The secret banking crisis

*The 2008 financial crisis and the recent rescue acquisitions of Credit Suisse and Silicon Valley Bank made for splashy headlines, but there was also a major banking crisis that passed with barely a ripple, as former top banking supervisor, **David Green**, recalls*

When, in 1998, banking supervisors moved offices from the Bank of England (BoE) to Canary Wharf, the then Governor, Eddie George, told them they should be proud to have undertaken the finest supervisory achievement in the BoE's history. Very few outside the BoE would have known what he was talking about. He meant the small banks crisis of 1991-93 when a third of all the small banks in the UK went out of operation, around 40 out of 120. It was a major event, but it merits just a page in David Kynaston's *City of London: the history*.

When I became Deputy Head of Banking Supervision for small banks in 1992, George gave me clear instructions: "Get rid of as many of them as possible, as silently as possible, at no cost to the public purse and with no surprises for me." And that is what we did, pretty much.

The recipe for bank stress had largely conventional ingredients: deposit runs that were overwhelming because of flawed reliance on an unstable funding source; assets that became unviable because of a tightening of monetary policy; much mismanagement; and the odd dash of crookery.

During 1990/91, the supervisors had identified – and to a great extent accurately – the risk build-up and the weakest banks. Many were former licensed deposit takers, which had been granted banking licences by default when the legislation changed. Plans to manage these risks were in place and were being implemented.

The collapse of BCCI

But then came the implosion in 1991 of The Bank of Credit and Commerce International (BCCI), which was incorporated in Luxembourg. No one knew that the Highland and Islands local authority had chased high returns by placing all its cash with BCCI, or that they were not the only ones. So, within days of BCCI's collapse, there was a panic in the money markets and runs on all suspect banks, especially those with risky property assets or any ethnic affiliations redolent of BCCI.

Given the febrile atmosphere following BCCI's failure, the BoE quickly stepped in to provide secret emergency support to a bank believed to be insolvent. Another failure would have caused a panic. Because the BoE could not afford to risk a domino effect it also lent to a couple of other banks that were clearly not systemic, all with the greatest secrecy. This was taken to the point that one of the banks never knew it was receiving official support because it was channelled via one of the clearers.

The Barber Boom of the late 1980s had triggered inflation. As interest rates rose to bring this inflation down, more and more banks started to come under pressure. The BoE did not want to get involved in further support, so each of the banks had to be managed to find a way out – in most cases, out of business.

> *Political pressure on the BoE vanished overnight and it was able to arrange orderly rundowns without losses*

Various techniques were deployed. Shareholders' arms were twisted to inject funds to allow an orderly run-down. Depositors' arms were twisted to keep funding in place to avert a disorderly failure. Mergers were arranged, assets were sold, and management teams required to depart. I recall being asked to take a bank chairman out to lunch to explain just where the process had got to in terms of reviewing his fitness and properness. He got the message.

One group of banks posed a particular challenge because of the sensitivities around the ethnicity of its customer base and/or management – mainly East African Asian. Most were run by decent people who served a particular community and had simply been overtaken by changed economic and social circumstances. In particular, in easier times, they could rely on their community to advise on credit risk, but that no longer served them well. The BoE's intrusive supervision attracted political attention and it was accused of trying to shut down a range of businesses on racist grounds. That was not true but, if it had been believed, it would have been self-fulfilling.

Alistair Darling, the then shadow spokesman on Treasury affairs, came into the BoE to try to understand what was at the bottom of all this. He immediately grasped what would happen if the BoE were to defend itself publicly and explain that it was simply sorting out badly-run businesses. We never knew what Darling did but the political pressure vanished overnight and we had the necessary space to arrange orderly rundowns without losses.

Darling was not the only memorable caller at the BoE during that time. One of the clearing banks reported that it suspected a smaller firm of money laundering and that firm was put into administration. The money-laundering allegation was never proven but numerous other shortcomings were found in the course of the investigation, which were upheld.

The closure came as a shock to the president of Kenya and a British government official came to see me to say that the president wanted to know if Mr Green knew whether he had any money in the closed bank. The president had a complicated relationship with the owners, who had been removed despite their appeal to the Banking Act Tribunal. I didn't know who stood behind the depositors and it didn't matter. The bank proved to be sufficiently solvent to repay its depositors in full.

> *At least 500 people knew about the secret support, yet not a single person broke the code of silence*

Another unexpected visitor was a prospective bank rescuer dripping with diamonds and gold. That added colour to the reports we had received, including one from Tiny Rowland, the corporate raider once described by Prime Minister Edward Heath as "the unacceptable face of capitalism", who came to see me in person, about the undesirability of the bejewelled person as a controller of a British bank.

Who was in the know?

The collapse of so many small banks was a major systemic crisis, so why does no one know about it? The management of the crisis was kept secret from the public, although the Treasury was informed – following an earlier episode where the BoE had not disclosed its support for the Johnson Matthey bank during that bank's crisis in 1984. However, this did not mean that the secret support was a secret in the City. It was provided by a consortium of lenders who were, in turn, indemnified by the BoE. On my calculation, once lawyers, auditors and so on were included, at least 500 people knew what was going on. Yet not a single person broke the code of silence. They understood and respected the overriding social imperative of preventing a systemic collapse. It was only when a member of the House of Lords referred to the support for one bank, which had by then already dispensed with it, that the story began to leak.

Why didn't the BoE's own accounts show what had been happening? It concealed it – with the agreement of its auditors – through use of a legislative provision that allowed it to not always adhere to Companies Act requirements. The loans and

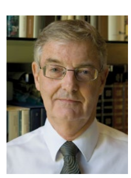
guarantees were described as "other" assets. Eventually, the Governor described what had been done, and why, in a speech at the London School of Economics.

Why was there so little public fuss about what might otherwise have been seen as a scandal? It is difficult to be certain. My own impression is that the press felt incredibly embarrassed that all this had been going on in plain view, with hundreds of people in the know, yet it had no inkling of what had been done.

Also, the operation had proved a huge success. There had been little impact on depositors, borrowers who were creditworthy had, by and large, been able to refinance, weak managements had gone, and much more robust systems were in place. Supervision had been given time to catch up with those deposit takers who should perhaps have never been authorised. Just as relevant was the distraction of the BCCI affair – and its global cast of colourful characters – and the world had moved on.

To the best of my knowledge, no comprehensive account has ever been written of this extremely complex episode. There was no outside pressure and those who were involved were drawn into their next challenge. There was an attempt some years ago – while some of those who had been involved were still alive – to assemble a group to draw out the lessons for the range of supervisory tools, analytical and remedial, that had been deployed in such variety. But this project was never concluded.

I have written this account entirely from memory and there will be shortcomings, as there always are in such circumstances, for which I apologise. But the general lines are clear and they exemplify what I was told when I embarked on a career in supervision: all your failures are very public and your successes must, by their very nature, remain hidden and unsung. ■



***David Green**, Former Deputy Head of Banking Supervision, Bank of England. In a career of more than 40 years, his other principal roles have been at the IMF and the UK's Financial Services Authority.*