Bank of England

Banking Act 1987 Section 16: Statement of principles

May 1988

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Banking Act 1987

Section 16: Statement of principles

1 Introduction

1.1 This statement is made pursuant to section 16 of the Banking Act which requires the Bank to publish a statement of the principles in accordance with which it is acting or proposing to act—

'(a) in interpreting the criteria specified in Schedule 3 to this Act and the grounds for revocation specified in section 11 . . .; and

(b) in exercising its power to grant, revoke or restrict an authorisation.'

1.2 These principles are, however, not only relevant to the Bank's decisions on whether to authorise an institution or revoke or restrict an authorisation. The Bank's interpretation of the Schedule 3 criteria and of the section 11 grounds for revocation, together with the principles underlying the exercise of its powers to grant, revoke or restrict authorisation, encapsulate the main standards and considerations to which the Bank has regard in conducting its supervision of all authorised institutions. The functions of banking supervision therefore include monitoring the compliance of authorised institutions with these standards and identifying any threats to the interests of depositors and potential depositors. If there are concerns, the Bank will consider what steps should be taken to protect depositors and potential depositors. Where appropriate it will seek remedial action by persuasion and encouragement. However, if its legal powers are exercisable and the Bank judges that the interests of depositors and potential depositors require that such powers are exercised, it will move to revoke or restrict authorisation.

1.3 The statement includes references to various papers published by the Bank which set out its detailed approach to a number of matters relevant to the principles. Copies are available from Banking Supervision Division, Bank of England, Threadneedle Street, London EC2R 8AH (telephone number 01-601-5082).

1.4 Part 2 of the statement considers the interpretation of each of the minimum authorisation criteria in Schedule 3. Part 3 sets out the considerations relevant to the Bank's exercise of its discretion to grant authorisation. It includes some paragraphs on the authorisation of overseas institutions. Part 4 considers the interpretation of the various grounds for revocation in section 11 of the Act. Part 5 sets out the principles underlying the exercise of the Bank's discretion to revoke or restrict an authorisation.

2 Schedule 3: minimum criteria for authorisation

2.1 Before an institution may be granted authorisation the Bank has to be satisfied that all the criteria in Schedule 3 to the Act are fulfilled with respect to it. This part of the statement sets out the Bank's interpretation of these criteria. It considers first the prudent conduct criterion in paragraph 4 of the Schedule as this sets the standards of most obvious relevance to the interests of depositors, actual and potential, and to assessing whether an institution's directors, controllers and managers are fit and proper persons to hold their positions. It then considers the other criteria in Schedule 3, concluding with the fit and proper person criterion.

Schedule 3, paragraph 4: requirement for a bank to conduct its business in a prudent manner

General

2.2 Paragraph 4(1) of the Schedule requires an institution to conduct its business in a prudent manner.

2.3 Sub-paragraphs (2)–(7) specify various detailed requirements, *each* of which must be fulfilled before an institution may be regarded as conducting its business in a prudent manner in terms of paragraph 4(1). But, as sub-paragraph (9) makes clear, this list of detailed requirements is not exhaustive. There are other considerations relevant to whether the business is being conducted prudently—that is, in the interests of depositors and potential depositors. These considerations, which are sometimes summarised under the heading of the 'general prudent conduct' requirement, are described in more detail below (paragraph 2.23).

Schedule 3, paragraphs 4(2) and 4(3): requirement for a bank to have adequate capital

2.4 The Bank's general approach to the assessment of capital adequacy[1] is set out in the following papers—

Title	Date of issue
Measurement of capital	September 1980
Subordinated loan capital(BSD/1986/2)	March 1986
Measurement of capital (BSD/1986/4) (amendments to the 1980 paper)	June 1986

2.5 Some other papers are also relevant to this subject—

Title	Date of issue
Foreign currency exposure	April 1981
Foreign currency options	April 1984
Note issuance facilities/revolving underwriting facilities (BSD/1985/2)	April 1985
Large exposures in relation to mergers and acquisitions (BSD/1986/1)	February 1986
Consolidated supervision (BSD/1986/3)	March 1986
Large exposures (BSD/1987/1)	September 1987

2.6 Capital is defined for the purposes of paragraph 4(2) as net assets—that is, in relation to a body corporate, paid-up capital and reserves—together with other financial resources available to the institution of such nature and amount as are considered appropriate by the Bank. Such 'other financial resources' are in practice constituted by subordinated loan stock issued by the institution, subject to the conditions set out in the paper *Subordinated loan capital* referred to above.

2.7 In order for capital to be sufficient for the purposes of the sub-paragraph it must be of an amount which is commensurate with the nature and scale of the institution's operations; and of an amount and nature sufficient to safeguard the interests of its depositors and potential depositors, having regard to the factors mentioned in paragraph 4(3) and to any other factors which appear to the Bank to be relevant. Paragraph 4(3) refers to the nature and scale of the institution's operations; and to the risks inherent in those operations and (where the institution is a body corporate) in the operations of any other body corporate in the same group[2] so far as they are capable of affecting the institution.

(1) This approach does not however extend to the discount houses, which are authorised under the Banking Act and are supervised not by Banking Supervision Division but by Wholesale Markets Supervision Division. This is because of the distinct nature of the business they conduct and the risks to which this gives rise. While much of this paper applies directly to them, as well as to other banks, the paragraphs on capital adequacy and liquidity (paragraphs 2.4–2.15) do not. The structure of the special capital adequacy regime applied to discount houses is described in articles in the June 1982 and December 1984 issues of the *Bank of England Quarterly Bulletin*, although there have been subsequent amendments. Because of the nature of these institutions, and their assets, it would be inappropriate to apply a liquidity test of the kind (see paragraphs 2.14–2.15) designed for the generality of banks.

(2) Section 106(1) provides that 'group', in relation to a body corporate, means that body corporate, any other body corporate which is its holding company or subsidiary and any other body corporate which is a subsidiary of that holding company.

2.8 A key purpose of capital is to provide a stable resource to absorb any losses incurred by an institution, and thus protect the interests of its depositors and potential depositors. Capital must therefore have two main qualities to achieve this purpose—a capacity to absorb losses and permanence. Most types of capital recognised by the Bank can absorb losses while leaving an institution able to continue trading, and are, in addition, irredeemable so far as the holder of capital instruments is concerned. As regards permanence, capital will not be of an appropriate nature if there are concerns that it may be paid away to the detriment of depositors' interests. Thus, for example, the Bank will only include distributable reserves in the capital base if the likelihood of their being paid away is remote.

2.9 The Bank recognises, however, that certain other types of capital, while not meeting the two criteria mentioned above, can also provide some protection to depositors. Term debt with a minimum maturity of five years and one day is eligible to be included as capital within the limits set out in the paper *Subordinated loan capital*. An essential feature of such capital is that it must be fully subordinated to the interests of depositors as it thereby provides a measure of protection to such depositors against loss in a liquidation. The Bank would not expect any element of capital regarded as permanent to be repaid at any time, and similarly would not expect subordinated term debt to be repaid before its maturity date. The Bank would normally only give its consent to early repayment of capital where the capital repaid was being replaced by capital of higher quality (for example, replacing term subordinated debt with perpetual debt or equity) or where the institution's need for capital was reduced for the foreseeable future.

2.10 In assessing capital adequacy the Bank seeks to take account of all risks of loss to which an institution may be subject. These risks include the risk of counterparty default whether arising from on-balance-sheet or off-balance-sheet business (credit risk); risks arising from open foreign exchange positions (foreign exchange risk); risks arising from open interest rate positions or unhedged investment positions (interest rate and position risk); risks arising from negligence or incompetence in the management of either the institution's own assets and exposures or those of third parties, for example in investment management (operational risk); risks arising from subsidiaries, associates and other connected companies which might expose the institution to direct financial costs or general loss of confidence by association (contagion risk); and risks arising from the concentration of business (for example, geographical, sectoral or individual counterparty concentrations). It is necessary therefore to look beyond an institution's lending and investment business to off-balance-sheet activities such as the provision of guarantees and the underwriting of share, commercial paper or other debenture issues. It is also necessary to take account of group and other connected companies and the risks they may pose to the institution.

2.11 The risks outlined above are analysed on the basis of regular standardised returns submitted to the Bank as well as internal management information provided by individual institutions on an *ad hoc* basis. Some of these risks are subject to formal measurement systems. Thus credit risk is measured using a risk weighting model outlined in the *Measurement of capital* paper (September 1980), as amended by BSD/1985/2 and BSD/1986/4. Foreign exchange position risk is assessed on the basis of the formal measurement system set out in *Foreign currency exposure* (April 1981) and *Foreign currency options* (April 1984). Other risks are analysed outside these frameworks. Risk analysis is undertaken both on a consolidated basis, in order to capture exposures arising in subsidiaries and other connected companies, and on an unconsolidated basis, in order to assess whether there is an appropriate distribution of capital within a group. In order to enable the Bank to monitor concentration risk there are special reporting arrangements for large exposures. The objective is to assess all the risks to which a particular institution is exposed in the light of its ability to manage those risks. Factors which are taken into

account by the Bank in assessing an institution's risk management capabilities include the expertise, experience and track record of its management, its internal control systems and accounting systems, its plans for the future development of the business, its size and position in its chosen markets, as well as exogenous factors such as the future prospects in its areas of business.

2.12 The results of this analysis are encapsulated in the form of a minimum capital ratio (a 'trigger ratio'). This ratio relates an institution's capital base to the measures of credit risk and foreign exchange position risk referred to above. However, in considering the appropriate level of this trigger ratio, the Bank takes into account many other risks to which the institution is exposed (including those outlined in paragraph 2.10), its capacity to manage those risks, as well as the quality of its capital and assets, and its profitability and general prospects. Individual trigger ratios are set for each institution after discussions with its senior management. They take into account the particular characteristics of the individual institution and are normally set within a range established for a group of similar institutions. In order to lessen the risk of the trigger ratio being breached, the Bank generally expects each institution to conduct its business so as to maintain its capital ratio at a margin above the trigger ratio. (This higher ratio is sometimes referred to as the 'target ratio'.)

2.13 Steps are presently being taken in the context of both the European Community and the Basle Committee of Banking Supervisors (which meets under the auspices of the Bank for International Settlements) to secure a greater harmonisation of approach between banking supervisors in the assessment of capital adequacy. A consultative paper, *Proposals for International Convergence of Capital Measurement and Capital Standards*, was issued by the Committee of Banking Supervisors in January 1987; similar proposals are under discussion in the European Community.

Schedule 3, paragraphs 4(4) and 4(5): requirement for a bank to have adequate liquidity[1]

2.14 An institution's ability to meet its obligations when they fall due depends upon a number of factors. In normal circumstances it depends in particular on the institution's ability to renew or replace its deposits and other funding, the extent to which the profile of future cash flows from maturing assets matches that of its maturing liabilities, and the amount of high quality liquid assets which it has readily available. As with the assessment of capital adequacy, each institution is assessed in the light of its own particular circumstances, including any potential liquidity problems which could arise in group or other connected companies. Many of the factors outlined above relating to the assessment of capital adequacy are also relevant to judging the adequacy of liquidity, notably the quality of management of the institution, its internal control systems and its position in the market. In addition, consideration is given to the diversity of funding sources, matching policies, and the institution's borrowing capacity. The Bank's approach is described in greater detail in its paper *Measurement of liquidity*, issued in July 1982.

2.15 The Bank is currently proposing some amendments to its liquidity policy designed to give greater emphasis to the role of a stock of highly liquid, high quality assets and to give greater precision to the way in which this stock is defined and measured. Its proposals in this area were set out in its paper *Proposals for a stock of hiqh quality liquidity* (2/88), issued in March 1988.

Schedule 3, paragraph 4(6): requirement for a bank to have adequate provisions

2.16 This mirrors the Companies Act 1985 requirement that provision should be made for

(1) See footnote (1) on page 4.

depreciation or diminution in the value of an institution's assets, for liabilities which will or are expected to fall to be discharged and for any losses which it will or it expects to incur. Thus provisions need to be made for, *inter alia*, bad and doubtful debts, expected losses on contingents (for example, connected with guarantees or other off-balance-sheet exposures) and tax liabilities. The Bank would expect liabilities and losses (including contingent losses) to be recognised in accordance with accepted accounting standards (as embodied in the Statements of Standard Accounting Practice).

2.17 In assessing the adequacy of an institution's provisions, the Bank has regard to its provisioning policy, including the methods and systems for monitoring the recoverability of loans (for example, the monitoring of the financial health of counterparties, their future prospects, the prospects of the markets and geographical areas in which they operate, arrears patterns and credit scoring techniques), the frequency with which provisions are reviewed, the policy and practices for the taking and valuation of security and the extent to which valuation exceeds the balance-sheet value of the secured loans. In some cases, clear objective indicators will be available to assist in the determination of the appropriate level of provisions; in others, more subjective judgements will need to be made. The Bank considers that it is essential that provisions be reviewed at frequent intervals.

2.18 The Bank considers that a reasonable assessment of the recoverability of country debt and of an adequate level of provisions against such debt can be made by reference to various objective criteria relating to the particular country's debt service performance, its economic situation and other factors. In August 1987 the Bank issued to authorised institutions incorporated in the United Kingdom a paper setting out a framework for provisioning, incorporating these objective criteria within a matrix, which institutions could use in establishing an adequate level of provisions against country debt.

Schedule 3, paragraphs 4(7) and (8): requirement for a bank to maintain adequate accounting and other records and adequate systems of control of its business and records

2.19 The nature and scope of the records and systems which an institution should maintain should be commensurate with its needs and particular circumstances, so that its business can be conducted in the interests of its depositors and potential depositors. In judging whether an institution's records and systems are adequate the Bank has regard to its size, to the nature of its business, to the manner in which the business is structured, organised and managed, and to the nature, volume and complexity of its transactions. The requirement applies to all aspects of an institution's business, whether on or off balance sheet, and whether undertaken as a principal or as an agent. The Bank's detailed interpretation of the paragraph 4(7) requirement is set out in the *Guidance note on accounting and other records and internal control systems and reporting accountants' reports thereon* (BSD/1987/2), issued in September 1987.

2.20 Paragraph 4(8) of the Schedule provides, *inter alia*, that an institution's records and systems shall not be regarded as adequate unless they are such as to enable the business of the institution to be prudently managed and the institution to comply with the duties imposed on it by or under the Act. In other words, the records and systems must be such that the institution is able to fulfil the various other elements of the prudent conduct criterion, and to identify threats to the interests of depositors and potential depositors. They should also be sufficient to enable the institution to comply with the notification requirements under the Act (for example, sections 36 and 38) and with requirements for the provision of information and documents under section 39 and section 41. Thus delays in providing information, or inaccuracies in the information provided, will call into question the fulfilment of the requirement in the sub-paragraph.

2.21 Paragraph 4(8) also provides that the Bank, in determining whether an institution's systems are

adequate, 'shall have regard to the functions and responsibilities in respect of them of any such directors of the institution as are mentioned in paragraph 3 above'.

2.22 The Bank interprets this provision as referring to the role of non-executive directors in audit committees of authorised institutions. The Bank's proposed approach to the role of such committees is set out in its consultative paper *Role of audit committees in banks*, issued in January 1987. (This is also discussed below in the context of the requirement relating to non-executive directors in paragraph 3 of Schedule 3.)

Schedule 3, paragraph 4(9): the 'general prudent conduct' requirement

2.23 As noted above, the list of specific points in Schedule 3 relevant to prudent conduct is not exhaustive. Other considerations include the institution's management arrangements (such as those for the overall control and direction by the board of directors); the institution's general strategy and objectives; planning arrangements; policies on accounting, lending and other exposures, and bad debt and tax provisions; policies and practices on the taking and valuation of security, on the monitoring of arrears, on following up debtors in arrears, and interest rate matching; and recruitment arrangements and training to ensure that the institution has adequate numbers of experienced and skilled staff in order to carry out its various activities in a prudent manner.

Schedule 3, paragraph 2: requirement for the business of a bank to be effectively directed by at least two individuals

2.24 This criterion—sometimes known as the 'four eyes' requirement—provides that at least two individuals must effectively direct the business of the institution. In the case of a body corporate, the Bank normally expects that the individuals concerned will be either executive directors or persons granted executive powers by, and reporting immediately to, the board; and, in the case of a partnership, the Bank will look for at least two general or active partners.

2.25 Paragraph 2 requires at least two independent minds to be applied to both the formulation and implementation of the policies of the institution. The Bank does not regard it as sufficient for one of the two persons to make some, albeit significant, decisions relating only to a few aspects of the business—each must play a part in the decision-making process on all significant decisions. Both must demonstrate the qualities and application to influence strategy, day-to-day policy and their implementation, and both must actually do so in practice. Both persons' judgements must be engaged in order that major errors leading to difficulties for the institution are less likely to occur. Similarly, both persons must have sufficient experience and knowledge of the business and the necessary personal qualities to detect and resist any imprudence, dishonesty or other irregularities by the other person. Thus where a single individual, whether a chief executive, managing director or otherwise, is particularly dominant in an authorised institution this will raise doubts about the fulfilment of the criterion.

Schedule 3, paragraph 3: composition of board of directors

2.26 This provides that, in the case of an institution incorporated in the United Kingdom, the directors include such number (if any) of non-executive directors as the Bank considers appropriate having regard to the circumstances of the institution and the nature and scale of its operations.

2.27 The Bank considers that non-executive directors can play a valuable role in bringing an outsider's independent perspective to the running of the business and in questioning the approach of the executive directors and other management. The Bank sees non-executive directors as having in particular an important role as members of an institution's audit committee or in performing the role which such a committee would otherwise perform. The Bank's views on the role of non-executive directors in this context are described in the consultative paper on the *Role of audit committees in banks*, issued in January 1987, and

in the Bank's report under the Banking Act for 1987/88. (See also paragraphs 2.21–2.22 above regarding paragraph 4(8) of Schedule 3.)

2.28 The Bank recognises that some small authorised institutions may find it difficult to appoint sufficient suitable non-executive directors for an audit committee to be established. The Bank is nevertheless committed to the principle that UK-incorporated institutions and UK-based banking groups should have an audit committee and that, unless there are sound reasons to the contrary, all authorised institutions should appoint at least one non-executive director to undertake some audit committee functions. The Bank may consider it unnecessary for an authorised institution to have non-executive directors or an audit committee, if, for example, there is an audit committee of non-executive directors of the institution's holding company which undertakes the functions of an audit committee in respect of the authorised institution itself.

Schedule 3, paragraph 5: requirement for the business of a bank to be carried on with integrity and skill

2.29 This criterion is, like the prudent conduct criterion, concerned with the manner in which the business of the institution is carried on and is distinct from the question of whether its directors, controllers and managers are fit and proper persons. It covers two elements: whether the institution's business is carried on with integrity; and whether it is carried on with the professional skills appropriate to the nature and scale of the activities of the institution concerned.

2.30 The integrity element of the criterion requires the institution to observe high ethical standards in carrying on its business. Criminal offences or other breaches of statute will obviously call into question the fulfilment of this criterion. Particularly relevant are contraventions of any provision made by or under enactments designed to protect members of the public against financial loss due to dishonesty, incompetence or malpractice. (Examples of such enactments are the Theft Acts of 1968 and 1978, the Consumer Credit Act 1974, the Companies Act 1985, the Company Securities (Insider Dealing) Act 1985, the Financial Services Act 1986, the Banking Acts of 1979 and 1987 and foreign legislation dealing with similar matters.) Doubts may also be raised if the institution fails to comply with recognised ethical standards of conduct such as those embodied in various codes of conduct. (Examples of such codes would be the London Code of Conduct for the wholesale markets in sterling, foreign exchange and bullion, the Finance Houses Association's Code of Practice on Credit, and the Take-over Code.) As with breaches of statutes, the Bank would have regard to the seriousness of the breach of the code, to whether the breach was deliberate or an unintentional and unusual occurrence, and to its relevance to the fulfilment of the Schedule 3 criteria and otherwise to the interests of depositors and potential depositors.

2.31 Professional skills cover the general skills which bankers should have in conducting their business as bankers, for example, in relation to accounting, risk analysis, establishing and operating systems of internal controls, ensuring compliance with legal and supervisory requirements, and in the standard of the various financial services provided to customers. The level of skills required will vary according to the individual case, depending on the nature and scale of the particular institution's activities.

Schedule 3, paragraph 6: requirement for a bank to have minimum net assets of £1 million at time of authorisation

2.32 This provides that an institution must have at the time it is authorised net assets of not less than £1 million (or an amount of equivalent value denominated wholly or partly otherwise than in sterling). It should be noted that this requirement only applies at the time of authorisation, and not thereafter. However, authorised institutions must continue to fulfil the capital adequacy requirement set out in paragraph 4(2) of Schedule 3 (see paragraphs 2.4–2.13 above).

Schedule 3, paragraph 1: requirement for directors, controllers and managers to be fit and proper persons

General

2.33 This provides that every person who is, or is to be, a director, controller or manager of an authorised institution must be a fit and proper person to hold the position which he holds or is to hold.

2.34 In considering whether a person fulfils the criterion, the Bank has regard to a number of general considerations, whilst also taking account of the circumstances of the particular position held and the institution concerned. In assessing the fulfilment of this criterion, the key consideration is the interests of depositors and of potential depositors.

Directors, chief executives, managing directors and managers

2.35 With regard to a person who is, or is to be, a director, chief executive, managing director or manager (as defined in section 105 of the Act), the relevant considerations include whether he has sufficient skills, knowledge, and soundness of judgement properly to undertake and fulfil his particular duties and responsibilities. The standards required of persons in these respects will vary considerably, depending on the precise position held by the person concerned. Thus a person could be fit and proper for one position but not fit and proper for a position involving different responsibilities and duties. The diligence with which he is fulfilling or is likely to fulfil those duties and responsibilities is also considered, so that the Bank can assess whether the person does or will devote sufficient time and attention to them.

2.36 The probity of the person concerned is very important: it is essential that a person with responsibility for the conduct of a deposit-taking business is of high integrity. In contrast to the other elements of the fitness and propriety criterion, the precise probity requirement will tend to be much the same whatever position is held.

2.37 In assessing whether a person has the relevant competence, soundness of judgement and diligence, the Bank considers whether the person has had experience of similar responsibilities previously, his record in fulfilling them and, where appropriate, whether he has appropriate qualifications and training. As to his soundness of judgement the Bank looks to, *inter alia*, the degree of balance, rationality and maturity demonstrated in his conduct and decision-taking.

2.38 More generally, the Bank takes into account the person's reputation and character. It considers, *inter alia*, whether the person has a criminal record[(1)]—convictions for fraud or other dishonesty are obviously relevant to probity. The Bank gives particular weight to whether the person has contravened any provision of banking, insurance, investment or other legislation designed to protect members of the public against financial loss due to dishonesty, incompetence or malpractice. (Examples of such legislation include the Theft Acts of 1968 and 1978, the Consumer Credit Act 1974, the Companies Act 1985, the Company Securities (Insider Dealing) Act 1985, the Financial Services Act 1986, the Banking Acts of 1979 and 1987 and foreign legislation dealing with similar matters.) In addition, it considers whether the person has been involved in any business practices appearing to the Bank to be deceitful or oppressive or otherwise improper or which otherwise reflect discredit on his method of conducting business. Some of the relevant considerations here are dealt with by the legislation referred to above. However, not all are spelt out in statute. In this connection, the Bank has regard to the person's record of compliance with various non-statutory codes, such as the Take-over Code and the London Code of Conduct for the wholesale markets in sterling, foreign exchange and bullion, in so far as they are relevant to the fulfilment of the Schedule 3 criteria

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(1) The Bank is permitted by section 95 of the Act to have regard to certain spent convictions under the Rehabilitation of Offenders Act 1974.

and otherwise to the interests of depositors and potential depositors.

2.39 The standards required are particularly high for those persons with the main responsibility for the conduct of an institution's affairs, although they will depend in part on the nature and scale of the business concerned.

2.40 Once an institution is authorised, the Bank has continuing regard to the performance of the person in the exercise of his duties. Imprudence in the conduct of an institution's business, or actions which have threatened (without necessarily having damaged) the interests of depositors or potential depositors will reflect adversely on the competence and soundness of judgement of those responsible. Similarly, failure by an institution to conduct its business with integrity and professional skills will reflect adversely on the probity and/or competence and/or soundness of judgement of those responsible. This applies whether the matters of concern have arisen from the way the persons responsible have acted or from their failure to act in an appropriate manner. The Bank takes a cumulative approach in assessing the significance of such actions or omissions—that is, it may determine that a person does not fulfil the criterion on the basis of several instances of such conduct which, if taken individually, may not lead to that conclusion.

Shareholder and indirect controllers

2.41 Shareholder controllers and indirect controllers (as defined in section 105 of the Act) may hold a wide variety of positions in relation to an authorised institution, and the application of the fit and proper criterion must take account of this. The key consideration is the likely or actual impact on the interests of depositors and potential depositors of a person holding his particular position as controller. This is viewed in the context of the circumstances of the individual case, and of the particular position held. The general presumption is that the greater the influence on the authorised institution the higher the threshold will be for the controller to fulfil the criterion. Thus, for example, higher standards will generally be required of a shareholder controller owning, say, 51 per cent of the shares of a bank compared with a controller owning 15 per cent. Even higher standards are likely to be required of a controller with a very substantial stake such as 75 per cent or more.

2.42 In considering the application of the criterion to shareholder controllers or persons proposing to become such controllers, the Bank has regard to two main considerations.

2.43 First, it considers what influence the person has or is likely to have on the conduct of the affairs of the institution. If the person does, or is likely to, exercise a close control over the business, the Bank would look for evidence that he has the probity and soundness of judgement and relevant knowledge and skills for running an authorised institution. The Bank would look therefore for the same range of qualities and experience that it would expect of the executive directors of an authorised institution. On the other hand, if the shareholder does not, or is likely not to, influence the directors and management of the authorised institution in relation to the detailed conduct of the business, it would not be necessary to require such a level of relevant qualities and experience. The Bank also has regard in this context to whether there could be conflicts of interest arising from the influence of the shareholder on the authorised institution—this could, in particular, arise from too close an association with a non-financial company.

2.44 The second consideration is whether the financial position, reputation or conduct of the shareholder controller or prospective shareholder controller has damaged or is likely to damage the authorised institution through 'contagion' which undermines confidence in it. For example, if the holding company, or a major shareholder, were to suffer financial problems it could lead to a run on the authorised institution, difficulties in obtaining deposits and other funds, or difficulties in raising new equity from other shareholders or potential shareholders. Generally, the higher the shareholding the greater the risk of 'contagion' if

the shareholder encounters financial difficulties. The risk of contagion is not, however, confined to financial weakness: publicity about illegal or unethical conduct by the holding company or another member of the group may also damage confidence in the authorised institution.

2.45 In considering the fitness and propriety of indirect controllers it is also necessary to have regard to the precise position held.

2.46 In the case of an indirect controller who 'directs' or 'instructs' a shareholder controller, in terms of section 105(3)(d), similar considerations apply as those relevant to assessing the fulfilment of the criterion in relation to shareholder controllers —see paragraphs 2.43–2.44 above. In other words, the standards which an indirect controller will need to satisfy are likely to be at the minimum the standards also required of the person who is indirectly controlled.

2.47 Where a person is an indirect controller by virtue of 'directing' or 'instructing' the board of an authorised institution, in terms of section 105(3)(d), the standards required will be high. The indirect controller would have to have the probity and relevant knowledge, experience, skills and diligence for running an authorised institution. The qualities required would be those which are also appropriate for the board of directors of an authorised institution.

3 Principles relating to the grant of authorisation

General

3.1 In order to be able to grant authorisation the Bank must be satisfied that all the minimum authorisation criteria in Schedule 3 are fulfilled with respect to the applicant. It cannot be so satisfied if the applicant institution and other relevant parties have not provided all the information and documents which the Bank has requested in connection with the application. Where the Bank is satisfied that the criteria are fulfilled, it can then decide whether to grant authorisation. It will not do so if it considers for any reason that there are any significant threats to the interests of the depositors and potential depositors, notwithstanding that the criteria are fulfilled. The Bank also considers, in exercising its discretion to grant authorisation, whether it is likely that it will receive adequate flows of information from the institution and relevant connected parties in order to monitor the fulfilment of the criteria and to identify and assess any threats to the interests of depositors and potential depositors.

3.2 The Bank's experience since the Banking Act 1979 came into operation has been that newly-formed institutions which are not directly associated with an established and proven deposit-taking institution can be susceptible to early difficulties. These difficulties on the whole tended to arise from lack of relevant expertise and judgement, particularly in lending, or from ill-constructed and insufficiently-tested business strategies. The Bank therefore found it difficult to be satisfied that an applicant institution which is not supported by an established deposit-taking institution will carry on a deposit-taking business in a prudent manner, unless the applicant institution had already for some time been carrying on successfully a business similar to that planned (even if on a lesser scale) but financed either by bank borrowing or from other sources not involving the acceptance of deposits as defined. This experience is equally relevant to the Bank's consideration of applications for authorisation under the 1987 Act.

Overseas institutions

3.3 In the case of an institution whose principal place of business is in a country or territory outside the United Kingdom, the Bank, under the terms of section 9(3), may regard itself as satisfied that the criteria relating to fit and proper persons, prudent conduct, and integrity and professional skill (see paragraphs 1, 4 and 5 of Schedule 3) are fulfilled if—

(a) the banking supervisory authority in that country or territory informs the Bank that it is satisfied with respect to the prudent

management and overall financial soundness of the applicant; and

(b) the Bank is satisfied as to the nature and scope of the supervision exercised by that authority.

3.4 The Bank has to form its own view directly on whether the 'four eyes' and minimum net assets criteria (paragraphs 2 and 6 of Schedule 3) are fulfilled with respect to the applicant. Paragraph 3, which is concerned with the composition of the board of directors, does not apply to such institutions, unless they are incorporated in the United Kingdom.

3.5 Despite the reliance that the Bank may place on assurances from overseas supervisory authorities with respect to certain criteria, the Bank examines the planned business of the proposed UK branch of the applicant, its business plan, its liquidity policies, its internal controls, its accounting and other records, and staffing and management arrangements. If there are any concerns in these areas, the Bank will discuss these with the applicant and, where necessary, with the overseas supervisory authority. Unless suitable assurances are received, or remedial action taken, the Bank may decide that it cannot be satisfied that all the criteria are fulfilled, and that therefore authorisation should not be granted.

3.6 Once such an overseas institution is authorised, supervision is in practice a shared responsibility between the Bank, as 'host supervisor', and the relevant 'home supervisor'. The principles underlying the sharing of responsibility are set out in the Basle Concordat.[1]

4 Section 11: grounds for the revocation of authorisation

4.1 Section 11 sets out the grounds on which the Bank's powers to revoke authorisation or restrict an authorisation become exercisable. Whether such a ground exists generally depends on the Bank's judgement of the circumstances relating to the authorised institution concerned and of the application of provisions of the Act to those circumstances. The following focuses on the Bank's interpretation of the section 11 grounds.

4.2 In general, the Bank's powers become exercisable when there is a threat to the interests of depositors and potential depositors. The threat may be relatively slight or remote, or it may be both immediate and serious. The Act recognises that the immediacy and severity of such threats may vary by, as a general rule, giving the Bank discretion to decide whether to revoke, impose restrictions or take some other action. The main principles underlying the exercise of this discretion are set out in Part 5 below.

Section 11(1)(a)

4.3 This provides that the Bank's powers become exercisable if it appears to the Bank that any of the criteria in Schedule 3 is not or has not been fulfilled, or may not be or may not have been fulfilled. The Bank's interpretation of these criteria is set out in paragraphs 2.1–2.47 above. The Bank would consider that a criterion 'may not be . . . fulfilled' in circumstances where it needed further information to form a firm view as to whether it was or was not fulfilled, but had been unable to obtain that information in a reasonable time. This provision thus enables the Bank to use its powers to protect depositors and potential depositors pending clarification of whether there is or is not a significant threat to depositors.

Section 11(1)(b)

4.4 Under this, the Bank's powers become exercisable if the institution fails to comply with any requirement imposed by the Act: for example, if it fails to notify a change of director under section 36. The Bank's powers also become exercisable if the institution fails to comply with any requirement imposed by secondary legislation

(1) *Principles for the supervision of banks' foreign establishments*, issued in May 1983.

under the Act (for example, advertisement regulations) or imposed by the Bank using its powers under the Act (for example, a condition imposed under section 12 or a requirement for information under section 39).

Section 11(1)(d)

4.5 This provides that the Bank's powers become exercisable if it is provided with false, misleading or inaccurate information by or on behalf of the institution. The mere provision of inaccurate information will render the power exercisable. In practice, however, the Bank is likely not to contemplate exercising its powers just because of a minor inaccuracy. There would generally have to be a wider prudential concern, of which the inaccuracy may be a symptom.

4.6 The Bank's powers also become exercisable under this paragraph if false, misleading or inaccurate information has been provided, in connection with an application for authorisation, by a person who is, or is to be, a director, controller or manager of the institution.

Section 11(1)(e)

4.7 Although the Schedule 3 authorisation criteria cover most of the range of circumstances which could pose a threat to the interests of depositors and potential depositors, they do not cover all—for example, a sudden external threat, unconnected with the institution's conduct, such as a natural catastrophe or the imposition by a government of a debt moratorium, may not necessarily fall within the prudent manner criterion. Paragraph (e) ensures that, in such circumstances, the Bank may act to protect the depositors and potential depositors by using its revocation or restriction powers.

Section 11(2)

4.8 This enables the Bank to revoke in certain circumstances if an institution has failed to make use of its authorisation. Authorisation under the Act is intended to enable a person to accept deposits in the United Kingdom in the course of carrying on a deposit-taking business. Provided that deposits are accepted in the United Kingdom, it is irrelevant where the institution carries on a deposit-taking business.

4.9 Section 5 of the Banking Act defines 'deposit'. An institution whose business activities are funded only by equity capital, retained profits, or borrowings from authorised institutions or its shareholder controllers or its directors or managers would not be accepting deposits within the meaning of the Act.

4.10 An institution will carry on a deposit-taking business as defined in section 6 of the Act unless it does not (a) lend money received by way of deposit to others; or (b) finance any other activity of the business to any material extent out of the capital of or the interest on money received by way of deposit; however, if the institution does utilise deposit money in these ways, it will not carry on a deposit-taking business if it does not hold itself out as accepting deposits on a day-to-day basis *and* if any deposits which are accepted are accepted only on particular occasions.

Section 11: subsections (1)(c), (3), (4), (6), (7), (8) and (9)

4.11 These subsections set out circumstances in which the Bank's powers become exercisable because of certain specified events occurring. These include withdrawal of authorisation (in respect of an overseas institution) by the banking supervisory authority of the country or territory in which the institution has its principal place of business; revocation of authorisation under the Financial Services Act 1986 or a licence under the Consumer Credit Act 1974; and certain events connected with insolvency, receivership and the like, such as the making of a winding-up order or the passing of a resolution for voluntary winding up.

4.12 There are two circumstances in which revocation is mandatory rather than discretionary. First, where an institution has its principal place of business in another Member State of the European Community and the banking supervisory authority

there withdraws the institution's authorisation. Second, where a winding-up order has been made against the institution in the United Kingdom or a resolution for its voluntary winding up in the United Kingdom has been passed.

5 Principles relating to the revocation of authorisation and to the restriction of authorisation

5.1 As noted above, the Bank's powers to revoke or restrict an authorisation may become exercisable in a wide range of circumstances.

5.2 The wide diversity of grounds in the Act for the exercise of the Bank's powers enables the Bank to exercise its powers before the threat to the interests of depositors or potential depositors becomes very great or immediate. The Bank can, therefore, where necessary, intervene before the deterioration in the institution's condition is such that there is a serious likelihood that depositors will suffer a loss.

5.3 In view of the need for flexibility in dealing with problem cases, the Act gives the Bank discretion—except in the case of mandatory revocation referred to in paragraph 4.12 above—to decide whether to revoke or restrict the authorisation or seek remedial action by some other means, through persuasion and encouragement. Where the Bank considers that adequate and speedy remedial steps are likely to be taken by an authorised institution (or its shareholders, for example by injecting new capital or appointing new directors) and that such action would protect the interests of depositors and potential depositors, it would generally be reluctant to revoke or restrict the authorisation.

5.4 The Bank would generally revoke, however, where there was no reasonable prospect of speedy and comprehensive remedial action, even though the threat to depositors was not immediate, for example because the institution currently had adequate capital and liquidity. In so far as this is consistent with the interests of depositors, actual and potential, the Bank will explore fully the prospects of remedial action; if, however, the financial position of the institution is weak or is deteriorating rapidly, the scope for such inquiries will be limited. The Bank has to balance the interests of existing depositors, for whom it may be desirable to continue the authorisation in order to allow more time for the scope for remedial action to be explored, and the interests of potential depositors who could be exposed to a risk of loss.

5.5 The circumstances in which a restricted authorisation rather than revocation is likely to be appropriate are where the Bank considers that the imposition of conditions is necessary to underpin the institution's efforts to improve matters, and that there is a reasonable prospect that all the relevant criteria for authorisation will be fulfilled again within a reasonable period. Such a restricted authorisation would normally be without time limit but the Bank's intention would be that the conditions would be removed once the remedial action was taken. The Bank would thus look for a sound and viable programme for swift remedial action.

5.6 Alternatively, the Bank may impose a restricted authorisation with a limited life. The Bank may impose such a time limit for a maximum of three years; it may also extend the life of a time-limited authorisation, but only provided the total duration is not more than three years. The Bank would generally impose a time-limited authorisation in order to facilitate an orderly repayment of deposits by avoiding liquidity pressures which could arise from a sudden loss of authorisation.

5.7 On occasion, when concerns arise, it may also be desirable to restrict the authorisation as a holding measure to protect depositors and potential depositors whilst further information is sought.

6 Conclusion

The principles set out in this statement are of general application, and take account of the wide

diversity of institutions authorised under the Act and of the prospect of institutional and market changes. Nevertheless, there is likely to be a need for the principles to be developed over time. Section 16(2) of the Act requires the Bank to record in its annual reports under section 1(3) of the Act if it makes a material change in the principles in accordance with which it is acting or proposing to act. This will complement the more detailed papers the Bank publishes on particular aspects of its supervisory requirements. In addition, the Bank will issue revised versions of the statement of principles when there have been significant developments in its approach.