling deposits in the United Kingdom, but not in foreign branches of U.K. banks, up to £20,000. Thus, the most an individual can collect in a bank failure is £15,000.¹

The Deposit Protection Board administers the deposit protection system and controls the Fund that pays out claims. The Board's sole function is to administer the deposit protection system. It has no regulatory or oversight function, nor does it assist in problem bank situations; it only steps in when a bank becomes insolvent and depositors are due funds.

The Deposit Protection Board is an independent body legally separate from the Bank, even though four of the Board's seven members are Bank officials, including the Board's chairman, who is the Governor of the Bank of England. The other three Bank officials on the Deposit Protection Board are the Bank's Deputy Governor, its executive director in charge of banking supervision, and its chief cashier. The three non-Bank Board members are bank representatives.

The Fund is maintained through contributions made by banks to the Fund. It is required by law to maintain a level of £5 million to £6 million—a small fraction of the approximately £550 billion in sterling deposits held by U.K. banks as of March 1994—and banks may be required to make three types of contributions to maintain this level of funding: (1) initial contributions of £10,000 when a bank is first authorized; (2) further contributions, if the Fund falls below £3 million, not exceeding £300,000 per bank based on the insured deposit base of the banks involved; and (3) special contributions,

¹These limits will change on July 1, 1995, when EU directives are implemented. Coverage will increase to 90 percent of deposits in any EU currency including deposits in EU branches of U.K. banks, with a maximum recovery of 20,000 European Currency Units (ECU), about £18,000. The ECU is a basket of European currencies consisting of specific amounts of 10 EU member states' currencies. Furthermore, banks authorized in other EU member countries will carry the deposit protection of their home countries and will, therefore, no longer be required to participate in the U.K. system.

again based on the insured deposit base of the banks involved, but with no contribution limit. Since the largest six banks in the United Kingdom hold 55 percent of the insured deposits in the United Kingdom, they would cover 55 percent of these special contributions. Special contributions of £80 million were necessary to fund expenditures after the BCCI failure.

If necessary, the Fund may borrow from the Bank—which it did after BCCI was closed in 1992. The limit of this line of credit is set by the Treasury and is subject to annual review. The line of credit was increased to £125 million in 1992 then reduced to £50 million in 1993. The line of credit is intended for short-term, liquidity purposes until the Deposit Protection Board can raise the funds from its member banks to repay the Bank loan. The Fund receives no direct financial backing from the Bank or the U.K. taxpayer. If a situation developed in which major banks would be jeopardized by contributing the necessary funds to resolve a large bank failure, the matter would be addressed at a political level at that time.²

The Bank's Other Bank-Related Responsibilities

The Bank's bank-related responsibilities are not limited to supervision and regulation. It also plays a role in liquidity provision, crisis management, payments clearance, the negotiation of international agreements, and acts as lender of last resort.

Liquidity Provider

The Bank undertakes daily operations in the U.K. money markets. The Bank supplies money to the banking system (or withdraws it from the system and the economy) to conduct monetary policy. These flows are concentrated across a small number of accounts—those of bigger banks—at the Bank.

The terms at which the Bank supplies liquidity are interpreted as a signal about the Treasury's desired level of short-term interest rates and, as such, have a general influence over interest rates.

Crisis Management

The Bank has taken a major role in crisis management involving financial institutions, both as a result of its role as lead regulator of banking firms and as a major participant in financial markets. Even though the Treasury has no formal role in banking supervision, the Bank would, as a matter of policy, keep the Treasury informed of potential crises.

²For additional information on deposit insurance in the United Kingdom, see [Deposit Insurance: Overview of Six Foreign Systems](#) (GAO/NSIAD-91-104, Feb. 22, 1991).

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The key role of any central bank is to supply sufficient liquidity to the financial system in a crisis. For example, after the 1987 market break, the Bank announced its intention of providing liquidity to the market, thereby giving its unofficial endorsement to the view that the banks at the center of the system would be able to meet their obligations in any event.

The Bank has, with greater and lesser degrees of success, also persuaded major U.K. banks to support rescue operations of individual or groups of banks. In the early 1970s, for example, a number of relatively unsupervised secondary banks experienced severe financial problems, primarily as a result of real estate speculation. The secondary bank crisis threatened serious repercussions on the major primary sector banks, and the Bank therefore organized a “lifeboat” of clearing banks to provide liquidity for secondary banks suffering runs. In most cases the risk of loss was borne by the clearing banks, although the Bank agreed to cover losses over the exposure limits, thereby exposing itself to significant risk as well. In the end, several of the banks failed, and the Bank bore losses under agreed-upon indemnities, even though significant recoveries were made over subsequent years as some of the failed banks’ loans were repaid or sold.

Another example of the Bank as organizer of a bank rescue occurred in 1984 in the case of JMB, a major participant in gold bullion and commodity trading and one of the five London gold price fixers. As a result of large exposures that it failed to report to the Bank, JMB’s capital was all but eradicated. The Bank feared for London’s position as the leading international gold bullion market and, after the JMB parent company could not provide enough capital to save the bank and potential purchasers who were approached by the Bank withdrew, the Bank itself provided support for JMB. After considerable pressure from the Bank, the four London clearing banks³ agreed to provide £35 million; the members of the gold market, £30 million; and the other members of the accepting houses committee, £10 million to support JMB. Neither the Bank nor any of the participating banks bore any losses in the JMB rescue.

Since the establishment of the Deposit Protection Fund in 1979, which limits the losses of small depositors, banks might be less inclined to participate in rescue attempts on the scale of the early 1970s, according to a Bank official. Nevertheless, in 1991, the Bank provided an indemnity to support a £200 million liquidity facility provided by a group of large U.K. banks to the banking subsidiary of a major mortgage lender and

³Barclays, Lloyds, Midland, and National Westminster.

subsequently took over the direct funding. In 1994, the Bank acquired the mortgage lender and its subsidiaries for a nominal consideration.

Payments Clearance

The Association for Payment Clearing Services (APACS), the umbrella organization for the privately owned clearing systems in the United Kingdom, is responsible for the provision and development of payment clearing mechanisms in the United Kingdom and for overseeing developments in payment systems⁴ generally. This means running the clearings for checks and paper credit transfers as well as for electronic debits and credits together with the systems that handle high-value transfers in the United Kingdom.

The Bank acts as settlement institution for members of the three sterling payment systems but does not, itself, own or operate any of these systems.⁵ It is, however, a member of APACS and of the individual clearing companies with the right to appoint a director to the board of each of the clearing companies. Consequently, the Bank has a voice in APACS decisions, and its special interest is generally recognized on questions of public policy.

There is no statutory supervision or regulation of the payment systems operating in the United Kingdom, though the Bank has implicit responsibility for oversight of the payment systems by virtue of its core responsibilities as a central bank. As such, it aims to ensure that they are reliable, efficient, and, as far as possible, risk-free.

The Bank is currently working with APACS to develop the Clearing House Automated Payment System into a real-time gross settlement system.⁶ The Bank hopes to begin phasing this system in by the end of 1995.

Participation in International Organizations

The Bank participates in developing U.K. positions with respect to several international organizations even though it takes the lead only on the Basle Committee on Bank Supervision, whose primary purpose is addressing bank supervision-related issues, and on the Banking Advisory Committee

⁴A payment system is a financial system that creates a mechanism for transferring money between suppliers and users of funds.

⁵The three sterling payment systems are (1) for the settlement of transactions in government securities, (2) money market instruments, and (3) ECU denominated securities.

⁶Real-time gross settlement means that all transactions in an electronic payments system are settled immediately in full, usually with a transfer of central bank balances.

of the EU. In both of these cases, Supervision and Surveillance represents the Bank. In other groups, such as the European Union Council of Ministers and the Organization for Economic Cooperation and Development, the Bank provides assistance to the Treasury or other government agencies in developing positions, and Bank staff may attend meetings. The SIB, as the regulator of U.K. securities firms, is the U.K. representative to the International Organization of Securities Commissions.

Lender of Last Resort

The Bank continues to act as lender of last resort to the banking system, a role almost as old as the Bank itself. According to the Bank, its responsibility consists of supporting banks whose failure would initiate a loss of confidence in the U.K. financial system as a whole. The Bank admits that size is an important factor in considering systemic effects, but that no bank should consider Bank assistance automatic or without penalty. Furthermore, before committing its own funds, the Bank will encourage a bank to find a buyer, attempt to persuade bank creditors to provide support to protect their own positions, or try to find a group of banks with an interest in an orderly resolution. If all else fails, the Bank may consider committing its own funds, but only if the bank's problem is one of liquidity, not of solvency. Nevertheless, the Bank does not mandate that its lending be collateralized.

At the time of any lender of last resort action, the lending is generally not made public, although the Bank will obtain the Treasury's approval for the proposed action. The lending is also generally made without a government guarantee, and the deposit protection system does not play a role in providing or guaranteeing funds. This means that the Bank is subject to losses if banks to which it has lent money on an uncollateralized basis are unable to repay the funds.

The most recent example of lender of last resort action made public by the Bank was when it provided liquidity support to a few small banks in 1991. During 1990 and 1991, a number of small banks had experienced difficulties due to the depressed real estate market and increasing defaults on consumer credit. The resulting failure of several smaller banks and the closing of BCCI in 1991 contributed to the small bank sector's experiencing wholesale funding difficulties as local authorities and public corporations in particular withdrew deposits on maturity. In order to avert a possible systemic disturbance that could result from multiple small bank failures, the Bank provided liquidity support with the government's knowledge, but

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without a government guarantee. As a result of its lending to small banks in 1991, the Bank made provisions in 1993 of £115 million against possible losses from the failure of some of these banks, although exact losses have not been published. If any of these banks were to fail and losses were to ensue, the Bank would be treated as an unsecured creditor and would participate in distributions by a liquidator. It would not receive any funding from the Deposit Protection Fund.

Purpose and Structure of the Bank of England

According to the Bank of England's (the Bank) annual report and accounts, the Bank's "core purposes, as the central bank of the United Kingdom, are to maintain the integrity and the value of the currency (monetary stability) and the integrity of the financial system (financial stability)." Related to the goal of financial stability is the promotion of "the efficiency of [the U.K.'s] key financial markets."¹

The Bank is subordinate to the government when determining monetary policy, although it has been granted a greater degree of independence in recent years. Monetary policy is still dictated by the Treasury, after consultation with the Bank, but the Bank has been given some flexibility in determining how to attain these monetary goals and may publish its own recommendation on monetary policy.

In July 1994, the Bank underwent a management restructuring that consolidated numerous divisions into two wings: the monetary stability wing and the financial stability wing. This restructuring was intended to emphasize the core purposes of the Bank, as described above. (See fig. I.1.)

The monetary stability wing extends from economic and monetary analysis (covering the United Kingdom and overseas), through the preparation of the Bank's monetary policy advice and the Inflation Report, to the implementation of monetary policy in the markets and to the banking services that support the Bank's policy operations.

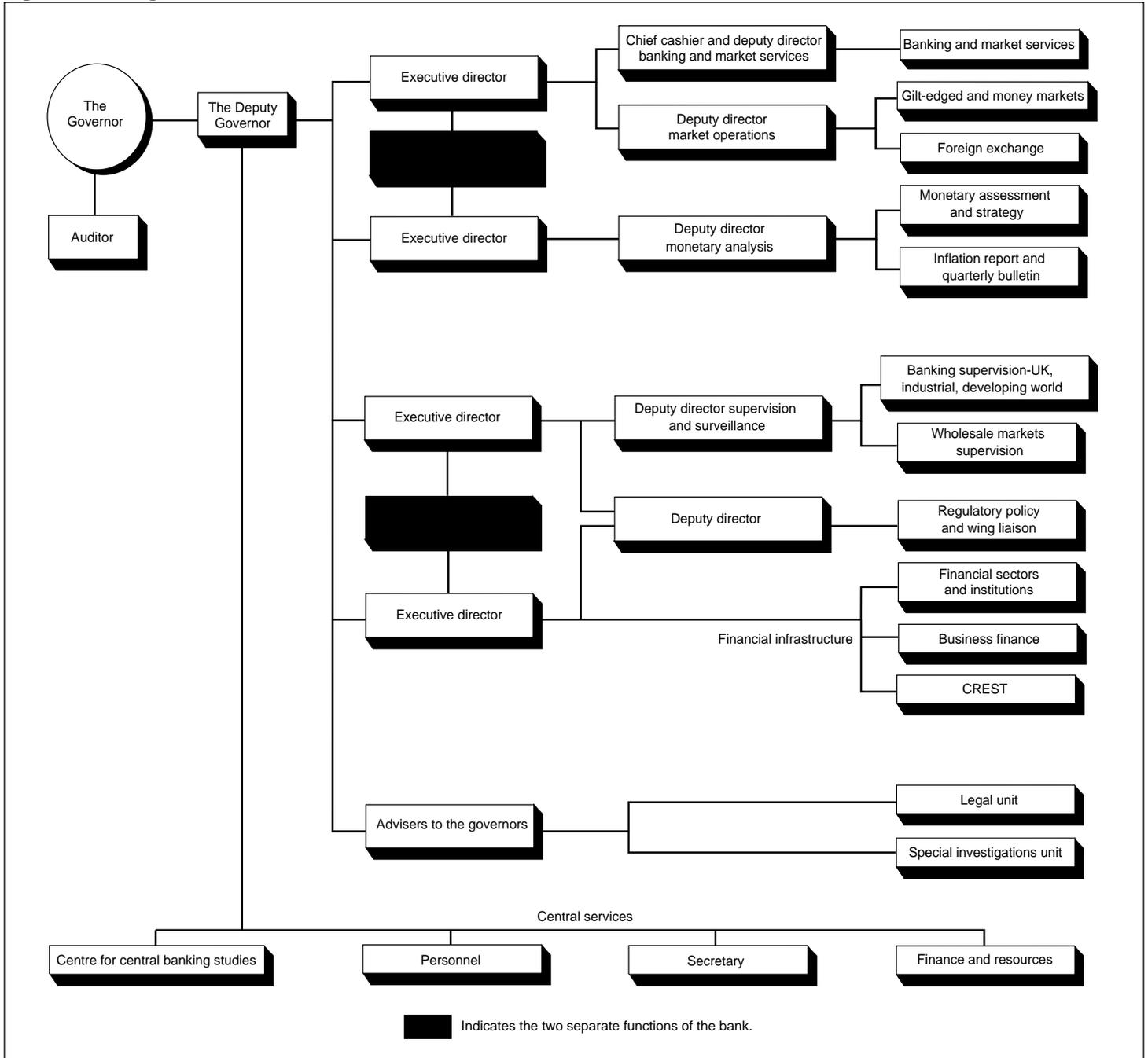
The financial stability wing brings together the Bank's statutory and nonstatutory supervision work, together with surveillance of markets and overseas financial systems; work on payment, settlement and clearing systems; and the Bank's nonstatutory interest in the stability of the whole of the financial system; the efficiency and competitiveness of the U.K. financial sector; the CREST securities settlement system project;² and finance for industry.

¹The 1946 Act makes no direct reference to monetary policy or the Bank's role in it, or to maintaining financial stability.

²At the proposal of the Stock Exchange, in March 1993, the Bank established a Securities Settlement Task Force to make proposals on an improved equity settlements system in the United Kingdom. The replacement settlements system is known as CREST.

**Appendix I
Purpose and Structure of the Bank of
England**

Figure I.1: Management Structure at the Bank



Source: The Bank of England.

Questions of Potential Conflicts of Interest Between the Bank of England's Role as Monetary Authority and Bank Supervisor

Questions have been raised recently in the United Kingdom about possible conflicts of interest when a central bank combines the role of central monetary authority and bank supervisor. While the Bank acknowledges that potential conflicts exist, it is the Bank's position that such potential conflicts are not severe and would exist whether or not the two functions are under the same roof. Furthermore, the Bank believes that any potential conflicts are easier to resolve within an institution, rather than between two, and that there are synergies involved in combining monetary authority and bank supervision under one roof that outweigh the potential conflicts.

Potential Conflicts of Interest

The Bank acknowledges that a number of potential conflicts could in theory exist when the responsibilities of the central monetary authority and bank supervisor are combined under one roof. The potential conflict that has raised the greatest concern is that the central bank that also supervises banks may compromise on the conduct of monetary policy if it believes that the financial viability of one or more banks or systemic stability might be at stake. It is possible, for example, that a central bank might keep interest rates artificially low for a period of time—to the detriment of monetary policy goals—in order to help banks contain problems in their loan portfolios that might be aggravated if interest rates were raised.

According to a senior Bank official, critics of combined monetary and bank supervisory responsibilities have also raised a number of other concerns. These critics believe that

- there is a potential conflict between the Bank's role as ultimate supplier of liquidity to an institution in difficulty and its role as supervisor,
- the knowledge that a central bank obtains as bank supervisor can give it an unfair competitive advantage when it competes with other financial institutions, for example, when it is acting as principal or agent in its banking operations, and
- the central bank's reputation may be damaged by supervisory failures and consequently compromise its ability to conduct monetary policy.

The Bank Agrees That the Potential for Conflicts Exists but Maintains That Synergies of Combined Central Bank and Supervisory Responsibilities Outweigh It

Bank officials acknowledge that some of these concerns may be valid, but argue that they are overstated and do not take into consideration the outweighing synergies associated with a combined central bank and bank supervisor. With respect to the tension that exists between monetary policy and bank supervision, the Bank contends that such a tension can exist whether or not bank supervision and monetary responsibilities are placed within the same institution. Furthermore, it believes that the conflicts that do develop are rare, because the monetary stability and financial stability wings of the Bank have similar objectives, and that conflicts are more easily coordinated and priorities more easily developed when these responsibilities are housed under one roof.

In addition, the Bank argues that the conduct of monetary policy can be frustrated if the financial system is unstable and that the central bank, therefore, has a very intense interest in ensuring the soundness of the banking system and consequently a need to be involved in bank supervision and related areas such as oversight of the payments system. It believes that the Bank must “put itself in a position to anticipate and judge how it should deal with any weaknesses in the infrastructure or institutions on which it relies for the conduct of monetary policy.” While it acknowledges that it can obtain information from a separate supervisor, it believes that it is more efficient if that information is available to it as the bank supervisor. It also believes that arguments to the contrary are not strong enough to justify placing its current supervisory responsibilities in a new bank supervisor.

The Bank also believes that there is no unmanageable conflict between the roles of the central bank as lender of last resort and supervisor of banks. Indeed, it believes that a decision on whether to provide such lending “is made less difficult if the central bank also has the information customarily obtained from conducting supervision.” It further argues that the possibility of having to provide lender of last resort liquidity to an institution serves to focus bank supervision.

With respect to arguments that the information the central bank receives as bank supervisor may be misused, the Bank contends that it has arrangements in place “to ensure that information, when received for supervisory purposes, is not abused or misused” and that procedures are in place to ensure that senior and qualified people “can strike the correct ethical and legal balance.”

Appendix II
Questions of Potential Conflicts of Interest
Between the Bank of England's Role as
Monetary Authority and Bank Supervisor

Finally, the Bank does accept that supervisory failures may damage the authority of the central bank. However, it believes that such potential damage may be overblown and that the worst impact is “the diversion of time and energy when supervisory problems demand, particularly if they occur at a time when issues of monetary policy are themselves problematic.”

Regulation and Supervision of Building Societies

Building societies are mutual deposit-taking institutions that lend predominantly for house purchases. Only 25 percent of their assets may be in commercial or unsecured lending. Furthermore, they have liquidity limits of 33 percent of total assets since their primary purpose is to lend their funds.

As of October 31, 1994, there were 83 building societies authorized to take deposits, of which the top 10 held some 80 percent of the industry's assets. While the number of building societies continues to drop from a high of approximately 2,500 at the turn of the century, the assets in the industry are rising, increasing to £280 billion in 1994 from £160 billion in 1988.

Building societies are regulated and supervised by the Building Societies Commission, rather than by the Bank, under the Building Societies Act of 1986.¹ This act extended building societies' powers to undertake some additional activities besides mortgage lending.

The Building Societies Commission is an independent body set up by the 1986 Act and is currently made up of seven Commissioners. During the fiscal year the Commission met 17 times.² The Commission's activities are funded by money voted by Parliament, which is met by a charge levied on the societies. At the end of the March 31, 1994, fiscal year, the Commission had 59 staff.

According to the Commission's annual report, its functions are to

- (1) ensure that the principal purpose of building societies remains that of raising, primarily from their members, funds for making advances to members secured by land for their residential use;
- (2) promote the protection by each building society of the investments of its shareholders and depositors;
- (3) promote the financial stability of building societies generally;
- (4) administer the system of regulation of building societies provided for, by, or under, the act; and

¹Before 1986 building societies were regulated by the Registry of Friendly Societies. The Registry is a nonministerial government department for which Treasury ministers answer in Parliament.

²The fiscal year runs from April 1, 1993, to March 31, 1994.

(5) advise and make recommendations to government on any matter relating to building societies.

In addition, the Commission is responsible for authorizing new societies, although applications for authorization are rare. The last new building society was authorized in 1981.

Regulation

The Commission's mandate under the 1986 Act is to "administer the system of regulation set out by, or under, the act." Included in the act are criteria of prudent management, which are the basis for the Commission's regulatory powers.

The Commission undertakes regulation in a number of ways. First, the Commission has the power to make secondary legislation, subject to the approval of Parliament. It uses this power to fine-tune the primary legislation relating to building societies, the 1986 Act. During the March 31, 1994, fiscal year, the Commission made seven such statutory instruments, while the Treasury made four following advice from the Commission. Since 1986, 109 statutory instruments have been made under the act, of which 59 are currently in force.

The Commission also produces regular prudential and policy guidance and advice to building societies. It does this primarily through

(1) Prudential Notes whose purpose is to set out and explain what, in the opinion of the Commission, is needed for a society to meet the criteria of prudent management set out in the act;

(2) Guidance Notes that usually explain statutory or administrative procedures; and

(3) "Dear Chief Executive" letters that cover a wide range of communications to societies.

Prudential and Guidance Notes are issued first as drafts for comment to the industry and other interested parties. During the March 31, 1994, fiscal year, the Commission issued 5 prudential notes and 21 Dear Chief Executive letters.

Supervision and Enforcement

The Commission receives supervisory information on the building societies in a number of ways. First, the Commission requires statistical

returns from the building societies, some monthly, some quarterly, and some annually. These returns are used to establish the continuing financial health of the institutions.

Second, the Commission's staff is expected to maintain close contact with the societies. It held about 400 regular meetings with the societies over the March 31, 1994, fiscal year. These meetings are intended to ensure that societies are fully and properly informed of the Commission's prudential guidance and that the Commission appreciates the business and the concerns of each society. These meetings include an annual meeting between each society and the Commission, which will be attended by the Board as well as senior management and will often be chaired by a Commissioner. At these meetings, the discussion is to include what has happened to the building society over the past year and what its plans are for the next year or two. This is to be followed by a report from the Supervisor to the Commission.

Third, the Building Societies Act requires that building societies have annual financial audits and that the Commission also receive systems reports from the societies and their external auditors, which provides information on the societies' systems and controls. The Commission does not set the scope of building society audits, and it has no codified list of what the auditors should do. Furthermore, the Commission does not have the power to require a building society to change its auditor nor does it have a list of approved auditors. The Commission will take up any issues it feels necessary with the building societies, their auditors, or both on an as-needed basis. Such discussions would be triggered by the annual report of the society's supervisor to the Commission.

The Commission does not have its own inspection branch, although it does have a wide range of experience and expertise among its supervisors to look at problem situations in societies. However, if the situation were complicated, the Commission would employ outside accountants to undertake the examination. This power has been used only three times since enactment of the 1986 Act. Very often just the suggestion of such an audit will convince a building society to take the necessary action.

According to the Commission's annual report, "the Commission aims to achieve its supervisory objectives by discussion and persuasion, but as a last resort, may use its powers of control set out in the 1986 Act." These powers include (1) imposing conditions on or revoking a society's authorization, (2) obtaining information from a society, or (3) appointing

investigators. The Commission may also require a society to increase its capital levels. During the March 31, 1993, fiscal year, it did not use any of its formal powers except to automatically revoke authorization following a merger.

Deposit Protection

The 1986 Act provided for the establishment of the Building Societies Investor Protection Fund (the Fund) from which payment would be made to investors in a society that became insolvent, and an Investor Protection Board (the Board) to hold and manage that Fund. The Investor Protection scheme protects to a maximum of 90 percent the first £20,000 of a person's shares and/or deposits. The Fund is financed by contributions levied on each society up to a current maximum of 0.3 percent of its share and deposit base.

The Board has seven members including three representatives of the building society industry. An additional three of the Board's members are members of the Building Societies Commission. The Chairman of the Board is, ex officio, the Chairman of the Building Societies Commission and the Deputy Chairman is, ex officio, the Deputy Chairman of the Commission. The Board's seventh member is the chief cashier of the Bank and a member of the Deposit Protection Board.

The Board met only once in the March 31, 1994, fiscal year and has not yet been called on to make any insolvency payments.

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